SECURITISATION AS A FINANCING MECHANISM TO PROMOTE HOUSING IN THE LOW-TO-MODERATE INCOME SECTOR

By

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<td>Amalgamated Banks of South Africa</td>
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<td>ASSA</td>
<td>Actuarial Society of South Africa</td>
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<td>ATM</td>
<td>Automated Teller Machine</td>
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<td>BEE</td>
<td>Black Economic Empowerment</td>
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<td>BESA</td>
<td>Bond Exchange of South Africa</td>
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<td>CCA</td>
<td>Consumer Credit Association</td>
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<td>CRA</td>
<td>Consumer Reinvestment Act</td>
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<td>CRI</td>
<td>Collateral Replacement Indemnity</td>
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<td>DBSA</td>
<td>Development Bank of South Africa</td>
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<td>DMC</td>
<td>Developing Member Countries</td>
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<td>FANNIE MAE</td>
<td>Federal National Mortgage Association (US)</td>
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<td>Farmers Housing Administration (US)</td>
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<td>FNMA</td>
<td>(See Fannie Mae)</td>
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<td>FREDDIE MAC</td>
<td>Federal Home Loan Mortgage Corporation</td>
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<td>GINNIE MAE</td>
<td>Government National Mortgage Association (US)</td>
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<td>GSE</td>
<td>Government Sponsored Enterprise</td>
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<td>HEF</td>
<td>Housing Equity Fund</td>
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<td>HIDF</td>
<td>Housing Institutions Development Fund</td>
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<td>HLG C</td>
<td>Home Loan Guarantee Company</td>
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<td>JSE</td>
<td>Johannesburg Securities Exchange</td>
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<td>Acronym</td>
<td>Description</td>
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<td>MBS</td>
<td>Mortgage Backed Securities</td>
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<td>Mortgage Indemnity Fund</td>
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<td>MIS</td>
<td>Management Information Systems</td>
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<td>National Urban Reconstruction Housing Agency</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<td>RDP</td>
<td>Reconstruction and Development Programme</td>
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<td>RHLF</td>
<td>Rural Housing Loan Fund</td>
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<td>SDO</td>
<td>Satisfactorily Disposed Of</td>
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<td>S &amp; L</td>
<td>Savings and Loans Institutions</td>
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<td>Special Purpose Vehicle</td>
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<td>Unified Subsidies Programme (US)</td>
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<td>VA</td>
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CHAPTER 1

THE HOUSING BACKLOG IN SOUTH AFRICA

1.1 BACKGROUND

The 1996 South African census revealed that out of a total of 9.1 million households at least 1.6 million dwellings were unsatisfactory and 1.4 million of these were categorised as informal (shacks). If the 1996 backlog was escalated at an annual rate of 1.91%, the total backlog for 2000 would have been approximately 1.7 million houses (National Housing Finance Corporation, 2001:1).

During 1996 approximately 1 million houses were built or were under construction. If this figure was deducted from the backlog of 1.7 million, the actual backlog would have been 700 000 units. However, a study undertaken by the National Housing Finance Corporation in 2000 (Unblocking Finance For Affordable Housing in South Africa) has shown that the actual backlog in the year 2000 was 1.24 million houses. This study was limited to the urban areas only. If the rural backlog is added the total backlog is estimated at 2.88 million dwellings (National Housing Finance Corporation, 2000:1).
1.2 CAUSES OF THE HOUSING BACKLOG

1.2.1 Lack of suitable financial products to address housing in the low-to-moderate income sector

The main cause of the backlog appears to be a lack of suitable financing in this market for loans between R20 000 and R50 000 by the formal banking sector. This resulted in households in the low-to-moderate income sector, with monthly gross incomes between R1000 and R6000, not being able to access housing finance from the formal banking sector (National Housing Finance Corporation, 1998:7).

Various factors have contributed to financial institutions virtually abandoning this market. During the 1980’s to early 1990’s bond boycotts and the non-payment for services by the previously disenfranchised African population was one of the strategies used to unseat the apartheid government of South Africa. Tomlinson, (2002:1) stated “there are a host of documented problems with delivering traditional banking services to this market. A few of these include: ...a culture of bond and service charges boycotts fostered during the struggle.”

South Africa’s well-established banking and finance system has been reluctant to become involved with low-cost housing because of bond boycotts, non-payment of debts and fees and an overhang of non-performing re-possessed properties. In 1997 the banks held approximately 250 000 mortgage loans with a total value of R11 billion in the townships, and of these 34 000 were non-performing with little prospect of obtaining possession (Mackay, 1999:391).

Diamond (2002:11) confirms the status citing “In South Africa, inappropriate lending into some poor areas has had much more
significant consequences. One of the more intractable problems facing the country is the failure of many township residents to pay their rates and services charges and/or mortgage bond instalments. Lending into such areas without first normalising the repayment situation could result in increased levels of defaults, even higher than those the banks already face.”

Banks have encountered community-based resistance when they attempted to evict bond defaulters. Local authorities have also been intimidated when they attempted to collect arrear service payments. In other instances subsequent purchasers of those housing units from which defaulting borrowers were evicted were prevented from taking occupation of the houses. The breakdown of law and order is confirmed in Diamond, (2002: 11) where it is stated “Many township borrowers have found defaulting on their bond repayments to be the easiest route to pursue when some event, such as unemployment or illness, makes repayment difficult. This is because law and order has broken down to such an extent that households no longer feel threatened by the normal repossession process.”

Subsequent to the general elections of 1994 some 33 000 housing loans with an average value of R40 000 each were in default or repossession by mainly African township residents. The total value of these non-performing loans was R1,3 billion. An agreement was reached between the national Department of Housing and the banks in 1995 to find solutions to assist property owners who were in default of their bond repayments. This agreement gave birth to Servcon, a joint initiative between the Government (represented by the departments of Housing, Safety & Security, Justice and the National Treasury) and the Banking Council, which represents the banking community. Those housing loans that were in default during the apartheid years and up to August 1997 were ringfenced into Servcon which institution was mandated to assist the defaulting borrowers to either resume payments by rescheduling their bond repayments, providing a rental option or alternatively
rightsizing occupants into more affordable homes. Any costs and losses arising from this initiative were to be shared on a 50/50 basis between the banks and the Department of Housing. This was one of the initiatives by the Government to encourage the formal banking sector to continue their lending activities in this sector (Parliamentary Monitoring Group Minutes, May 30, 2001).

A further initiative by the Department of Housing to encourage the banks to lend in this market was the establishment of the Mortgage Indemnity Fund (MIF) in 1995. This fund was established as an insurance against defaulting borrowers in the specific sector. Through such cover, 140,345 loans were facilitated at a value of R10 billion (Smit, 1999:1).

In 1994 with donor funding from the Open Society Foundation (main patron — international financier, George Soros), the National Urban Reconstruction and Housing Agency (NURCHA), a Section 21 company, was established through the government’s Reconstruction and Development Programme (RDP). The mandate of NURCHA was to provide guarantees to banks which made available bridging finance to developers / contractors active in the low-to-moderate income market and to provide limited guarantees to financial institutions in respect of housing loans advanced to low-income households (Parliamentary Monitoring Group Minutes June 6, 2001).

Despite these efforts by the government and the donor community the formal banking sector’s appetite for housing finance in the low-to-moderate income market appears to have waned. The democratisation of South Africa in 1994 also triggered other events that shifted the formal banking sector’s focus away from this market. The death of apartheid meant the acceptance of South Africa into the International Community. This led to the globalisation of economies caused by the transcending of physical borders occasioned by the worldwide web and the Internet communication technologies. Technology facilitated more
efficient, speedier and cost effective processing and communication, resulting in other first world financial institutions having a competitive edge over South Africa’s financial institutions. The foreign banks that began entering the country had the necessary networks internationally to facilitate trade financing between local businesses and their overseas trading partners. The foreign banks targeted high net-worth clients thereby earning fees from high value transactions using the parent bank’s capital base in the home country (Tucker, 1999:8).

In order to counter the threat of the international banks the local financial institutions began upgrading their technology and reducing costs by downsizing, reducing brick and mortar branch networks and personnel. Their strategy was to serve the mass market using technology-driven processes and products. Thus Automatic Teller Machines were installed in places such as shopping malls and other strategic places where there was a high degree of pedestrian traffic. Call Centres to attend to customer queries and Internet banking were also introduced. These interventions required minimum face-to-face interactions with customers thereby reducing costs for the banks. One of the four major banks closed 100 branches in 1998 (Tucker, 1999:9).

Closing down branches is really bad news for the origination of low income loans, since it is that staff and those branches which were crucial for actually engaging the clients, assisting them, assessing their creditworthiness, and recovering defaulted loans (Tucker, 1999:9).

Globalisation affected all sectors of the economy. Labour-intensive industries such as manufacturing and mining were affected. Many industries also consolidated, increased the use of technology and robotics and retrenched large numbers of semi-skilled and unskilled workers resulting in large-scale unemployment and consequent poverty. In a publication titled ‘An Economic profile of South Africa 2002’ Standard Bank notes that technology contributed to an increase in the number of employed skilled workers (1984 to 1988: 1,37%, 1988 –
but led to reduction in the number of elementary workers employed (1984 to 1988: -6.06%, 1988 to 1993: -2.32 and 1993 to 1997: -9.66) (Standard Bank Group, 2002:16). These statistics indicate that the reduction in employment in the respective years was greater than the gain occasioned by the introduction of technology. This also was one of the prime-contributors of non-payment of loans and for services.

Ferguson (1999:187-188) states that the characteristics of traditional mortgage finance poorly suit the conditions in that low / moderate-income households are self-employed, their incomes vary greatly and they occasionally face crises – such as sickness and injury – that absorb all their available resources. Hence these households have trouble making regular payments when these payments represent a large part of their income. He further elaborates that in contrast, low-income households often pay back smaller loans well, when provided by private sector sources, and take their credit more seriously than middle-income households. This is confirmed by Tucker (1999:9) when he states “It became very obvious that the mortgage loan was, in many instances, significantly less than an ideal form of security. It is costly to originate and difficult to understand. Moreover, because it relates to property, any form of common protest around the issue of property, its condition, or discrimination in its allocation is easily reflected in a boycott of bond payments.”

1.2.2 Lack of availability of secondary housing units

The findings of a research conducted jointly by Abt Associates and Social Surveys (Pty) Ltd in May 1998 indicate that the apartheid policies and legislation of the previous government have stifled the market for secondary / existing houses in the townships. Prior to the promulgation of land reform statutes in 1991 black township residents were not allowed to own property at all – the most secure tenure being temporary land rights in the form of a 99-year lease. As a result the
secondary housing market in predominantly black residential areas has remained inactive (Abt Associates Inc & Social Surveys (Pty) Ltd, 1998: 1).

Indications are that the emerging black middle class is moving from townships, are acquiring more expensive housing in the townships or other communities, frequently keep their original property in the family (Abt Associates Inc. & Social Surveys Pty Ltd 1998:16). Consequently, houses do not change ownership but remain in the family. This further contributed to the static nature of the secondary market.

1.2.3 Limited development activity of new houses for the low-to-moderate income sector

In an interview with Mr W L Vos, the Managing Director of Southfin (Pty) Ltd, a lending intermediary of the National Housing Finance Corporation, the lack of suitable end-user financing in the low-to-moderate income sector has caused the larger developers of new housing units to exit this market. Due to thin profitability margins prevalent in the low-income market, in order to make development viable through economies of scale, large quantities per project have to be built and successfully marketed (Vos, 2003).

According to an article in the Business Day (2003) titled ‘Builders alarmed as materials cost leaps’ the builders claim that their profit margins generally remain below 5%.

It therefore stands to reason that large quantities of housing units have to be developed in order to make the business of construction viable. The shortage of financial service-providers is a deterrent to potential developers. The smaller start-up developers who emerge from the townships are unable to service the market due to cash flow
constraints. Financiers are reluctant to finance such emerging entrepreneurs.

1.3 THE SOUTH AFRICAN GOVERNMENT'S INITIATIVES TO PROMOTE HOUSING FINANCE IN THE LOW-TO-MODERATE INCOME MARKET

1.3.1 The establishment of the National Housing Finance Corporation (NHFC)

In addition to the establishment of Servcon, NURCHA and the Mortgage Indemnity Fund the National Housing Finance Corporation (NHFC) was established in 1997. The mandate of this institution was to provide wholesale funding to Retail Lending Intermediaries, mainly A2 banks (these are banks other than the large institutions such as ABSA Standard Bank, First Rand Bank and Nedcor who each have a large capital base and a large retail banking infrastructure in South Africa) and other non-bank institutions involved in housing finance, in order to facilitate the availability of end-user financing to the sector. A further mandate of the institution was to establish partnerships with other stakeholders who wished to participate in the market. This strategy was intended to attract private sector funding and encourage the formal banking sector to become more active in the market. It was envisaged that joint funding would spread the risk amongst more players thereby providing an incentive to the formal banking sector to play a prominent role in the financing of housing in the low-to-moderate income sector (Government Gazzette No. 18377, 1997:3).

In September 1997 Gateway Home Loans (Pty) was conceived as a partnership between Government and the Private Sector. Gateway Home Loans was established at the beginning of 1999 as a subsidiary of the
National Housing Finance Corporation with 85% of the equity being held by the NHFC and the balance of 15% held by Old Mutual Life Assurance Company and Southern Life Association Ltd. The project was a pilot to test the viability of securitization in order to promote housing finance in the sector. Housing finance institutions, both bank and non-bank, could originate housing loans and sell these over to Gateway, which institution would in turn hold the loans on its balance sheet until such time an adequate volume and value of performing loans was accumulated. As soon as critical mass was achieved, bonds or tradable securities backed by the collateralised loans would have been made available to potential investors. Money raised via this mechanism would have been ploughed back into financing further housing acquisitions (National Housing Finance Corporation, 1998:20).

Although two of the big four banking groups, viz Standard Bank and Nedcor Bank, signed up as originators of housing loans in the specific sector, they did not deliver any loans to Gateway. At the end of the 18-month pilot period the NHFC decided to discontinue the project. The equity stakes of the two private sector institutions were bought out and Gateway Home Loans was absorbed into the NHFC (Gateway Home Loans, 2001).

1.3.2 Promulgation of the Home Loan and Mortgage Disclosure Act of 2000 and the draft Community Reinvestment Act in 2002

Having had little success with the various incentives that were made available to the private sector financial institutions, the government decided to legislate in order to compel the financial institutions to actively lend in the market. The Home Loan and Mortgage Disclosure Act was promulgated in 2000. This Act required banks to report on all housing finance undertaken by them as well as housing finance applications rejected by them and the geographical areas in which such loans were granted / rejected. The government would then monitor such
lending / unwillingness to lend to establish whether the previously disadvantaged communities were being marginalized by the banking sector. The Community Reinvestment Bill was drafted in 2002 and is currently under discussion eliciting comments from interested parties. The legislation was scheduled to come into effect by the second half of 2003. The intention of this piece of legislation is to compel banks to make housing finance available in communities where they do business (Government Gazzette No. 21900, 2000).

1.4 THE AIM OF THIS STUDY

The aim of this study is to investigate whether the economic, policy / regulatory and market environments are conducive for the introduction of securitisation as a medium to attract capital to be deployed in the financing of housing in the low-to-moderate income sector.

1.5 OBJECTIVES

- To motivate a narrowing of the Credit Gap – the unavailability of suitable finance for houses between R20 000 and R60 000.

- To encourage the creation of an environment where holders of capital will be comfortable in investing such capital in housing finance and the borrowers would be willing and able to repay loans obtained for housing needs.

- To encourage the coming together of all stakeholders in the low-to-moderate income sector with a view to jointly addressing the problem of South Africa's housing backlog.
1.6 ASSUMPTIONS

If the proper environment is created to support Securitisation of mortgage loans in the low-to-moderate income sector, and the market is provided with suitable loan financing, more people will be able to own homes resulting in the housing shortage in South Africa being significantly reduced.

1.7 DEFINING CONCEPTS

- **Low-to-moderate income market**: households earning between R1000 and R6000 per month.

- **Securitisation**: "a process whereby cashflow-generating assets are assembled, packaged into tradeable securities and sold off to an insolvency remote, off-balance sheet vehicle. This special purpose vehicle funds its purchase of the receivables through the issue and sale of varying classes of debt instruments either to institutions or the syndicated bank market." (David Field: Business Day July 19, 2001:9).

- **Credit Gap**: Lack of suitable housing finance for houses priced between R20 000 and R60 000.

- **Primary Market**: According to Van Order (2000:5) the primary (i.e., origination) mortgage market in the United States has been dominated historically by depository institutions and mortgage bankers, who, unlike European mortgage banks, act as dealers and servicers in mortgages rather than investors.
• **Secondary Market** is derived from Secondary Marketing which is the function of financing and, subsequently, selling the originated mortgage to institutional investors. This activity includes the warehousing of the mortgage between the time the mortgage is closed and subsequently sold to an investor. It is arguably the most critical function in the secondary market (Lea, 2000:33).

Van Order (2000:10) states “The main reason, now, for the important role of secondary markets, and particularly for their rapid increase in the 1980s, is simply that secondary markets have for the most part been an efficient, low cost and stable way of raising money and managing cash flows. This is primarily because of economies both in raising money “wholesale” in the capital markets, in processing the purchase and servicing of large numbers of mortgage loans, and in managing risks, through diversification, and because Fannie and Freddie have an implicit guarantee which gives them a benefit comparable to deposit insurance for depositories.”

• **Special Purpose Vehicle / Institution** is an intermediary agency whose basic function is to hold the security charge on behalf of the investors and then issue certificates to the investors of beneficial interest in the charge held by the intermediary (Kothari, 2000:12).

1.8 LIMITATIONS

For securitisation to be successful it requires that disciplines such as the Primary Market and the Secondary Market be efficient and effective. For each of these markets to be successful reliance is placed on availability of housing stocks, credit risk management, interest rate risk management, a vibrant lending sector who will be able to originate large numbers of homogenous loans, willingness of the holders of
capital to invest in such ventures, efficient reporting mechanisms to keep investors fully informed and a myriad of other factors and role players that are relevant. To do justice to all these disciplines would require far more than the six months budgeted to complete this study. The writer will as far as possible endeavour to elucidate the issues to an acceptable level of understanding but not delve into time-consuming detail.

1.9 VALUE OF THE STUDY

The value of the study is to provide suitable information to all stakeholders in the low-to-moderate income housing sector to enable them to jointly address the housing shortage in the sector.

1.10 LAYOUT OF THE REPORT

The layout of the report will be in the following format:

1.10.1 Chapter 1: The Housing Backlog in South Africa

In this section a background has been provided of the housing shortage scenario in the country encompassing history and the current situation. The aim, objectives and limitations are also discussed.

1.10.2 Chapter 2: Literature Review.

This section examines the conditions that are required for securitization to be successful. Lessons learned by successful implementers of the mechanism are explored.
1.10.3 Chapter 3: An evaluation of the various mechanisms introduced by the Government to promote housing.

A critical evaluation of the various government initiatives to promote housing is undertaken. Any successes, failures and lessons learned are highlighted.

1.10.4 Chapter 4: The readiness or otherwise of the Primary Market in South Africa

This chapter assesses the preparedness of the originators and servicers of mortgage loans to enter the securitisation market. It also examines whether the environment in the primary market is conducive for securitisation.

1.10.5 Chapter 5: The readiness or otherwise of the Secondary Market for Securitisation

This chapter assesses the preparedness of the holders of capital to invest in assets backed by mortgages originated in the specific sector and whether the preconditions for a successful secondary market prevail.

1.10.6 Chapter 6: Conclusions and Recommendations

The closing focuses on the overall conclusions and recommendations to housing finance stakeholders and practitioners.

1.10.7 Chapter 7: Methodology

The methodology used in this research is fully described in this chapter.
1.11 CONCLUSION

There is evidently a housing shortage in South Africa and the traditional method of financing by banks alone would not alleviate the problem. Other solutions more acceptable to all the stakeholders have to be found and this research is intended to recommend solutions that may be amenable to all parties involved.
CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter will trace the origination of securitisation and establish the preconditions that are necessary for the mechanism to function effectively and efficiently.

2.2 DEFINITION OF SECURITISATION

According to the United States Office of the Comptroller of Currency, Asset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten and sold in the form of asset-backed securities. From the perspective of credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favourable rates. By removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations (Comptroller of Currency in Kothari 2000:15).
2.2.1 Core features of Securitisation

2.2.1.1 Marketability

The very purpose of securitisation is to ensure marketability to financial claims. Hence, the instrument is structured so as to be marketable. This is one of the most important features of a securitised instrument, and the others that follow are mostly important only to ensure this one (Kothari, 2000:10).

2.2.1.2 Merchantable Quality

To be market-acceptable, a securitised product has to have a merchantable quality. The concept of merchantable quality in case of a physical good is something which is acceptable to merchants in the normal trade. When applied to financial products, it would mean the quality of the product is acceptable. For widely distributed securitised instruments, evaluation of quality, and its certification by an independent expert, viz., rating, is common. In case of securitisation of receivables, the concept of quality undergoes drastic change making rating almost a universal requirement for securitisations. As already discussed, securitisation is a case where a claim on the debtors of the originator is being bought by the investors. Hence, the quality of the claim of the debtors assumes significance, which at times enables investors to rely purely on the credit-rating of debtors (or a portfolio of debtors) and so, make the instrument totally independent of the originators' own rating (Kothari, 2000:11).

2.2.1.3 Wide Distribution

The basic purpose of securitisation is to distribute the product. The extent of distribution which the originator would like to achieve is based on a comparative analysis of costs and the benefits achieved thereby. Wider distribution leads to a cost-benefit in the sense that the
issuer is able to market the product with lower return, and hence, lower financial cost to himself. But wide investor base involves costs of distribution and servicing (Kothari, 2000:11).

2.2.1.4 Homogeneity

To serve as a marketable instrument, the instrument should be packaged into homogenous lots. Homogeneity, like the above features, is a function of retail marketing. Most securitised instruments are broken into lots affordable to the marginal investor, and hence, the minimum denomination becomes relative to the needs of the smallest investor. Shares in companies may be broken into securities of small denomination while debentures may be divided into a larger denomination. Designed for larger investors, commercial paper may be in still higher denominations. Securitisation applications may also follow this logic (Kothari, 2000:12).

The need to break the whole lot to be securitised into several homogenous lots makes securitisation an exercise of integration and differentiation: integration of those several assets into one lump, and then the latter's differentiation into uniform marketable lots. This often invites the next feature: an intermediary to achieve this process (Kothari, 2000:12).

2.2.1.5 Special Purpose Vehicle

In case the securitisation involves any assets or claim which needs to be integrated and differentiated, that is, unless it is a direct and unsecured claim on the issuer, the issuer will need an intermediary agency to act as a repository of the asset or claim which is being securitised. Let us take the easiest example of a secured debenture, in essence a secured loan from several investors. Here, security charge over the issuer's several assets needs to be integrated, and thereafter broken into marketable lots. For this purpose the issuer will bring in an
intermediary agency whose basic function is to hold the security charge on behalf of the investors, and then issue certificates to the investors of beneficial interest in the charge held by the intermediary. So, whereas the charge continues to be held by the intermediary, beneficial interest therein becomes a marketable security (Kothari, 2000:12).

The same process is involved in securitisation of receivables, where the special purpose intermediary holds the receivables with itself, and issues beneficial interest certificates to the investors (Kothari, 2000:12).

2.3 A COMPARISON OF A TRADITIONAL MORTGAGE DELIVERY SYSTEM AGAINST AN UNBUNDLED MORTGAGE DELIVERY SYSTEM.

2.3.1. The Traditional Mortgage Delivery System

The concept of securitisation can be explained diagrammatically by comparing the traditional mortgage delivery system and the unbundled mortgage delivery system.

Figure 2.1 shows that the traditional model of mortgage lending is the portfolio lending model in which one institution performs the major functions of origination, servicing, funding and portfolio risk management. These intermediaries may utilize the services of third party vendors, such as mortgage insurers, appraisers and credit agencies. However, a single firm accomplishes the primary functions.
The portfolio lender originates a mortgage to a homebuyer, services it, and performs pipeline risk management and portfolio management functions, including funding. Portfolio lenders may be depository institutions (commercial banks, savings and loans, building societies), contract savings or European-style mortgage banks (Lea, 2000:26).

This is the model that is currently applicable in South Africa and has been for more than three decades. It has not been successful in addressing the housing shortage in the low-to-moderate income market. It is also evident in Figure 2.1 that the institution performing the lending carries all the risks prevalent in this type of lending. Consequently, a bank, which normally engages in the business of mortgage lending, would be reluctant to lend to a market where the risks are high and the Return on Equity (ROE) low; occasioned by the non-payment of loans and the large branch infrastructure and personal required to service the low-to-moderate income market (See Chapter 1, paragraph 1.2.1).
2.3.2 The Unbundled Mortgage Delivery System

Participants:
* Agency
* Private
* Agency
* Mortgage Brokers
* Mortgage Bank
* Pension Fund
* Mortgage Banks
* Depository
* Insurance Company
* Depositories
* Depository
* Foreign Investors
* Depositories

Functions:
* Funding
*营销
* Payment processing
* Cashflow Risk
* Processing
* Collections
Management
* Underwriting
* Foreclosures

* Closing
* Warehouse
* Pipeline Risk Management

Figure 2.2: Unbundled Mortgage Delivery System – Modern Model
(Lea, 2000:27)
Figure 2.2 shows the modern unbundled mortgage delivery system characteristic of a secondary mortgage market. In this model the functions of origination, servicing, risk management and funding are unbundled and managed by different specialised entities. Originators may be traditional depositories, mortgage companies or mortgage brokers. The institution that originates the loan may or may not be the one that services it. Depositories or mortgage companies do servicing. In the unbundled model there are a wide variety of investors ranging from depositories (investing in loans originated and serviced by others) to mutual funds (Lea, 2000:27).

