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**An investigation into over indebtedness in South Africa with  
a focus on the Western Cape Province**

Presented to the

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Master of Commerce (Financial Management)

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## **Abstract**

This study aims to present an analysis of the literature on the nature and causes of over indebtedness by studying all surveys related to over indebtedness among urban South African households with a focus on consumers in the Western Cape in order to answer the research question “who is most likely to be over indebted and what are the main variables that explain this risk” and how does the debt levels in South Africa compare to that of the UK, USA, Australia and Canada.

University Of Cape Town

## **Acknowledgment**

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**A special thank you to my husband John, for his unwavering belief in me and the incredible support he provides me with that enables me to pursue my goals.**

**I certify that it is my own work and all references used are accurately reported in the text.**

## **Terminology and abbreviations used**

<b>NCA</b>	<b>National Credit Act 34 of 2005</b>
<b>NCR</b>	<b>National Credit Regulator</b>
<b>CSLS</b>	<b>Centre for the study of living Standards</b>
<b>CFV</b>	<b>Consumer Financial Vulnerability</b>
<b>HDI</b>	<b>Household Disposable Income</b>
<b>BER</b>	<b>Bureau for Economic Research</b>
<b>SARB</b>	<b>South African Reserve Bank</b>
<b>IFC</b>	<b>Irving Fisher Committee</b>
<b>FNB</b>	<b>First National Bank</b>
<b>ABSA</b>	<b>Amalgamated Banks of South Africa</b>
<b>LTV</b>	<b>Loan-to-Value</b>
<b>UK</b>	<b>United Kingdom</b>
<b>USA</b>	<b>United States of America</b>
<b>SA</b>	<b>South Africa</b>
<b>DSR</b>	<b>Debt Service Ratio</b>
<b>NDMA</b>	<b>National Debt Mediation Association</b>
<b>pa</b>	<b>Per annum</b>

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## 1 CHAPTER 1 – INTRODUCTION

In the introduction household debt will be defined followed by a discussion on the eminent warning signals that serves as proof that consumers are becoming over indebted. The nature and causes of indebtedness, will be briefly discussed in order to answer the research question “who is most likely to be over indebted” and the chapter will conclude with the additional variables that contribute to the risk of becoming over indebted.

### 1.1 Definition of household debt

*Household debt by definition consists of debt incurred by the household sector. Generally debt (including household debt) refers to an obligation or liability arising from borrowing money or taking goods or services “on credit”, i.e. against an obligation to pay later.*<sup>1</sup>

It is important to point out that household debt may contain a component of corporate debt that is not factored into the measurement of household debt. It is not the intention in this study to measure the impact of this component but rather to bring it to the attention of the reader.

The IFC Bulletin<sup>2</sup> (July 2007) highlighted the fact that it should be kept in mind that the household sector’s finances can be strongly interwoven with that of the corporate sector. The IFC held that in South Africa many individuals choose to set up a close corporation to own their fixed property, rather than to own it directly. Should a loan be required to acquire such property, it would generally be a loan to the close corporation, which forms part of the corporate sector. However, the individual would have to pay the instalments on such loan from his or her household income, and would often also in his or her personal capacity guarantee that the close corporation will honour its commitments. Additional information on loan guarantees given by the household’ sector, and on the extent of lending to close corporations (rather than to companies) is currently not available in South Africa.

Therefore, the level of debt which has to be serviced from household income may in fact be higher than is recorded in the household debt figures.

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<sup>1</sup>Household debt, wealth and saving by J W Prinsloo, South African Reserve Bank Bulletin, December 2002

<sup>2</sup> Irving Fisher Committee on Central Statistics IFC Bulletin No.26

Furthermore, it is important to discuss securitisation as it complicates the measurement of household debt as the level of household indebtedness in South Africa is not established through a survey of households, but by surveying lenders such as banks, asking them how much they have lent to households and adding up the creditor data obtained in this way.

The English Oxford Dictionary<sup>3</sup> defines securitisation as a conversion of an asset, especially a loan into marketable securities, typically for the purpose of raising cash. The IFC held that securitisation has gained in importance in South Africa in recent years. The securitised advances disappear from the balance sheet of the banking sector and it is difficult to establish how much of the securitised loans are loans to the household sector, as opposed, to other sectors. There is also the issue of advances to households by insurers and pension funds. Life insurers frequently lend money to individuals against the security of life policies, with the loan usually repayable in instalments. Life insurers also extend mortgage advances. In South Africa in certain instances an employee may also borrow part of his accumulated savings from his own retirement fund to acquire fixed property. Repayments are generally made on a monthly basis at a market-related interest rate and are spread over many years, much like the repayment of a mortgage loan. While it is reasonably easy to obtain data in respect of lending by life insurers, obtaining information from the numerous retirement funds in South Africa on their loans to the household sector can be fraught with difficulties. Furthermore the micro lending industry extended - and still extends - large numbers of small loans, mainly to individuals, at comparatively high interest rates. Although micro-lenders must be registered with the National Credit Regulator (NCR) in terms of the National Credit Act (NCA), some micro lending by entities that are not registered with the regulator persists. Its extent is impossible to fathom, since the lenders prefer to remain illegal and some of the borrowers using such finance are probably in embarrassing financial difficulty. Both parties are likely to refrain from providing information to outsiders.

Household debt is arguably the most important variable scrutinised for signs that a consumer's financial position is deteriorating.

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<sup>3</sup> [http://www.askoxford.com/concise\\_oed/securitize?view=uk](http://www.askoxford.com/concise_oed/securitize?view=uk)

In the next section we discuss the ratio's that generally serve as warning signals that consumers are becoming over indebted.

## 1.2 Debt-to-income ratio

The debt-to-income ratio reflects how much of your gross monthly income is used towards your monthly debt payments.<sup>4</sup>

In South Africa, the level of household sector debt is estimated by the South African Reserve Bank. The ratio of household debt to disposable income is published in the Bank's Quarterly Bulletin. Another way to gauge the magnitude of households' payment obligations is the aggregate debt service ratio, which equals an estimate of required debt payments divided by disposable income. Household debt ratios are important analytical tools because they allow policy makers, analysts, economic researchers and others to evaluate a household's financial situation and to forecast final consumption expenditure.<sup>5</sup>

In South Africa, as in many other countries, the increase in the household debt-to income ratio over the past three decades can largely be attributed to three factors:<sup>6</sup>

- The financial deregulation from the beginning of the 1980s;
- The reduction in interest rates, both in nominal and real terms;
- The rise in wealth-to-income ratios.

Rising incomes following a prolonged period of stable and positive economic growth, caused house price booms, and mortgages could be financed with relatively cheap loans. This led to soaring debt levels and declining savings rates. The bursting of asset bubbles and the ensuing economic recessions facing most developed economies, then spread around the world, triggering the global recession that led to job losses, falling real incomes, and financial hardships as households battled to repay their loans even at very low interest rates.<sup>7</sup>

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<sup>4</sup> <http://www.debtconsolidationcare.com/calculator/debtincomeratio.html>

<sup>5</sup> *Household Debt, wealth and saving* by J W Prinsloo, SA Reserve Bank Bulletin, December 2002

<sup>6</sup> *Estimating Household Sector Wealth in SA – SA Reserve Bank Quarterly Bulletin June 2006*

<sup>7</sup> [http://www.ecoquant.co.za/cvj\\_dec2009.pdf](http://www.ecoquant.co.za/cvj_dec2009.pdf)

Disney, Bridges, Gathergood (2008)<sup>8</sup> held that the life cycle hypothesis of saving and consumption (spending) suggests that households will spend a significant part of their working lives with low or negative assets (debt) because they are using capital markets to smooth out fluctuations in income. Financial liberalisation allowing access to capital markets has tended to increase indebtedness over time.

### **1.3 Savings ratio**

Prinsloo J W (2002)<sup>9</sup> held that the spending and saving behaviour of individuals is determined by various factors such as their material and social needs, tradition, standard of living, existing indebtedness, net worth and disposable income. Consumption expenditure by households is therefore determined to an important degree by the extent of and the actual and anticipated changes in the income of consumers, as well as their ability to spend future income now by making use of credit.

In the same report Prinsloo stated that saving by the household sector is defined as that part of current income, after the payment of direct taxes, which is not consumed or transferred as part of a household's current expenditure. Dissaving occurs when current expenditure exceeds current income. In terms of standard accounting practices, the saving of a household or of any other organisation will be equivalent to the increase in the net asset value of the household or organisation. Increases in the credit commitments of households will accordingly lead to a decline in their saving, unless this is counteracted by similar or stronger increases in the assets of households. Generally speaking, an inverse relationship can be expected between increases in the utilisation of consumer credit and the saving of private households over time.

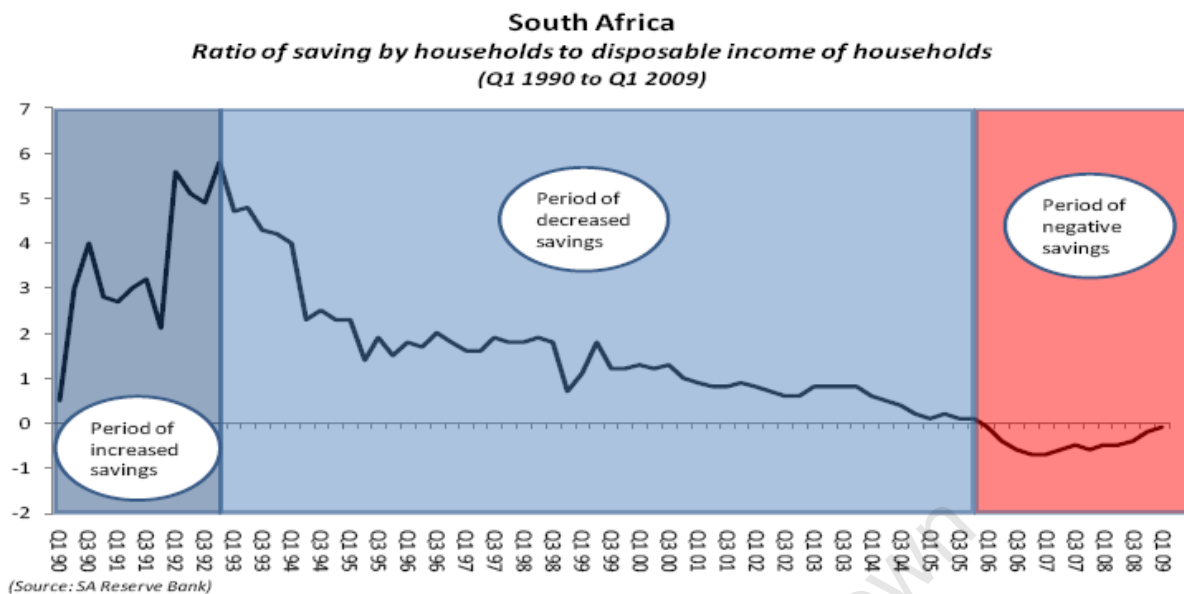
Figure 1 illustrates the decline in savings in South Africa from quarter one in 1993 to quarter one in 2009. The deterioration in the saving ratio of households at the beginning of 1993 coincided with the greater use of credit by households. Alongside these developments, there was an increase in the net wealth of households relative to their personal disposable income.