In the global market they may be either domestic or foreign. Finally, credit risk management is often specialised as well, provided by third parties such as mortgage insurance or bond insurance companies (public or private) (Lea, 2000:27).

2.3.2.1 Loan Origination

Originating a mortgage loan in the unbundled model is more detailed than the traditional model due to the involvement of the different parties. Lea (2000:30) describes the various activities involved in the origination of mortgage loans:

- Finding the borrower, using a variety of distribution channels and marketing tools;

- Gathering information about the borrower, the loan and the property being used as collateral;

- Underwriting the loan involves the evaluation of the borrower in terms of his willingness and ability to repay the loan and charges such as rates and taxes that may accrue as a result of ownership of the property and also in the light of all other living expenses the borrower
may incur, the evaluation / assessment of the property and any other collateral the borrower may offer;

- Getting any required investor approvals - in order to place a pool of loans with a particular investor, the originator might have to obtain an approval from such investor upfront. The originator also has to obtain all the required legal documentation in order to protect the investor's interests;

- Arranging for the collection of property taxes and insurances and in some instances, mortgage insurances in order to protect the investment;

- Closing the loan and providing the necessary disclosures to the borrower regarding the costs involved and the rights and obligations of both the borrower and the lender (Lea, 2000:30).

One of the key components of the origination process is the ‘underwriting’ of the loan. According to Lea (2000:30) “Solid and consistent underwriting is key to secondary mortgage market development. Investors must have confidence that lenders are properly judging risk and using a consistent set of criteria in evaluating loans. A degree of standardisation is necessary to lower costs of due diligence and allow investors, rating agencies and guarantors to quantify credit risk.”

Lea (2000:30) lists the objectives of home mortgage underwriting as:

- To control the probability and cost of default losses.

- To ensure that all legal and finance requirements are completed satisfactorily on the property that serves as collateral for the mortgage so that interests of the mortgage holder are protected.
• To meet the requirements of third parties who have an interest in the safety of the mortgage including such groups as:
  - Regulators who are concerned about the safety and soundness of the lending institution;
  - Secondary market organisation that may be interested in purchasing the mortgage;
  - Security rating services that may be called upon to provide a quality rating for a security that may include the mortgages as collateral (Lea, 2000:30).

2.3.2.2 Risk Management

Lea, (2000:34) states that the secondary marketing function is responsible for finding investors that will purchase loans from the mortgage operation and for managing the financial risks involved in making loans with an established interest rate in a changing interest rate environment, as well as other risks associated with the process. Although referred to in totality as pipeline risk, there are in fact four major risks the seller must manage as part of the secondary marketing function:

- **Commitment risk:** The risk that an interest rate commitment ("rate lock") offered to a home buyer for a loan is made and the firm is unable, generally due to market forces, to earn an adequate sales price to cover the costs of providing the commitment. This risk may be reduced or offset by purchasing offsetting commitments (i.e., committing in advance to sell a loan or pool of loans at a particular rate) (Lea, 2000:34).

- **Pipeline risk:** The risk that a closed loan will change in value between the time of closing and shipment to an investor. This risk is often hedged using forward, option or futures contracts (Lea, 2000:34).
• **Documentation risk**: The risk that a closed loan is underwritten improperly and does not conform to the investor's requirements. These loans are known as "lame loans" and frequently can be converted into acceptable loans for delivery, but usually after months of seasoning and additional documentation. The delays in delivery, or inability to deliver, produce costs for the originator (Lea, 2000:34).

• **Liquidity risk**: The risk that certain types of mortgage loans may face large buy price-sell price (bid-ask) spreads. This can happen if a firm buys loans wholesale (i.e., from other lenders) and is unable to generate a sufficient volume to securitize or sell the loans at a profit. Problems in reselling the loans may produce losses for the firm (Lea, 2000:34).

2.3.2.3 Loan Servicing

The **Servicing** of mortgages is a critical component of a viable secondary mortgage market. The collection of mortgage payments and the periodic remittance of these payments to the investor (or conduit) is the major task of servicers (whether they are originators or third parties). In addition, servicers are the primary repository of information on the mortgage loans. Thus, they must maintain accurate and up-to-date information on mortgage balances, status and history and provide timely reports to investors. Mortgage loan servicing involves all the activities related to collection of mortgage payments, accounting for all financial transactions, collecting past due accounts, remitting payments to investors, foreclosing on seriously delinquent properties and disposing of foreclosed real estate. Additional responsibilities may include administering an escrow account for real estate taxes and insurance, furnishing tax information to mortgagors when applicable and safe-keeping collateral (custodial function) (Lea, 2000:34).
2.3.2.4 The Investor

The Investor in Figure 2.2 funds the acquisition of the portfolio of loans by investing in the securitisation issue. The main risk faced by the investor is cash flow risk which is the risk of delayed payments or risk of prepayments. Risk of delayed payments may be covered by credit enhancements, particularly the cash collateral and the over-collateralisation provided by the originator. Therefore, normal expected levels of delinquencies will be well-covered. However, what is not covered is the risk of prepayments (Kothari, 2000:454).

Appreciably, if borrowers prepay and the investor is able to reinvest the prepaid principle at the same rate of return as being offered by the investment, there is no risk. However, the propensity of the borrowers to prepay increases when rates of interest in the economy come down – that is exactly where the investors would not be able to reinvest at the underlying rate. In other words, prepayment risk is essentially the risk of interest rates going down, and the investors not being able to reinvest prepaid principle at the original rate of return (Kothari, 2000:164).

2.4 A TYPICAL ASSET BACKED SECURITISATION STRUCTURE

Figure 2.3 shows the relationship between the various parties and the flow of transactions. Kothari (2000:184) defines obligors as the debtors who have sums to pay to the originator. They are not active parties to the transaction, but their obligations to pay the originator are transferred to the Special Purpose Vehicle.
Other parties involved in a securitisation transaction are:

2.4.1 The Special Purpose Vehicle (SPV)

The Special Purpose Vehicle (SPV) is the conduit to which the originator must sell the assets (cashflows from the mortgage loans). This SPV is normally a trust administered by trustees on behalf of the investor. Kothari in (2000:58) further explains “The SPV is created by the company for the sole purpose of holding the receivables for the benefit of the investors and safeguarding their interests (such as bringing a suit against the debtor or the company in case of default). So, once the receivables are transferred by the originating company to the SPV, it is the SPV which now becomes the owner of the receivables”. The rationale behind transferring the assets being securitised into a SPV is to prevent the liquidators in any insolvency
action against the originator reclaiming the assets (loans) that were purchased by the investors. Hence the need to make the SPV bankruptcy-remote from the originator (Kothari, 2000:58).

2.4.2 Trustee

The role of the Trustee is to monitor the transaction and to ensure that investors are paid in accordance with the terms of the securities, as well as to check compliance with the trust deeds (if applicable). The trustee may also be required to monitor the performance of the servicer (Duff & Phelps Credit Rating Co. Africa, 1999:5).

2.4.3 Credit Enhancer

The Credit-enhancer(s) is/ are the party(ies) absorbing the risk of the portfolio of loans in the SPV. Underwriting of a certain portion of the risks by the credit enhancer, affords comfort to the investor as well as enables the competitive pricing of the portfolio. Duff & Phelps Credit Rating Co. Africa, 1999:5) state “Credit enhancement may take many forms, but the principal objective of the enhancement is to adjust the cash flow from the SPV in order to strengthen its ability to honour its obligations to investors.”

2.4.3.1 Originator credit enhancement

Originator credit enhancement can take any of the following forms:

- Excess spread or profit. This is the difference between the rate at which loans were contracted with the borrower (say 17% per annum) and the rate at which the SPV discounted the cashflows (say 13% per annum) from the loan after the originator / servicer takes his agreed servicing fee (say 2%). The excess spread in this instance will be 2% (17-13-2). This excess profit may not be paid to the originator
immediately but retained in the SPV until a further date or until the end of the transaction. The retention of the spread itself serves as a cushion for the investors (Kothari, 2000:195).

- **Cash Collateral or cash deposit** refers to the contribution of the originator to the corpus of the SPV, normally by way of a subordinated loan. It may be liquid cash in the form of a risk free investment, either transferred to the SPV or kept as a security. The contribution in the form of cash deposit is normally a set-off from the amount receivable as proceeds of the securitisation issue (Kothari, 2000:196).

- **Overcollateralisation.** This refers to the originator assigning a higher value of receivables, but collecting only a percentage thereof and leaving the balance with the SPV. As the most common form of margin, this is one of the most common forms of credit enhancements, particularly in markets which do not have credit insurers. Apart from legal effects, there is not much difference between overcollateralisation and a cash deposit (Kothari, 2000:196).

2.4.3.2 Structural Credit Enhancements

Figure 2.4 reflects the Junior / Senior structure or tranched securitisation.

A common form of credit enhancement in developed securitisation markets is to classify the resulting securities into senior, mezzanine and junior or subordinated securities. The receivables will be used first to pay for the senior securities, which have a claim over the entire cash flows to get paid first. Obviously enough, senior securities are safest of all and would have to be contented with a very low rate of return. The subordinated securities are those which are paid at the last, that is, after settling the claims of the senior and the mezzanine security holders. These are almost like equity holders in a company – they stand
a chance of suffering a loss of principal and interest, but do not have any likelihood of making profits. These high risk securities are sold at tempting rates of interest, in order to attract speculative investors. Alternatively, the originator himself acquires the subordinated debts taking the residuary risk in the portfolio, as also standing liable to suffer the residuary loss (Kothari, 2000:197).

**Figure 2.4:** Diagrammatic Representation of structured Credit Enhancements (Kothari, 2000:197).

The junior-senior structure is quite popular among securitisers. The junior most securities are bought by the originator, but that limits the risk of the originator. The rest of the credit risk is distributed among investors, and since the coupon offered on different classes of risks are different, there are investors for each class. The overall support required from the originator is much lesser in a stratified securitisation.
than in case of a direct support provided by the originator. The originator can look at the weighted average cost of funds. Besides, the structure meets the needs of different investors as per their own investment objectives. Most significantly, the senior notes may easily draw safety-minded investors such as charitable trusts, schools, churches etc. Most securitisation transactions use a combination of excess spread retention and/or cash collateral, and stratification of the investors (Kothari, 2000:198).

As opposed to Figure 2.1 where all the risks are carried by the single bank which originates, funds and services the loan, the structure in Figure 2.4 will be more appropriate in the South African scenario as risks on the loan will be shared by more than one party in accordance with each one's appetite for risk. It can attract a wide array of investors such as churches, schools and charitable trusts who need their capital preserved albeit at lower rates of return. The vehicle can be structured with additional buffer to the Junior debt by any profit in the SPV being retained as first loss mechanism. The next layer will be the 'overcollateralisation' layer which is the difference between the assigned value of the receivables and the percentage collected by the originator. A further mechanism that could be added to this structure is a small percentage as a provision for bad debt which can provide further cover to the Junior debt. This last-mentioned mechanism is already present in traditional lending institutions and is therefore not a new concept.

2.4.3.3 Third Party Credit Enhancements

These are credit enhancements provided by insurers and other guarantors (at a fee of course). In South Africa Credit Life/Mortgage Insurance is available which would cover the lender should a borrower decease before settling the debt. Banks also insist on Home-Owners Insurance to protect the asset against structural damage. In the USA special insurance institutions have developed to provide insurance
against default in financial transactions. They are referred to as **Monoline Insurers** as they are not engaged in traditional insurance business. A monoline insurance company would provide insurance cover to the securitisation transaction which, based on the rating of the insurance company itself, would substantially upgrade the rating of the transaction (Kothari, 2000:198)

2.4.4 The Rating Agency

The role of the rating agency is succinctly captured by Duff & Phelps Credit Rating Co. Africa (1999:5) in ‘Securitisation in South Africa’, where it is stated “The rating agency assigns credit rating. The rating is not a recommendation to buy or sell the security, but it provides a view of the credit risk to the investor. Whilst the rating largely ignores the originator’s creditworthiness, it directly addresses the ability of a specified asset or pool of assets to service payment obligations to the investor.”

According to Fabozzi & Modigliani (1992:161) in arriving at a rating “Consideration is given to the distribution of the loan-to-value ratios in the pool, the geographic concentrations of the loans, the quality of the servicing agent and hazard coverage.”

2.5 THE ORIGIN OF SECURITISATION

Fabozzi & Modigliani in ‘Mortgage and Mortgage-Backed Securities Markets’ (1992:17) look at the mortgage market in the USA post-World War II which was dominated by depository institutions and to a lesser extent by insurance companies. According to the writers, by 1950 at least 50% of the loans was held by depository institutions of which Savings and Loans Institutions (S&L) held 20%; by the mid-1970s the depository institutions of mortgage loans had grown to 64% of which
S&Ls held 37%. The supply of funds to the mortgage market depended on the depository institutions’ ability to raise funds. By legislation and regulation the businesses of seeking deposits and lending of the depository institutions were confined to their local market. This resulted in poor allocation of mortgage capital resources as some states had excess supply of funds at low rates of interest while other states experienced shortages of capital and consequently higher rates (Fabozzi & Modigliani, 1992:17).

This situation led to a new participant called the mortgage banker / mortgage broker entering the market. Mortgage brokers did not provide funds from deposit taking but merely originated mortgages and sold them to the life insurance companies and depository institutions who had surplus funds in other parts of the country. Although the market continued to operate in this fashion during the 1960s it had a major flaw in that it depended on the availability of funds from thrifts and banks (Fabozzi & Modigliani, 1992:18).

Fabozzi & Modigliani (1992:18) further note that “The late 1960s was a period of high and fluctuating inflation and interest rates; disintermediation, induced by government-imposed interest rate ceilings on deposits, led to a reduction in the funds available to all depository institutions for investment in the mortgage market. Even if funds were available, the traditional fixed-rate mortgage loan in such an economic environment was an unattractive investment, particularly to depository institutions that were borrowing short term. To counter, or at least mitigate this problem, a mortgage market that was not dependent on deposit-taking institutions was needed. This could be accomplished by developing a strong secondary mortgage market in which financial institutions, in addition to deposit-taking institutions and life insurance companies would find it attractive to make investments that in turn provided funds to housing.”
According to Van Order (2000:1) the use of short term deposits to fund mortgages posed two problems for thrifts, viz liquidity risk and duration mismatch risk. Although most of the time the thrifts (S&Ls) enjoyed a stable source of core deposits, there were times when deposits flowed out of thrifts (or did not grow fast enough to keep up with the market), and they did not have an elastic source of funds with which to replace them.

Fabozzi & Modigliani (1992:18) trace the foundations of the secondary mortgage market to the Great Depression. The United States Congress's response to the adverse effects of the depression on financial markets was to establish several public-purpose agencies. The two entities that were established to provide credit facilities for depository institutions were the Federal Reserve for commercial banks and the Federal Home Loan Banks for thrifts. In 1934 the Federal Housing Administration (FHA) was founded through the National Housing Act. The mandate of the FHA was to provide programs to assist in constructing, acquiring, and/or rehabilitating single-family and multi-family properties.

To meet its policy objectives the FHA reduced credit risk for investors by offering insurance against mortgage defaults. In offering the mortgage insurance it developed and promoted a mortgage design that was more acceptable to borrowers. The FHA only insured mortgages where the applicant satisfied the underwriting standards established by the FHA. It therefore standardised mortgage design and is consequently the pioneer of standardisation which was essential for the development of a secondary market and is still a core requirement today in mortgage securitisation. Prior to the establishment of the FHA the only mortgage product that was available was a balloon mortgage. This product required the homeowner to pay only interest and make no capital repayments for the term of the loan, normally 5 or 10 years. At maturity the borrower was required to settle the capital in full either with savings or by obtaining another mortgage bond. As the borrower
was unable to obtain funding to pay the loan off. The probability of default in balloon mortgages was high. The FHA developed and promoted the long-term self-amortising mortgage loan. This provided for continual repayment of the principal balance, making the balloon payment unnecessary (Fabozzi & Modigliani, 1992:19).

Although the FHA insured the mortgages and standardised them, there were insufficient investors in the marketplace. The intake by the thrifts was limited due to the illiquidity of the investment. The US Government had to create a market where the investments in mortgages could be traded. The US Congress created a Government agency viz. the Federal National Mortgage Association (FNMA), which is now known as Fannie Mae, to provide liquidity in the marketplace. Fannie Mae was an investor in mortgages (Fabozzi & Modigliani, 1992:19).

The introduction of Fannie Mae did not cause the secondary market to develop rapidly as reliance was placed on depository institutions to originate mortgage loans. It was difficult for these institutions to originate mortgage loans when economic circumstances were unfavourable. In 1968 the US Congress consequently divided Fannie Mae into two; the current Fannie Mae and the Government National Mortgage Association (Ginnie Mae), which had 'the full faith and credit of the US Government'. This meant that any investment paper issued / backed by this entity on the capital (secondary) markets was fully guaranteed by the US Government. Ginnie Mae's mandate was to buy FHA guaranteed mortgages as well as mortgages insured by the Veterans Association (VA) and the Farmers Home Administration (FmHA). The former was created in 1944 and insured loans for war veterans in order to promote housing in that sector whilst the latter was created in 1947 to provide rural housing and development funding at below market rates (Fabozzi & Modigliani, 1992:20).
In 1970 the government authorised Fannie Mae to purchase mortgages that are not insured by the Federal Housing Administration (FHA), Veterans Association (VA) or Farmers Housing Administration (FmHA) whilst at the same time establishing a further agency called the Federal Home Loan Mortgage Corporation (Freddie Mac) to support Fannie Mae in the acquisition of FHA, VA and FmHA loans. As opposed to Ginnie Mae, Fannie Mae and Freddie Mac did not carry the full faith and credit of the US Government. They were and still are government sponsored agencies (GSE) trading on the New York Stock Exchange (NYSE). They do not receive any subsidies and neither do they receive any tax concessions. Ginnie Mae guaranteed securities issued by private entities that pooled FHA, VA and FmHA mortgages together and sold them in the secondary market as investments. Fannie Mae and Freddie Mac purchased and pooled conventional mortgages and issued securities on the market using the pool of mortgages as collateral (Fabozzi & Modigliani, 1992:20).

The process of converting individual mortgages into securities collateralised by mortgage pools is called Securitisation and the securities created are called Passthroughs (Fabozzi & Modigliani, 1992:21).

2.6 PRE-CONDITIONS ESSENTIAL FOR SECURITISATION

According to Fannie Mae (2002:3), the four most critical factors impacting on the viability and sustainability of a secondary mortgage market and / or securitisation programme are:

2.6.1 Sufficient Legal, Tax and Regulatory Framework

Applicable laws and regulations include:
- Real estate standards, title registration infrastructure;

- Enforceable liens on property;

- Effective and efficient foreclosure laws;

- Seamless transfer of ownership of mortgage assets to secondary market and capital market investors;

- Comprehensive tax and accounting rules to support securitisation of mortgage assets including:
  - Sales treatment for transfer of loans
  - Liability for recourse
  - Structure of securitisation vehicles
  - Accounting treatment of investing in mortgage assets
  - Off-balance sheet accounting for MBS;

- Well-informed and effective regulators;

- Disclosure requirements:
  - Mortgage Documentation
  - Consumer Disclosures
  - Estimation for Settlement Costs;

- Lender's right to Possess and Resale of collateral (Real Property):
  - Foreclosure laws and regulations
  - Jurisdiction and enforcement
  - Claims process
  - Rights of lender and borrower
  - Alternative Contractual Dispute Resolution (Arbitration)
  - Timeframe from filing to foreclosure
  - Timeframe for resale of collateral;
- Borrower's rights to residence under jurisdiction's bankruptcy laws;

- Legislation allowing for the sale and transfer of Asset-backed Securities including:
  - Existence of Special Purpose Vehicles (SPVs) or Trust laws for securitisation
  - Types and Regulations of Asset Securitisation
  - Registration of Issuer and Securities (first and future transactions)
  - Required legal documentation for transactions
  - Treatment of pooled assets (performing and defaults)
  - Treatment of default by Issuer
  - Bankruptcy laws
  - Oversight Authority
  - Judiciary and enforcement regulations (Fannie Mae, 2002:8)

2.6.2 Robust Primary Market Operations and Product Standardisation

2.6.2.1 Factors taken into account when carrying out an assessment of the Primary Market

- Stability of the macroeconomic environment;

- Marketability and liquidity of the housing market;

- Sufficient network of quality primary market lenders

- Standardisation across industry pertaining to:
  - Products
  - Business practices
  - Documentation
  - Data and information access
Alternative credit enhancement options to overcome insufficient credit quality or lack of data. Investors would require a certain level of comfort when investing in securities arising from securitisation. Acceptance of part of the risks by other parties makes the investment more palatable (Fannie Mae, 2002:9).

2.6.2.2 Loan origination criteria for viability of Securitisation

- Continuous origination of large volume of mortgage loans;

- Loan products acceptable to the market to enable the origination of large volume of loans;

- Factors driving product offerings and interest rates;

- Standardisation of processes, products and documentation. It is important to have a large pool of homogenous loans (cash flows) to make it easier and hence less expensive for rating agencies to rate the securities as opposed to performing an analysis of each loan or a heterogeneous mixture of loans in a pool, to afford investors some certainty in terms of expected cash flows from their investment and to lower costs by having standardised processes, documents and products (Fannie Mae, 2002:11).

2.6.2.3 Loan Underwriting

The following aspects are crucial to the underwriting of loans in a securitisation environment:

- Level of borrower pre-qualification screening – this process should enable the selection of borrowers who have the capacity and willingness to repay the loan and reject non-qualifying applicants;
• Credit risk criteria (income, employment, credit); the originator has to ensure that the borrower has regular income from employment and has a good record in terms of servicing other credit;

• Required and average loan-to-value – ideally the loan should be less than the value of the property to make the investment in the property attractive to the borrower hence maintaining his commitment to repay the loan in full. The generally acceptable loan to value (of property) ratio is 80%;

• Level of industry standardisation - primary market originators should use similar standards to originate and evaluate borrowers;

• Availability of current and historical borrower data - to enable decision making on whether to grant credit or not to a borrower, information, past and present, pertaining to the borrower is required;

• Credit repositories and centralisation - as borrowers would access credit from all possible sources for different requirements their performance in respect of servicing all these debts should be available at a central repository to enable future credit providers to assess credit applications;

• Credit scoring, a statistical model of determining whether a borrower will repay his loan or not, should be used to underwrite loans. It is based on the behaviour of individuals with similar profiles. Credit scoring removes subjectivity in credit-granting decisions as the human element is removed from such decisions;

• In the event that credit scoring is not available, properly defined alternative underwriting criteria should be available to originators;
- Property appraisal methodology must be a standardised and generally accepted. This is required to ensure stability in the market;

- Availability of recorded property valuation data is essential to ensure there is a consistency in the valuation process and market values of the properties being financed can be determined in accordance with the general price of properties in the area;

- Training / Certification of Real Estate valuers / appraisers is crucial as proper standards have to be maintained in the industry. Certification or accreditation of valuers / appraisers ensures that only licensed persons are authorised to perform valuations;

- Quality control and due diligence practices; both these aspects are important to provide credibility and comfort to the investors that proper processes were followed in sourcing the assets (Fannie Mae, 2002:12).

2.6.2.4 Funding and loan closing

- The processes of disbursement of the monies to the sellers of the property, the registration of the mortgage bond and transfer of the property into the borrower’s name must be standard across the industry;

- There must be participants in the loan closing/funding process. Here parties such as conveyancers who prepare the necessary documents for submission to the Deeds Registry and effect settlement transactions between borrower and seller and financiers are required to fund the transaction until the loan is sold to the issuer of the security;
Duration from loan approval to loan closing / funding - too long a
time lag is not conducive as the borrower's financial circumstance may
change and if this change is for the worse the lending transaction will
be in jeopardy;

Disclosure requirements - financial transactions and the legal
implications of entering into such contracts are in many instances not
understood by the consumer. Disclosure of amounts advanced and
charges thereon should be regulated;

Methods and practices of distribution of mortgage funds should be
standard. The correct amount of money as per the mortgage loan
contract must be made available in the form of performance guarantees.
Conditions for release of the funds are stipulated on the guarantee. If
the conveyancer acting of behalf of the lender certifies that the agreed
conditions of sale have been met by the parties involved, the funds may
be released to the seller;

Loan warehousing is the act of holding the loans on a lender’s books
(balance sheet) in the interim before meeting all the conformity
requirements stipulated by the issuer (SPV). In some instances a
'seasoning period' is stipulated to ensure that the loan has been
properly closed, the security perfected and loan repayments by the
borrower (mortgagor) have commenced. The warehousing of the loans
requires the lender to have sufficient funds to accommodate the loans
until such time that they are eligible for sale to the issuer;

Recordation of transfer of property ownership and lien rights - there
must be a central registry where the title of ownership of the property
as well as the mortgage bond on the property to protect the lender
against loss arising from the alienation of the property by the
borrower/owner can be registered (Fannie Mae, 2002:13).
2.6.2.5 Loan Servicing

- There must be participants, methods, practices and management of loan servicing. Again securitisation is a volume-driven business which should lead to specialisation and hence efficiency and a reduction in costs. This should encourage the use of proper technology and the continuous quest for efficiency and cost effectiveness. Especially in the USA there are many companies who have become specialist loan-servicers and are very profitable businesses. Back-up servicers must be available in the event that the main servicer is unable to meet agreed service levels;

- Industry standardisation is essential in order to be able to transfer loans from one servicer to another with the least amount of interruptions;

- Timing and remittance of borrower payments. The servicer has to collect loan repayments from the borrowers and pass them onto the investors at agreed intervals and in the agreed format. It must be borne in mind that interest and capital repayments in respect of each loan may accrue to different parties and is dictated in terms of the investment condition in the Special purpose Vehicle (SPV);

- Lender regulatory and disclosure requirements pertaining to loan servicing should be in place and must be adhered to;

- Document custodian – a mortgage loan transaction has many documents validating each part of the contract. First there is the loan application, then the loan agreement, the Title Deed / Deed of Transfer of the property being mortgaged and the Mortgage Bond Certificate. These are security documents and have to be stored in secure facilities and properly controlled. They will be required in cases of instituting legal claim against the borrower for non-payment;
• Asset disposition and Loss mitigation — in the event of non-payment of the loan by the borrower the servicer must be able to take the necessary action to minimise the loss by either disposing on the mortgaged property or alternatively re-negotiating repayment terms with the borrower (Fannie Mae, 2002:14).

2.6.2.6 Criteria, Timing and Management of Loan Default

• Responsibilities and roles in loan default have to be clearly spelt out to ensure that timeous action is taken against the borrower in case of default. If the roles and responsibilities are not spelled out and adhered to, any delays in following up non-payments could result in the value of the collateral becoming eroded;

• Default ratios, historical and current, are essential in order to monitor the performance of the loans and improve performance where necessary. These ratios can provide guidance to issuers, originators and the secondary market on the performance of loans in terms of geographic locations, the sector / industry in which the borrower is employed and socio-economic effects on the mortgage industry as a whole;

• Level of borrower interaction / counselling and work-out techniques; here again prompt follow-up in the case on default / non-payment is absolutely essential. Mere despatching of letters / reminders when borrowers have missed payments may not result in resumption of payments. Actions such as telephonic contacts and face-to-face contact between the servicer and the borrower may elicit a favourable response. Such contacts and discussions are known as ‘counselling of the borrower’. Workout techniques involve agreeing with the borrower on the best method to rectify the default. It could mean rescheduling repayments to clear out the arrears, getting the borrower to sell the
house and repay in full the loan whilst there is still sufficient equity in the collateral;

- The costs of loan default management and loss mitigation activities must be low. If costs are high it will result in uncompetitive pricing of the loans which in turn may become an unattractive investment to potential investors (Fannie Mae, 2002:15).

2.6.3 Capital Market Preparedness and Appetite for Mortgage-Backed Securities (MBS)

In order for securitisation to be successful an issuer has to assess the state of development of the capital market in the country concerned. This is important in that many developing countries / emerging markets do not have a sufficiently developed market. An issuer has to determine the investor appetite for investment options in securitisation vehicles / paper. Generally, a developed capital market will offer investment products such as government bonds, institutional debt, mortgage-backed bonds, mortgage-backed securities, asset-backed securities and other instruments. The types of investors associated with most capital markets are governments, pension funds, institutional investors, insurance companies and unit trust funds (Fannie Mae 2002:16).

- Specific factors that need assessing are:
  - Whether an active and interested investor base exists.
  - Is there a supportive broker / dealer network?
  - Is there an efficient and regulated clearinghouse infrastructure to give effect to transactions?
  - Are there sufficient information providers such as analysts, rating agencies and financial publications to keep investors informed (Fannie Mae, 2002:17).
In assessing the market characteristics the following factors need to be taken into account:
- The size of the market by the type of instrument.
- The level of international and domestic investments in the country.
- The funding sources for investments.
- The barriers to participation in the market.
- Investor investment preferences and market share.
- The liquidity of the market.
- The level of risk tolerance of the investors of interest rate and credit risk (Fannie Mae, 2002:18).

The supporting infrastructure that is essential for securitisation includes:
- Rules and regulations supporting capital investments.
- Specific to securitisation, the infrastructure to support the transactions, the issuance of investments paper and the settlement thereof.
- The players in the market including the central bank, investment banks, broker / dealer network, bond administrators / fiduciary trustees, global custodians, rating agencies, financial guarantors and information service providers.
- The structure of Exchange to facilitate trading.
- A clearinghouse/bond administration process.
- Investor reporting requirements.
- Adequate technology to support the entire process (Fannie Mae, 2002:19).

In preparing for securitisation the status of the capital market investment vehicles has to be assessed. The following assessments have to be carried out:
- The value and volume of outstanding issuance and the current and historical trends of these investments.
- The value and volume of annual issuance and the current and historical trends pertaining to these issuances.
- The market trends that impact growth or contraction of the market.
- Investor interest in mortgage-backed investments.
- International market demand for the product.
- Interest in new investment instruments.
- Alternative sources of investment funds.
- Consumer savings and investment strategies - current and future trends.
- Asset and liability profiles of major lending institutions.
- Current sources of funding of lenders.
- The challenges to funding.
- Alternative sources of funding leveraged by lenders.
- Current and anticipated future re-capitalisation needs.
- Lender preferences of holding or selling securities.
- Estimated cost / benefit analysis of either holding, selling or securitising loans (Fannie Mae, 2002:21).

2.6.4 Economic Incentives for Secondary Market Participation

Issues to consider in evaluating whether market conditions support securitisation include financial incentives which encourage sale or securitisation of assets and execution alternatives for lenders. In considering the financial incentives the following have to be taken into account (Fannie Mae, 2002:22):

- Funding evaluation:
- Liquidity crunch for the lenders
- Disintermediation in deposit taking, creating higher cost of funding or liquidity issues;

- Credit risk evaluation:
- Historic and current default levels
- Availability and value of credit enhancements
- Guarantees issued by third parties;

- Interest rate risk evaluation:
- Interest rate risk for lenders
- Competitive pressure to launch a fixed-interest rate mortgage product requiring interest rate management
- Asset and liability mismatches

- Risk-based capital and taxation evaluation:
- Do lenders / investors obtain capital relief for holding a security versus a whole loan?
- Favourable taxing of securities (Fannie Mae, 2002:22).

2.7 CONSTRAINTS TO THE DEVELOPMENT OF SECONDARY MARKETS AND APPROACHES TO MINIMISE CONSTRAINTS

In summary, the constraints to securitisation, according to Fannie Mae (2002:25), can be grouped into four broad categories viz:

- Underdeveloped primary mortgage markets with little standardisation;

- Inadequate legal / regulatory framework;

- Underdeveloped capital markets;

- Inadequate business models. This last aspect is determined by the innovativeness or otherwise of the stakeholders in the securitisation industry. There are many permutations as to how the SPV can be
structured as well as how the risk can be carved up to ensure a wider spread of the risk among investors (Fannie Mae, 2002:25).

The above constraints can be minimised by the following approaches:

- Collaboration between the various stakeholders such as issuers, originators, servicers, estate agents, property developers, lawmakers, lenders, regulatory authorities, and investors;

- There must be a balancing of public and private involvement. Private involvement on its own will be profit-driven and hence ignore the housing needs of the poor as this market is perceived to be risky and therefore costly. On the flip side of the coin, excessive government involvement can distort the free-market economy system which will then lead to inefficiencies;

- Regional integration is essential in order to have a broader market for the sourcing of mortgage loans as well as to have a wider range of investors;

- There must be a continuous reform of the capital markets to take care of innovations in the secondary market sector (Fannie Mae, 2002:26).

2.8 ADVANTAGES OF SECURITISATION

Kothari (2000:94-98) lists the following advantages of securitisation:

2.8.1 For the Issuer

- Lower Cost
Cost reduction is one of the most important motivations in securitisation. Securitisation seeks to break an originating company's portfolio into echelons of risk, trying to align them to different investors' risk appetite. This alchemy supposedly works — the weighted overall cost of a company that has securitised its assets seems to be lower than a company that depends on generic funding (Kothari, 2000:94).

- **Retail distribution of assets**

Securitisation enables a financial intermediary to retail-market its assets to a large section of investors. The role of the intermediary is changed from a fund-based intermediary to a distributor of an asset, while at the same time, maintaining its spreads. Retail distribution of liabilities remains the aim of any financial firm. Securitisation offsets a retail liability against a retail asset, and hence, achieves this purpose (Kothari, 2000:94).

- **Perfect matching of assets and liabilities**

As a liability is created perfectly matching up an asset, it avoids the need to manage the maturity mismatches. At a time when asset-liability management is the key concern of any financial institution manager, this feature of securitisation needs to be stressed (Kothari, 2000:95).

- **Makes the issuer-rating irrelevant.**

Being asset-based financing, securitisation may make it possible even for a low-rated borrower to seek cheap finance, purely on the strength of the asset quality. Hence the issuer makes himself irrelevant in a properly structured securitisation exercise (Kothari, 2000:95).
• **Multiplies asset-creation ability**

Securitisation makes it possible for the issuer to create any amount of assets with given equity. The securitiser creates assets and then parts with same. In essence, therefore, the issuer acts as a manufacturer and inventoriser of assets. The extent of assets he can create is therefore solely dependent on his 'conversion cycle', that is, the period that elapses between the date an underlying receivable is created and marketed (Kothari, 2000:95).

• **Off-balance sheet financing**

Off-balance sheet funding, especially for financial institutions allows higher returns on assets and higher returns on equity without affecting the debt-equity ratio. As tools of managerial performance, these have a definite relevance. Securitisation allows a firm to create assets, make income thereon, and yet put the assets off the balance sheet the moment they are transferred through a securitisation device. Thus, the income from the asset is accelerated and the asset disappears from the balance sheet, leading to an improvement in both income-related ratios as also asset-related ratios (Kothari, 2000:96).

• **Helps in capital adequacy requirements**

Capital adequacy requirements are requirements relating to minimum regulatory capital for financial intermediaries. One of the very strong motivations for securitisation is that it allows the financial entity to sell off some of its on-balance sheet assets, and thus, remove them from the balance sheet, and hence reduce the amount of capital required for regulatory purposes. Alternatively, if the amount raised by selling on-balance sheet assets is used for creating new assets, the entity is able to increase its asset-creation without a haircut for its capital (Kothari, 2000:96).
Improves capital structure

By being able to market an asset outright (while not losing the stream of profits therein) securitisation avoids the need to raise a liability, and hence, it improves the capital structure. Alternatively if securitisation proceeds are used to pay off existing liabilities, the firm achieves a lower debt-equity ratio. If securitisation results into either transfer of risks inherent in assets, or capping of such risks, there is a real redistribution of risks taking place, leaving the firm with a healthier balance sheet and reduced risk (Kothari, 2000:97).

Extends Credit pool

Securitisation keeps the other traditional lines of credit undisturbed; hence it increases the total financial resources available to the firm (Kothari, 2000:97).

Not regulated as a loan

Most countries have laws regulating borrowing abilities of financial companies, since financial companies are taken as para-banking companies. Securitisation does not suffer borrower-related fetters, as it is not taken by regulation to be debt. For example, a regulation relating to borrowings from public will not be attracted, since securitisation is not a case of borrowing (Kothari, 2000:97).

Reduces credit concentration

Securitisation has also been used by many entities for reducing credit concentration. Concentration, either sectoral, or geographical, implies risk. Securitisation by transferring on a non-recourse basis exposure by
an entity has the effect of transferring risk to the investor (Kothari, 2000:98).

- Avoids interest rate risk

One of the primary motives in securitisation of mortgage receivables was to transfer interest rate risk to the investors. The lenders were subject to the risk since the mortgages carried a fixed rate of return whilst the loan taken by the lenders had a variable rate. When the mortgages were securitised, the lender made an instant spread on the basis of a fixed rate, and therefore completely avoided the price risk (Kothari, 2000:98).

2.8.2 For the investor

Kothari (2000:98-100) lists the under-mentioned advantages of securitisation for the investor:

- Good ratings

With increasing institutionalisation of the investment function, investments are being managed by professional managers who would prefer a formally rated instrument to an unrated one. Therefore, investment managers have preferred rated structured finance products (Kothari, 2000:99).

- Better matching with investment objectives.

Securitised instruments have a great flexibility to match with the investment objectives of the investors. Investors looking for a safe high-grade investment can pick up senior most A-type product, while those looking for a mediocre risk but with higher rate of return can opt
for a B-type option. Similarly, investors can look at investing over a short term, medium term or long term (Kothari, 2000:99).

- Excellent tool for hedging

Securitised products can be excellent tools for hedging. Let us say, a mutual fund has invested primarily into floating rate instruments. As a partial hedging device the fund may like to invest in inverse floating instruments — if the rates of interest decline, these instruments will offer an increasing rate of return, which will partly offset the decline in rates of return on the other section of the investments. Similarly, an investment institution which has fixed costs of funding, but has invested in floating rate assets may like to hedge itself by investment in reverse floaters (Kothari, 2000:99).

- Yield Premiums

Securitised offerings have offered good yields with adequate security. Empirical data about securitisation offerings reveal that an investor who maintained a good balance of emerging market and developed market offerings has been able to come out with good rates of return. Securitised products have provided good spreads over treasuries (Kothari, 2000:100).

2.9 DISADVANTAGES OF SECURITISATION

The following disadvantages are listed in Kothari, (2000:100-101)

- Costly source
The aggregate cost of securitising assets is theoretically expected to be lower than the cost of mainstream funding. However, in actual experience, securitisation has been shown to be a costly source, primarily in emerging markets. Being a new product, the investors place a penalty for their own lack of understanding. Besides, the costs of rating and legal fees also tend to be huge (Kothari, 2000:100).

- Uneconomical for lower requirements

Since there are huge upfront costs in the form of rating fees and legal costs, including stamp duties where applicable, would add-up to a heavy initial payment. Securitisation, in order to be cost effective has to be limited to large sourcings (Kothari, 2000:100).

- Passes on data base to investors

One of the most important limitations of securitisation is that the entire data about the receivables is passed on to the SPV. The SPV may technically be under the control of the originator himself, but the beneficiaries have a legal right to inspect the books of the SPV. Hence, in a competitive environment, a competitor may corner the company's portfolio and push the originator out of the market (Kothari, 2000:101).

- Can leave the entity with junk assets

One of the common concerns about securitisation is: if the investors have preference for cherry-picked assets, securitisation will leave the originator with junk assets. If one imagines an entity as a composite of good, medium and poor assets, if the good assets are chipped off, what remains is junk assets (Kothari, 2000:101).
Investor could be faced with prepayment risk

Prepayment is seen as a distinct risk in securitisations. Prepayment refers to the option of the debtor to prepay the loan / lease / mortgage and thereby foreclose the transaction. Prepayment may either be an option under the contract, or even if not an express option, it may be an implicit or embedded option. Sometimes, even the statute requires a prepayment option be given to the borrower. In the event of prepayments, the prepaid principal has either to be reinvested by the originator / SPV, or passed through to the investors. In the former case, the prepayment risk refers to the inability of the SPV to reinvest the prepaid principal either immediately, or at the same rate of return as the prepaid transaction. Both will have an impact on the rights of the investors (Kothari, 2000:213).

2.10 CONCLUSION

In the USA, securitisation emanated from the need to allocate funds efficiently to the mortgage market. In the 1950s to 1970s the depository institutions and the Savings and Loans Institutions (S&Ls) were confined by legislation to lend to their local market (paragraph 2.5). The financial institutions were locally based and not nationally represented as in the case of South Africa where the banks operate nationally and have even expanded internationally. The similarity between the two countries is that funds for mortgage lending were not efficiently allocated.

In order to reach the level of efficiency as described by the preconditions in this chapter the economy of the country has to be fairly developed as in the USA where the securitisation of mortgages was pioneered. For a developing nation such as South Africa it could
be a long haul to attain such a status. However, South Africa is facing the same situation that was faced by the USA some 60 years ago in terms of housing finance shortage. The latter took concrete steps to address the problem by legislating as well as creating the necessary institutions and environment for Securitisation to work. Although any financing mechanism would not completely satisfy housing shortage the USA has gone a long way in addressing housing shortage.
CHAPTER 3

AN EVALUATION OF THE VARIOUS MECHANISMS INTRODUCED BY GOVERNMENT TO PROMOTE HOUSING IN THE LOW-TO-MODERATE INCOME MARKET.

3.1 INTRODUCTION

In order to stimulate the participation of the formal banking sector in the delivery of housing in the low-to-moderate income sector the South African Government introduced various programmes at different stages subsequent to the 1994 general elections. These programmes were either one-off projects for a certain period of time or longer term projects. Some of these programmes achieved a measure of success whilst others did not have the desired effect. The programmes will be evaluated in this chapter to establish the possible reasons for their success or failure.

3.2 MORTGAGE INDEMNITY FUND (MIF)

3.2.1 Establishment of the Mortgage Indemnity Fund and its mandate

The Mortgage Indemnity Fund (MIF) was a wholly Government-owned Company established as a short term (3 years) intervention in June 1995. Its main focus was to provide financial institutions with
indemnity insurance for a limited period against loss in certain areas, if they were unable to repossess properties due to a breakdown in the due process of law. The MIF assessed and provided cover to accredited financial institutions, assessed prioritised areas and provided accreditation for these areas. It also resolved problems in areas that were unable to be accredited (User Friendly Guide, 2003:8).

3.2.2 MIF's Performance

In its three years of existence it accredited 15 banks and 543 geographical areas mainly in black townships which were identified as 'problematic' by the banks in terms of repayment of mortgage loans. The programme was discontinued in 1998 and during its 3-year duration it generated 140,345 loans with a total value of R10 billion. Of these 77,996 loans (worth R4,2 billion) were for subsidy-eligible households i.e. households with gross monthly earnings of R3,500 and under (Smit, 1999:1).

The MIF was terminated in May 1998 in terms of its original mandate. In April 1998 a 'New Deal' was signed between the Government and the commercial banks. In terms of the New Deal all non-performing loans covered by the MIF and not resolved by May 1998, will be placed under a new portfolio to be managed by Servcon, for a period of 8 years (until 2006). The New Deal also catered for the establishment of a Policy Committee under the Chairmanship of the Minister of Justice and the Chair of the Banking Council to review progress relating to the effectiveness of the legal process to address default on mortgage loans (User Friendly Guide, 2003:8).

The MIF was a short-term intervention by government. Its purpose was to facilitate R10 billion worth of housing loans in the low-to-moderate market in the three-year period and this it achieved within the specified period (Smit, 1999:1). With the signing of the New Deal with the banks the loans covered by the MIF were transferred over to
Servcon, the vehicle that was established jointly by Government and the banks to deal with defaulting loans (User Friendly Guide, 2003:9).

Once the MIF guaranteed loans were moved to Servcon, no further analysis of the portfolio was done to assess the success or otherwise of the MIF. Moreover, three years are insufficient to gauge the performance of 20-year mortgage loans. If the pilot had yielded the origination of R10 billion worth of loans the programme should have been rolled out for a longer period as it appeared to sufficiently incentivise the banks to lend in the specific market.

3.3 SERVCON

3.3.1 The Establishment of Servcon and its mandate

Servcon is a joint venture between the Government and the Banking Council which represents the commercial banks of South Africa. It was established in 1995 to address the numerous properties repossessed by the banks mainly in the black townships. The initial portfolio of loans comprised some 33,000 properties where loans were either in default or properties have been repossessed by the banks prior to 31 August 1997 (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001:1).

The idea of establishing Servcon was a government initiative to encourage banks to continue lending in the townships. The value of the portfolio under management was R1,28 billion. In terms of a presentation done to the Housing Portfolio Committee of the Parliamentary Monitoring Group (PMG) on 30 May 2001 the Managing Director of Servcon stated that the objective of the programme was "to offer the occupants of those properties a rehabilitation programme to save them from losing their properties as would normally happen..."
without any assistance programme from the government or the banks".
The four main products offered by Servcon are: a rental option, a buy-back option, a right-sizing option, rescheduling of the loan and special assistance for the aged and disabled (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001:1).

3.3.1.1 The Buy-Back Option

This option was an instalment sale programme and applied to households whose houses have been repossessed but who can afford the property. In terms of this option they can buy back the property in terms of a subsidised instalment programme (User Friendly Guide 2003:8).

3.3.1.2 The Rescheduled Payment Option

This option applies to households whose properties have not been repossessed but who are in default and who cannot afford the property. In this option Servcon arranges for their loan balance to be recalculated and their loan repayments to be rescheduled (User Friendly Guide, 2003:8).

3.3.1.3 The Right-sizing Option

This option applies to households whose properties have been repossessed or who are in default and cannot afford the property. In this option the household is assisted in finding alternative affordable long-term accommodation. While this process is underway the family is permitted to continue living in the property for an affordable rental. Such families are eligible for relocation assistance from the housing subsidy scheme (User Friendly Guide, 2003:9).
3.3.1.4 Special Assistance for the Aged and Disabled Programme

This programme was dedicated to assisting old and disabled homeowners where loans whose outstanding balances were under R16,000 were settled in full. This was the maximum subsidy amount made available by the government and old and disabled who were in default with their repayments were assisted in accessing these subsidies in order to settle the loan. Where the subsidy amount was insufficient to settle the loan the borrower was right-sized into a smaller house the price of which was covered by the amount of the subsidy or where the owner could afford paying of the balance owing he/she was allowed to do so (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001: 2).

3.3.2 Servcon's Performance

From table 3.1 it is evident that of the 33319 loans allocated to it (Column 2, last row) Servcon attained success at the rate of 31.07% (column 4, last row) over a three year period (April 1998 - March 2001) in addressing some of the problematic loans. Satisfactorily disposed of (SDO) are properties in respect of loans that have been normalised and removed from Servcon's books and returned to the bank either by selling the properties back to the ex-owners, rescheduling the loans, obtaining vacant possession through occupant voluntarily vacating and rightsizing or legal eviction of uncooperative occupants (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001: 4).

No follow-up data is available to establish the success or otherwise of the Satisfactorily Disposed Of properties (SDO) since March 2001 to date. There is no guarantee that all rehabilitated borrowers will continue paying without further hiccups.
Table 3.1: Table of Performance of Servcon as at 30 April 2001

<table>
<thead>
<tr>
<th>Province</th>
<th>No. of Properties</th>
<th>Total SDO</th>
<th>%</th>
<th>Rightsising signed</th>
<th>Other Leases</th>
<th>Total Agreements signed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>1641</td>
<td>469</td>
<td>28.58</td>
<td>380</td>
<td>348</td>
<td>852</td>
</tr>
<tr>
<td>Free State</td>
<td>1880</td>
<td>299</td>
<td>15.90</td>
<td>173</td>
<td>208</td>
<td>480</td>
</tr>
<tr>
<td>Gauteng</td>
<td>22276</td>
<td>7193</td>
<td>32.29</td>
<td>3644</td>
<td>5332</td>
<td>13912</td>
</tr>
<tr>
<td>Kwazulu Natal</td>
<td>536</td>
<td>241</td>
<td>44.96</td>
<td>68</td>
<td>91</td>
<td>244</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>1524</td>
<td>791</td>
<td>51.90</td>
<td>420</td>
<td>314</td>
<td>882</td>
</tr>
<tr>
<td>North West</td>
<td>1389</td>
<td>308</td>
<td>22.17</td>
<td>311</td>
<td>231</td>
<td>617</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>51</td>
<td>30</td>
<td>58.82</td>
<td>0</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>Northern Province</td>
<td>97</td>
<td>74</td>
<td>76.29</td>
<td>3</td>
<td>7</td>
<td>15</td>
</tr>
<tr>
<td>Western Cape</td>
<td>3925</td>
<td>947</td>
<td>24.13</td>
<td>494</td>
<td>1406</td>
<td>2454</td>
</tr>
<tr>
<td>Total</td>
<td>33319</td>
<td>10352</td>
<td>31.07</td>
<td>5493</td>
<td>7944</td>
<td>19467</td>
</tr>
</tbody>
</table>

(Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001:4)

Table 3.2 provides a further breakdown of the SDOs. It is interesting to note that 29.95% (column 3, row 10) of the 10352 households have either settled or normalised their loans. The table also reflects 1774 'Rescheduled Loans' (Row 3, Column 3). These are loans where repayments have resumed either by increasing the payments to cater for the arrear amounts or extending the loan terms using lower repayments, again to accommodate the arrear repayments. This indicates a willingness of borrowers to resume payment. No investigations have been done by Servcon to establish why these households fell into arrears with loan repayments in the first place.
Table 3.2: Table of breakdown of Satisfactorily Disposed Of (SDO) properties countrywide

<table>
<thead>
<tr>
<th>No</th>
<th>Description</th>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Instalment sale to ex-owners</td>
<td>1166</td>
<td>11,25</td>
</tr>
<tr>
<td>2</td>
<td>Instalment Sale to Occupants</td>
<td>62</td>
<td>0,60</td>
</tr>
<tr>
<td>3</td>
<td>Rescheduled Loans</td>
<td>1774</td>
<td>17,14</td>
</tr>
<tr>
<td>4</td>
<td>Resale to original owner</td>
<td>914</td>
<td>8,83</td>
</tr>
<tr>
<td>5</td>
<td>Outright sale to Occupant</td>
<td>194</td>
<td>1,87</td>
</tr>
<tr>
<td>6</td>
<td>Outright Sale to 3rd party registered</td>
<td>73</td>
<td>0,71</td>
</tr>
<tr>
<td>7</td>
<td>Occupant Rightsized – property vacated</td>
<td>778</td>
<td>7,52</td>
</tr>
<tr>
<td>8</td>
<td>Property Vacated</td>
<td>1453</td>
<td>14,04</td>
</tr>
<tr>
<td>9</td>
<td>Successful eviction</td>
<td>837</td>
<td>8,09</td>
</tr>
<tr>
<td>10</td>
<td>Debt settled/loan normalised</td>
<td>3101</td>
<td>29,95</td>
</tr>
<tr>
<td>11</td>
<td>Total</td>
<td>10352</td>
<td>100,00</td>
</tr>
</tbody>
</table>

(Parliamentary Monitoring Group Housing Portfolio Committee Minutes, May 2001: 4).