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<sup>8</sup> *Drivers of over indebtedness: Report to the Department of Business, Enterprises and Regulatory Reform by Richard Disney, Sarah Bridges and John Gathergood, October 2008*

<sup>9</sup> *Household Debt, Wealth and Saving by J W Prinsloo, SARB Quarterly Bulletin December 2002*

Figure 1



Prinsloo maintained that another fundamental cause of the decline in households' saving is that consumers, at least to a certain extent, have rationally decided to lower their saving rates or alternatively to keep consumption expenditure at a relatively high level. The deterioration of households' saving in 1993/94 and the very low level of saving during 1999/2000 were accounted for by lower growth in real personal disposable income relative to growth in consumption expenditure by households – an indication that other factors have supported consumption growth. If it is assumed that at any particular time, consumption by households should also reflect their perceptions of the “wealth effect”, then ultimately what households care about is their net worth – total assets minus liabilities. Household wealth has risen sharply since the mid-1980s, but more specifically from 1993 onward. This rise was driven by increases in both equity and house prices. Consequently, households' low saving rate is a sign that consumers felt comfortable with the evolution of their net worth and that they saw little reason to curtail consumption as a way to increase their net worth even further. The higher rate of growth in household wealth since 1993 was closely followed by accompanying increases in private consumption expenditure.

## 1.4 Reasons for decline in savings ratio

The main reasons for the decline in savings ratio as per the economic help website<sup>10</sup> are:

- Easy availability of Credit until 2007 encouraged consumers to take out loans
- Rising house prices encouraged consumers to borrow because of their positive wealth effect
- Cultural/Social trends encouraging an attitude of borrowing and spending
- Low interest rates

In the previous sections we defined household debt and discussed the warning signals that indicate that consumers are becoming over indebted. In this section we briefly highlight the main cause of over indebtedness and the additional variables that contribute to the risk.

## 1.5 Nature and causes of over indebtedness

Anderloni & Vandone<sup>11</sup> (December 2008) stated that the risk of being over indebted and facing financial difficulties is higher among the poorest groups and the conclusion of their analysis confirmed that poverty itself was the main cause of financial difficulties.

Although poverty is the main cause of over indebtedness, there are additional variables linked to the risk of becoming over indebted viz.:-

- housing tenure, real estate wealth and equities wealth;
- savings;
- attitudes towards payments, credit and money management;
- ethnicity;
- debt literacy;

This study aims to provide a greater understanding of the nature and causes of over indebtedness and the variables that contribute to this risk.

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<sup>10</sup> Published on the website <http://www.economicshelp.org>

<sup>11</sup> Households over-indebtedness in the Economic Literature by Anderloni & Vandone, December 2008

Therefore, the manner in which the paper is structured will be as follows:

The research paper commenced with an introduction in Chapter one to the concept of household debt, followed by discussion on the warning signals that are generally indicative of the fact that consumers are becoming over indebted. Chapter two provides a background of the most important components of household debt that contribute to over indebtedness whilst Chapter three is a literature review and theoretical discussion on the nature and causes of over indebtedness and the additional variables that contribute to the risk and includes an international comparison between SA, USA, UK, Australia and Canada. An overview of the methodology employed and an analysis of the data is discussed in Chapter four whilst Chapter five highlights the results of the study followed by a conclusion in Chapter six.

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## 2 CHAPTER 2 – BACKGROUND

The previous chapter provided an introduction to household debt and highlighted the additional factors that contribute to over indebtedness. In this section we provide a background into the relationship between increased consumption expenditure and the additional factors that contribute to over indebtedness.

### 2.1 Final consumption expenditure

Household final consumption expenditure (HFCE) is a price index which represents consumer spending. Household final consumption expenditure consists of the expenditure, including imputed expenditure, incurred by resident households on individual consumption goods and services, including those sold at prices that are not economically significant.<sup>12</sup> It also includes imputed rent for the provision of owner-occupied housing services, and consumption of own production. The household sector covers not only those living in traditional households, but also those people living in communal establishments, such as retirement homes, boarding houses and prisons.

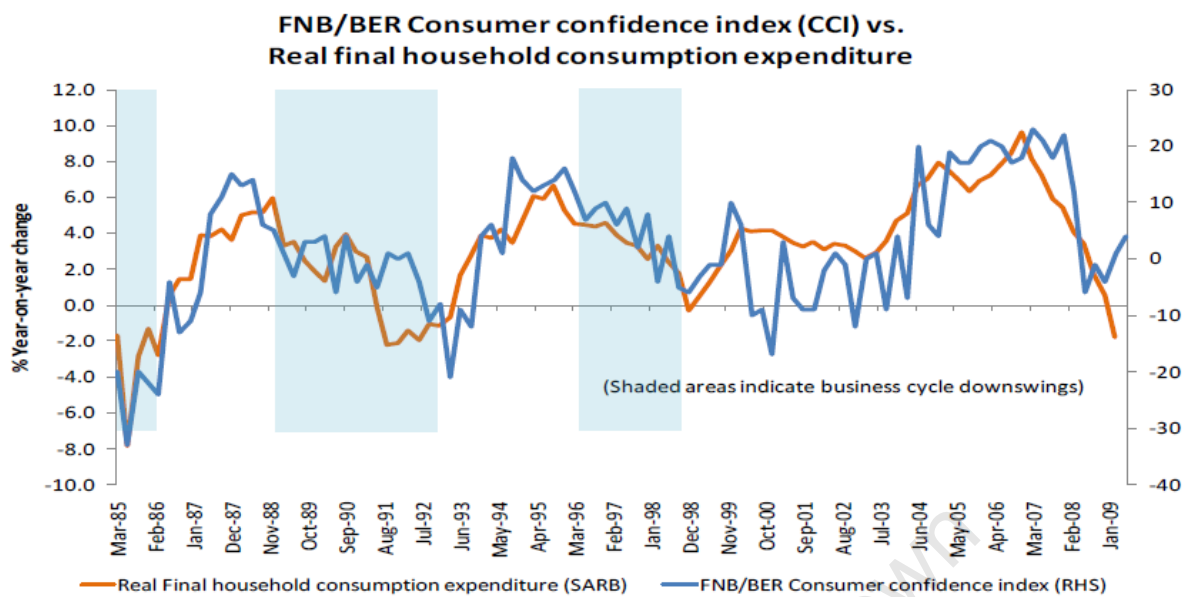
Disney, Bridges, Gathergood (2008)<sup>13</sup> held that in South Africa real final consumption expenditure by households increased at an exceptionally brisk average annualised rate of 5,3 per cent from late 1999 to late 2007 as depicted in figure 2. This can be attributed to sustained increases in real disposable income of households and a surge in the real value of households' wealth, reflecting the buoyancy of the residential property and equity markets during this period. Households' real wealth rose at an average annualised rate of more than 10 per cent between 2000 and 2007, before it declined, at an annualised rate of 11 per cent from its high in the second quarter of 2007 to the second quarter of 2009.

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<sup>12</sup> <http://stats.oecd.org/glossary/detail.asp?ID=1257>

<sup>13</sup> *Drivers of over indebtedness: Report to the Department of Business, Enterprises and Regulatory Reform by Richard Disney, Sarah Bridges and John Gathergood, October 2008*

Figure 2



The sustained increase in real consumption expenditure by households during the upward phase also manifested itself in an increase in households' average propensity to consume. The average propensity of households to consume rose from 97.4 percent during the 1990s to more than 100 percent from the first quarter of 2006, resulting in the household sector becoming a net dissaver. The borrowing requirement of the household sector increased substantially in 2006 and 2007, before it moderated somewhat in 2008 and the first half of 2009.

Household's consumption expenditure currently represents more than 76 percent of South Africa's gross domestic product.<sup>14</sup> When a large share of household income is devoted to debt repayment, households have fewer funds available to purchase goods and services. Households with high debt levels relative to income are also more likely to default on their obligations when they suffer an unanticipated misfortune such as job loss or illness.

Changes in asset prices can have a powerful impact on household consumption through wealth effects. Households' ability to borrow will, in practice, depend strongly on their capacity to supply collateral as security for repayments, and real estate is the most widely used collateral asset. Consumers can withdraw part of the increase in housing equity by

<sup>14</sup> *Business Day South Africa, Credit figures will boost case for rates cut, Mariam Isa, 30 March 2009, <http://allafrica.com/stories/200903300023.html>*

increasing their borrowing secured on rising property values, and use part of the proceeds to finance additional consumption.<sup>15</sup>

## 2.2 The Wealth Effect

The wealth effect as an economic term is associated with private spending arising from a change in wealth. Wealth effects are usually associated with changes in the value of equity, bonds and real estate referring to an increase in spending that accompanies an increase in perceived wealth.<sup>16</sup> The effect would cause changes in the amounts and composition of consumer consumption caused by changes in consumer wealth. People should spend more when one of two things is true: when people actually *are richer* (by objective measurement, for example, a bonus or a pay raise at work, which would be an income effect), or when people perceive themselves to be "richer" (for example, the assessed value of their home increases, or a stock they own has gone up in price recently).

Peltonen, Sousa and Vansteenkiste (January 2009)<sup>17</sup> reported that household consumption is affected not only by income but also by wealth, such as real estate and stock ownership. When real estate or stock prices rise, the wealth of homeowners or shareholders increase and household consumption can rise even when labour income remains constant. Such rise in consumption due to the increase in real estate prices is called the housing wealth effect, whereas the rise in consumption that is due to the increase in stock market prices is called the stock market wealth effect. In the same paper, the relationship between consumption and several components of wealth for a panel of 14 main emerging economies was analysed. Drawing upon quarterly data for the period 1990:1-2008:2, the study revealed that wealth effects are statistically significant and relatively large: a 10% rise in housing prices leads to an increase in private consumption of between 0.25% and 0.49%; an increase of 10% in stock prices is associated with a 0.29% to 0.35% increase in consumption; and when money wealth rises by 10%, consumption increases by 0.41% to 0.50%. For both financial and housing wealth the study found that consumption reacts asymmetrically, i.e. that a negative shock has a bigger impact than a positive shock. The results also suggest that consumption growth exhibits a substantial persistence and responds sluggishly to

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<sup>15</sup> *Household debt, wealth and saving: by J W Prinsloo*

<sup>16</sup> <http://stats.oecd.org/glossary/detail.asp?ID=2917>

<sup>17</sup> *Wealth effects in emerging market economies by Tuomas A Peltonen, Ricardo M Sousa and Isabel S Vansteenkiste, Working Paper Series No 1000/January 2009*

shocks. This may be an important reason for concern particularly, in the case of a negative downturn, given that emerging economies have often witnessed episodes of economic, financial and currency crises.