3.4 NATIONAL URBAN RECONSTRUCTION AGENCY (NURCHA)

3.4.1 The Establishment and Funding of NURCHA

As mentioned in the introductory chapter, the National Urban Reconstruction Agency was established in 1994 as a project of the Reconstruction and Development Programme, introduced by the Government in 1994 to fast-track poverty alleviation in previously disadvantaged communities. NURCHA is a not for profit organisation (Section 21 company) with a small portion of funding coming from central government and the major component bring from donor-funding such as the Open Society Foundation of which billionaire George Soros...
is the main donor. In a briefing given by NURCHA's Chief Executive Officer, Mr Cedric de Beer, to the Housing Portfolio Committee of the Parliamentary Monitoring Group (PMG) on 6 June 2001 it was stated that the funding of the entity at that time was approximately R170m with R25m coming from national government contributions. Banks are encouraged to provide bridging finance to emerging contractors and NURCHA undertakes to guarantee a percentage of the loans advanced by the banks to such emerging contractors. A further mandate is to guarantee a portion of each loan advanced to end-users for housing purposes in the low-to-moderate income sector (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, June 2001:1-2).

3.4.2 NURCHA's Performance

According to Mr de Beer, the bridging finance programme to emerging contractors has been successful in that from October 1999 to February 2001 NURCHA has provided guarantees to banks totalling R171m for some 337 housing projects. Of the 337 projects 213 were completed and the relevant loans have been paid back. This resulted in the building of 70,000 housing units worth over R1.2 billion. Although NURCHA supports many new, high risk small businesses the default on the loans is under 2% (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, June 2001:2).

As regards the second business of securing individual loans to end users only 5000 of these were achieved over the same period. Reasons given for this unsatisfactory performance is that the banks were not making loans the necessary loans to the specific sector, hence the non-utilisation of the guarantee (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, June 2001:2).
Although the institution was established in 1994, its performance prior to 1999 has not been reported upon. It is apparent that not much success was attained during this initial period.

As regards its poor performance in guaranteeing individual end-user loans (5000 loans since the programme came into existence) it is clear that NURCHA did not have the necessary experience or expertise. This business required expertise in assessing credit risks of individual borrowers. These types of assessments were more the domain of retail banks and NURCHA was staffed mainly by professionals from the building industry such as quantity surveyors, civil engineers and project managers who were able to assess and control building projects. Hence their success in providing guarantees to institutions which provided bridging finance to developers involved in building projects in the low to moderate sector.

In an attempt to guarantee loans to individual borrowers NURCHA partnered with another Section 21 company viz Home Loan Guarantee Company (HLGC) in providing such guarantees. The HLGC specialised in this type of guarantee/ insurance by agreeing to guarantee at least 30% of loan which had a maximum value of R60 000. Whilst HLGC was involved in the administration of the programme NURCHA played the passive role of part guarantor. To have had any impact NURCHA would have had to play an active role in the programme. This would then have required it to hire the right human resources as well processing systems to measure and analyse risk in the marketplace before deciding to guarantee such loans.

NURCHA’s decision to discontinue this leg of its business is therefore justified.
3.4.3 National Savings for Home Loans Campaign

In January 2001 NURCHA launched in conjunction with PEP Bank in the Western Cape a National Savings for Housing Loans campaign in order to supplement the housing subsidy made available by the Government. This campaign was launched to encourage savings in the low to medium income sector. The savings were to supplement the housing subsidy made available by the government (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, June 2001:2).

3.4.3.1 Comments on the National Savings Campaign

Seeing that the maximum subsidy was R16 000 for an individual who earned under R1500 per month and the average price of a 40m² was R60 000 a wide gap existed between the monthly repayment that could be afforded by the borrower and the required minimum repayment on the loan that was needed to finance the house. This can be demonstrated using a simple example:

Industry accepted monthly repayment ratio - 25% of gross income. Taking monthly salary of R1500, 25% will amount to R375.00 per month. Using present value (PV) calculations at an interest rate of 17% per annum with a term of 20 years (standard for mortgage loans in S.A.) the actual loan amount the client will qualify for is R25 566. Using the subsidy of R16 000 to top up the shortfall, the total amount available to the client is R41 565.85. The net shortfall at the end of the day will be R60 000 minus R41 565.85, which is R18 434.15.

By introducing the savings scheme NURCHA wished to bridge the gap between affordable amount and required loan. NURCHA had hoped to establish 125 000 new savers by year end 2001 with each saver having saved at least R6000 (Parliamentary Monitoring Group Housing Portfolio Committee Minutes, June 2001:3).
At the time of conducting this study no updates were available as to the number of savings accounts opened under this specific scheme.

The savings scheme introduced by NURCHA was long overdue in South Africa especially in the low-income sector. The most acceptable loan to value ratio for mortgage loans in the banking sector was 80%. This means that if a housing unit costs R100 000 the bank would be comfortable in providing up to R80 000 in loan funding. Besides the reserve requirements if a bank advanced a loan in excess of 80% were more punitive. Since many borrowers did not have the necessary cash, banks were prepared to accept bought-in guarantees, which were provided by institutions such as the Home Loan Guarantee Company (HLGC) at a cost to the borrower. Hence the loan was further inflated by the cost of such guarantees and legal fees for the transfer and registration of the mortgage bond. This resulted in the loan to value being in excess of 120% in some instances. This would be a risky investment for a bank especially if the borrower defaulted on repayments in the initial years. Should the bank sell the property to recoup its loan it will experience a shortfall unless there was dramatic increase in the value of the property which is very unlikely in a depressed township property market.

However, the savings scheme is in its infancy and is very much voluntary. The revised subsidy scheme which came into effect in June 2002, which will be discussed in paragraph 3.6, requires borrowers to save a minimum of R2479 or provide ‘sweat equity’/labour equivalent to the value of R2479 to qualify for a housing subsidy. Although this is a step in the right direction, it does not incentivise potential borrowers adequately to save as much as possible. In order to make the necessary impact in housing, savings should be linked to subsidy which should in turn be linked to credit.
3.5 THE NATIONAL HOUSING FINANCE CORPORATION (NHFC)

3.5.1 Establishment of the NHFC

The National housing Finance Corporation (NHFC) is a public company set up in April 1996, wholly owned by government and operating under specific exemptions from the Banks Act, Act 94 of 1990 (Government Gazette No: 1837, 1997:1).

The role of the NHFC is to increase the number and type of institutions that provide housing finance to low-to-moderate income households in urban and rural areas. It is also mandated to make such institutions sustainable. The NHFC was initially capitalised by the Government to the tune of R1 billion. With this initial funding it was to leverage funds from the private sector (User friendly Guide, 2003:10).

3.5.2 Programmes of the NHFC

The NHFC commenced by implementing four wholesale lending programmes and establishing a subsidiary called Gateway Home Loans (Pty) Ltd and each of these programmes will be dealt with separately. However, when the analysis of the programmes is done it will be a combined analysis of all the programmes of the institution.

3.5.2.1 The Niche Market Lenders Programme (NML)

This programme was targeted at housing institutions, non-bank lenders and small banks which focus on providing products for the non-traditional and microfinance sector. The NML offered debt funding to such organisations (User Friendly Guide, 2003:11).

Among its lending intermediaries were the now defunct Unibank, the recently failed Saambou Bank and Altfin, which merged with other
microlenders to form African Bank. A further programme of the NML is Southnet Financial Services (Pty) Ltd (Southfin) which has gradually moved away from providing microloans to focus more on financing complete housing units. According to an impact research carried out by the NHFC as at 30 June 2000 (the MRA Survey), through funding made available by the NML intermediaries were able to advance 117254 end-user loans and a further 19900 mortgage loans. The end-user loans were mainly microloans and the research established that between 85% and 100% of loans granted by the established lenders (such as Unibank / Saambou) went towards housing and between 40% and 80% of loans advanced by emerging lender group went towards housing. The leakage (funds not used for housing finance) is attributed to the ‘fungible nature of money’ and the fact that end-users in the lower end of the market access credit primarily to satisfy basic survival needs and emergencies (National Housing Finance Corporation, 2001: 67).

The NML however, takes credit for institution-building in that the R74 million loan facility it provided to Altfin (the largest division of African Bank) had a total loan capital of R444 million with a total loan book of R1,2 billion. As at the June 2000 the market value of African Bank on the Johannesburg Securities Exchange (JSE) was R10 billion. Some of the other smaller lenders that the NML programme supported are Grand Finance (Pty) Ltd and Rural Housing Finance Company (National Housing Finance Corporation, 2001: 67).

During the restructuring of the NHFC at the beginning of 2001 the NML programme became one of the product streams of the NHFC and is now known as the Incremental Housing Division (IH). It still advances wholesale funding to microlenders mainly involved in the financing of home improvements, hence the name ‘Incremental Housing’.
3.5.2.2 The Housing Equity Fund (HEF)

This programme was targeted at new and emerging non-bank lenders who provided housing finance to the low-income market. The HEF provided both debt and equity finance and its focus was mainly to provide equity funding to start up such lending institutions, provide guarantees and technical assistance (User Friendly Guide, 2003:11).

As at the end of June 2000 the intermediaries funded by the HEF were responsible for making 8571 end-user loans. The fund made available an amount of R33000 comprising loan facilities, equity and quasi-equity to 11 clients. These are mainly micro-lending clients. The Fund was closed when the NHFC was restructured National Housing Finance Corporation, 2001: 72).

3.5.2.3 The Housing Institutions Development Fund (HIDF)

The Housing Institutions Development Fund (HIDF) was targeted at housing institutions formed by employers, municipalities, developers and non-governmental organisations. It assists in the formation of such institutions through providing start-up capital, capacity building (technical assistance) and institutional development. These institutions assisted by the HIDF are known as 'social housing institutions'. The strategy behind the establishment of this fund was to take advantage of the institutional subsidy scheme introduced by the government to fund construction of complete housing projects (User Friendly Guide, 2003: 12).

According to an impact report compiled by the NHFC, at the end of June 2000 the fund had approved loan facilities totalling R93 million and some 30 000 new housing units were delivered. This fund was also discontinued at the restructuring of the NHFC in 2001 (National Housing Finance Corporation, 2001: 72).
The Rural Housing Loan Fund (RHLF)

The Rural Housing Loan Fund was the only programme that focused on the government's strategy of providing housing credit to the rural-based low-income earners. The Fund was capitalised through donations from the German Government and it was managed by the NHFC on behalf of the Department of Housing of the S. A. Government. It made funding available mainly through intermediaries such as building material suppliers who made building materials available on credit via funding from the RHLF. It has also funded start-up housing finance ventures in the rural areas of South Africa (User Friendly Guide, 2003:12).

As at the end of June 2000 it has delivered some 1300 housing units in rural areas. The majority of the end-users (54%) accessing credit via the RHLF earn below R1500 per month. Only 20% of the beneficiaries are regular income-earners. The rest are either irregular income earners or informally employed. Subsequent to the restructure of the NHFC the RHLF separated from the former and became an independent organisation with its own board and management structure. It also moved off the premises of the NHFC to concentrate independently on its main mandate, i.e. to facilitate housing finance to the rural poor (National Housing Finance Corporation, 2001: 72).

Gateway Home Loans (Pty) Ltd

a) The Establishment of Gateway Home Loans (Pty) Ltd

As mentioned in Chapter 1, Gateway Home Loans was established in March 1999 as a partnership between the National Department of Housing and the private sector. The NHFC held 85% of the equity of the company whilst the balance of 15% was held between Old Mutual life Assurance Company and Southern Life Association Ltd (Gateway Home Loans, 2000:6).
The vision of the partnership was for the private sector to eventually acquire a 49% shareholding in the venture once a successful track record was established whilst the NHFC will hold the balance of 51% as controlling shareholder. It was rolled out as a two-year pilot project and its performance was to have been reviewed after 24 months from inception (Gateway Home Loans, 1999:2).

b) The Model

The Gateway model was based on the Fannie Mae secondary market concept where originators, commencing with two of the big four banking institutions, viz Standard Bank and Nedcor Bank were accredited as loan originators and loan servicers or Primary Market Lenders. The loans were to be originated in terms of criteria determined and stipulated by Gateway. The loans were to be purchased by Gateway and incentives paid to the Primary Market Lenders were a once of origination fee of R1000 per loan originated and sold to Gateway and a monthly loan servicing fee of 1% per annum on the outstanding balance of the loan (Gateway Home Loans, 1999: 4).

c) The Loan Product

Prior to the establishment of Gateway a feasibility study was conducted by the NHFC during 1998. Based on the experiences of the formal banking sector in the low-to-moderate income sector, a loan product without using the housing unit as collateral was developed. In other words the loan product was a mortgage substitute using alternative collateral such as pension / retirement fund guarantee, cession of an insurance policy with a surrender value, savings and a bought in guarantee that was provided by the Home Loan Guarantee Company (HLGC) at a cost to the borrower. The financial collateral to be tendered by the borrower was for 50% of the loan whilst the bought-in guarantee was for the balance of 50%. The maximum rand amount of the bought-in guarantee was capped at R25 000. Other controls were in
place in order to ensure that the borrower was not inordinately exposed to high level of debt. For instance, the monthly repayment on the loan could not exceed 25% of the monthly gross salary if the borrower was earning under R3500 or 27.5% if the earnings were above R3500. In order to ensure that the correct market was served households earning more than R5000 (gross income) per month were excluded. The loan was for a fixed period between 5 and 8 years, at a fixed rate of interest in order to keep repayments constant and the rate of interest prevailing also had a bearing on the size of the loan granted (National Housing Finance Corporation, 1998:7-9).

In order to ensure monthly repayments a stop order (payroll deduction agreement) had to be signed between the employer, borrower and the lender (National Housing Finance Corporation, 1998:16).

- Illustration

Assuming that the borrower's gross monthly income was R2000 and he was able to tender a provident fund guarantee (after tax) of R11 400 he will qualify for a loan of R22 800. However, at a fixed interest rate of 21.5% prevailing at the time, the maximum loan affordable over 8 years would be R22 833 for an instalment of R500. For this income the borrower would have qualified for a subsidy of R9500. Hence the total package would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan</td>
<td>R22 833</td>
</tr>
<tr>
<td>Subsidy</td>
<td>R 9 500</td>
</tr>
<tr>
<td>Total Package</td>
<td>R32 333</td>
</tr>
</tbody>
</table>

Due to charges to be paid by the borrower viz an administration fee of R1000, a premium of R2082 on the bought-in guarantee at 9.12% (inclusive of VAT) and costs to transfer the property into the borrower's name (approximately R750) the amount for which the house
could be purchased was R28 500 (National Housing Finance Corporation, 1998:13).

• Rationale behind development of the product

Since the secondary market (market for resale of existing houses) in the black townships was virtually non-existent, it was difficult to realise the collateral in times of default by the borrower where a mortgage bond was taken over the property. Therefore, instead of using the property as collateral, alternative financial collateral such as pension fund guarantees, which could be easily realisable in need was sought (National Housing Finance Corporation, 1998:8).

Secondly, Standard Bank (one of the big four banking institutions in the country) and Alexander Forbes (Pty) Ltd, a large and well-established pension fund administrator, pioneered the concept of fully guaranteed loans in the low-to-moderate income market. The maximum amount of the loan was R10 000, was dependent on the amount of guarantee that could be provided by the pension fund and the repayment term was between 36 months and 60 months. The method of repayment was via payroll deduction (National Housing Finance Corporation, 1998:15).

The advantages of the fully-guaranteed loan product (FGL) was that the bank (lending institution) did not need a vast branch infrastructure to market the product as large employers and pension funds were targeted via their corporate head offices. Tri-partite agreements were signed between the lender, the pension fund and the employer to access the pension fund guarantee and blanket payroll-deduction agreements were signed between the employer and the lender for purposes of the repayment of the loan. Each employee that qualified for a loan then signed a stop-order instruction authorising the employer to deduct the
amount from his salary and remit same to the lender concerned (National Housing Finance Corporation, 1998:16).

The disadvantage of the FGL is that whilst the Pension Funds Act allowed pension funds to guarantee loans for housing purposes it did not require the trustees / administrators to ensure that the loan was indeed used to acquire or build a house. The borrower merely signed a clause on the loan application form to the effect that the money borrowed will be used for housing. No research has been conducted to establish what portion of the loans so granted actually went into the financing of houses. A further disadvantage is that it was not possible to acquire a house for R10 000 as land and top-structure prices during 1990 were around R1200 to R1500 per square metre (National Housing Finance Corporation, 1998:10).

Gateway’s loan product was primarily based on the pension fund guarantee for portion of the collateral which was then geared by the bought-in guarantee from the Home Loan Guarantee Company (HLGC) in order to ensure a bigger loan. To ensure repayment a payroll deduction had to be in place. In order to prevent fluctuations in the repayment that could arise in a changing interest-rate environment the product was initially designed with a fixed term of 8 years and a fixed interest rate. In order to satisfy the requirements of the Pension Fund Act the lenders were required to provide proof of transfer of the property into the borrower’s name before the loan could be bought by Gateway (National Housing Finance Corporation, 1998:34).

d) The Piloting of Gateway

From inception at the beginning of March 1999 the programme was allocated a period of 24 months at the conclusion of which an evaluation was to be done to determine its viability. Gateway’s strategy was one of initially filling key positions with suitably qualified and experienced staff whilst outsourcing specialist functions.
to external consultants and the day-to-day administrative and secretarial services to the NHFC. At the same time, in order to standardise the intake of loans it developed a credit-scorecard as well as origination software. The idea was that the software would be installed at accredited originators (Primary Market Lenders) so that the credit vetting and loan granting processes would be largely automated (Gateway Home Loans, 1999:4).

Developing such software was contracted to local software developers whose credentials and track record were not widely known. Besides, for the entire system to work the origination system had to access the system of the credit bureau and the credit-scoring system which were located at remote sites. Synchronising these various systems and getting them 'to talk to each other' was in itself a complicated and time-consuming task.

Although, as mentioned in Chapter 1, Standard Bank and Nedcor Bank signed up as originators, no concerted effort was evident from these institutions to originate loans. Standard Bank, in particular, had a large captive market in terms of employers and pension funds that they signed-up for their Fully Guaranteed Loan product. They were reluctant to use existing agreements as they believed that such agreements were specific to the product being offered by them and new agreements would have to be signed between Gateway, the employers and the pension funds for the new product to be rolled out. Gateway held several road shows as well as promotion exercises in the various provinces of the country. Employers and pension funds were also approached but the reception from these institutions was luke-warm as Gateway was a new company without a track record and most of the employers / pension funds had existing arrangements with one or more of the bigger well-established banking institutions that offered loans, albeit not specifically housing loans, at competitive interest rates to their employees.
Again, looking at it from the perspective of Standard Bank, it does not make business sense for them to market a loan that was in competition with their FGL product which was structured without any risks for themselves as the loan was 'fully guaranteed', payment was ensured through the payroll deduction mechanism. Advancing smaller loans with shorter repayment terms encouraged repeat business and therefore rapid turnaround of capital and hence a larger return on equity.

Standard Bank however made an alternative proposal to the Gateway; to sell R500 million of FGL book to Gateway to enable the latter to test its securitisation strategy. Standard Bank proposed that the NHFC fully guarantee the investment notes issued by the Special Purpose Vehicle against any non-payment or late payment of any loan by the borrowers. The NHFC was not supportive of this proposal as it was required to take a major portion of the risk and there was no evidence that all the loans were used for housing purposes; Gateway's mandate was to ensure that completed housing units were transferred into the borrowers' names (Gateway Home Loans, 2000:17).

Gateway then embarked on a strategy of accrediting microlenders and smaller banks (second-tier banks) which showed interest in originating housing loans. However, these institutions had their own problems in terms of liquidity as the Gateway model required them to originate conforming loans, disburse the funds, close the loans and then sell them over to Gateway. Because of the elaborate processes involved in attaining conformity of the loans (as stipulated by Gateway) until payroll deductions have been implemented and taking into account the average size of each loan, around R60 000, large amounts of capital would be tied up for long periods before the loans could be sold to Gateway and the capital recycled. In some instances it took up to six months before the loan could be sold to Gateway.

Making smaller, shorter-term loans was much more profitable to these organisations because of the quick turnaround of capital.
Eventually there was support from only three of these smaller institutions viz Cash and Savings Bank Ltd (Cashbank), Southnet Financial Services (Pty) Lt t/a Southfin and Greenstart Home Loans (Pty) Ltd. The first mentioned was a second tier bank while Southfin was a microlender which began piloting housing loans and Greenstart was established specifically to take advantage of the Gateway model.

Cashbank had a special arrangement with Gateway and the NHFC where a Special Purpose Vehicle was established. Cashbank invested in the SPV by accepting the 10% subordinated (junior) tranche. By so doing it was prepared to assume first loss in the SPV should any loss arise as a result of non-payment of the loans. The mezzanine / senior debt of 90% was temporarily taken by the NHFC. The initial investment in the Vehicle was R50 million. The idea was that as soon as the volume exceeded R50 million other private investors would be encouraged to invest in the SPV. In a six-month period commencing January 2000 some 1000 housing loans with an average value of R60 000 were originated into the SPV. During the latter part of 2000 Cashbank was experiencing liquidity problems due to rapid growth and merged with BOE Bank. This larger entity subsequently financed the buy-back of the loans from the SPV.

As for the remaining two originators / servicors (Southfin and Greenstart) they remained with the NHFC subsequent to the restructuring of the NHFC and are still originating loans for sale to the NHFC but on a limited scale due to capital constraints.

During mid 2000 Gateway also mapped out a Primary Market Originator (PMO) strategy which entailed crediting loan originators or entities known as 'brokers' by the financial services industry. These were institutions that were formed to fill the gap between banks/financial institutions and borrowers and sourced business for the banks/financial institutions. They were remunerated by commissions paid by the
banks/financial institutions on successful business introduced. These institutions were perceived as the ideal link in the supply chain for microlenders as well as the banks. In the case microlenders, they were small institutions without a large branch network and it was cost effective for them to source business via brokers. Gateway targeted the ‘brokers’ who were active in sourcing business for the microlenders. Gateway accredited approximately a half a dozen of these institutions when a few problems surfaced. Firstly, these originators did not have systems to pre-qualify borrowers nor verify their creditworthiness. They were accustomed to completing loan applications and passing all details to the financial institutions themselves for the process to be taken further. This resulted in large volumes of applications being taken but after initial screening it was found that the majority of the applicants could not qualify in terms of the stipulated criteria.

A further problem was that the brokers did not have capital to originate loans. They merely passed on the loan applications to Gateway which was then required to perform the credit vetting, approval, granting and finally disbursing of the loan. A loan servicer had to be then sourced to service the loans. A further snag with this strategy was that it was in contravention of the exemption granted by the Minister of Finance to the NHFC (the holding company under whose mandate Gateway operated). The NHFC was exempted from the provisions of the Banks Act but was prohibited from providing retail financial services directly to end-users in competition with the banks. It was however required to partner with the banks in making housing loans available and also provide wholesale finance to institutions active in housing finance in the low-to-moderate income market. The PMO strategy was therefore abandoned in mid-2001.

In line with the increase in the costs of building and the general increase in the prices of housing Gateway had proposed to the NHFC to increase the upper threshold of permitted loan sizes to R120 000. At a
board meeting of the NHFC in December 2000 the proposal was turned down citing the government's mandate to the NHFC to facilitate housing finance in the low-to-moderate income sector as the main reason. Gateway's pilot period was extended for a further 3 months until June 2001. In March 2001 a decision was taken by the NHFC to restructure itself and most of the previous programmes mentioned above were consolidated into a single brand, viz, the NHFC brand and three main product streams were being offered by the NHFC. The three product streams were 'Home Ownership', 'Incremental Housing' and 'Alternative Tenure'. These three products were offered by three distinct divisions of the NHFC, each with its executive manager and staff complement.

As the names of the products suggest, the Home Ownership Division supported lending institutions whose business was to provide housing finance to households who wished to acquire houses the titles to which were to be immediately transferred into the borrowers' names. Gateway's business was primarily absorbed into this division. The Incremental Housing Division continued with the business of the former Niche Market Lender programme; i.e. the business of making wholesale finance available to microlenders who provided small, short term loans to encourage the progressive building of houses by building additional rooms and making other improvements on existing houses. The Alternative Tenure Division financed institutions which made available funding for the construction of rental, rent-to-buy and instalment sale housing.