Belsky and Prakken (2004)<sup>18</sup> stated that modelling of consumer spending reveals that the effects of changes in housing wealth and stock wealth on consumer spending are similar in magnitude but different in timing: housing wealth effects are more immediate. Consumers may be slower to spend out of gains in stock wealth because they are cautious about making lifestyle changes based on near-term movements in stock prices that could well prove unsustainable. The immediacy of the response to gains in housing wealth, on the other hand, means that housing produces a quicker lift to the economy.

### **2.3 Housing Wealth Effect**

Belsky and Prakken (2004) held that housing influences the level of consumer spending. When housing wealth increases, consumers spend more and they spend even more freely when capital gains from home sales and home equity borrowing escalate in tandem with rising home values. The authors suggests that liquidation of home equity and the realisation of capital gains from home sales can add significantly to growth in consumer spending in the short run. However, unlike the lasting impact that gains in housing and stock wealth have on consumer spending, the impacts of home equity extraction and realised capital gains are only temporary and their statistical significance is not nearly as great as that of housing wealth. Therefore, while they can give a large temporary boost to spending, it is home price growth that imparts lasting benefits. As long as home prices continue to climb on average nationally, housing typically adds at least marginally, and during some periods substantially, to consumer spending.

Belsky and Prakken (2004) maintain that housing is an important anchor for household wealth. Whereas nominal declines in home values are relatively uncommon even at the level of individual homes, nominal declines in stock values are common. In addition, stock values can rise and fall rapidly even over the course of a single day. Home values are not

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<sup>18</sup> *Housing Wealth Effects: Housing's Impact on Wealth Accumulation, Wealth Distribution and Consumer Spending* Eric Belsky and Joel Prakken December 2004

subject to these frequent and large swings. As a result, the nation's aggregate housing wealth is far less volatile than the nation's stock wealth.

## 2.4 Equities Wealth Effect

Hassan Shirvani (2002)<sup>19</sup> held that the Federal Reserve in the US has focused its attention on the stock market as a potential source of instability to the economy through the wealth effect. Although the wealth effect of rising stock prices has been beneficial to the economy of the US, increases in stock prices posed the risk of increasing the inflation rate. The opposing concern is that stock prices may fall, lowering consumption and resulting in an economic downturn. (Shirvani and Wilbratte, (2000)) indicated that a fall in stock prices exerts a more powerful effect than a rise, thus heightening the importance of this possibility. An additional concern is that rising stock values seem to have contributed to a sharp decline in personal savings in recent years, possibly as a consequence of the effects of rising stock values on consumption. Presumably, this occurred as a result of households<sup>20</sup> treating the growth in their wealth through rising stock prices as a substitute for savings from current income to stock wealth.

The European Central Bank (2008)<sup>20</sup> reported that their findings suggest that households are considerably more sensitive to changes in housing wealth than to stock market wealth.

In South Africa housing wealth is far more broadly distributed across income levels than stock wealth. Home equity is especially important to lower income households as more low income earners will have more home equity than stock equity.

In the previous section we discussed the impact of the wealth effect and its link to over indebtedness and in the next section we discuss some of the additional factors that contribute to over indebtedness.

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<sup>19</sup> *The Journal of Applied Business Research* Volume 18, Number 2 9 *The Wealth Effect Of The Stock Market Revisited* by Hassan Shirvani, University of St. Thomas Barry Wilbratte, University of St. Thomas, 2002

<sup>20</sup> *Housing, Equity Wealth effects of Italian Households* by Charles Grant for the European Central Bank, Eurosystems, working paper 857/January 2008

## 2.5 Ethnicity

Daniels (2001)<sup>21</sup> reported that as far as indebtedness by race in South Africa is concerned, the evidence supports the fact that there is indeed a particular racial distribution to indebtedness, with Black people experiencing the lowest levels of indebtedness, followed by the Coloured population. The Indian population has the second highest indebtedness levels, while White people are the most indebted.

Anderloni & Vandone(2008)<sup>22</sup> held that as far as ethnicity is concerned, in most European countries, minorities are overrepresented in the low-income groups and in the category of more unsecured working positions, living in rented housing therefore, they are, in principle, more at risk. However, little empirical evidence is available in this field for two main reasons. Firstly, in order to limit the risk of feeding and disseminate discrimination, statistics on over indebted people do not show the variable “ethnicity”. Secondly, often surveys include in their samples only the native population, while migrants and ethnic minorities are eventually the target of specific analysis and, in this case, the focus is generally on the difficulty of access or financial exclusion rather than matters related to over indebtedness. The evidence of these studies is that it would be wrong to consider migrants or minority as a homogenous category, because their access to financial services, behaviour and needs are very diverse. Personal features, ethnic groups as well as the stage in the migrant life cycle, are all relevant elements in explaining the level of access to financial services and the difficulties faced.

## 2.6 Debt Literacy

Finmark Trust (2006)<sup>23</sup> held that financial literacy refers to the knowledge, skills and attitudes required for good money management practices for earning, spending, saving, borrowing and investing. The study emphasised the fact that good money management remains a daily challenge for poor people as pressures on cash flows are persistent and often urgent. Financial education builds the capacity of the poor to control their finances, become proactive, and use information and resources to enhance their economic security.

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<sup>21</sup> *Consumer indebtedness among urban South African households by Reza Daniels, September 2001*

<sup>22</sup> *Households over-indebtedness in the Economic Literature*

<sup>23</sup> *The National Credit Act and its Regulations in the context of Access to finance in South Africa by RP Goodwin-Groen with input from Prof M Kelly-Louw, November 2006*

Lusardi & Tufano<sup>24</sup> (December 2008) held that there was a strong relationship between debt literacy and both financial experiences and debt loads. The authors held that because individuals engaged in many financial transactions that required careful consideration of interest rates and comparisons of alternatives those who were less knowledgeable may engage in higher-cost borrowing or less advantageous financial contracts; resulting in a negative relationship between financial skills and certain wealth-depleting financial behaviours.

Hurwitz & Luiz (March 2007)<sup>25</sup> stated that in South Africa consumers need to be educated about basic money management, interest rates and credit costs. However, the possible impact of education is limited as many of the causes of over borrowing are socio economic.

## **2.7 Attitudes towards payments, credit and money management**

Anderloni & Vandone<sup>26</sup> stated that the propensity to fall into arrears is affected by adverse events, but the extent to which they matter varies across countries and depends crucially on institutional factors.

Rinaldi and Sanchez-Arellano (2006)<sup>27</sup> investigated the effect of institutional factors on borrowers' arrears and repayment behaviour. The researchers held that empirical analysis found that, although the set of individual variables affecting households' over indebtedness is the same, there are significant differences across countries in households' propensity to fall into arrears and that households in different countries respond differently to adverse shocks: households in similar circumstances fail to repay their loans on time in some institutional environments but keep up with their repayments in others. These differences are explained by institutional factors, among which the most important are: the information sharing structure, the efficiency of the judicial system, the existence of informal credit markets. The ability of the financial market to punish default is influenced by the cost and

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<sup>24</sup> *Debt Literacy, Financial Experiences and Over Indebtedness* by Annamaria Lusardi, Dartmouth College and NBER and Peter Tufano, Harvard Business School and NBER, December 22, 2008

<sup>25</sup> *Urban Working Class Credit Usage and Over-Indebtedness in South Africa* by Ingrid Hurwitz and John Luiz, *Journal of Southern African Studies*, Volume 33, Number 1, March 2007

<sup>26</sup> *Households over-indebtedness in the Economic Literature* by Anderloni & Vandone, December 2008

<sup>27</sup> *The Determinants of Consumer Credit: A Review of the Literature* by Rinaldi and Sanchez –Arellano, 2006

efficiency of judicial enforcement, the level of information sharing and the importance of informal credit markets.

Having defined household debt, discussed the warning signals that indicate that households are becoming over indebted and provided background into the factors that contribute to over indebtedness it is necessary to discuss the link between consumer financial vulnerability and over indebtedness.

Vulnerability analysis complements the traditionally static asset-based poverty analysis and expands the “scope of poverty analysis into a dynamic, forward looking dimension by identifying those who are in danger of becoming poor in the future” (Tesliuc and Lindert 2002:6).

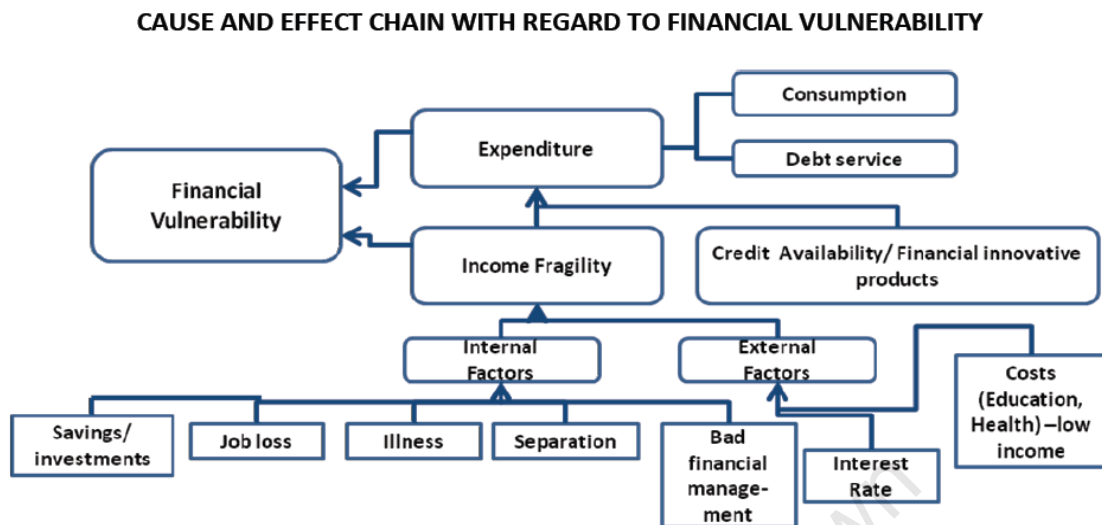
## **2.8 Consumer Financial Vulnerability**

Consumer Financial Vulnerability is defined in the Princeton University (2009) Wordnet database and the online dictionary, dictionary.com (2009) differently and relates to notions such as the state and/or feeling of being exposed, weak or being susceptible; a weakness in personal security; the degree to which people, property, resources, systems, cultural, economic, environmental and social activity are susceptible to harm, degradation or destruction on being exposed to a hostile agent or factor.

For the purpose of this research study, the term ‘consumer financial vulnerability’ refers to the state and/or feeling of being exposed to financial insecurity, or actually experiencing financial insecurity and/or inability to cope financially.

In June 2009 the first Consumer Financial Vulnerability Index for South Africa was created as a joint effort between the Bureau of Market Research (UNISA) and Finmark Trust based on available international consumer financial vulnerability indices. In the report it was held that financial vulnerability depends on various factors both outside a person’s control, such as adverse economic conditions, and those that are specific, including levels of savings or debt. It appears from figure 3 that income vulnerability and expenditure is the main driver’s of CFV.

Figure 3



Source: Finmark Trust

The Finmark study held that expenditure can be constrained by income vulnerability leaving even less money available for consumption expenditure and to spend on debt servicing. Income vulnerability in turn is brought about by a range of internal and external factors. Internal factors include not having sufficient savings and/or investments, becoming unemployed, ill health, separation/divorce and bad financial management, while external factors include higher interest rates, price inflation and adverse economic conditions. As can be seen from the range of internal factors mentioned such 'internal factors' are factors endogenous to the lives of consumers, while 'external factors' are those exogenous to consumers' lives.

### 3 CHAPTER 3 – LITERATURE REVIEW

The focus of this thesis is on “who is most likely to be over indebted” and the main variables that affect this risk. In order to answer the research question it is important to understand the recent history of the financial sector and policy developments that affected the credit lending environment in South Africa.

#### 3.1 Credit Usage in South Africa

Daniels (2001)<sup>28</sup> held that the rationale for investigating consumer indebtedness in South Africa stemmed from the fact that the financial sector had undergone a process of deepening as a result of important regulatory changes to the sector since the early 1990s. In this regard, one of the more significant legislative changes that occurred was the Exemption to the Usury Act in 1992, which removed interest rate ceilings on small loans under R6000.00 with a repayment period of less than thirty-six months. Daniels in the same paper maintains that the phenomenal growth in the micro-finance industry provides a good example of how a latent sector was able to develop given a favourable incentive system. The implications for the consumer were greater access to finance through a diverse range of new financial instruments that, in many cases, targeted the poor directly.

Aron and Muelbauer, (2002)<sup>29</sup> held that government initiated financial liberalisation following the De Kock Commission reports (1978, 1985) resulted in interest and credit controls being removed in 1980, and banks’ prescribed minimum liquidity ratios being reduced substantially between 1983 and 1985. However, the early deregulation affected the consumer in the 1980’s when credit growth and not mortgage market growth took place. Growth in the mortgage market only caught up in the mid 1980s when competition rose in the mortgage market following the amendments to the 1986 Building Societies Act, in 1987-1988, and various financial innovations.

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<sup>28</sup> *Consumer Indebtedness Among Urban South African Households: A descriptive overview by Reza Daniels, September 2001*

<sup>29</sup> *Estimating household sector wealth in South Africa by J Aron, Muelbauer and J Prinsloo, South African Reserve Bank Quarterly Bulletin (June 2006)*

Prinsloo (2002)<sup>30</sup> stated that there were several reasons for the growth in indebtedness since the mid-1980's. One is the deregulation of financial institutions that is believed to have encouraged an expansion of personal debt. Another is the strong demand for residential mortgage loans, spurred by inflation and the relatively high level of house prices as well as other factors, such as aggressive marketing of sectional title units and the government initiative to boost owner-occupied dwelling units among certain lower-income communities. More recently, households' fear for their safety and security has also contributed to an increasing demand for residential development in security complexes. In addition, the household sector's indebtedness, particularly in the form of mortgages, rose much faster than disposable income in the second half of the 1980's. Prinsloo held that another development related to household debt has been the growth in the micro lending industry since the beginning of the 1990s. The exponential growth of the micro-lending industry in South Africa, especially during the 1990s, firmly established the role that micro lenders have played in increasing access, particularly by low-income households, to credit extension in South Africa. The expansion of the micro-lending industry was also partly responsible for growing concern about the levels of indebtedness of the household sector. Micro loans are targeted at the middle to low-income section of households, whereas cash lenders are more active among households with minimum living standards.

The rapid increase in household sector debt led the Department of Trade and Industry (DTI) to commission Reality Research Africa (2002)<sup>31</sup> to conduct research as part of the review of the credit laws in South Africa.

The Reality Research Africa's report concluded that across all income groups and all categories of credit, consumers were affected by a lack of information about their rights, hidden costs and interest rates in South Africa. This report led to the drafting of new legislation in an attempt to protect the unwary from unscrupulous moneylenders, shops and banks. In June 2006, The National Credit Act 34 of 2005 was implemented and is the regulatory framework for the granting of credit facilities to consumers by financial institutions in South Africa.

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<sup>30</sup> Prinsloo J W, *Household Debt, Wealth and Saving, S A Reserve Bank Quarterly Bulletin, December 2002*

<sup>31</sup> *10 things you should know about the National Credit Act by Charlene Clayton*

## 3.2 The Regulatory Environment

The Act provides a regulatory framework for the granting of credit in South Africa as well as regulating the previously unregulated micro lending Industry in South Africa.

The Act requires credit providers to conduct an affordability assessment on credit applications and to practice responsible credit granting. Sellers of goods and services are held liable for the amount of credit that they grant to a borrower which in turn helps to keep the indebtedness of borrowers within reasonable limits. The implications for the consumer are greater access to finance through a diverse range of new financial instruments.

The key aspects of the Act<sup>32</sup> deal with fairness in credit markets and can be summarised as follows:<sup>33</sup>

- Negative option marketing and automatic increases in credit limits are prohibited;
- A compulsory, standard, one page pre-agreement quote on all agreements must be issued to the applicant;
- “Penalty interest” is prohibited; and the “In Duplum”<sup>34</sup> rule was introduced;
- Single premium credit life insurance is prohibited;
- Changed structure of disclosure away from “APR”, to separate disclosure and the Act provides for the regulation of interest, initiation fees and monthly service fees;
- Prohibited arrangements that give one credit provider a preference over others, particularly in payment systems or through payroll deductions;
- Prohibits specific contractual clauses that are considered unfair;
- A register of credit agreements was created and the Act regulates credit bureaus to provide a complete and accurate picture of payment profiles and indebtedness;

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<sup>32</sup> *The National Credit Act 34 of 2005 implemented in June 2006*

<sup>33</sup> *Regulatory requirements and experience re Credit Bureaus, Gabriel Davel, 22 October 2008*

<sup>34</sup> *The common law in duplum rule holds that “interest stops running when the unpaid interest equals the outstanding capital.” <http://www.creditmanagement.co.za/in-duplum-interest-and-the-national-credit-act/>*

However, despite the provisions of the National Credit Act, that amongst other provisions outlawed reckless lending, consumers has incurred high levels of debt in South Africa. In the previous section we discussed the recent history of the financial sector as well as the financial innovation that took place in credit markets that led to increased levels of debt amongst South African households and the regulatory environment that currently governs access to credit in SA. In the next section we undertake a review of the literature on the nature and causes of indebtedness.

### **3.3 Poverty and Race**

According to Hurwitz and Luiz (2007)<sup>35</sup> South Africa is a country of extremes, where great wealth and poverty coexist. About 40% of the economically active population is unemployed (expanded definition): 48.5% per cent live in poverty below the minimum living level; and the Gini coefficient of 0.635 points to one is one of the highest levels of inequality in the world.

Okurut (2006)<sup>36</sup> investigated the factors that influenced access by the poor and blacks to credit in the segmented financial sector in South Africa, using income and expenditure survey data from 1995 and 2000. Okurut sheds light on the extent of financial sector deepening through household participation especially among the poor and Blacks, in the context of the fight against poverty. In this study, three types of credit were identified. Formal credit was defined to include debts from commercial banks (including mortgage finance and car loans), semi-formal credit included consumption credit (for household assets such as furniture and open accounts in retail stores), and informal credit specifically referred to debts from relatives and friends. The results suggest that the poor and Blacks have limited access to the formal and semi-formal financial sectors in South Africa. In the same report the author held that at the national level, access to bank credit is positively and significantly influenced by age, being male, household size, education level, household per capita expenditure and race (being Coloured, Indian or White). Being poor had a negative and significant effect on formal credit access. Semi-formal credit access is positively and

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<sup>35</sup> *Urban Working Class Credit Usage and Over-Indebtedness in South Africa by Ingrid Hurwitz and John Luiz, Journal of Southern African Studies, Volume 33, Number 1, March 2007*

<sup>36</sup> *Access to credit by the poor in South Africa: Evidence from Household Survey Data 1995 and 2000 by Okurut (2006)*

significantly influenced by household size, per capita expenditure, provincial location (Eastern Cape, Northern Cape, Free State and North West) and being Coloured. The negative and significant factors in determining access to semi-formal credit include being male, rural location, being poor and being White. Informal credit access is negatively and significantly influenced by education level and race (being Coloured or White). Among the poor, access to bank credit is positively and significantly influenced by being male, provincial location (Western Cape, Gauteng and Mpumalanga) and being Coloured. Access to semi-formal credit is positively and significantly determined by household per capita expenditure, provincial location (Western Cape, Northern Cape, North West and Gauteng) and being Indian. Access to informal credit by the poor is positively and significantly influenced by provincial location (KwaZulu Natal and Gauteng). Within the black population, access to bank credit is positively and significantly influenced by age, being male, household per capita expenditure and education level. Semi-formal credit access by Blacks is positively and significantly influenced by household size, household per capita expenditure, education level and provincial location (Eastern Cape, Northern Cape, Free State and North West). However being male, poor and located in a rural area negatively affected access to semi-formal credit by Blacks. Informal credit access by Blacks is negatively influenced by education level, but positively influenced by being located in the Western and Eastern Cape. These findings confirm that improving access to organised credit markets (i.e formal and semi-formal credit markets) by the poor and Blacks, remains important in the fight against poverty.