3.5.3 The performance of the NHFC

Since establishment in 1996 the NHFC was able to finance several microlenders by providing finance in the form of debt funding and in some instances both debt and equity funding. Whether the NHFC actually delivered the number of housing units as claimed in its impact report is questionable in that debt funding was made available to
primarily micro-lenders who in turn advanced small loans (maximum R5000) over a short period of time (anything from 6 to 36 months). Take for example the claim that the Housing Institutions Development Fund (HIDF) disbursed an amount of R93 million which made available some 30 000 housing units (paragraph 3.5.2.3 above), the cost of each housing unit will be around R3000. Even at 1996 prices it would have been patently impossible to build houses at R3000 per unit when subsidies offered by the government housing department for an RDP house was R16 000. Furthermore, two of the NHFC’s funds worked together in that whilst the HIDF provided the funding the Social Housing Fund (SHF) provided the technical assistance to train and capacitate the housing institutions accredited by the HIDF. Some funding would obviously have gone towards institutional development of such housing institutions.

Closer investigation of the NHFC’s claim reveals that the figures supplied were based on projections made by the institutions when submitting business plans in support of application for funding. No verification was done to establish how many physical units were actually delivered to end-users.

The restructuring of the NHFC into a more streamlined organisation appeared to be a good strategy in that all the various funds were servicing the same customer base. In many instances the lending intermediaries wanted to expand their product offerings and therefore approached each of the specialised funds for funding. However, the restructuring was not taken to its ideal conclusion where the NHFC would have been a single business entity offering a range of products.

Splitting the NHFC along product-specific divisions does not make absolute sense in terms of effectiveness and efficiency as the position remains where the same customers / intermediaries are approaching different client managers and product teams in order to make available all the NHFC products to their respective customers. Since the NHFC
now offers three product lines viz Home Ownership, Incremental Housing and Alternative Tenure the intermediary would have to submit three proposals to the NHFC and three different client managers would have to attend to the needs of the intermediary. Besides, each of these divisions has its own requirements that the client has to meet before funding is made available. Each division also requires monthly, quarterly and annual reporting from the client as to the latter's financial performance and the impact being made in the market place.

A more efficient restructuring from a cost as well as customer-service perspective would have been for a single client manager to manage the entire portfolio of a lending intermediary.

3.6 HOUSING SUBSIDIES

3.6.1 Introduction

The housing subsidy strategy focused on providing subsidy assistance to households that were unable to satisfy their housing needs independently. It was formulated with due cognisance of the fiscal constraints as well as the high unemployment rate in South Africa. As opposed to subsidising interest rate and therefore distorting the markets the government opted to provide one-off capital payments to persons in different income bands between R0 and R3500 per month (User Friendly Guide, 2003:13).

The strategy comprised three programmes which made up the National Housing Programme:

- The Housing Subsidy scheme
- The Discount benefit Scheme

Page 83
3.6.2 The Housing Subsidy Scheme

The Housing Subsidy Scheme was implemented in March 1994 and replaced all previous government housing subsidy programmes. The scheme provided subsidies to households earning up to R3500 per month in order to assist them to acquire secure tenure, basic services and a top structure. A range of different subsidy mechanisms were provided such as the Individual Subsidy, the Project Linked Subsidy, the Consolidation Subsidy, the Institutional Subsidy, the Relocation Assistance Subsidy and the Rural Subsidy (User Friendly Guide, 2003:13).

As the Individual Subsidy is the most relevant subsidy to this study, since it pertains to home ownership, rather than other forms of tenure such as leasehold or rental, it will be discussed here.

When the housing subsidy scheme was implemented in 1994, it was as follows:

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>R0 – R1500</td>
<td>R16000</td>
</tr>
<tr>
<td>R1501 – R2500</td>
<td>R10000</td>
</tr>
<tr>
<td>R2501 – R3500</td>
<td>R5500</td>
</tr>
</tbody>
</table>


At the time the subsidy was designed to provide some financial assistance to those earning less than R3500.00 per month household income and a full subsidized housing unit to those that have incomes less than R1500.00 per month. This strategy also envisaged that some

Page 84
of the beneficiaries will be able to blend or lever additional housing credit through the use of subsidies (Pillay, 2003:91).

In 2002 the government took a decision to increase the subsidy amounts for the different income bands, to make it mandatory for a beneficiary to contribute a minimum amount of R2479 in order to access the subsidy and to have all houses, including the RDP or free houses, enrolled with the National Home Builders Council (NHBRC). This statutory body was constituted as regulatory body under the Housing Consumer Protection Measures Act of 1998 (See paragraph 3.7 below). In accordance with the decision to require registration of all housing units with the NHBRC the subsidy amount were revised in 2002 as follows:

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>R0 – R1500</td>
<td>R20300</td>
</tr>
<tr>
<td>R1501 – R2500</td>
<td>R12700</td>
</tr>
<tr>
<td>R2501 – R3500</td>
<td>R7000</td>
</tr>
</tbody>
</table>


A further review was undertaken by the Government in April 2003 and currently the amounts are as follows:

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>R0 – R1500</td>
<td>R23100</td>
</tr>
<tr>
<td>R1501 – R2500</td>
<td>R23100</td>
</tr>
<tr>
<td>R2501 – R3500</td>
<td>R7800</td>
</tr>
</tbody>
</table>

(Department of Housing, Directorate: Housing Subsidy Scheme, 2003)
3.6.3 The Discount Benefit Scheme

This scheme promoted home ownership for long-term tenants who occupied state financed rental stock prior to 15 March 1994. The scheme also applied to individual loans and deed of sale transactions concluded before 15 March 1994, specifically if the balance of the purchase price or loan still existed. The scheme was limited to formal housing stock. The tenants of the housing stock received a maximum discount of R7500 on the historic cost of the property. This amount of R7500 was decided on the basis that in many instances the discount equalled the selling price of the property. On application of the discount nothing further was owed on the property resulting in its free transfer to the tenant who then became the owner. Where there was an outstanding balance after the application of the subsidy the tenant was required to finance it from his/her own resources either by means of a cash contribution or by obtaining a home loan from a financial institution (User Friendly Guide, 2003:14).

3.6.4 Public Sector Hostels Redevelopment Programme

This subsidy was introduced to rehabilitate public sector hostels in order to create acceptable living conditions and to integrate hostels with the surrounding community. The subsidies had an upper limit of R16000 per family or R4000 per individual living in hostel administered by the Provincial Housing Board or a municipality (User Friendly Guide, 2003:14).

No information is available as to whether this subsidy was utilised to upgrade the living conditions of hostel dwellers.

3.6.5 Effectiveness of the Subsidy Scheme

The principle in the allocation of once-off capital subsidy to the poorer communities is in line with international norms and South Africa has
steered away from interest rate subsidies which would have distorted and caused inefficiencies in the market. The unhealthy effects of subsidised interest rates in Asian Development Bank's publication 'Finance for the Poor: Microfinance Development Strategy' which states "With subsidized interest rates and poor loan collection rates, these interventions undermine sustainable development of microfinance. As a result, most Developing Member Countries (DMC) are crowded with poorly performing government microfinance programmes that distort the market and discourage private sector institutions from entering the industry" (Asian Development Bank, 2000:15). In an interest-rate subsidy environment the benefit would have been skewed towards those who were able to afford large loans and therefore, benefit from low interest rates. It would not have made much difference to the poorer communities. In a capital subsidy scheme the actual persons who the subsidy was intended to benefit can be targeted.

In South Africa the capital subsidy is tiered in accordance with income bands was devised on the basis that persons earning less that R1500 per month will qualify for the full subsidy of R23 100 which should enable them to get a basic 'starter home' which is priced at R25 580. The idea is that once allocated a starter home the owner should be able to incrementally improve the house by making additions as and when he / she is able to access the necessary funds either through savings or credit. Introduction of a mandatory contribution of R2479 or equivalent 'sweat equity' in the form of labour to build the house forces an applicant to contribute towards housing.

The shortcoming in the subsidy is that persons earning in excess of R3500 do not qualify for any subsidy at all. According to Vos (2003), the managing director of Southfin (Pty) Ltd, a financial intermediary in the low-to-moderate income sector, persons acquiring houses by accessing full credit without subsidies are unhappy about the fact that the houses purchased by them are marginally better than the 'free' or
'RDP' houses allocated to persons earning under R1500 per month. This is due to the high cost of obtaining serviced stands on which to build the houses obviously dependent on the area / province in which the house is being built, the cost of building materials in the specific area and the condition of the soil. Because of unstable soil conditions in certain areas extra reinforcing of the foundation of the building is required which obviously results in increasing costs. In some instances serviced stands cost up to R30 000 leaving an amount of R38 000 for the top structure. Consequently, a person earning R4000 per month, using R1000 as a repayment factor on the loan, will qualify for a loan of R68 000 over a twenty-year period. Building costs are anywhere between R1000 and R1500 per square metre depending on the required finish and the area in which the development is taking place. If one averages the cost at R1200 per square metre, the size of the house will be limited to 32 square metres (Vos, 2003).

Subsidy should accordingly be made available to persons earning between R3501 and R5000. This would be an incentive for persons in a slightly higher income bracket to acquire homes via credit and servicing the credit knowing that they have acquired better quality or bigger homes. This strategy is supported in (Pillay, 2003:212) where it is stated “A change in the income bands in the higher end of the income spectrum would facilitate the blending of credit with subsidy. While this was the intention of the subsidy policy it did not happen on a wide scale.”

3.6.6 Linking of subsidy to Savings and Credit

South Africa has not yet linked subsidy allocation with savings and credit. The first attempt of linking credit to savings is the requirement that persons qualifying for the maximum subsidy of R23 100 had to contribute R2479 or sweat equity to that value in the construction of the housing unit. Germany, in a strategy to address housing shortage, has successfully linked savings to credit and subsidy via the
Bausparkassen System which was developed in 1885 (JDR Consulting cc, 1995:3). The German home loan system which combined mortgage finance with Bauspar State subsidies and personal savings has been highly effective and has resulted in 70% of all housing stock being privately owned (JDR Consulting cc, 1995:8). The basis on which the system operates is that the potential home buyer will contractually agree to save a certain amount over a certain period of time with a specific financial institution. When the agreed amount has been saved a subsidy is made available as well as credit is granted by the institution to enable the client to purchase the house (JDR Consulting cc, 1995:8).

A similar system was successfully implemented in Chile in the 1970s. The government-assisted programmes that provide partial financial support for privately produced include several line of action, the most important of which is the Unified Subsidies Programme (USP). It issues cash vouchers that complement household indebtedness capacity and savings, helping households to buy dwellings built by private developers. Vouchers are issued to beneficiaries for the total amount of the corresponding subsidy. Upon settlement for a house, the beneficiary endorses the voucher to the developer as part of the payment. The remainder of the house price is covered by the beneficiary’s own savings and a mortgage loan provided by a private bank (Rojas, 1999:468).

3.7 THE ESTABLISHMENT OF THE NATIONAL HOME BUILDERS REGISTRATION COUNCIL (NHBRC)

The National Record of Understanding (an arrangement between the South African banks and the Government) and the 1994 White Paper on Housing called for an establishment of a central, self-regulatory defects warranty scheme for new houses. The need for such a body arose from the complaints by housing consumers of the shoddy sub-
standard work of builders involved in the construction of houses. One of the reasons for bond boycotts in the townships was the quality of houses that deteriorated within months of being built. As a result the NHBRC was established in June 1995 as a non-statutory body. Since this was a non-statutory body builders chose to ignore it especially considering that the builder had to register with the Council and pay a licence fee and thereafter each building unit being constructed had to be enrolled with the Council at a cost of 1.3% of the total cost of the house plus stand. Consequently the Council was given statutory powers under the Housing Consumer Protection Measures Act, No. 95 of 1998 (User Friendly Guide 2003:9).

The objectives of the Act are to:

- create a national registration council with power to regulate the home building industry effectively;

- provide consumers with protection by establishing a home builders warranty that forms part of every agreement in regard to a newly built home;

- establish a mechanism to set minimum national quality standards for all home builders, including builders of the subsidised housing;

- enable subsidy housing providers to conclude agreements with the new national regulatory body to monitor the construction quality of housing built by registered home builders;

- create a national fund or more than one such funds for repair on new homes, on a non-compulsory basis, where home builders have failed to honour their warranty obligations;
provide for the protection of consumers in the competitive market based on insurance backed warranties (User Friendly Guide, 2003:9).

The NHBRC has not been enthusiastically accepted by the building fraternity as it is alleged that the price to the consumer is eventually increased by a further 1,3%. The NHBRC is not an insurance scheme in that it only steps in if the builder is not in business anymore in the five-year period covered by the warranty covers.

3.8 THE PROMULGATION OF THE HOME LOAN AND MORTGAGE DECLARATION ACT AND THE COMMUNITY REINVESTMENT ACT.

3.8.1 The Home Loan and Mortgage Disclosure Act 63 of 2000

This Act was passed by Parliament and Gazetted in December 2000. In terms of Government Gazette No. 21900 dated 15 December 2000, the Act was promulgated in order "to promote fair lending practices, which require disclosure by financial institutions of information regarding the provision of home loans; to establish an Office of Disclosure; and to provide for matters".

3.8.1.1 Objectives of the Act

In terms of Section 2(1) (e) (v) and (vi) of the Housing Act No 107 of 1997 national, provincial and local government must, inter alia, promote:

- effective functioning of the housing market while levelling the playing fields and taking steps to achieve equitable access for all to that market; and
the measures to prohibit unfair discrimination on the ground of gender and other forms of unfair discrimination by all actors in the housing development process;

- The Act requires that financial institutions disclose in their annual financial statements the following information:
  - the total number and amount in rand of completed home loan applications received during the financial year in respect of which the financial statements have been prepared in accordance with categories of borrowers and/or geographic areas as may be prescribed by the Office of Disclosure;
  - the total number and amount in rand of home loan applications declined and the reasons for the rejections in respect of categories of prospective borrowers and/or geographic areas as may be prescribed by the Office of Disclosure;
  - the total number and amount in rand of all home loans closed and disbursed by a financial institution in the financial year;
  - the total number of loans approved by the financial institution in the financial year. This information is also to be disclosed in accordance with specific categories or geographic areas as prescribed by the Office of Disclosure.

3.8.1.2 Establishment of the Office of Disclosure

The Act also caters for the establishment of an Office of Disclosure, the functions of which will be to:-

- receive the required information from the financial institution;

- analyse and interpret such information;

- receive and investigate public comments on financial institutions relating to home loans;
• make available to the public information that indicates whether or not financial institutions are serving the housing credit needs of their communities, and rating such financial institutions in accordance with the information received;

• assist in identifying possible discriminatory lending patterns and assist any statutory regulatory body in enforcing compliance with anti-discriminatory legislation;

• report to the Minister of Housing annually and make such necessary recommendations to the Minister on the performance of the financial institutions on their compliance with the Act (Government Gazette No. 21900, 2000).

3.8.1.3 Effectiveness of the Act thus far

As at date of compilation of this report the establishment of the Office of Disclosure has not been operationalised. A scrutiny of the financial statements of the ‘Big Four’ banking institutions, viz ABSA, Standard Bank, Nedcor Bank and FirstRand Group indicate that no reporting on housing loans is evident. In discussions had with a senior manager of one of the banks it came to light that the banks did not do such reporting at this stage because of logistical problems such as:

• The Office of Disclosure was not yet established and hence proper guidelines on the format of the reporting was not available;

• Since scrapping of racial classification in South Africa, banks have deleted any reference to race in their computer systems. Since the government wishes to normalise the previously-disadvantaged market which is traditionally black the racial classification of the applicants / borrowers would be paramount in determining the impact. Banks have therefore to re-configure their computer systems to include the race of
borrowers and probably gender to correctly reflect the required information. It would also require them to reclassify the large database of their current customers. This act in itself could raise sensitivities in the customer base of the bank. The costs of such exercises would be enormous.

These are but two of the issues faced by the banks that require negotiations with the Office of Disclosure and therefore until the office has been established the banks would not be able to comply with the requirements of Home Loan and Mortgage Disclosure Act. Indications are that the Department of Housing is currently busy with establishing the office and it is hoped that it will be operational in mid 2003.

3.8.2 The Draft Community Reinvestment (Housing) Bill

The Community Reinvestment (Housing) Bill (CRA) was drafted in 2002 made available to interested parties and the general public for their comments. Banks expressed their dissatisfaction at the proposed promulgation of the Act but government countered that no amount of moral suasion or incentive programmes could cause the banks to voluntarily lend in the low to moderate income market. Opinions were also taken from legal experts and the general public and certain modifications were made to the original draft. The Bill was scheduled to be tabled and passed in Parliament during April 2002 however, due to the banking sector's dissatisfaction with the draft they were given the opportunity to comment on it. The Intention of the National Housing Department was to finalise the bill and get it passed through parliament in the latter half of 2003. The Principles of the proposed CRA as detailed in the draft bill are:

- In attempting to meet the needs of low and medium income in accessing home loan finance, financial institutions must:
- refrain from refusing home loan finance to borrowers purely on the grounds of the current or future expected socio-economic characteristics of the residents in the neighbourhood in which the home is located;
- refrain from the practice of redlining other than where dictated by safe and sound business principles;
- afford borrowers the necessary dignity, courtesy and honesty when discussing and processing applications for mortgage loans;
- communicate transparently and openly with borrowers during all stages of negotiations;
- communicate clearly and openly with all borrowers on the outcome of their applications and furnish reasons in writing for rejected applications;
- encourage where possible a climate of saving amongst home owners and borrowers and provide meaningful incentives for those who save;
- notwithstanding any reasons that are considered acceptable by the Minister, meet or exceed the targets and standards prescribed by the Minister for lending to households with low and medium income levels; and

• If they are unable to meet those targets and standards by lending directly to such end-users, opt for one or any combination of the following:
  - provide funding through a prescribed wholesale lender at a mutually agreed interest rate for on-lending to niche lenders to provide end user loans;
  - purchase such wholesaler lenders' securities and debt issues; and
  - provide funding directly to niche market lenders to make available for end user loans. (See Appendix 1 for Draft CRA).
3.8.2.1 Reaction to the proposed bill

There is widespread discontent in the banking sector with the proposed Community Reinvestment Act (CRA) as banks contend that it compels them to lend to a riskier market. Banks submit that they are on-lending deposits that belong to the public at large and lending these monies in the risky market could affect the stability of the banking system as a whole which could result in systemic risk. Coovadia (2003) mentioned that the banks were not averse to the concept of a Community Reinvestment Bill but they were averse to the penalties proposed in the bill for non-compliance. They believe that low-to-moderate market cannot be addressed by any single party but require a ‘partnership’ intervention by both the government and the private sector. In line with this thought the banks have jointly, of their own accord, developed a comprehensive Financial Services Charter (a Financial Services equivalent to the recent Mining Charter which was drafted by the Mineral and Energy Affairs Ministry to redress the imbalances in mineral ownership caused by Apartheid) which addresses both Black Economic Empowerment (BEE) as well as making available financial services to the low-to-moderate income sector.

In this document, according to Mr Coovadia, a risk-sharing mechanism is proposed where any losses arising out of lending to the low-to-moderate-income market should be shared between government and the private sector. The banks apparently are willing to contribute an amount of R20 billion over a five-year period. He also mentioned that this proposal was presented to Cabinet on 6 August 2003 at which sitting the proposal received a good reception from the government. Consequently the draft CRA bill was put on hold until the charter had been fully considered by the cabinet (Coovadia, 2003).
3.8.3 Conclusion

As much as government has tried various avenues to encourage the private sector financial institutions to get involved in financing of housing in the low-to-moderate sector it would appear that the laws promulgated and institutions created by the government did not achieve the desired results hence the last two pieces of legislation to compel banks to be involved in the specific sector. Clearly, the institutions created by government are working in isolation and in many instances not in cohesion with their sister organisations. If this is the case then they are unable to create an environment that is conducive to lure the financial institutions into partnership. A case in point is the closure of Gateway Home Loans by the National Housing Financing Corporation where there existed a private / public partnership, albeit small. Had this programme been built-on and made successful, there would definitely have been potential for other private sector/ public sector partnerships developing.

Viewed from the perspective of the private sector financial institutions (banks), one is able to empathise with them as their mandate from their shareholders is to generate a fair rate of return on the capital they have injected in the institution whilst depositors in these institutions would require certainty that their monies are in safe hands. The banks are very unhappy with the proposed Community Reinvestment Bill as it compels them to lend in a market which they believe is risky. The SA Reserve Bank as the regulator of banks, a government agency itself, has expressed concerns about the proposed Act in that the bill may oblige privately owned financial institutions that are entrusted with the savings of the general public – that is, banks - to resolve the housing crisis in the country (South African Reserve Bank – Bank Supervision Department, 2002:29).

This perception could also have a negative impact on the investment rating of the country. Although bank loans and advances are made to
borrowers from both shareholders' capital and depositors' funds, most loans are made from depositors' funds. Hence it is to be expected that the financial institutions would be reluctant to engage in high risk and high costs business with low returns. Providing housing finance in the lower end of the market which does not have a very high level of literacy and not sufficiently connected to technology is a labour-intensive and therefore costly business.

Rust, (2003:16) sums up the situation when she states "Some respondents complained the government had moved away from its collaborative approach to housing policy; it was not engaging with stakeholders except to issue instructions and lay down minimum standards."

CHAPTER 4

THE READINESS OR OTHERWISE OF THE PRIMARY MARKET IN SOUTH AFRICA TO SUPPORT SECURITISATION

4.1 INTRODUCTION

This section of the research evaluates the primary market environment in South Africa against the preconditions established in Chapter 2. It will also examine the impact of microlending and consumer debt on the low-to-moderate income sector.

4.2 THE EXISTENCE OF SUFFICIENT LEGAL, TAX AND REGULATORY FRAMEWORK TO SUPPORT SECURITISATION

The most important enabling legislation to support securitisation was the amendment of the Banks Act No. 94 of 1990 in 2001 to allow banks and other institutions to invest in or transfer (sell) assets into bankruptcy-remote Special Purpose Vehicles (SPV) for the purposes of securitisation. The Act specifies the risk weightings for the different levels of investments in the SPV and hence stipulates the mandatory reserve requirements that have to be adhered to by banks investing in such vehicles. The Act also stipulates conditions relating to servicing of the securitisation scheme, appointment of auditors and disclosure requirements of securitisation schemes (Government Gazette No: 22948, 2001).
Income derived and expenditure incurred from the activities of the SPV are treated in the normal manner as for companies and governed by the Income Tax Act of 1962 (Act No. 58 of 1962). Generally SPVs are risk-structured in such a manner so as to minimise taxation expenses in the SPV itself by matching expenditure to income as the interest earned by the investors and management fee of the issuer are taxable in the hands of the investors and issuer respectively (Bagley, 2003).

Accounting and auditing of SPVs is in accordance with General Accepted Accounting Practice (GAAP). The Accounting profession in South Africa is aligned to the International Accounting Standards Board and therefore subscribes to the International Accounting Standards (IAS).

The practice of registration of title deeds (ownership of real estate) has been in place for over 90 years. The transfer of properties is regulated by the Alienation of Land Act, 1981. It is supported by Deeds Registry offices in the main centres of Johannesburg, Cape Town, Bloemfontein and Durban. Common law allows the registration of mortgage bond(s) over immovable property as collateral over the loan being taken. Mortgage bonds are also registered in the Deeds Registry.

As regards the enforcing of liens on property and effective and efficient foreclosure laws, this is supported by the Magistrates Court Act No. 32 of 1944 in respect of debt owing under R100 000 and the Supreme Court Act No. 59 of 1959 which caters for debt in excess of R100 000. As much as the laws are in place in some cases it has been difficult to implement due to joint action by communities defying eviction, especially in the previously marginalised black townships. The legal and justice system is still unable to enforce law and order when financial institutions need to enforce lien over the properties financed (Pillay, 2003:105).
From the above it is evident that the legal, tax and regulatory environment is adequate to support securitisation generally. The enforcement of law in terms of obtaining evictions on bought-in properties needs to be tightened up.

4.3 ROBUST PRIMARY MARKET OPERATIONS AND PRODUCT STANDARDISATION

4.3.1 Stability of the Macroeconomic Environment

Absolute stability of any economy in the light of globalisation is not possible. South Africa is a developing nation and is generally classed together with other developing nations by the developed world. Generally, any economic crisis that affects one of the developing nations affects all other developing nations as investors become nervous and withdraw their investments in panic. In South Africa circumstances are on the positive side as the transition to democracy in 1994 was peaceful and the country is building on this success to further stabilise the environment. The government's policies to stabilise the economy and promote long term growth are acceptable by the world at large. Monetary policies such as the control of inflation are high on the agenda of the Reserve Bank. The targeted inflation rate has been set between 3 and 6 percent (Standard Bank Group, 2002: 57) and interest rates are used effectively to bring inflation within the set parameters.

During 2001 the rand fell nearly 40% against the dollar and at one point it was at an unprecedented level of R12.9263 per dollar. The Government instituted a judicial enquiry to determine what the cause of such devaluation was. Although the exact cause of the devaluation could not be established the appointment of the commission and the investigation gave credibility to the authorities. The rand has since
gained almost 40% from its lowest position and April 2002 was trading around R7.70 (Business Day April 22, 2003).

At the beginning of June 2003 the Monetary Policy Committee of the Reserve Bank reduced the Repo rate (the rate at which the banks can borrow money from the Reserve Bank) by 150 basis points to 12%. The banks have responded immediately by reducing the prime lending rate to 15.5%. The mortgage lending rate is mainly based on prime and hence it makes the purchase of assets such as houses cheaper to the consumer.

Although the Gross Domestic Product (GDP) growth rate has been languishing around the 2-3% range over the past 3 years it has not been negative (Standard Bank Group, 2002:11). According to ABSA economists SA's economy has reached its bottom turning point, and is once again on a path towards higher growth. Real economic growth was forecast to reach 2.2% for the year (2003) rising to about 3% next year and reaching 3.3% in 2005 (Wilson, 2003).

The unemployment in South Africa is reported to be around 41.8% of the potential workforce or 7,925,000 persons when applying the broad definition of unemployed which included discouraged job-seekers who said they were unemployed but had not taken active steps to find work in the four weeks prior to the interview. This translates to 20% of the total population of 40 million, in terms of the 1999 census, is unemployed (I-Net Bridge 2003 June 20).

In an article by Bloomberg dated July 4, 2003, the National Treasury had indicated that Central Government, local governments and state companies will lift infrastructure spending to about R67.5 billion in the 12 months to March 2004. Such capital projects will contribute to reducing unemployment and grow the economy (Bloomberg, 2003).
HIV/AIDS is a very real problem being faced by many of the developing nations. World-wide the number of persons infected is estimated at 42 million and Sub-Saharan Africa accounts for 25 million or 60% of the total. In terms of a research commissioned by the Medical Research Council and the Actuarial Society of South Africa the estimated number sufferers HIV/AIDS sufferers in South Africa is 6,5 million, predicted in terms of a model developed by the Actuarial Society of South Africa (ASSA). Of these 95,1% or 6,1 million persons were in the age group 18-64 years which is the age group that is most likely to form part of the labour force (Dorrington et al, 2002:4).

Currently, HIV/AIDS-related deaths are not covered by insurance policies and many insurance companies require applicants for life policies to undergo Aids-testing before acceptance. Lending institutions become wary of lending large amounts for extended periods under such conditions especially for mortgage home loans. The eviction of a family due to non-payment arising from the death of a breadwinner can provoke a backlash from the community. The Home Loan Guarantee Company (HLGC) is, together with the banking fraternity, currently investigating a suitable insurance product which will address the risk of aids (McArthur D, 2003).

Provincial Governments, commencing with KwaZulu Natal, the Western Cape and more recently Gauteng, have rolled out HIV/AIDS treatment programmes. HIV/AIDS education has become quite prominent in South Africa over the last two years. Adverts and special programmes feature prominently on radio, television, schools, adult education centres, on outdoor media etc. Some large employers such Anglo American, Gold Fields and SAB Miller, have introduced policies which included providing workers with drugs to fight the effects of the disease (Sunter, 2003).

Despite some of the above unfavourable circumstances the fundamentals or ‘building blocks’ of the economy are sound. In August
2002 Fitch Ratings ascribed a 'BBB- sovereign rating' to the country. According to Fitch Ratings the rating outlook for South Africa changed to Positive from Stable to reflect a strong macroeconomic policy, specifically the positive trend in public finances in South Africa, which will deliver further improvements in the country's credit fundamentals, as well as the increased resilience of the local economy to domestic and external shocks (Fitch Ratings, 2003).

4.3.2 Marketability and Liquidity of the Housing Market

The developed housing market in South Africa is robust and liquid. This market mainly consists of the suburbs that were previously 'whites only' designated during the apartheid years. Because services were preferentially delivered and houses were properly maintained by the owners, housing in these areas are generally of a high quality. Since the abolishing of the Group Areas Act these areas have opened up to the other races. An article in the Business Day dated 07 February 2003 aptly sums up the situation when it states "The demise of apartheid has released enormous value in the housing market, shown in the rally in house prices over the past few years. Signs of the turnaround emerged after the Group Areas Act was scrapped in the late 80s allowing black people to own property and reside in what use to be exclusively white suburbs. The migration of the black middle class into the suburbs revitalised residential property markets which were previously dead because there was virtually no secondary market. The opening up of economic opportunities to black people after 1994 lent further impetus to the market" (Property Editor, 2003).

The housing market in the former black townships is not very active. Because there was no economic motivation to develop private units for sale to any income strata of the black population, a crises level of housing backlog developed. The current result is that there simply is little or no secondary housing stock available. Consequently, township residents do not frequently move out of their current housing. There
are simply too few units to select from, particularly for those at lower-income levels (Abt Associates Inc / Social Surveys, 1998:16).

As a result of unavailable stock, residents tend to stay in their properties and frequently upgrade them rather than moving within the housing market. Moreover, those who have economic means to 'trade-up' to more expensive housing in townships or other communities, frequently keep their original property in the family (Abt Associates Inc / Social Surveys, 1998:16).

A further factor discouraging the normal functioning of the market in these areas is the sub-standard nature of services being delivered in the areas. Higher-income groups are better catered for in respect to services, facilities and infrastructure. The fact that these considerations are prioritised by lower-income residents reflects the inadequacy of such services and facilities, and illustrates the principle that housing cannot exist in isolation. The mere construction and delivery of housing units does not constitute the establishment of a township (Abt Associates Inc / Social Surveys, 1998:17).

Chapter 1 paragraphs 1.2.1, 1.2.2 and 1.2.3 detail the factors that contributed to the housing market, specifically in the black townships, being stagnant. One of the objectives of this study is to find ways to address this undesirable status in order to normalise the housing market throughout South Africa.

**4.3.3. Sufficient Network and quality of Primary Market Lenders**

Institutions that have been active in the mortgage loan market are mainly the registered commercial banking institutions of which there were 9 in 2001 with 342 branches country-wide (Daniels, 2001:9). These are the institutions which have the expertise and infrastructure to deal with credit assessments for long term lending, establishing the value of residential property for collateral purposes and the
registration of mortgage bonds. There are however many lenders involved in providing loans to the low-to-moderate income sector. In terms of registration figures obtained from the Micro-Finance Regulatory Council (MFRC), the statutory body established by the Department of Trade and Industry to regulate the Micro Finance Industry, excluding the registered banks there are 1300 registered microlenders with some 4700 branches proliferating the country (Daniels, 2001:9).

However, these institutions are mainly engaged in the provision of small, short term loans; amounts are for less than R10 000 and the maximum term of the loan is 60 months. The inability of these organisations to provide larger and longer term loans is occasioned by their inability to raise long-term finance in the market. Due to the riskiness of the market and the desire to increase profitability, investors in these ventures require high returns which may be achieved by lending small amounts for shorter periods thereby enabling the institution to turn its capital over at a faster rate than would have been possible if capital was tied up in a 20-year home loan. Moreover, due to the costliness and the riskiness of the low income sector and the threat of competition many of the local banks have scaled down their branch network and have turned to technology such as computerisation, Automated Teller Machines (ATMs), call centres and the Internet to deliver services cost-effectively to the mass market.

By nature of their core business of offering financial services to the low-to-moderate income sector the microlenders are closer to the specific market than the formal banking sector. If regulations are formulated to facilitate the acceptance of deposits from the public by the microlending fraternity and such institutions are capacitated to originate mortgage loans as well as a secondary market institution is created to buy loans from these smaller institutions a robust primary market can be created.
4.3.4 Standardisation across the Industry pertaining to Products, Business Practices, Documentation, Data and Information Access

4.3.4.1 Standardisation of Products

Generally a mortgage loan product has a loan to value ratio of 80% and a twenty year repayment term. Where the borrower does not have a 20% cash deposit or acceptable collateral in another form (such as a pension fund credit / savings deposit which can be ceded to the bank) the Home Loan Guarantee Company (HLGC) has developed a Collateral Replacement Indemnity (CRI) as a substitute for the 20% collateral. The client has however to pay a premium of 8% in respect of this guarantee. It is for a period of five years and operates on the basis that should the borrower default on his / her repayments in the first five years of the loan the HLGC will stand good for any loss incurred by the bank after the sale in execution of the property, up to a maximum of 20% (Diamond & Hoek-Smit, 2000:12).

Clients with high value mortgages in prime locations have access to various products and shop around. Outside prime areas (and in township areas in particular), the housing market is ineffectual and mortgage finance is generally unavailable. A large majority of the population can thus not benefit from what should be their best security — their mortgage — and faces generally high cost of finance (Portfolio Committee on Trade and Industry, 2003:23).

4.3.4.2 Standardisation of Business Practices

As far as business practices are concerned the registration of title of ownership of property and the registration of bonds is dictated by the requirements of the deeds registry. The registration of title deeds and mortgage bonds can only be effected by conveyancers - attorneys licensed to provide this service. The documentation and processes are
therefore uniform. The Usury Act 73 of 1968 & Exemption Notice and Credit Agreement Act, 75 of 1980 are intended to regulate the business practices of credit providers. These Acts require that the providers of credit make certain disclosures to the borrower relating to the capital amount being lent, the interest rate and the reference rate on which the rate being charged is based, any other charges being added to the loan etc. The loan contract or 'Letter of Grant' as it is commonly known on which these charges are reflected together with the terms and conditions of the loan is standard across the industry. However, in a study carried out by a Technical Committee appointed by the Department of Trade and Industry it was established that the weaknesses in the disclosure rules imply that the actual cost of credit is frequently much higher than the disclosed interest rate. This undermines the consumer's ability to make informed choices and relieves the pressure on the suppliers to reduce interest rates. The enforcement of the Usury Act and the Credit Agreements Act has been both ineffectual and unequal between different providers and products. Through lack of enforcement, the practices of less scrupulous providers have become the norm. As a result the non-prime market operates in an oblique manner with little effectual or transparent competition (Portfolio Committee on Trade and Industry, 2003:18-19).

4.3.4.3 Data and Information Access

Standardisation pertaining to data and information access is a problematic area due to strategic and competitive reasons and a bank's duty of secrecy towards its customers. A bank is legally prevented from divulging the details of a customer's financial affairs to a third party unless ordered by a court of law to do so. Only information pertaining to bad payers, delinquent accounts or instances where judgements are taken against non-paying clients are collated and maintained at central repositories known as credit bureaux. Current credit information exchange is fragmented and incomplete. Credit bureaux exclude information on substantial and important parts of the consumer credit
market, while the other information on the bureaux is frequently inaccurate. This undermines the credit provider's ability to identify non-creditworthy consumers; leads to high levels of bad debts and thus to increased cost of credit across the board (Portfolio Committee on Trade and Industry, 2003:20).

Information pertaining to short term consumer debt such as clothing and furniture accounts are collated by the Consumer Credit Association (CCA) as many retailers are affiliated to this organisation in order to source credit information pertaining to their clients. In order to source information from this institution an affiliate has to supply full details of their debtors as well as monthly reports on the performance of the debtor accounts. Again for strategic reasons as well as the duty of secrecy, banks have not affiliated to the CCA.

In September 2002 the Micro Finance Regulatory Council (MFRC), the statutory body set up by the Department of Trade and Industry to regulate the microlending industry, developed a National Loans Register (NLR). This register was introduced to regulate the amount of debt made available to the low-to-moderate income sector as indiscriminate lending to the low income sector has caused large-scale hardship among the poor. Lenders registered with the MFRC are compelled to fully disclose loans made to each borrower to the NLR. The NLR is also linked to the Consumer Credit Association's (CCA) database of consumer debtors (those persons accessing retail credit from furniture, clothing and other retail institutions) to enable the microlender to examine the current debt of any borrower and ensure at the same time that the borrower is not over-committed (Microfinance Regulatory Council, 2000).

From the above it can be concluded that data and information pertaining to the lower end of the market is available, albeit in a fragmented state. If the credit industry is sufficiently regulated to
facilitate the availability of accurate and complete data to enable a credit grantor to make proper credit decisions and credit-grantors compelled to perform proper analysis of borrowers' financial circumstances before granting credit, more responsible lending could be encouraged.

4.3.5 Alternative Credit Enhancement options to overcome insufficient credit quality or lack of data

In the lower income sector whilst data / information is not readily available, barring the Home Loan Guarantee Company (HLGC) (mentioned in paragraph 4.3.4.1 above), there are no other institutions significantly involved in the issuance of such credit enhancements. Currently, there are no significant investors in Junior Debt in securitisation transactions. The originator or issuer will have to accept this obligation as is the case with the two securitisation issues undertaken by S A Home Loans over the last three years (Stockley, 2003).

It can only be assumed that once securitisation becomes a successful form of financing, institutions would be established to take advantage of investment opportunities that will arise and therefore provide the necessary credit enhancement.

4.3.6 Loan Origination, Underwriting, Funding and Loan Closing

4.3.6.1 Loan Origination

Under current circumstances, the acceptance of the majority of the risk by the banking sector and the large capital outlay that is required in making mortgage loans available prevents large volumes of housing loans being originated in the low-to-moderate income sector. If the risks were shared among other parties and capital made available to
originate loans large volumes could be originated. For originators who
do not wish to hold mortgage loans on their books and others who need
to off-load their mortgage loans in times of illiquidity, a conduit such
as the Fannie Mae’s or the Freddie Mac’s is the ideal vehicle to buy the
loan from such originators. As was the trend in the United States in the
1960s and 1970s (Fabozzi & Modigliani, 1992:17), South Africa has a
large network of mortgage originators who link-up borrowers with the
financial institutions.

These institutions operate as freelance brokers and refer mortgage loan
applications to the various banks with whom they have loan origination
agreements. Their functions entail the completion of application forms,
location of a house and the forwarding of these applications to the
financial institutions. They do not perform credit vetting or
disbursement of the loan, which is performed by the bank which grants
the loan. If these mortgage brokers are trained to do proper credit
vetting and assessments of applicants, valuations of residential
properties being purchased and are provided with ‘pipeline’ funding to
close loans large numbers of loans could be originated via this
network.

4.3.6.2 Underwriting

As regards proper underwriting practices, there has been a distortion in
the marketplace since micro-lending has become the means of access to
financing by the low-to-moderate income sector. Because access to
financing from the formal banking sector was not readily available to
the low-to-moderate income market, many borrowers turned to informal
lenders and microlenders. Prior to the establishment of the
Microfinance Regulatory Council (MFRC) in 1999 microlenders
practised ‘Pay-day lending’ which is commonly known as a 30-day
loan. These loans were lent at exorbitant interest rates and with other
add-on administration charges. The borrower had to make available his
Automated teller Machine (ATM) card together with his Personal
Identification Number (PIN) to the microlender to enable the latter to withdraw the full amount lent together with the 'finance charges' on the date the borrower's salary was deposited into the borrower's banking account, hence the term 'payday lending'. The client could re-borrow the capital the very next day after having 'paid' the microlender. The practice of retaining a borrower's ATM card and PIN has been outlawed by the MFRC, however, according to the MFRC it has not been completely eradicated although microlenders are being prosecuted for such practices (Davel, 2002).

A further factor that made it unnecessary to practice prudent underwriting was the advent of payroll deductions. Institutions active in the microloan industry such as African Bank, one of the biggest and well-established players in the microloan industry, as well the now defunct Unibank and Saambou Bank have had special arrangements with employers for deduction of repayments in respect of microloans obtained by employees of the contracted employers. As a condition of the loan an employee was required to sign an 'irrevocable stop order' instructing his employer to deduct loan repayments from his salary and remit such monies direct to the bank / microlender which advanced him the loan. Under these circumstances the credit-worthiness of the employer played a major role in the lender's decision to lend to the employee and not the financial circumstances of the employee.

Whether the borrower was over-exposed to other debt did not affect the decision to lend as repayments were almost guaranteed as the specific microlender was at the head of the queue in terms of repayments that have to be deducted from the employee's salary. The scourge of payroll deductions was aptly described by Paul Slot, managing director of General Union - a company specialising in working with employers to assist workers manage their debt, in an article on News24.com on April 1 2003, when he states that it turned out to be a serious mistake, particularly after the discovery of payroll deduction as a form of security for loans raised with banks and microlenders. While
employers, including government stood by passively, deductions from their employees' salaries as well as stop and debit orders on their bank accounts steadily eroded their take-home pay. At its nadir, some state employees even had to pay in on their salaries. The result was employees clocking up debts of R15 billion with microlenders, R10 billion with furniture retailers and R18 billion with their local municipalities (Sapa, 2003).

Whilst credit scoring was and is being practised in the middle-to-upper income market, it was virtually non-existent in the low-to-moderate income sector; again, because adequate data was not collected nor was data held at a common repository. In order to develop a score-card, historical data of the market being targeted must be available as a starting point to determine trends in debt servicing by different age-groups, income categories, gender, employment sector, location etc. Once the parameters of acceptability and rejection have been determined based on the historic data, the credit scorecard has to be tested by processing new applications. This entails feeding a potential borrower's details to the scorecard which will either approve or reject the application in accordance with the parameters determined.

The testing of the scorecard will indicate whether the parameters set are too rigid or too liberal by rejecting the majority applicants in the former instance or accepting the majority of applicants in the latter. The next step is to adjust the scorecard by either relaxing the rigid parameters or tightening the liberal parameters. This exercise is undertaken until an acceptable level of risk is reached. Performance data of the loans granted via the scorecard has to be fed into a performance database on a regular basis to establish trends. The establishment of such trends will indicate how the scorecard should be adjusted on an ongoing basis to ensure that it is up to date in a changing consumer environment.
As credit scoring is based on probability, the certainty occasioned by repayments via payroll deduction will distort the scoring system. The aim of a scorecard is to determine the behaviour pattern of an individual in terms of servicing debt based on the various criteria mentioned in the previous paragraph. In the case of a payroll deduction the willingness and ability to pay of the borrower cannot be established as the contract to ensure repayments is between the lender and the employer whilst the borrower is almost left-out of the equation.

One of the actions taken by the Government that forced microlenders to consider prudent lending was the action by the Minister of Finance in 2000 to stop government departments from providing payroll deduction services to lenders making finance available to its employees. This required microlenders to turn to other avenues of debt collection such as debit-orders processed against the borrower's bank account or other card-based payment systems. The position is confirmed in KPMG (2001:26) where it is stated 'Government's surprise decision to end all deductions from its Persal payroll system (and phase out existing ones by mid-2001) sent microlending stocks tumbling. African Bank and Unifer shed 50% during 2000, as their public sector lending (their primary activity) relied on access to payrolls. These groups are now focussing more on private sector lending, based on credit scoring etc., while collecting their substantial public sector books through alternative means (debit orders at large banks) (KPMG, 2001:26).

In order to compel lenders to practise prudent underwriting, employers must refrain from agreeing to perform payroll deductions on loans and the practice of retaining borrower ATM cards and PINS should be completely eradicated, even by prosecution of offenders. These malpractices take away the need to establish whether a potential borrower will be willing and able to repay his loans and therefore destroys lenders' ability to assess the creditworthiness of a potential borrower.
4.3.6.3 Property Appraisal

South Africa has a property appraisal infrastructure comparable with any developed country of the world. Assessors or valuators are accredited / licensed by the South African Council of Valuers. Obviously, there are standards and a code of ethics laid down by this body which members must adhere to. Training and examining of potential property valuers is undertaken by this institution. Appraisal methods are generally standard across the industry. In a developed and robust property market, as in the case of the previously whites-only suburbs, valuations are easier to carry out as the demand for and supply of housing stock determines the market value of a house. In a stagnant secondary property market valuations will be more difficult to perform. However, if there is a large-scale migration of blacks from townships into formerly ‘whites-only’ suburbs (as stated in paragraph 4.3.2) it will result in township houses becoming available for sale and would consequently create a proper secondary housing market in the townships.

It was reported in the Business Day of the 26 June 2003 that there was a shortage of black valuers. Of the 1200 qualified for the 9-million properties in South Africa, only 30 are black. ABSA Bank was involved in an empowerment deal worth R375million where it outsourced its residential valuations to a black empowerment company. The deal was structured in order to increase the entrance of blacks and women to the profession and to provide the necessary training for potential valuers (Wilson, 2003).

4.3.6.4 Funding and loan closing

As banks and previously the building societies have been dealing with mortgage loans for over five decades the funding and loan closing process has been somewhat perfected and standardised. Generally, the process is as follows:-
In the case of an existing house:
- The borrower signs the ‘Offer to Purchase’ with the seller of the property
- The borrower signs the loan agreement with the bank / lender.
- The bank / lender issues property guarantee to the conveyancer appointed by the seller to the effect that the amount borrowed by the borrower will be paid subject to the property being transferred into the borrower’s name and a bond being registered in favour of the lender in the Deeds Registry.
- The conveyancer appointed by the lender ensures that the transfer of the property into the borrower’s name is effected in the Deeds Registry and the bond in favour of the lending institution is simultaneously registered.
- Once these items have been completed the conveyancer representing the lender signs-off the guarantee issued by the bank confirming that the conditions have been met.
- The conveyancer holding the guarantee on behalf of the seller then presents the guarantee to the designated branch of the bank for payment.
- The guarantee is paid by the lending bank and the borrower’s mortgage loan account is created and debited with the amount paid.
- The loan account becomes ‘live’ on this date and interest is calculated at the agreed rate on the loan and the borrower is billed for repayment of capital and interest on a monthly basis.

As regards a building loan (where a top-structure has to constructed):

- Where the borrower already owns the building site, a bond is registered over the property. Where the borrower has to buy the property the payment in respect of the property is made first and the bond is simultaneously registered over the property.
- A building contract is signed between the builder and the borrower. In certain instances, especially in large developments, a developer will undertake to make the site available as well as construct the top structure. In such instances a single building contract encompassing these two transactions is signed.
- However as soon as the borrower signs the loan agreement the monies in respect of the site will be paid out to the developer as agreed in the contract.
- In the building agreement itself the building plan approved by the local authority, in whose jurisdiction the house is being built, as well as specifications pertaining to the structure, size of rooms and specific materials to be used in the construction are included.
- Engineers are generally employed at different stages of the construction to ensure that the construction is carried out in accordance with the specifications. These mainly pertain to the foundation stages as well as the construction of the roof.
- Lending institution normally pays the developer / builder at agreed intervals which are determined in accordance with the stage of completion of the building unit. In the initial stages lenders insist on a certificate by the engineer in attendance that the trenches and foundations were laid in accordance with minimum specifications.
- A valuation report is also obtained from an approved valuer to the effect that the stage of completion in respect of which a draw-down has been requested has been completed. At the same time the borrower has to sign a certificate of approval of the draw-down as confirmation that he is satisfied with the construction.
- Generally, a portion (say 5-10%) of the final draw-down is held back by the lending institution as retention monies for a period of 90 days to cater for any problems that may arise with the construction within the 90 days after occupation by the borrower. The contractor will be called upon to rectify such faults before the retention monies are finally released to him.
- Upon final payment to the contractor, interest accrued on the loan portion applicable to the construction will be deducted from this
payment. The borrower’s loan account becomes ‘live’ and attracts interest on the loan as soon as disbursement in respect of the land has been made. Interest on the construction portion is retained from the contractor.

Due to their ability to attract cheap retail and wholesale deposits the larger banks are able to fund this entire process without much problems obviously taking into account the capital adequacy and reserve requirements of the S A Reserve Bank. However, the non-bank lenders involved in this market need to access large amounts of funding to enable them to originate a large volume of loans where the average loan size is around R60 000. Conveyancers acting on behalf of sellers of property and contractors / developers refuse to accept guarantees issued by any party other than a bank for fear that the guarantee might not be honoured.

A bank will only issue a guarantee on behalf of a lender provided the cash amount equivalent to the guarantee has been deposited into its account by the party requesting the guarantee. Where the lenders have sufficient cash in their possession they would normally deposit such monies into a trust account of the bond-registering conveyancer who will issue the guarantee and settle the seller’s conveyancer as soon as the property has been transferred into the borrower’s name and the bond has been registered in the lending institution’s name.

The National Housing Finance Corporation (NHFC) has in certain instances assisted its non-bank lending intermediaries by either issuing the guarantees on the latter’s behalf or by making revolving loans available to the intermediaries as soon as confirmation has been obtained from the conveyancer that the registration of transfer and the bond are imminent. As soon as the bond has been registered the loan can be sold to the NHFC and the capital portion disbursed by the NHFC in respect of the guarantee or the revolving credit is held back by the NHFC at the time of sale of the loan by the lending intermediary.
It is clear from this process that non-bank lenders have to be supported via cash injections to facilitate loan closure.

4.3.6.5 Loan Warehousing

In order to provide comfort to potential investors in mortgage-backed securities that the underlying loans are good investments there should be some track record as to the performance of the loans. Any conduit wishing to buy the loan off an originator also needs some comfort that it is not buying dud-loans. One of the ways this can be achieved is by the originator 'warehousing' all loans for a 'seasoning' period agreed between the conduit and the originator. This means that the originator will have to hold the loans in his book to ensure that all documents of security pertaining to the loan are received and repayments on the loan are made on a regular basis. In South Africa it takes between 4 and 6 weeks to effect transfer of a property into the purchaser's name and register a mortgage bond and a further 8 to 10 weeks before the originator can obtain the security documents (title deeds & bond document) from the deeds registry via the conveyancer's office. Three scenarios can occur during this period that can create hardship for the originator:

• The originator, not being a large bank with sufficient cash, may experience cash flow problems and not be in a position to originate further loans until easing of the cashflow constraint. This is a real problem currently being faced by some of the non-bank lending intermediaries accredited by the NHFC.

• The originator may be faced with pipeline risk. This risk arises as a result of the financial circumstances of the borrower changing for the worse subsequent to the loan being granted and the house being transferred into the borrower's name. If the borrower is unable to
commence repaying the loan in the initial stages, interest on arrear payments accumulate at a rapid rate on the loan as the capital amount on the loan will be at its highest. The value of the collateral (the property bought with the loan) could be dwarfed against the liability (the loan amount being owed). Taking legal action against the borrower is a time-consuming process encompassing the instructing of an attorney to issue summons, obtaining service of the summons on the borrower via a sheriff of the court and obtaining a civil judgement against the borrower. Only subsequent to judgement can the property be sold in a sale-in-execution by which time the amount owed on the property including legal fees can be in excess of 40% of the market value of the property. In order to cut its losses the originator may have to make a quick sale by offering the next purchaser a further discount of the market value thereby incurring further losses.