The findings of the Finmark Trust (2009)<sup>37</sup> report point towards very serious socio-economic problems in South Africa, which as a result of their severity, give rise to higher than expected levels of consumer financial vulnerability. Such problems include very high levels of poverty giving rise to high levels of income vulnerability, relatively high consumer price inflation rates with respect to necessities (i.e. food and clothing) giving rise to high levels of expenditure vulnerability, as well as high debt-to-income ratios that in conjunction with relatively high interest rates, gives rise to high levels of debt servicing vulnerability.

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<sup>37</sup> *FinMark Trust (July 2009) in conjunction with the Income and Expenditure Research Division of the Bureau of Market Research (BMR) at Unisa (University of South Africa) initiated and compiled the first consumer financial vulnerability index for South Africa*

C.K Prahalad (2005)<sup>38</sup> illustrated that the poor usually have to pay a premium for everything from rice to credit and that in India, research indicates that the poverty penalty can be as high as 5 to 25 times what the rich pay for the same services. When the price that lower income households pay for credit was examined by Hurwitz and Luiz(2007)<sup>39</sup> this finding was supported in the South African context.

Nationmaster<sup>40</sup> reported that 50% of the population of South Africa live below the poverty line. South Africa ranked 23<sup>rd</sup> out of 141 countries with Liberia at the top end of the scale as the most impoverished country and Taiwan at the bottom end of the scale as the least impoverished country.

Anderloni & Vandone<sup>41</sup> (December 2008) stated that the risk of being over indebted and facing financial difficulties is higher among the poorest groups and the conclusion of their analysis confirmed that poverty itself was the main cause of financial difficulties.

Daniels (2001)<sup>42</sup> held that the data confirmed that Black and Coloured people are overwhelmingly the most impoverished in South Africa (see Borat 2001).

In the previous section we presented literature supporting the fact that poverty and race were the major causes of over indebtedness. In this section an examination of the factors that contribute to the likelihood of consumers becoming over indebted as highlighted by the Consumer Financial Vulnerability indices for South Africa, the UK and the USA will be discussed.

Prior to 2009 there was no consumer financial vulnerability index available to arrive at an understanding of the extent and distribution of consumer vulnerability in South Africa.

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<sup>38</sup> C.K. Phahalad, *The Fortune at the Bottom of the Pyramid* (Upper Saddle River, NJ, Wharton School Publishing, 2005),pp 1-401

<sup>39</sup> *Urban Working Class Credit Usage and Over-Indebtedness in South Africa* by Ingrid Hurwitz and John Luiz, *Journal of Southern African Studies*, Volume 33, Number 1, March 2007

<sup>40</sup> As published on the website:<http://www.nationmaster.com/country/sf-south-africa/eco-economy>

<sup>41</sup> *Households over-indebtedness in the Economic Literature* by Anderloni & Vandone, December 2008

<sup>42</sup> *Consumer indebtedness among urban South African households* by Reza Daniels, September 2001

### 3.4 Consumer Financial Vulnerability - South Africa

FinMark Trust (July 2009)<sup>43</sup> in conjunction with the Income and Expenditure Research Division of the Bureau of Market Research (BMR) at UNISA (University of South Africa) initiated and compiled the first consumer financial vulnerability index for South Africa with the first update on the study published in the third quarter of 2009.<sup>44</sup>

In the report Finmark stated that the following aspects must be taken into consideration when assessing a person's financial vulnerability:

Income Vulnerability, that includes job security, income growth, social grants and the ability to access transfers from family and friends

Saving vulnerability that is influenced by the savings and assets that a person can access when times are tough.

Expenditure vulnerability, that depends on various factors including whether a consumer is able to deal with rising costs of food and transport or is living within his means.

Debt Service vulnerability, that is driven by the cost of servicing debt and the level of debt a consumer has.

The Finmark<sup>45</sup> overall index and sub-indices are based on a ten-point scale where 0 indicates total financial security and 10 indicates total financial vulnerability as indicated in figure 4.

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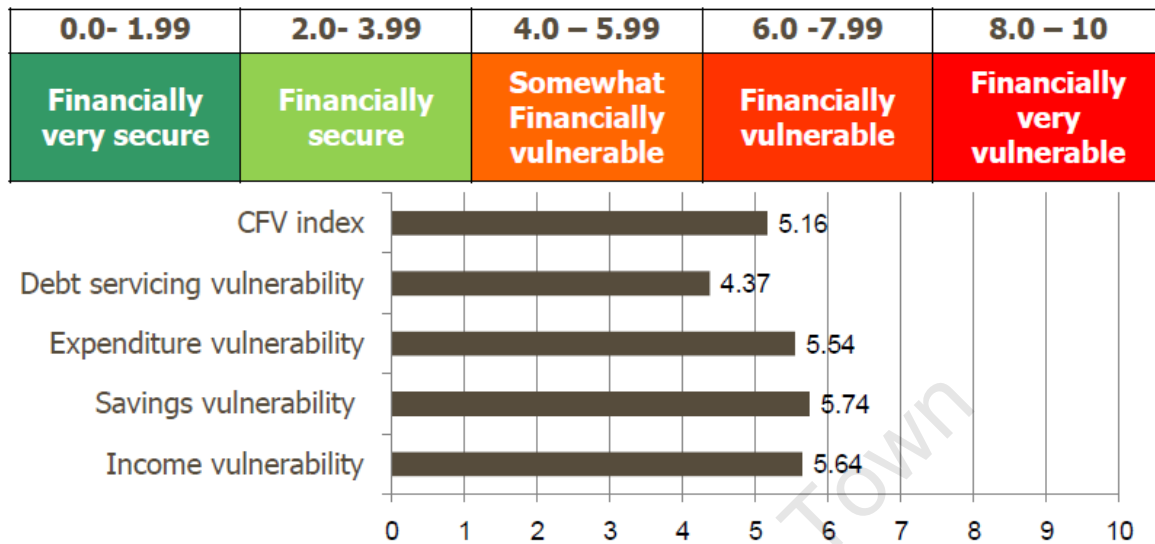
<sup>43</sup> *FinMark Trust (July 2009) in conjunction with the Income and Expenditure Research Division of the Bureau of Market Research (BMR) at Unisa (University of South Africa)*

<sup>44</sup> *Consumer Vulnerability Index – Third Quarter 2009 Update*

<sup>45</sup> *FinMark Trust (July 2009) in conjunction with the Income and Expenditure Research Division of the Bureau of Market Research (BMR) at Unisa (University of South Africa) initiated and compiled the first consumer financial vulnerability index for South Africa*

Figure 4

## Financial vulnerability strata and scores



Compiled by the Bureau of Market Research for FinMark Trust – July 2009






With a score of 5.17, South Africans are at risk, especially when compared with consumers in European countries measured on a similar index: Sweden would score 0.4, Norway 0.9, Denmark 1.3, Great Britain 3.1 and Ireland 3.4.

These scores show that while debt is a problem, other factors are significant in causing many South Africans to be financially vulnerable. The high level of income vulnerability is partly explained by the national poverty rate of 47% of households; reported at a level of 50% by Nationmaster<sup>46</sup>, however income vulnerability is being exacerbated by the economic downturn and job losses. The very low level of savings in South Africa is reflected in the savings vulnerability score of 5.74. Expenditure vulnerability is being spurred by the relatively high levels of consumer price inflation in South Africa, especially food price inflation.

A third quarter update of the CFV index reflects the results of the survey for the second and third quarters of 2009 as depicted in figure 5.

<sup>46</sup> As published on the website: <http://www.nationmaster.com/country/sf-south-africa/eco-economy>

Figure 5

CONSUMER FINANCIAL VULNERABILITY	Second quarter 2009	Third quarter 2009	Movement
Savings vulnerability	5.74	5.90	
Expenditure vulnerability	5.54	5.45	
Debt servicing vulnerability	4.37	4.76	
Income vulnerability	5.64	6.03	
<b>Overall CFVI</b>	5.17	5.49	

Source: Finmark Trust

The overall index increased from 5.17 in the second quarter of 2009 to 5.49 in the third quarter. It is evident that South Africans are at risk and becoming more at risk as the economic crisis deepens and the number of retrenchments and defaults on payments mount. The index also measures which sectors of the population are most susceptible to financial stress and, if conducted annually, whether the situation is improving or deteriorating. In the present economic climate, many South Africans consumers are facing financial difficulties.

At the end of December 2009 more than one million South Africans had lost their jobs since the onset of the current recession, and about 42.4% of them could not keep up with payments on their accounts even though they might have an income.

The Finmark paper is an important and revolutionary index on consumer financial vulnerability in South Africa however cognisance must be taken of the fact that it is based on a very small sample of 976 consumers (Van Aardt 2007) that generated a total of 887 consumer responses.

The majority of the interviews (571) were conducted telephonically and cognisance must be taken of the bias associated with telephonic surveys<sup>47</sup> viz.

- Individuals with particular characteristics are expensive to identify

<sup>47</sup> As published on the website <http://www.harrisinteractive.net>

- Long or numerous response categories are not easy to present
- Ability of respondents to discriminate among response categories is constrained by memory limitations, yielding lower reliability
- Respondents are often rushed to formulate answers
- Personal or sensitive questions are difficult to ask
- Technology is making it more difficult to reach people given the increasing number of non-traditional households, using non traditional means of electronic communication. This country has many domestic landlines that are not answered by the person who can answer the question during the day, and many other families who share one cellular telephone. Thus any ICT method may be missing broad demographic areas, especially among the extremes of our society.
- Respondents are more likely to give socially desirable answers
- Lower reliability and validity of data collected by telephone

A Micro-Finance Regulatory Council (MFRC) report defines vulnerability to over indebtedness in terms of location, incomes, race, gender, total outstanding debt, and proportion of debt outstanding and types of debt. The report held that the most vulnerable groups are Black and Coloured households, headed by either gender in the lowest income categories (R0-R15 000 p.a), and the next most vulnerable group, the R15 000 to R75 000 p.a category, who spend more than 50% of their income on basic needs and owe the majority of their outstanding debt to retailers. They are therefore vulnerable to over indebtedness from two perspectives; increased access and interest rate volatility. An interesting point made in this study is the apparent use of loans to pay other loans. This could not be accurately estimated and was found in survey data to be anywhere between 2 per cent and 27 percent.<sup>48</sup>

A comparison of consumer financial vulnerability between SA, the UK and the USA will be discussed in the following section.

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<sup>48</sup> *Urban Working Class Credit Usage and Over-Indebtedness in South Africa by Ingrid Hurwitz and John Luiz, Journal of Southern African Studies, Volume 33, Number 1, March 2007*

A similar financial consumer vulnerability index for 15 European countries and the USA was conducted by Genworth and the results of the index can be summarised as follows:-

### **3.5 Consumer Vulnerability in the UK and the USA**

Consumer Vulnerability in the UK and the USA is measured in terms of the Genworth Index. In the study four groups are identified viz:

**Group A**, 'Financially Vulnerable', comprises people who have been experiencing financial difficulties often or all the time and who feel that their situation is unlikely to improve.

**Group B**, 'Strivers', is a relatively small group of people who tend to have experienced financial difficulties relatively frequently but who now feel more confident (that is, they are expecting their situation to improve). These individuals are neither financially vulnerable nor financially secure.

**Group C**, 'Circumspect', is a large group who have not often experienced difficulties, if at all, and who tend to expect their situation to remain the same. These individuals are, again, neither financially vulnerable nor secure.

**Group D**, 'Financially Secure', is made up of people who have rarely or never experienced financial difficulties, and who expect their financial situation to improve.

The Genworth Index takes the ratio of the percentage of people who are financially secure relative to the percentage of those who are financially vulnerable. The resulting value is rescaled so that a score of -100 indicates maximum possible relative financial security and a score of 100 indicates maximum relative financial vulnerability.

Table 1 represents the percentage share of the population falling into each segment in each country, starting with the country with the highest score on the Index.

Table 1

## THE PICTURE BY COUNTRY

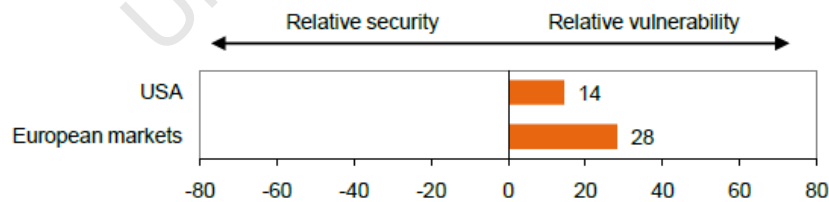
Table 1: Index scores and percentage of people in each group by country, Europe 2009

	Percentage in each group (row per cent)				Index score
	Financially vulnerable	Strivers	Circumspect	Financially secure	
Ireland	39	2	57	2	63
Poland	46	8	43	3	60
Greece	45	15	36	4	52
Portugal	39	8	48	5	45
Italy	25	8	63	4	40
Germany	19	5	72	4	33
Turkey	38	26	28	9	32
Spain	27	9	58	6	31
France	21	17	56	7	24
Great Britain	14	15	62	9	10
Finland	8	14	66	11	-7
Sweden	7	7	68	19	-20
Denmark	6	8	69	18	-25
Norway	2	8	71	19	-48
<b>14 countries</b>	<b>24</b>	<b>12</b>	<b>58</b>	<b>7</b>	<b>28</b>

Source: Genworth

Given that the Index score is based on the ratio of the financially vulnerable to the financially secure, it is reasonable to assume that countries towards the top of the table will be those with the highest proportions of vulnerable and the lowest proportions of secure households. Table 2 represents the result of the USA survey by Genworth.

Table 2



	Percentage in each group (row per cent)				Index score
	Financially vulnerable	Strivers	Circumspect	Financially secure	
USA	20	20	49	10	14
European markets	24	12	58	7	28

Source: Genworth

In terms of the study the current financial difficulties being experienced in the USA was broadly similar to those experienced in UK. Dynan & Kohn (2007)<sup>49</sup> reported that the ratio of total household debt to aggregate personal income in the United States has risen from an average of 0.6 in the 1980s to an average of 1.0 and the personal saving rate has fallen from an average of 9.1 percent in the 1980s to an average of 1.7 percent this decade.

If we apply the methodology used in the Genworth index to the results of the Finmark study “whether South Africans have the ability to make ends meet”, 55.2% of South African disagreed that they could make ends meet and 22.4% agreed that they could make ends meet. In terms of these responses South Africa would score 41 points on the Genworth index and would rank fifth in terms of table 1. This will position South Africa among the countries with the highest proportions of financial vulnerability.

No consumer vulnerability index is available for Canada and Australia.

In the next section we undertake a review of the literature into which consumers are “most likely to be over indebted”.

A complete literature on the subject of consumer indebtedness was recently published by Anderloni & Vandone<sup>50</sup> (December 2008) in a paper entitled Households over indebtedness in the Economic Literature and provided insight into which consumers are most likely to be over indebted in the European Union Countries (EU) and therefore financially vulnerable.

The results of the study can be summarised as follows:

In terms of the study age and level of income were the most common variables considered by the large majority of surveys and the most exposed to the risk of over indebtedness are people in their thirties. In the same study it was found that in Great Britain young people tend to use more credit and loans and with debts increasing so is the frequency of being

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<sup>49</sup> *The Rise in U.S. Household Indebtedness: Causes and Consequences* by Karen E. Dynan and Donald L. Kohn August 8, 2007

<sup>50</sup> *Households over-indebtedness in the Economic Literature* by Anderloni & Vandone, December 2008

over-indebted. However the likelihood of being in financial difficulty exists mainly for young householders, while young people still living with parents were not found to have a higher level of risks. In the same study it was found that in the age groups from 40-45 to 50 and over is usually accompanied by a decrease in demand for borrowing, either because incomes are sufficient to cover household expenses or because people are more conservative towards borrowing. The authors held that the marital status of the population is often analysed as a personal feature which may influence the risk of being in financial difficulties. However, the result was difficult to comment on as the criteria of classification of marital status are not homogeneous across countries and even among different surveys in the same country. Furthermore, changing family circumstances i.e having a baby or family breakdown leading to separation and divorce are among the causes generating financial difficulty.

Anderloni & Vandone reported that the relationship between employment status and the risk of over indebtedness has been widely studied by most surveys and it is a point strongly considered in credit scoring models. The authors held that from a theoretical stand point they had to consider that, on the one hand, the possibility of obtaining credit (consumer credit, personal loans and mortgages) is linked to the employment status and to the level of income. Therefore if a person is employed full time, with a stable job, well skilled and with a good job position can account for a wider selection of credit and can benefit from better economic (i.e. level of interest rates) and financial (length of loans contracts, flexibility on reimbursement) conditions. Therefore, these categories of persons have more opportunities of over-borrowing. Generally they are also more well equipped (financially and culturally) to face changing situations and managing difficulties. According to the authors, those with the worst creditworthiness and lowest credit scores are often forced to access more expensive credit conditions and to negotiate different lines of credit with different lenders. Both the two mentioned situations can cause, in the event of a change in conditions (with reference to the family circumstances or to the economic status), the risk of facing difficulties which could increase even more. Consequently, the unemployment condition is more often a cause of falling into over indebtedness or, from a different perspective, the poverty itself (that is inadequate income and poor or nil working conditions) is the main reason of financial difficulties. Generally households which are economically inactive due to

retirement or with an unemployed head resort more rarely to borrowing. In the same report it was held that cross country comparisons in this field are difficult or partially misleading due to the difference of social welfare in different countries and, again, to the fact that in some cases over-indebted persons studied are those who applied for debt-settlement procedures, while in other cases the results are related to a more general sample. Empirical evidence generally supports what is said above on a logical basis: over indebted people are more often employees (white collar or blue collar without a strong difference in our societies) rather than self-employed or pensioners and other inactive persons. With regards to the level of education, this is a variable that is generally linked to the labour status (evidently a higher level of education is related to better jobs and economic positions) but is also important from a different stand point: a person better educated has both more opportunity to evaluate his/her financial position and the terms and conditions of the credit offered, and later, is better equipped to manage situations of difficulties dealing with banks and credit institutions, and other social institutions.

According to Anderloni & Vandone income is another variable analysed in depth when studying the phenomenon of household over indebtedness and there are at least three main points of interest. First of all, as for the above described variables, it is very useful in order to better understand and depict the profile of those who are more at risk of falling into financial difficulties. Secondly, it is often used in constructing objective indicators of over indebtedness as it is an economic parameter both of financial flows and, to some an extent, of the level of household wealth. Here it is important to outline how different definitions or measures can be taken, these varying from the nominal income, to the disposable income, to equalised income (in order to take into account how many persons resort to those resources for living), to the earned income and so on. Finally, in conducting stress tests in order to predict the impact of changes in the economic situation of a country or of an area (i.e interest rates and level of income, generally linked to evolving conditions in the labour market) one of the elements considered is the impact of these changes on the level of income and, therefore, on the affordability of the level of indebtedness. As it is easy to predict on a logical basis, the majority of surveys provide evidence that there is a strong link between household income and the likelihood of having financial difficulties.

Daniels (2001)<sup>51</sup> evaluated the topic of consumer indebtedness among urban South African households by analysing household indebtedness by income, by the race of head of the household and the gender of household head. Daniels' study revealed an upward trend in debt between the R40K-R50K and the R50K-R75K income groups with housing becoming a significant contributor to debt. According to Daniels what is also immediately visible from the results is the theory confirming the relationship between income and indebtedness; that is, indebtedness increases as income increases. In the same report Daniels reported that as far as indebtedness by gender was concerned, there is a distinct gender distribution to indebtedness, where male-headed households are at least twice as indebted as female-headed households across all four debt variables.

Hurwitz and Luiz (2007)<sup>52</sup> reported that the most important variables that affected indebtedness levels were age and number of dependants. For example, the mean debt to income ratio was 106.2 per cent for those aged 35 or younger, but 74.3 per cent for those older than 35.

Dynan & Kohn (2007)<sup>53</sup> reported that demographic shifts in the age and education composition of the U.S. population might explain the long-term rise in indebtedness as the researchers found that debt use increases between the youngest age group and middle age group but then falls off in the older group. In the same report it was held that debt use increases with education, so the rising educational attainment for the population during the past several decades would tend to boost the aggregate debt-income ratio. However, the researchers found that debt use increased within each educational group, which suggested that other factors were also at work.<sup>54</sup>

The Australian Bureau of Statistics Social Trends, Economic Report (March 2009) reported that linked with changes in employment and income, people are generally more likely to

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<sup>51</sup> *Consumer indebtedness among urban South African households by Reza Daniels, September 2001*

<sup>52</sup> *Hurwitz, Ingrid and Luiz, John (2007) Urban Working Class Credit Usage and Over-Indebtedness in South Africa. Journal of Southern African Studies 33: 1, 107-131*

<sup>53</sup> *The Rise in U.S. Household Indebtedness: Causes and Consequences by Karen E. Dynan and Donald L.Kohn August 8, 2007*

<sup>54</sup> *For both age and education groups, the rise in the amount of debt held also shows up prominently at higher points in the debt-income distribution*

owe money from young adulthood to middle age, and less likely to have debt during retirement and older age. Owner occupied property debt increased steadily with age, peaking for households where the reference person was aged 35-44 years (51%) before declining in older age groups. In 2005-06, the prevalence of all types of debt increased with income, as the more income and assets a household owned, the easier it is for that household to borrow money. Households in the top two income quintiles owed almost two-thirds (64%) of all debt.