- There may be a delay in the first repayments being received as a result of the lag in the implementation of debit order instructions or payroll deductions with the employer (see 4.3.6.2 above for an explanation of how the payroll deduction mechanism of repayment works). Monthly salaries in most industries and companies are paid between the 25th and the end of each month. Due to the statutory (taxes) and benefit contributions (retirement/medical aid) to be paid by the employee and employers, the payroll function in the majority of employers is computerised. Employers generally require a lead time of between 30 and 60 days to implement a payroll deduction agreement.

The monies collected from the employees have to then be remitted to the lender either by forwarding a cheque to the lender or depositing the money into the lender's bank account. As explained in the previous paragraph, a two month delay in the initial repayments can cause the debt to escalate substantially. The only way to address such a situation is reschedule the loan term by allowing it to overshoot the agreed original loan term or by increasing the remaining repayments to cater
for non-receipt of the initial repayments. Both these actions can raise the risk profile of the loan as the first solution will increase the cost of the loan whilst the second option could impact on the affordability of the borrower as in many instances the loan offered to the customer is calculated at the maximum repayment the borrower could afford. Obviously any increase in the repayment at this level will render the repayment unaffordable and therefore jeopardise the loan.

4.3.7 Loan Servicing

4.3.7.1 Development of the Industry in South Africa

Prior to the last decade loan servicing or debt collection was performed by the banks who granted the loans or by the retailers such as furniture and clothing retailers who sold goods on credit. In the last decade several debt-collections agencies have been established. These were mainly formed by debt collectors who were previously employed in the banks' debt collection departments teaming up with attorney firms who were involved in legal collections. Generally the banks' and other retailers' collections departments would handle collections that were 30 days to 90 days in arrears.

Where no success has been attained either in terms of getting the customer to resume payments or contacting the customer the files are passed on to debt-collection agencies. The debt collection agencies actively contacted the debtors telephonically or wrote letters couched in legal terminology threatening the consumer with legal action if payment was not received. Tracing agents were used to trace customers who did not respond to telephone calls or written communication. Where contact was made with a customer a mechanism for resumption of payment of the loan was put into place. Obviously a portion of what the collection agencies collected was taken as a fee for their services. Where payments were not forthcoming, legal action was taken against
the debtor resulting in judgements being taken and sales in execution of assets of the debtor.

Other than the banks and debt-collection agencies, microlenders have proliferated the low-to-moderate income market. Microlenders collected on loans on their own behalf. As pointed out previously some of the microlenders used unethical collection methods such as retention of the borrower's ATM card and PIN codes and withdrawals of amounts owed as on as the borrower's salary was deposited into his account. Bigger microlenders like African Bank, the now defunct Unibank used payroll deductions to obtain repayment on their loans.

What can be noted from these various players is that although the banks were the pioneers in lending and collection of debts they have somewhat moved further away from the low-to-moderate income market by relying on technology and technology-driven methods to lend and collect repayments from borrowers. This method of business suits the middle-to-upper income market who are familiar with and have access to first-world technologies such as computers, the Internet, telephones and Automated Teller Machines (ATMs) to carry out electronic transactions on their accounts. The low-to-moderate income market on the other hand are less sophisticated and do not have access to most of the privileges enjoyed by the middle-to-upper income market. Items such as computers would be classed as luxury items in the low-to-moderate income market.

However, cell phones are one of the fastest-growing communication media in every market and financial institutions and other businesses are exploring ways of enhancing the functionalities of cell phones to use as a tool to facilitate financial transactions. The debt collectors and microlenders, on the other hand, have moved closer to the low-to-moderate market and have shown an understanding of the market by devising appropriate methods to ensure repayment of the loans they have granted. However, microlenders have not experimented with long-
term lending which up to now is necessary for housing acquisition. There is no doubt that if they are correctly incentivised to provide long-term housing finance, their collection expertise could be utilised to obtain repayments from the borrowers.

4.3.7.2 Standardisation of Systems and Procedures used in the Servicing of loans

The level of computerisation or automation used in the collection industry mainly evolved with the advent of technology and the experience gained with manual administration where some three decades ago banks in this country used the manual ledger system to administer loans. Customer accounts were opened and transactions recorded manually in a ledger. Since then computers were introduced and initially very basic information such as the main transactions on the accounts were updated. In order to administer the accounts, collect on loans and monitor the performance of the loans the computer systems were enhanced further with Management Information Systems (MIS) to a point were management can determine the profitability or otherwise of each loan or a group of loans.

The banking sector have developed their systems to a point of sophistication to provide various types of Management Information Systems (MIS) and this is one of the reasons why the low-to-moderate income sector was classified as 'high-risk' and less profitable. Banks did not use this information to develop mechanisms to successfully service the low-to-moderate income market. The specific market was measured using the general standard developed for the middle-income market and because the low-to-moderate income sector did not measure up to such a standard the business was branded as 'risky' and 'financially unviable.'

Each bank developed its own systems over a period of time and most of the systems were developed in-house and are known as legacy systems.
Reporting mechanisms were added on the systems in accordance with their individual needs. However, legal, accounting and regulatory requirements such as regulatory requirements of the S.A. Reserve Bank have compelled banks to perform certain basic reporting. A further example is the Usury Act which required the banks to declare to the customer the finance charges and applicable interest rate, the maximum permissible of which is revised on a regular basis. The banks have devised contractual documents spelling out the charges and the clients monthly statements reflects the charges as well as the applicable interest rate being used. Any change in interest rate must be communicated to the customer at least one calendar month in advance. Account statements issued by a bank reflect the interest charge on the outstanding amount calculated at the agreed rate.

The Usury Act also requires that statements of account be despatched to the customer at least once a quarter. The banks, however, despatch account statements on a monthly basis. In some instances banks have also gone a step further where the computer has been programmed to issue reminder letters where a payment is overdue and follow-up letters of demand where no response has been elicited by the reminder letter. The most recent collection system innovation is a link-up of arrear accounts to automated outward dialling telephone system which dials the borrower's telephone number and as soon as a connection is made a collection officer is alerted and is able to talk to the borrower regarding the non-receipt of payment. Sending SMS messages to borrowers on their cell phones is currently being experimented on.

It is therefore evident that banks have sufficiently enhanced their computer systems to fully or partially automate some of these requirements and to a certain extent the collection systems and procedures are standardised. Consequently, absolute standardisation in terms of investor requirements as required by the issuer / securitisation conduit should not be difficult to achieve between the banks themselves. It would accordingly be easy to appoint a bank as back-up
servicor in the event that an appointed servicor is unable to fulfil its loan-servicing mandate.

With regard to the micro-lending fraternity the situation in terms of systems and procedures is more informal than formal. The larger microlenders such as African Bank and the erstwhile Unibank had proper documented systems and procedures as these were in any event registered banking institutions that were subject to the same rules and regulations as the other registered banks. The non-bank microlenders on the other hand were, prior to the establishment of the Micro Finance Regulatory Council, not regulated by any statutory body. Again these were mainly either Non-Governmental Organisations (NGO's), Section 21 (not-for-profit) Companies and other entrepreneurial ventures started by one or a few individuals. These institutions could not afford sophisticated and expensive computer systems due to capital constraints. Where any computer programs were used, these were mainly basic excel spreadsheets with the bare necessary information of the borrower and loan. Procedures and policies were not documented but were held in the heads of the owners or management. As these microlenders businesses grow so do they acquire incrementally sophisticated computer systems.

In order to achieve standardisation among microlenders who are accredited to service housing loans it would be necessary for a computer bureau service provider to provide the computer systems with the required functionality for administration and reporting on the loan whilst the microlenders are contracted to perform the collection function. If a servicor is unable to perform the collection function in accordance with agreed standards, it would merely require that the servicor be changed whilst the database on which the loans are administered remains intact.
4.3.7.3 Loss Mitigation and Loan Workouts

Loss mitigation refers to the minimization or prevention of loss should a loan become delinquent through non-payment. Loan workout pertains to the 'working out' of a loan from a delinquency situation back to a normally performing loan, free of arrears. Loss mitigation can occur if speedy action is taken by the servicing institution to identify the cause of delinquency in the early stages before the debt, due to the accumulation of arrear interest, exceeds the equity in the property. Should the borrower be unable to make further payments he / she is encouraged to sell the property on the open market at the market value, settle the outstanding amount with the lending institution and retain any profit realised from the sale.

Loan workout on the other hand, requires that a suitable arrangement be made between the borrower and the lender for the arrears to be paid of either by rescheduling the loan or obtaining assistance from family. The borrower may have to either step-up repayment over an agreed period until the arrears have been paid-up or the lender extends the term of the loan to accommodate any financial hardships the borrower may be experiencing. In other instances the borrower could be encouraged to obtain assistance from his relatives and friends to settle the arrear amounts or may be further encouraged to let some portion of the house on rent in order to derive income which will assist in the repayment of the loan.

The banks involved in mortgage lending in South Africa do encourage the rescheduling of loans where agreements are reached with defaulting borrowers to pay of arrear repayments over an extended period of time but have not actively promoted other mechanisms of loan workouts or loss mitigation. Both these approaches require close interaction with and guidance of the borrower and are therefore labour-intensive. It also requires that action be taken in the early stages of delinquency in order
for the intervention to be effective. Such actions being labour-intensive would raise the operational costs of the bank.

Utilisation of such loan-regularization methodologies would go a long way towards creating an environment which is conducive for future lending in the low-to-moderate income market as opposed to foreclosing on the loan, obtaining judgement on the client and thereby blemishing the client's credit record.

4.3.7.4 Buying-in and Administration of Properties-in-Possession (PIPS)

Irrespective of the amount of loss mitigation and rescheduling of loans there will inevitably be borrowers against whom legal action must be taken for non-payment of loans. Subsequent to judgement being taken against the defaulting borrower, the property that served as collateral is normally auctioned off at a public auction by the sheriff of the court. The bank in its quest to minimise its losses will decide on a strike price at which it will let the house be bought at the auction. It is normally not the intention of the bank to buy the house unless of course the strike price has not been attained in which case the bank will be the final bidder and buy the house. Once the property is bought the borrower / occupant has to be evicted and the property becomes the asset of the bank. The bank has to then find a suitable buyer for the property and sell it as soon as possible. The speed with which this is achieved is critical as the banks have suffered losses through vandalism of the properties especially in the townships. There were instances reported where houses were completely pulled down commencing with the interior to the windows, doors, roof and finally the bricks from the walls. This is not surprising in the South African context considering the number of people without houses and the proliferation of informal housing (squatter camps). Many of the people living in such informal settlements are unemployed and there is
consequently a large demand for cheap hardware to erect the informal structures.

Banks have also reported that people being evicted sometimes wilfully damaged the property in retaliation. Banks have to appoint security companies at great expense to guard vacated properties twenty four hours day. Besides, the longer the property remains in the bank’s books, the greater the maintenance expenses incurred. If the area in which the house was bought is not an area where demand is high (this could be for reasons such as a high rate of crime, being far away from proper facilities such as shops, hospitals schools etc.) the bank could be saddled with the property for an indefinite period.

The bigger banks in South Africa are experienced in the entire process of taking legal action against defaulting borrowers, obtaining judgement, buying the properties at a ‘Sale-in Execution’ and holding them on their books until a new purchaser is found. The only problem for the issuer / conduit is how to sufficiently incentivise a servicer to perform this function as efficiently as possible. The issuer has to be close to the entire loss mitigation process, Sale-in-execution and PIP management process to ensure that the loss incurred is minimised substantially or this aspect of the business could become a nightmare for the issuer.

4.3.7.5 Loan Performance Monitoring and Investor Reporting

Performance of individual loans as well as loan portfolios have to be closely monitored and reported-on on a regular basis in order to keep the investors fully informed of the performance of their investments. With the volume of loans involved and the kind of sophistication involved in gauging the performance of the loans various ratios and trends have to be determined. Such reporting assists in identifying non-performing loans, reasons for non-payment, taking corrective action where loans are not performing, if there are common denominators in
non-performing loans to pinpoint such common denominators and identify trends in loan performance. Such reporting helps in proper risk management, proper pricing and taking speedy action against non-performing loans. It will also assist the issuer in determining when to limit the intake of a specific category of loans for instance if a certain industry is experiencing a downturn resulting in layoff of employees in that industry it is a sign that loans in that industry should be limited until such time the industry has improved.

The South African Banks have learnt the benefits of data-mining from their counterparts abroad and are employing the technology to monitor loans. Some of them have partnered with foreign companies who have expertise in this field e.g. Nedcor has partnered with Capital One, a company that has used data mining to great advantage in the US. Specific computer programmes are available to extract the information from the banks database and write the necessary reports. The investor community has to specify the type of reporting required and technology could be developed to perform such reporting.

4.4 CONCLUSION

South Africa has a first-world banking infrastructure comparable with that of any of the developed nations. The infrastructure is not adequately geared to serve the third-world component of the population. The micro-lending industry, on the other hand, have the reach and expertise to serve the low-to-moderate income market. The microlending sector does not have the necessary capital or technology to service the market adequately. In order to create a proper Primary Market there has to be a melting pot where the banking sector teams up with the microlenders, each sector bringing its expertise to the table to make the market work. With proper rules, standardisation and incentives a robust primary market could be created.

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CHAPTER 5

CAPITAL MARKET PREPAREDNESS AND APPETITE FOR MORTGAGE-BACKED SECURITIES

5.1 INTRODUCTION

This chapter explores the status of capital market in South Africa in terms of its ability to handle securitisation transaction, the appetite of institutional investors such as life insurance companies and pension funds and fund managers to invest in securitisation issues.

5.1.1 The Bond Exchange of South Africa (BESA) – An Exchange to facilitate the Issue of Mortgage Backed Securities

The Bond Exchange of South Africa (BESA) started off as the Bond Traders Association in June 1989 (Bond Exchange of S A, 2003:5). It became licensed as a bond exchange in May 1996. It is an independent financial exchange operating under annual licence granted by the Financial Services Board (FSB) which is the country’s securities market regulator. The FSB is responsible for regulating the debt securities market in South Africa. The FSB is a statutory body governed by the Financial Markets Control Act No. 55 of 1989 (Bond Exchange of South Africa, 2003: 2).

According to the profile of BESA it has 57 members made up as follows:

Primary Dealer Banks 10

Page 130
<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
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<tr>
<td>Other Banks</td>
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<tr>
<td>Securities Trading Houses</td>
<td>29</td>
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<tr>
<td>Broking and Matched Principal Houses</td>
<td>5</td>
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<tr>
<td>Bond Issuers</td>
<td>6</td>
</tr>
<tr>
<td>Asset Managers (Life Officers Association)</td>
<td>4</td>
</tr>
<tr>
<td>South African Reserve Bank</td>
<td>1</td>
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The licensing authority for the members of BESA is BESA itself whilst the licensing authority for the traders on the bond market is BESA in conjunction with the SA Institute of Financial Markets. BESA allows membership by foreign entities provided that such entities are corporate entities registered under South African law, and have local presence for trading, settlement and compliance (Bond Exchange of South Africa, 2003:3).

In 1993 a central securities depository, Central Depository Ltd, was formed for the immobilisation of securities. In 1994 a clearing house named Universal Exchange Corporation Ltd (UNEXcor) was established to facilitate the clearing and settlement process. UNEXcor provides clients with up-to-date on-line information on deals taking place on a daily basis. The introduction of this technology did away the need to have open-outcry trading on floor of BESA. Trading in bonds is now conducted either telephonically or electronically. The settlement process is managed by four major clearing banks using trade data reported to UNEXcor. Funds and scrip on behalf of all market participants are settled in this way (Bond Exchange of South Africa, 2003:5).

### 5.1.1.1 Protection for Investors

BESA has appointed a Listings Advisory Technical Committee (Listech) to provide on-going advice on the exchange’s disclosure requirements and rules in order to keep abreast with international requirements, rules and best practices. This is to ensure that the rules
of the exchange contribute to strengthening of investor protection and market confidence (Bond Exchange of South Africa, 2003:10).

Some of the other control mechanisms are:

- **Regulation** — BESA and its members must adhere to the financial Markets Control Act and a set of approved rules. BESA undertakes ongoing surveillance over all aspects of the bond market activity in S.A.

- **Price Discovery** — Trading takes place either telephonically or inter-dealer broker screens and the transactions are executed in an open and competitive securities market.

- **Ethics and Dispute Resolution** — All members of BESA must adhere to a prescribed code of conduct regarding their trading in bonds and the advertising of their services. Trading dispute between members and clients must be reported to the Exchange. There are mediation and arbitration mechanisms to resolve disputes.

- **Minimum Admission Standards** — Entities applying for membership of BESA must be incorporated in South Africa and must meet minimum capital and fiduciary requirements. Registered officers of these entities as well as trading staff must comply with prescribed examinations, ethical and work experience requirements prior to being authorised to trade.

- **Capital Adequacy Requirements** — Member firms are required to maintain a minimum level of unimpaired capital to support their trading activity. The standards are based on those of the European Union (EU) and require members to make specific provision for counterparty, large exposure and position risks involved in bond trading.
• Fidelity Cover — Although few members handle the cash and scrip of clients, all member firms must hold fidelity cover to cater for possible fraud or misappropriation. The independent auditors of the member firms must report annually to the Exchange on the adequacy of the fidelity cover.

• Immobilisation and Screening of Securities — Investors are assured that the listed debt securities they invest in have been screened by the Financial Services Board (FSB). All new listings must be immobilised in the Central Depository to prevent the possibility of tainted scrip being transferred. Settlement takes place electronically on a daily basis.

• Guarantee Fund — The Exchange maintains a Guarantee Fund to ensure, as far as possible, the performance of transactions entered into on the Exchange. The Fund provides members and clients with price-risk cover against member default, to a maximum aggregate value of R190 million. However, since inception there has not been a need to call on the fund (Bond Exchange of South Africa, 2003:16-17).

5.1.2 Debt Instruments traded on BESA

As at 31 March 2003 there 272 bonds on the market issued by 43 borrowers with a total nominal value of R442 billion. The main issuer of debt is the South African Government which has issued 60% of the above debt. The balance (40%) is shared among local government, public enterprises and major corporates. Some of the well-known listed corporates that have issued debt are Telkom S.A. Ltd, ISCOR, ABSA Bank, Investec Bank Ltd, The Standard Bank of South Africa Ltd, SASOL Financing and INCA (a corporate financier) (Bond Exchange of South Africa, 2003:10).
The following pie chart reflects the breakdown of the debt issued among the various sectors:

Figure 5.1: A Pie-graph of debt issue on BESA  (Bond Exchange of South Africa, 2003:10)

From Figure 5.1 above it is clear that the Central government is the largest issuer of Debt (60%), followed by Public Enterprises and Securitisation transaction holding 11% each. The volume and take-up of debt issued by public enterprises is understandable in that these entities are parastatals, the majority being wholly-owned by Government and therefore their paper is guaranteed by the Central Government even if not explicitly stated, the government being the main shareholder would have to stand good for any loss incurred by these entities. It is only recently (May 2003) that Telkom has partially privatised. The other main public enterprises that are still wholly owned by Government are ESKOM (the electricity utility), Transnet (the transport utility) and the Development Bank of South Africa.
(DBSA) which is a development finance institution. What is significant for the purposes of this study is the 11% securitisation debt issued.

Considering that parastatals commenced issuing debt in 1980s (ESKOM was the first parastatal to issue debt securities in the 1980s) and the first mortgage-backed securities issued only in 2001, the growth in and acceptability of securitisation paper evidences a phenomenal growth.

On the Mortgage-Backed Securities, S A Home Loans (Pty) Ltd has placed two issues over the last three years – the first being for R1,15 billion in 2001 with a follow-up issue of R1,1 billion in 2003. These issues were publicly placed and are traded on BESA. It must be pointed out that S A Home Loans originates mortgage bonds in the affluent end of the market catering for home loans in excess of R300 000. The securitisation issue was arranged by Standard Corporate and Merchant Bank (Stockley, 2003).

According to Bagley (2003) of Fitch Ratings, a local office of an international rating agency, the demand for securitisation paper is on the increase as government is repaying its debts and not issuing many new bonds as in the past. As capital and interest payments on the bonds are being paid to the investors, Institutional investors such as Insurance companies and Fund managers end up with surplus cash which has to be invested in alternative investments. Corporate bond issues are few and far between hence there is a trend in supporting securitisation issues. More recently a R1 billion issue was oversubscribed by four times (Bagley, 2003).

In terms of an article on page 4 of Business Report dated August 12, 2003, “In terms of current assets the formal listed market is estimated to be worth R20 billion. Last year alone assets worth about R19,5 billion were securitised compared with R1,8 billion in the previous two years” (Von Lieres, 2003).
It is clear from the above that there is a world-class bond exchange which is regulated by the Financial Services Board. It has strict criteria for issuers, dealers as well as investors and therefore affords the necessary protection to investors. It is also evident that there is a demand for securitised investments. However, securitising of mortgage-backed securities in the low-to-moderate income sector requires government intervention either by the latter providing some kind of implicit guarantee to the issuer as in the cases of Fannie Mae and Freddie Mac of the USA or actually investing in the SPVs, thereby sharing the risk with the other investors. Such action by the government will lend credibility to the transaction, which will then result in the issue obtaining a better rating thereby attracting more investors whilst at the same time being able to place the issue on the market at fine rates. This will in turn benefit the end user who will be able to access loans at lower rates of interest. Should this be the case it gives the paper being issued more credibility and if the sovereign risk of the country is acceptable it will attract foreign investors and therefore make available sufficient funding to create housing opportunities for the low-to-moderate income sector.
CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 INTRODUCTION

In this chapter conclusions will be drawn as to the readiness of the South African economy, which includes the capital market (wholesale funds) as well as the primary market (retail financial services market) to embrace Securitisation as a financing mechanism to alleviate the housing shortage in the low-to-moderate income sector. Recommendations will be made to address any potential problems that may need addressing in order to make the environment conducive. Other options to finance housing acquisition will also be explored.

6.2 NARROWING OF THE CREDIT GAP – THE UNAVAILABILITY OF SUITABLE FINANCE FOR HOUSES BETWEEN R20 000 AND R60 000.

One of the objectives of the research was to motivate a narrowing of the Credit Gap i.e. the unavailability of suitable finance for houses between R20 000 and R60 000.
6.2.1 Conclusion

Traditional mortgage loans are not suitable for the whole low-to-moderate income sector, especially if potential borrowers are self-employed with unstable incomes (paragraphs 1.1.2 and 3.5.2.4) or earning salaries that are low.

The formal banking sector is not adequately represented physically (by points of representation or branch networks) close to the low-to-moderate income sector due to the risky nature of the market and regulatory requirements arising from their holding public deposits (paragraph 1.1.2). Microlenders on the other hand, although community based, are unable to advance large sums of money required to build houses over long loan terms as these institutions are constrained by capital availability as they are not licensed to accept deposits from the public (paragraph 4.3.3).

As long as the above circumstances prevail the availability of credit for housing purposes to the low-to-moderate income market will be problematic.

6.2.2. Recommendation

6.2.2.1 Segmentation of the low-to-moderate income market and provision of proper products.

The low-to-moderate income sector should be segmented in terms of income levels. Persons earning less than R3000 per month should rather be provided with incremental housing loans. Such borrowers could borrow small amounts of money over short repayment periods, e.g. 24 to 36 months, to make improvements to the property on an incremental basis. Once the loan has been repaid in full the client should be able to access a further amount on similar repayment terms and so on.
Mortgage loans should only be available to persons earning a salary of R3000 per month and above.

6.2.2.2 Allocation of Subsidies and linking of Subsidy to Savings and Credit

Subsidy allocations should also include persons earning above R3500 to incentivise them to acquire housing and repay loans obtained for this purpose. Subsidy should be linked to savings and credit on a contractual basis. Should a person intend acquiring a house he / she should be required to sign a contract with a bank to save a certain amount of money over a stipulated period of time, say six months, with the promise that a certain subsidy amount will be available at the time the targeted savings has been achieved. Furthermore, based on the amount saved, a certain amount of credit will be made available to the borrower in order to acquire / build a house. This will encourage people to save and will distribute subsidy and housing finance in a more structured manner.

6.2.2.3 Create an environment to facilitate the acceptance of deposits by Microlenders

Microlenders are currently prohibited from accepting deposits as they are not registered under the Banks Act, 1990. Registering as a bank is financially prohibitive as the initial capital requirement is R250 million.

Special regulations should be formulated to enable microlenders to accept small deposits specifically from the low-to-moderate income sector and Small and Medium businesses operating in such markets. The conditions of license to operate as a bank with special exemptions would restrict such banks to provide essential financial services specifically required by the low-to-moderate income sector e.g. savings and other term deposits from individuals and small businesses and the
provision of payments systems (debit order facilities). Volatile businesses such as foreign exchange and share-dealing transactions should not be allowed as such business activities could place the microlender and hence depositors' funds under risk.

The state will however have to introduce deposit insurance to protect depositors against loss of their savings in the event that the bank fails.

The creation of such a banking sector will benefit both the consumers and the bank itself. The low-to-moderate income sector will have access to a full range of financial services on the one hand whilst the banks will have depositors' funds with which to advance loans to the same sector.