The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>55</sup> held that in Canada certain socio-economic groups are particularly susceptible to increasing debt. The most vulnerable are the hardest hit – low income, households with children, young adults, and the retired. Canadian families in particular are struggling with increasing debt. Households with one or more children under the age of 18 reported debt as rising more often than those with no children, with 49% reporting their debt had substantially increased. Respondents with lower income were much more likely to report increasing debt compared to the respondents in other income groups. And, those with low wealth continue to sink into debt and to experience further deterioration in their net worth positions.

In the previous section we considered “who is most likely to be over indebted”. In the next section we will consider the recent research into the additional variables that affect the risk of becoming over indebted.

### **3.6 Reasons for Borrowing**

The research by Finmark Trust (2009)<sup>56</sup> states that among South Africans income security, level of savings, cost of debt and living expenses all play a part in consumers’ financial well-being. The report stated that someone who has lost his job and who has little or no savings will be financially vulnerable. Someone else, also faced with loss of income, but who has sufficient savings and social networks will be less vulnerable. Some high-income earners are

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<sup>55</sup> *The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>55</sup> embarked on a second consumer survey on the topic of household debt and consumption in Canada in a report entitled Where Has the Money Gone The State of Canadian Household Debt in a Stumbling Economy*

<sup>56</sup> *FinMark Trust (July 2009) in conjunction with the Income and Expenditure Research Division of the Bureau of Market Research (BMR) at Unisa (University of South Africa)*

financially vulnerable due to high debt service and living expenses, despite having income security.

Anderloni & Vandone<sup>57</sup> (2008) found that the main variables that affect the risk of becoming over indebted in EU Countries can be summarised as follows:

That in broad terms, living in rented accommodation is associated with a higher likelihood of being in financial difficulties. As far as savings are concerned, generally the surveys that collect information on this aspect, all conclude that those who are over-indebted or at high risk of being in financial difficulty, lack this form of safety net, which is very useful in times of hardship. As regards attitudes towards payments, credit and money management, it suffices to mention here that psychological features of the individuals and their attitudes towards payments, use of credit and deferment of payments often play an important role in influencing the level of debt and the risk of facing problems with reimbursement. With regards to health, illness is a possible cause of over indebtedness also if it is generally statistically less important than others. In principle, aspects of health could be positively correlated with over indebtedness, similarly to age, economic activity and income. In other words, more fragile persons are to a larger extent exposed to hardship and, consequently, to the likelihood of passive over indebtedness.

Dynan & Kohn (2007)<sup>58</sup> held that in the United States of America demographic shifts, house price increases, and financial innovation all appear to have contributed to the rise and stated that the increase in house prices particularly, but not exclusively, over the past half-dozen years appears to have played the central role. Financial innovation also seems to have boosted debt, not primarily by increasing the share of households that are able to borrow but by increasing the amount of debt held by households that already had some access to borrowing.

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<sup>57</sup> *Households over-indebtedness in the Economic Literature by Anderloni & Vandone, December 2008*

<sup>58</sup> *The Rise in U.S. Household Indebtedness: Causes and Consequences by Karen E. Dynan and Donald L.Kohn August 8, 2007*

Dynan & Kohn<sup>59</sup> stated that households have become more exposed to shocks to asset prices through the greater leverage in their balance sheets, and more exposed to unexpected changes in income and interest rates because of higher debt payments relative to income. At the same time, an increase in access to credit and higher levels of assets should give households, on average, a greater ability to smooth through shocks. However, the ability to borrow more easily or cheaply means that household's with unreasonable expectations about future income or asset appreciation can take on more debt than may be appropriate. The most important factors behind the rise in debt and the associated decline in saving out of current income have probably been the combination of increasing house prices and financial innovation.

Having discussed the additional variables that may lead to the over indebtedness of households it becomes important to discuss one of the major components of household debt viz mortgage finance and its contribution to household debt.

### **3.7 Mortgage finance as a component of household debt**

Prinsloo (2002)<sup>60</sup> stated that the two major components of household sector debt are customarily classified into household credit and mortgage advances and it is therefore important to distinguish between these components and the movement of these aggregates relative to total credit extended to the domestic private sector by banks in order to analyse household debt. Prinsloo held that mortgage advances come into play when households enter into loans (home mortgages) to buy homes and other fixed property and provide the property concerned as security for the loan. One feature of such loans is that the borrowers (mortgagees) will, under normal circumstances, have to pay off a certain portion of the price of the property themselves before the lender (mortgagor) makes the remaining portion of the purchase amount available. The size of the loan is usually determined according to the annual income of the borrower and the value of the pledged property. The loan is repaid over a long period that ranges from 20 to 30 years, although shorter periods may also be arranged.

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<sup>59</sup> *The Rise in US Household Indebtedness: Causes and Consequences* Karen E. Dynan, Donald L. Kohn, Federal Reserve Board. August 8, 2007

<sup>60</sup> *Household Debt, Wealth and Saving* by J W Prinsloo, December 2002

Bridges, Disney & Henley (July 2004)<sup>61</sup> examined the relationship between housing wealth and the level and growth of debt in financial assets in the United Kingdom and stated that house price fluctuations affect the value of lifetime wealth. In the life cycle saving 'story', permanently higher house prices increase the value of lifetime wealth of homeowners, reduce their need for additional borrowing, and, on the margin, increase consumer spending. In the same report it was held that the net impact on overall spending and lifetime wealth of a period of increasing house prices may be less clear-cut: the increase may be regarded as transitory or, if perceived as likely to continue, induce consumers to substitute spending on housing consumption for spending on other goods. Moreover, there are distributional effects: would-be buyers face a greater hurdle as house prices rise and may have to increase their indebtedness in order to enter the market, whereas housing wealth gains can only be obtained by downsizing or re-mortgaging.

Carroll (2004)<sup>62</sup> points out, that fluctuations in house prices redistribute wealth in the economy, rather than increasing the overall real income of the economy, although this redistribution may increase spending in the short to medium term.

Mortgage finance can be the single most important source of personal borrowing, dominating the balance sheets of many households. Thus the size, extent and the contractual features of mortgage finance are bound to have important implications for the national economic performance of many countries, along with individual and social welfare. Given the benefits of owner occupation, access to mortgage credit can significantly affect life chances, for example equity can be withdrawn to finance education and owners have access to an asset that materially affects wealth (Stephens 2000).<sup>63</sup>

Equity extraction can also be used to finance the purchase of business or other assets (Disney et al. 2002; Jones 1993, 1994, 1995) complicating the link between mortgage and housing demand.

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<sup>61</sup> *Housing Wealth and the accumulation of financial Debt: Evidence from UK Households* by Sarah Bridges, Richard Disney and Andrew Henley March 2004

<sup>62</sup> *How do house prices affect consumption*, CD Carroll, 2004

<sup>63</sup> *Economics of the mortgage market: Perspectives on households decision making* by David Luce, 2004

The Irving Fisher Committee on Central Bank Statistics (August 2006) reported that the housing wealth effect will very likely make homeowners “feel” richer. Moreover, because there is more collateral available up front, and monthly payments at lower interest rates appear more affordable, lenders will find it easier to provide credit which will allow homeowners to borrow more to invest still more in housing. Should the past increase in house prices generate extrapolated expectations of still further increases, this can create a dynamic of higher house prices which, in the end, bears little relationship with the initial interest rate shock. Speculative price increases of this sort (separable from those associated with lower interest rates) fail to increase the aggregate real wealth of the nation.

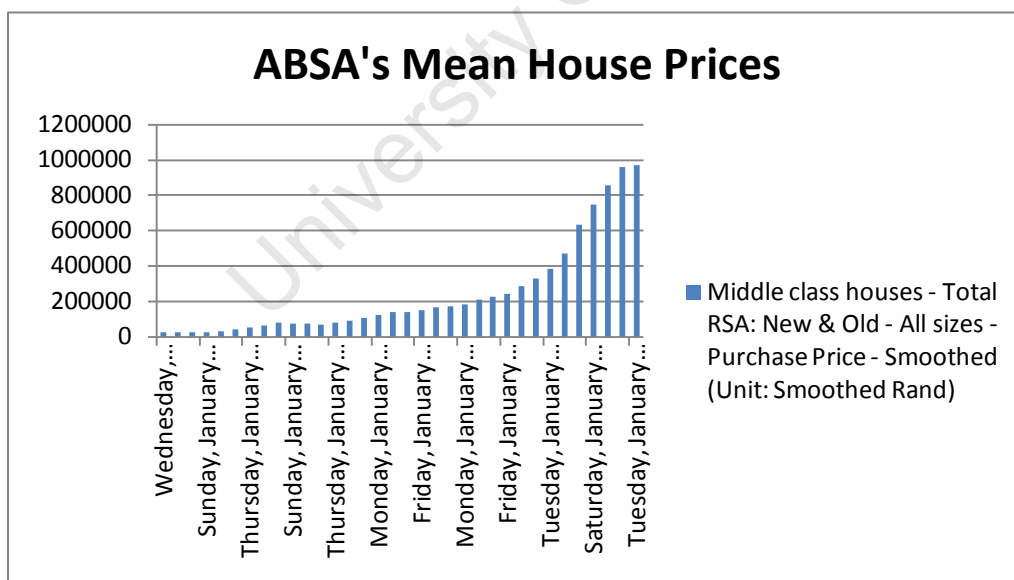
### **3.8 House Prices in South Africa**

An analysis of house prices as depicted in figure 6 reveal some interesting aspects of the economic and socio-political conditions that prevailed in South Africa between the late 1970s and the late 1990s. The 1970s brought wars in the Middle East, which sent oil prices soaring and presented the world with inflationary problems. In South Africa, the 1976 Soweto student uprising had a material impact on confidence and adversely affected economic performance. From the third quarter of 1976 to the fourth quarter of 1979, house prices declined by a total of 22.4 percent in real terms. The early 1980s saw a massive loss of confidence in the dollar and concerns about spiraling inflation in most of the developed world. Consequently the gold price boomed, reaching a high of \$676 on average during September 1981, which had huge positive spin-off effects for the South African economy. At that stage, income from gold exports constituted nearly 50 percent of total South African export revenue. Rising incomes and a reduction in tax rates considerably boosted households’ net wealth position. Improved liquidity conditions even facilitated a reduction in mortgage lending rates. However, the good times were about to end when the gold price pulled back and interest rates started to increase. The property market held up quite well during 1981 through to 1983, peaking in the first quarter of 1984. But severe pressure on the balance of payments, which sent mortgage rates soaring, together with increasing political pressure from both domestic and foreign sources, caused the property market bubble to burst. During the period from mid-1984 until the end of 1987, house prices declined by no less than 42 percent in real terms. From the end of 1986 through to the end of 1991, house prices simply kept pace with inflation. In 1992/93, confidence suffered a

setback owing to uncertainty about the political future of the country. With the advent of the new democratic order in April 1994, confidence was restored and house prices recovered somewhat. However, an ongoing exodus of skilled managers and professionals during much of the 1990s served to keep the property market under pressure. Only in 1998 did the market start to recover on the back of lower inflation and interest rates, higher economic growth, and a much improved fiscal situation. Unfortunately, contagion effects from the Asian crisis caused a massive fall in the value of the rand, which once again caused interest rates to soar by some seven percentage points during 1998. By late 1999, the situation had more or less stabilised, and the house price boom resumed. By mid-2003, house prices had nearly doubled in nominal terms from their early 1998 values.<sup>64</sup>