6.3 THE CREATION OF AN ENVIRONMENT WHERE HOLDERS OF CAPITAL WILL BE COMFORTABLE IN INVESTING IN HOUSING FINANCE AND BORROWERS WILL BE WILLING AND ABLE TO REPAY LOANS FOR HOUSING NEEDS

The second objective of this study is to motivate the creation of an environment where holders of capital will be comfortable in investing in housing finance and where borrowers will be willing and able to repay loans obtained for housing needs.

6.3.1 Conclusions

The traditional mortgage delivery system currently practised in South Africa is unsuitable for the low-to-moderate income sector (paragraph 2.3) as all risks associated with the loan are carried by the institution making the loan. A more appropriate model is the 'Unbundled Model' depicted in Figure 2.2 (paragraph 2.3) that breaks down the loan granting and servicing into various specialised functions in order to
diversify the risk as well as create economies of scale and hence a reduction in costs for the ultimate borrower of the home loan. The mechanism is called Securitisation and is being successfully implemented in the United States and other countries have also followed suite.

The Secondary (Capital) Market in South Africa has an appetite for investing in Securitisation transactions (paragraph 5.1.2). There is an adequately regulated Bond Exchange (paragraphs 5.1 and 5.1.1) to facilitate securitisation transactions and at the same time to protect investors. There are brokers, analysts and rating agencies in the country each of whom have a specific and important role in securitisation transactions.

As far as the Primary Market is concerned, sufficient legal, tax and regulatory framework exist to support securitisation (paragraph 4.2). In terms of the macroeconomic environment, the South African economy is well managed for a developing country (paragraph 4.3.1). High unemployment and HIV/AIDS however threaten the economy. Albeit at a slower pace, both Government and business are addressing these issues and as long as concrete steps are being taken the problem will eventually be addressed.

As far the network and quality of Primary Market Lenders is concerned the banks have the necessary technology to support the origination, underwriting and servicing procedures whilst they lack the soft skills of human interaction with the low-to-moderate income market. On the other hand the microlenders do not have the sophisticated infrastructure and know-how to deal with mortgage loans but are good at marketing and sourcing the loans as well as collecting monies from the borrowers as they are located close to the borrowers and interact closely with the latter to ensure repayment of loans (paragraphs 4.3.3 and 4.3.7). Due to cash constraints microlenders would not be able to fund, close and warehouse mortgage loans (paragraphs 4.3.6.4 and 4.3.6.5).
The banks have the necessary experience and systems to take legal action against borrowers for non-payment of loans, the buying-in and management of Properties-in-Possession (PIPs) (paragraph 4.3.7.4) and to perform investor reporting (paragraph 4.3.7.5).

The microlending sector has however distorted the market in the underwriting department by not performing a proper analysis of a borrower’s willingness to pay as methods such as ‘payday lending’ and payroll deduction gave them preference over the borrower’s salary (paragraph 4.3.6.2). These mechanisms have taken away the responsibility to pay, and hence their dignity, from the borrowers as payment is more by coercion than by borrowers taking responsibility for the repayment of their loans and services. In such circumstances a lender is unable to predict the future trends of customer behaviour which is essential in decisions to grant loans or not.

6.3.2 Recommendations

6.3.2.1 Risk Sharing between Government and the Private Sector

The private sector banks have indicated on various occasions that they are prepared to enter into partnership schemes with the Government provided there is some sort of risk-sharing agreement. Where Government could play a role is perhaps the acceptance of political risk - the risk of the law not taking its course (i.e. resistance to evictions) in case of non-payment of loans. Government should also be able to absorb the risk of non-payment of loans arising from rampant crime or the failure to deliver basic services such as water, sanitation and electricity. Commercial risk, the risk of non-payment through bad lending practices or loss of jobs, should be absorbed by the banking sector. Such allocation of risks will force both parties to be diligent in their responsibilities arising from the arrangement.
Securitisation Special Purpose Vehicles should be created on this basis and provide investors with comfort that their funds are partially guaranteed by the Government. After all, the Fannie Maes and the Ginnie Maes were created and supported by the United States Government to facilitate securitisation and the bonds issued by these institutions are sought after as good investments by the investing public. The fine rates at which these bonds trade result in the low-to-moderate income borrowers being able to access credit at competitive rates.

6.3.2.2 Collaboration between banks and the microlenders

Banks and microlenders should collaborate to address their respective shortcomings i.e. the banking sector's lack of reach of the low-to-moderate income market and microlending sector's cash constraints and lack of operational capabilities. Banks could perhaps supply microlenders with funding at reasonable rates to originate and close loans on their behalf and provide the necessary loan servicing back-up whilst microlenders can source the borrowers, originate loans and provide collection services.

6.3.2.3 Prohibition of 'payday lending', retention of ATM Cards and PIN by microlenders

The thirty-day loan or 'payday lending' is a scourge to consumers in the low-to-moderate sector as it is a never-ending revolving loan payable in full together with exorbitant interest charges at the end of each month whilst simultaneously a further loan is made available to the borrower for the full capital amount. Borrowers are perpetually indebted to the microlender as they are not encouraged to pay the capital off in small instalments. The authorities should legislate against such practices to ensure that the capital gets paid off in instalments. Although the Micro Finance Regulatory Council (MFRC) follows-up on members retaining ATM cards and PIN numbers and
prosecutes offenders, laws should be implemented making the practice a crime. Stiff penalties, including jail sentences should be introduced to deter the practice.

6.3.2.4 Limiting payroll deduction to statutory deductions and housing loan repayments in the short-to-medium term but phasing out home loan deductions in the long term

Statutory deductions such as tax, pension / retirement and medical aid payments have always been deducted from employees' payrolls as the employer is compelled to pay these over to the relevant parties. This arrangement should remain. As for other deductions such as insurance premiums and loan repayments these should be prohibited except for housing loan repayments which should be allowed for a limited period, say for the next three years. This is because a window period is needed in order to ensure that repayments are more certain and regular in order to give investors in the secondary market comfort that their investments are performing and therefore reasonably safe. Over the long term all institutions selling financial services should compete on a level playing field for repayments using other available avenues such as debit orders on bank accounts and cash / cheque payments. This action will compel financial service providers and other credit grantors to perform a proper analysis of the borrower's financial circumstances before granting him / her credit.

6.3.2.5 Credit Bureaux and the types of non-payment that can be listed on the credit bureaux should be regulated.

Before listing a debtor on the credit bureaux certain mandatory steps should be taken by the credit grantor to ensure recovery of monies owed by the debtor. These steps should be determined by a panel consisting of the credit grantors, the consumers and the authorities. Taking judgement against borrowers should also be made stringent. Issues such as whether non-payment as a result of retrenchment should
be allowed as a reason for obtaining judgement should be considered. Can a debtor perhaps advance any other assets in settlement of the debt without going to judgement? If an affected party repays outstanding debt in full within the period of five years, is it fair or ethical that he/she should still remain listed on the credit bureau as a judgement debtor for the entire five-year period? These are matters that should be debated and ruled-on so that judgements are allowed in extreme and wilful cases of default only.

An easier method of rescinding judgements should be available to debtors rather than the long and expensive route of applying to the courts using legal council as consumers in the low-to-moderate income market cannot afford the costs involved. This may be achieved through the creation of an ombudsman similar to that which is available in the banking and insurance industries.

All credit bureaux should have the same information and a consumer should be able to access any bureau to establish his credit record and to challenge any information he believes is incorrect.

6.3.2.6 Regulating the amount of credit granted to the low-to-moderate income sector

The Micro Finance Regulatory Council (MFRC) has established a National Loans Register where all consumer loans granted by the registered microlenders have to be updated. Prior to making a loan to a borrower the microlender is to access the NLR to establish the debtor's indebtedness in order to prevent the debtor from being over-committed. Once credit has been granted the details of such credit and the date of grant must be updated on the NLR.

Accessing this database and updating it in respect of all credit granted to the low-to-moderate income sector, irrespective of whether it is for
loans or the purchase of items such as clothing and furniture, should be mandatory especially for the low-to-moderate income sector.

6.4 THE COMING TOGETHER OF ALL STAKEHOLDERS WITHIN THE LOW-TO-MODERATE INCOME HOUSING SECTOR WITH A VIEW TO JOINTLY ADDRESSING THE HOUSING SHORTAGE

The final objective of this research is to encourage the coming together of all stakeholders in the low-to-moderate income sector in order to jointly address the housing shortage.

6.4.1 Conclusion

The institutions set up by the government appear to be working in isolation of the other stakeholders. Besides working closely in Servcon, which was a joint initiative between the National Housing Department and the then Association of Mortgage Lenders, which represented the banks, no other government housing institution has been credited with making meaningful inroads into the low cost housing sector (paragraph 3.5.3 paragraph 3.7, paragraph 3.8.2.1 and paragraph 3.8.3).

6.4.2 Recommendation

6.4.2.1 Coming together of Housing Industry Stakeholders

There are numerous stakeholders that can make meaningful contributions to address the housing shortage in this country. Besides the banks, the microlenders and the government institutions mentioned in this research, there is the building industry that is accused of poor quality building standards (hence the establishment of the NHBRC —
paragraph 3.5), the hardware industry that makes available building materials, the estate agents, the engineers and town planners, other government ministries such as Trade and Industry, Health and Welfare, Local Government and the list can go on.

New housing developments must take place on a well-planned basis for sustainability. There should be good infrastructure, safety and security, reasonably priced good quality homes close to places of employment and sufficient amenities such as shops, schools, hospitals and community centres. Working in collaboration on a project-by-project basis will result in the creation of sustainable communities which will in turn be able to pay for loans and services. The scene for such a collaborative effort has been set by events such as the collapse of large companies such as US oil giant Enron and others and especially in South Africa, the adoption of the King II Code on Corporate Governance. The latter requires that companies measure their performance in terms of the 'triple bottom line' which embraces profitability, a sustainable environment and social responsibility. Companies worldwide have come to realise that sustainability requires attention to all these aspects and if they do not, they are doomed to failure.
CHAPTER 7

RESEARCH METHODOLOGY

7.1 INTRODUCTION

In Chapter 1 the motive and the objectives of the research study were formulated. In Chapter 7 the research design and method of this study will be described.

7.2 METHODOLOGY USED IN THIS STUDY

The methodology used in this study is a combination of exploratory study which involves mainly the gathering of information from existing available literature, case study and observation. This method was adopted since the topic being discussed (mortgaged-backed securitisation) is a model that has been successfully developed and implemented in the United States of America but is a fairly new concept in South Africa while the origination, funding and servicing of mortgage bonds is a practice that has been in use for some time in the home loans industry in South Africa. The aim is to establish whether the model / concept could be successfully replicated in South Africa in order to make housing finance available to the low-to-moderate income sector.
7.2.1 Explorative research

The concept 'explore' implies scrutinising unknown areas for the purpose of discovery (Woods & Cantazaro, 1988:150). Exploratory studies tend toward loose structures with the objective of discovering future research tasks. The immediate purpose of exploration is usually to develop hypothesis or questions for further research (Cooper & Emory, 1995:115).

This study is exploratory as it is being conducted to gain insight and understanding of the factors related to implementing the concept of Securitisation in the low-to-moderate income housing finance market in South Africa.

7.2.2 Case study methodology

Case study research consists of a detailed investigation, often with data collected over a period of time, of one or more organisations, or groups within organisations, with a view to providing an analysis of the context and processes involved in the phenomenon under study. The phenomenon is not isolated from its context (as in, say, laboratory research) but is of interest precisely because it is in relation to its context (Hartley, 1994:208).

Yin (1981:58) indicates that the case study does not imply the use of a particular type of evidence. Case studies can be done by using either qualitative or quantitative evidence. The evidence may come from fieldwork, archival records, verbal report observations, or any combination of these. An example of an organisational case study that combines qualitative and quantitative evidence is the research of Gross et al., (1971:58), in other examples, case studies have even relied solely on quantitative data, as in studies of the economic development of urban areas (Vietorisz & Harrison, 1970:58).
Yin (1981:59) further argues that the case study does not imply the use of a particular data collection method. A common misconception is that case studies are solely result of ethnographies or of participant-observation, yet it should be quickly evident that numerous case studies have been done without using these methods (Allison, 1971:59). Conversely, using these methods does not always lead to the production of case studies (e.g. the ethnographic and observation research on police behaviour (Reiss, 1971; Rubenstein, 1973; and Van Maanen, 1979), none of which had been designed as case studies.

What the case study does represent however, is a research to be likened to an experiment, a history, or a simulation, which may be considered alternative research strategies. None of these other strategies is linked to a particular type of evidence or method of data collection either (Yin, 1981:59). Citing two contrasting examples, there are some experiments – e.g. in biology and neuroanatomy – that use qualitative evidence and for which statistical analysis is irrelevant; in the same breath, the field of history has been increasing its use of quantitative indicators (Furet, 1971:59).

As a research strategy, the distinguishing characteristic of the case study is that it attempts to examine:

- a contemporary phenomenon in its real-life context, especially when
- the boundaries between phenomenon and context are not clearly evident.

Experiments differ from this in that they deliberately divorce a phenomenon in its context. Histories differ in that they are limited to the phenomenon of the past, where relevant informants may be available for interview and relevant events unavailable for direct observation (Yin, 1981:59).

These distinctions among type of evidence, data collection method, and research strategy are critical in defining case studies. Related
clarifications also need to be discussed but can only be enumerated thus:

- The different types of case studies that are possible (exploratory, descriptive, and explanatory),

- the types of research questions best addressed by case studies as opposed to other research strategies (explanations rather than incidence questions); and

- the types of case study designs – all must cope with the essential problem that, because the context is part of the study, there will always be too many 'variables' for the number of observations to be made, thus making standard experimental and survey designs irrelevant (Yin, 1981:59).

A case study therefore, while often including qualitative methods, cannot be defined through its techniques. Rather, it has to be defined in terms of its theoretical orientation. This is not necessarily substantive theory but rather the emphasis on understanding processes alongside their (organisational and other) context (Hartley, 1994:210).

The value of theory is key. Although case studies may begin with (in some situations) only rudimentary theory or a primitive framework, they need to develop theoretical frameworks by the end which inform and enrich the data and provide not only a sense of uniqueness of the case but also what is of more general relevance and interest (Hartley, 1994:210).

In some situations, grounded theory may lead to emergent theory, while in other situations the researchers may have some clear propositions to explore. Either way, without a theoretical framework, a case study may produce fascinating details about life in a particular organisation but without any wider significance. However, a case study without the
discipline of theory can easily generate into a ‘story’ (Hartley, 1994:210).

Case studies place more emphasis on a full contextual analysis of fewer events or conditions and their interrelations. Although hypotheses are often used, the reliance on qualitative data makes support or rejection more difficult. An emphasis on details provides valuable insight for problem solving, evaluation, and strategy. This detail is secured from multiple sources of information. It allows evidence to be verified and avoids missing data (Cooper & Emory, 1995:116).

Although case studies have been maligned as ‘scientifically worthless’ because they do not meet minimal design requirements for comparison (Kerlinger, 1986:295), they nonetheless have a significant scientific role. It has been observed that important scientific propositions have the form of universals, and a universal can be falsified by a single counter-instance (Kaplan, 1964:37). Thus a single well-designed case study can provide a major challenge to a theory and provide a source of new hypotheses and constructs simultaneously (Cooper & Emory, 1995:117).

7.2.3 Data Collection

In order to provide an analysis of the context and process involved in the concept under study and to maintain the discipline of theory:

7.2.3.1 Literature Search

A literature search was carried out with a view to developing a model relevant to the South African situation;
7.2.3.2 Secondary Data

Secondary data was sourced from relevant reports, newspaper articles and journals.

7.2.4 Aural interviews with experts in the field of Securitisation and Housing Finance

In order to substantiate the theory behind the concept of securitisation, unstructured aural interviews with experts in the housing finance industry and securitisation industry were conducted in order to obtain their expert opinions on the matters relevant to this study. The context of the interviews are fully captured in the relevant sections of the text of this study.

7.2.5 Observation of procedures of Housing Finance Institutions

Observations were also undertaken in operations of local housing loan finance institutions in order to understand how the loan origination and servicing processes worked.

7.2.5.1 Observation

Participant observation is where the researcher attempts to participate fully in the lives and activities of the subject and thus becomes a member of their group, organisation or community. This enables the researcher to share their experiences by not merely observing what is happening but also feeling it (Gill & Johnson, 1991:109).

Participant observation has its roots in social anthropology, but it was the Chicago school of social research that encouraged its students to study by observation the constantly changing social phenomena of Chicago in the 1920s and 1930s (Saunders et al., 1988:187).
Participant observation has been used much less in management and business research. However, this does not mean to say that it has a limited value for management and business researchers. Indeed, it can be a very valuable tool, usually as the principal research method, but possibly in combination with other methods (Saunders et al., 1988:187).

7.3. CONCLUSION

To reiterate, securitisation is a concept that has been perfected in the United States and in South Africa it is in its embryonic stages. Mortgage-backed securitisation has not been attempted in the low-to-moderate income sector. The exploratory, case study and observation methods had to be used to establish whether the environment was suitable for the model to be workable in low-to-moderate income sector.


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BILL

To provide for the meeting of specific minimum targets by financial institutions in lending to low and medium income level households for housing purposes and to provide for matters connected therewith.

PREAMBLE

AND WHEREAS, in terms of section 26(1) and (2) of the Constitution —
(a) everyone has the right to have access to adequate housing; and
(b) the state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of this right;

AND WHEREAS, sections 2(1) and 3(1) of the Home Loan and Mortgage Disclosure Act, 2000 provide that every financial institution must disclose information regarding the completed home loan applications received; loan applications declined, the home loan applications closed and disbursed and the home loan applications that are approved by a financial institution;

AND WHEREAS, there is now a need to ensure that all financial institutions in the business of providing home loans should in addition to disclosing certain information as set out in the Home Loan and Mortgage Disclosure Act, 2000, contribute towards making finance available to the lower end of the home loan market;

AND WHEREAS, it is not the intention of this Act to promote, in any way, unsound business practices among financial institutions in their business of providing home loans;

BE IT THEREFORE ENACTED by the Parliament of the Republic of South Africa, as follows:

Definitions

1. In this Act, unless the context indicates otherwise —

“borrower” means any person who has already applied, is in the process of applying, or is planning to apply to a financial institution for a home loan, whether or not the application is successful;

“business strategy” refers to the document prepared annually by a financial institution and mapping out its plan to meet the specified targets and standards for the current year including the delineation of quarterly indicators and the attainment of quarterly milestones and, where these have not been met for the previous year, detail on how it intends to improve its performance;

“Department” means the Department of Housing;
“disparate impact” refers to the adverse effect on a borrower or household of any attitude, practice or policy of a financial institution (or its representatives) that it cannot reasonably justify on the basis of safe and sound business principles;

“financial institution” means any bank or mutual bank registered as such under the Banks Act, 1990 (Act No. 94 of 1990), or the Mutual Banks Act, 1993 (Act No. 124 of 1993), or any other registered institution whose business is, in full or in part, either the acceptance of deposits from the general public, the advance of credit to persons or both such acceptance and advance, with the security of a registered mortgage bond or any other form of accepted security, for the purpose of providing home loans;

“home” refers to any dwelling unit that complies with NHBRC minimum requirements (including but not limited to, extensions, renovations and improvements) that is being used or is to be used in full or in part for residential purposes;

“home loan” means a loan or advance by a financial institution to a person for purposes of constructing, purchasing, renovating or improving in any way such person’s home, whether owner-occupied or rented out, with the security of a registered mortgage bond or any other form of accepted security;

“low income level” means a monthly household income in a range to be prescribed;

“medium income level” means a monthly household income in a range to be prescribed;

“Minister” means the Minister of Housing;

“NHBRC” means the National Home Builders Registration Council established under section 2 of the Housing Consumers Protection Measures Act, 1998 (Act No. 95 of 1998);

“niche market lender” refers to a financial institution for which more than half of its outstanding rand volume of home loans are to households with low or medium income levels

“Office” means the Office of Disclosure established in terms of the Home Loan and Mortgage Disclosure Act, 2000 (Act No. 63 of 2000);

“red lining” occurs when a financial institution does not offer a home loan to a borrower or household mainly on account of the house to be financed being located in a particular geographical area or neighbourhood.

“standard” refers to the performance, conduct and level of compliance that is prescribed by the Minister to a financial institution in attempting to meet its target;

“target” refers to that proportion of a financial institution’s book that is prescribed by the Minister for disbursement either directly or indirectly to low and medium income level households for housing purposes.

Scope and Application

2. The provisions of this Act shall apply to all financial institutions.
Functions of the Office

3. The Office must:

(a) outline data requirements to be furnished by financial institutions;
(b) collate such data;
(c) verify and authenticate such data if considered necessary;
(d) analyse and evaluate such data;
(e) monitor the progress of financial institutions in meeting their targets in terms of section 4(1)(h) below and intervene where necessary to ensure compliance with the provisions of this Act;
(f) impose punitive measures as prescribed;
(g) provide incentives and rewards as prescribed;
(h) report to the Minister and to the public; and
(i) request and review a business strategy for any financial institution if this is necessary for the Office to properly carry out its functions.

Principles applicable to Community Reinvestment for Housing

4. (1) In attempting to meet the needs of low and medium income households in accessing home loan finance, financial institutions must:

(a) refrain from refusing home loan finance to borrowers purely on the grounds of the current or future expected socio-economic characteristics of the residents in the neighbourhood in which the home is located;
(b) refrain from the practice of redlining other than where dictated by safe and sound business principles;
(c) afford borrowers the necessary dignity, courtesy and honesty when discussing and processing applications for mortgage loans;
(d) communicate transparently and openly with borrowers during all stages of negotiations;
(e) communicate clearly and openly with all borrowers on the outcome of their applications and furnish reasons in writing for rejected applications;
(f) encourage where possible a climate of saving amongst home owners and borrowers and provide meaningful incentives to those who save;
(g) notwithstanding any reasons that are considered acceptable by the Minister, meet or exceed the targets and standards prescribed by the Minister for lending to
households with low and medium income levels; and

(h) if they are unable to meet those targets and standards by lending directly to such end-users, opt for one or any combination of the following:

(i) provide funding through a prescribed wholesale lender at a mutually agreed interest rate for on-lending to niche lenders to provide end user loans;

(ii) purchase such wholesale lenders’ securities and debt issues; and

(iii) provide funding directly to niche market lenders to make available for end user loans.

(2) In attempting to meet the needs of the poor in accessing home loan finance, financial institutions must not:

(a) lend without due regard to a borrower’s repayment ability;

(b) for low-income borrowers, make mortgage loans where the principal amount loaned is greater than the amount needed for housing purposes; and

(c) implement policies that lead to discrimination or have a disparate impact

(3) A financial institution must not, unless reasonably justified by business necessity:

(a) fail to provide information or services regarding the home lending process, including credit availability, application procedures or underwriting standards;

(b) discourage or selectively encourage borrowers;

(c) refuse to extend credit or use different underwriting methods;

(d) vary credit terms, including amount, interest rate, duration or type of home loan;

(e) service a home loan or invoke default remedies differently;

(f) use different standards for pooling or packaging home loans.

Reporting requirements

5 (1) Every financial institution must prepare for the Office an annual report containing information to be prescribed by regulation.

5 (2) Such report must be furnished to the Office within 60 days from the end of the reporting period.

Performance and ratings

6. The Minister must, by regulations, prescribe the following:
6 (1) Targets and standards applicable to financial institutions in respect of community reinvestment for housing.

6 (2) An assessment instrument which includes the following criteria:

(a) Amount of Home Lending to Low or Medium Income Levels
(b) Innovation in Home Lending to Low and Medium Income Levels
(c) Home Lending in Previously Disadvantaged Areas
(d) Lending to Small Building Contractors
(e) Performance with Respect to other aspects of home lending

6 (3) A rating model in order to assess a financial institution's performance in respect of community reinvestment in housing. The model must incorporate the following four categories of performance:

- Outstanding
- Satisfactory
- Unsatisfactory
- Substantial non-compliance

Written Assessment

7. After examination of a financial institution, the Office must prepare a written assessment, as prescribed, of the financial institution's record of meeting housing credit needs, with respect to the targets and standards set by the Minister and using the assessment instrument prescribed according to Section 6(2).

Report to Minister

8. The Office must include in its annual report to the Minister, a section outlining the actions it has taken to carry out its responsibilities in terms of this Act.

Regulations

9. The Minister must, after consultation with the Ministers of Finance, Justice and Trade and Industry, make regulations regarding any matter which —

(a) in terms of this Act is required or permitted to be prescribed; and

(b) is necessary or expedient to prescribe in order to achieve or promote the objectives of this Act.
Exemptions

10. (1) The Minister may exempt a financial institution or a category of financial institutions, from any or all of the requirements of this Act for a specified period of time, if the financial institution or category of financial institutions requires time to adjust systems and procedures in order to comply with the provisions of this Act.

(2) An exemption contemplated in subsection (1) may not exceed one year.

(3) The Minister may also exempt a financial institution or a category of financial institutions, from any or all of the requirements of this Act for a specified period of time, based on the size or period of existence of the institution.

Offences and penalties

11. (1) Any person and/or financial institution who contravenes or fails to comply with any provision set out in sections 4(1), 4(2), 4(3), 5(1) and 5(2) of this Act is guilty of an offence.

(2) A person and/or financial institution convicted of an offence in terms of subsection (1) is liable to a fine not exceeding R500 000,00.

Short title and commencement

12. This Act is called the Community Reinvestment (Housing) Act, and takes effect on a date determined by the President by proclamation in the Gazette.