The recent property boom in South Africa has been attributed to the Black middle class as a result of significant changes in the class structures of post-apartheid South Africa. South Africa has seen a rapidly emerging Black elite and urban middle class, which have changed the economic landscape and left companies scrambling for a piece of this new market.<sup>65</sup>

Figure 6



Source: ABSA Bank

<sup>64</sup> *The Absa residential property market database for South Africa - key data trends and implications, BIS Papers No 21 by Christo Luüs, 2001*

<sup>65</sup> *Hurwitz, Ingrid and Luiz, John (2007): Urban Working Class Credit Usage and Over-Indebtedness in South Africa. Journal of Southern African Studies 33: 1, 107-131*

Dynan and Kohn (August 2007) In a Federal Reserve Report stated that an increase in house prices could also boost debt. First, a wealth effect may boost consumption. It might seem that a household whose home appreciates in value has experienced a matching increase in its nominal housing wealth and its cost of living and therefore would make no change in its consumption, saving, or borrowing. However, if that household expects to downsize in the future and does not have a perfect altruistic link to its children, then it is indeed richer. If this household's children cannot reduce consumption in the face of the positive shock to their future housing costs that they have experienced--perhaps because they are too young to be active economic agents--then the aggregate effect is an increase in consumption. The resulting reduction in saving will generally lead to more borrowing. Secondly, when house prices rise, expenditures are more front-loaded relative to income. Like other durable goods, a home is generally purchased before the consumption of its services, and the vast majority of households borrow large amounts to make this purchase. When house prices are higher, larger amounts must be borrowed to obtain the same housing services (although the desired quantity of housing services may also adjust). Thirdly, an increase in house price changes the composition of household portfolios and may induce portfolio rebalancing that involves increases in debt holding. In particular, households may borrow against their house to invest more in tax-deferred retirement assets.

In the next section we will discuss an important component of mortgage finance viz. the loan to value ratio (LTV). The lower the LTV percentage, the more equity you have in your home.

### **3.9 The definition of the Loan-to-Value Ratio (LTV)**

A Loan to Value ratio or LTV in its shortened form is a ratio used by lenders to partially determine the risk factor of a mortgage. This is coupled with several other factors such as a borrower's credit rating and financial history to determine if giving them a loan is worth it or not. During bad economic times this ratio becomes even more important.

If the Loan to Value ratio is high then the mortgage risk factor is high and therefore more collateral may be requested from the borrower, higher interest rates will probably be implemented and it will generally cost the borrower more to make the loan more profitable

to the lender. It is therefore better for the borrower to obtain a low LTV mortgage if the borrower has a bad credit score. A lender will not offer a loan without being completely certain they'll get their money back with interest, whether it's from collateral or successful repayment.<sup>66</sup> Hence mortgages where no deposit exists have a 100 percent LTV.<sup>67</sup>

Mortgage lenders typically do not want loan-to-value ratios that are higher than 80 percent. If the LTV is above 80 percent and the value of the property declines, it is possible to end up owing more than your home is worth.<sup>68</sup>

In South Africa the four major banks<sup>69</sup> granted mortgage loans to a maximum of 108 percent LTV prior to 2008. However during 2008, South African banks tightened their home loan lending policies in response to the slowdown in the local residential property market and the rising interest rates and discontinued discounting all cost inclusive (108 percent) mortgage loans setting the maximum LTV at 100 percent of the property value. (Mortgage Innovations)<sup>70</sup>

In the section that follows a comparison between the mortgage markets of South Africa, USA, UK, Australia and Canada will be undertaken in order to observe the impact that financial innovation and deregulation has had on mortgages and the resultant increase in debt levels in these economies.

### **3.10 An international comparison of housing finance systems**

Different housing finance systems provide the background to mortgage choices. Different economies will be at different stages in this process so significant differences in housing finance systems will be observed.

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<sup>66</sup> [http://www.financialdictionary.net/define/LTV+\(Loan+to+Value\)/](http://www.financialdictionary.net/define/LTV+(Loan+to+Value)/)

<sup>67</sup> As published on the website <http://www.selfcertmortgageuk.co.uk>

<sup>68</sup> As published on the website <http://www.ezinearticles.com>

<sup>69</sup> Standard Bank, ABSA, First National Bank and Nedbank

<sup>70</sup> As published on the website <http://www.propertyloans.co.za>

### **3.11 South Africa**

Prinsloo (2002)<sup>71</sup> explained that in South Africa the interest on mortgage loans is normally determined at a variable rate and the lender may adjust the interest rate after giving one month's notice. A fixed-rate option is also available that protects the mortgagee against sharp increases in mortgage rates. The maximum period that the banks are prepared to lock into such a fixed-rate agreement depends mainly on the expected change in interest rates however repayment usually takes place in monthly instalments. The amount repaid each month may vary in accordance with interest rate movements, if a variable rate was chosen. The mortgagee may redeem the mortgage debt at any stage without being penalised provided the mortgage loans falls within the ambit of the NCA as the Act prohibits the levying of early settlement fees and also prohibits the payment of penalty fees. The converse is true if the agreement falls outside the ambit of the NCA.

The South African retail credit markets changed markedly during the 1990s. Consequently, the retail finance sector has seen new developments, particularly in private-label credit cards and unsecured loans. As part of these developments, households enter into mortgage loans to acquire funds for purposes other than the purchase of fixed property. In such a case the fixed property owned by a household is pledged as security for the loan. The keen competition among the various financial institutions in South Africa since the first half of the 1980's has caused mortgage advances to be promoted increasingly for purposes other than the financing of transactions in fixed property.

### **3.12 United States of America**

David Leece (2004) in a publication entitled *Economics of the Mortgage Market: Perspectives on Households decision making* stated that the US market for residential mortgage debt has several important characteristics that will be referred to when evaluating research into mortgage choices. There are a variety of available mortgage designs, with the key instruments being fixed rate debt (the FRM) and the adjustable rate mortgage (the ARM). Fixed rate mortgages fix the rate for 15 or 30 years, while for adjustable rate debt the adjustment period is from 1 to 5 years. This compares with fixed rate debt in the UK and Canada, which is typically fixed for 1 to 5 years, with some longer periods available, but

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<sup>71</sup> *Household Debt, Wealth and Saving* by J W Prinsloo, December 2002

which reverts back to a variable rate of interest after the period for which the mortgage rate was fixed. These differences will be seen to be significant when household behaviour was examined regarding the choice of mortgage instruments and the impact of mortgage contract choice on housing demand. For example, UK borrowers appear to focus much more on expected movements in short-term interest rates than long-run interest rate expectations. The mortgage banks have generally superseded the Savings and Loans institutions and dominate mortgage finance in the US. These mortgage banks originate loans, which are then sold to government sponsored agencies (GSEs). That is, the mortgage debt is passed on the secondary mortgage market. The mortgage banks came to prominence after the Savings and Loan crises in the US. One advantage of this system is that the mortgage banks do not need large amounts of funding to conduct their business, as the debt is sold on. They are also able to pass on the risks of holding mortgage debt to investors, and the risks are largely outside any regulatory framework. A critical factor in understanding US research is the importance of the securitised mortgage market, where mortgage loans are packaged into securities. Lenders in most economies traditionally originate, fund and service loans. The securitisation of debt separates the functions of originating, funding and servicing. Securitisation has been the main reason for the growth of this market in the US.

In the United States 100 percent LTV's are sometimes offered to first time buyers. The United States Department of Agriculture also offers 100 percent LTV programs for borrowers with an income not exceeding 115 percent of median income. Borrowers must not currently own a home but does not need to be a first time home buyer. Together/Plus Mortgages represents loans of 100 percent or more of the property value typically up to a maximum of 125 percent. Such loans are normally (but not universally) structured as a package of a 95 percent mortgage and an unsecured loan of up to 30 percent of the property value.<sup>72</sup>

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<sup>72</sup> As published on the website <http://www.en.wikipedia.org>

### 3.13 United Kingdom

Andrew C Worthington (November 2003)<sup>73</sup> held that in the United Kingdom the Bank of England has called for 'close monitoring' of the growth in unsecured lending – some 19 percent of household debt up from 14 percent a decade ago – and has expressed concern about total household debt – currently rising by 13 percent annually – and the possible impact on the banking system if the housing bubble bursts, particularly in London and the Southeast (Nickell 2003; Scheherazade 2002).

Leece<sup>74</sup> (2004) held that the UK mortgage market is one of the most sophisticated and liberal markets in the world. The UK economy and its housing market also have their own particular characteristics. The results of Leece's findings can be summarised as follows:

There are high levels of owner occupation, high levels of indebtedness and high proportions of mortgages where the interest rate is variable rather than fixed. These features of the UK housing and mortgage market have led to high sensitivity of consumer spending, and savings decisions, to changes in interest rates (Earley 2000). The funding of mortgage finance in the United Kingdom has been primarily through retail deposits though there has been an increase in off balance sheet financing and the securitisation of mortgage debt. Securitisation has primarily been used by so called centralised mortgage lenders who entered the UK market during the late 1980s (Pryke & Whitehead 1991; Paid 2002). Some of these lenders were of US origin, a competitive incursion to be repeated later with the development of the UK sub-prime lending market (e.g the entry of Money Store in 1997). The centralised lenders were competitors to the traditional building societies and banks. Recently the share of lending by centralised sector has declined having dropped below 10 percent during the 1990s but increasing competitive pressures are leading more traditional providers to consider mortgage securitisation. The UK mortgage market is an example of a mature and deregulated mortgage market where competition has generated a large variety of mortgage contracts. The United Kingdom is interesting both for institutional reasons (it has a high level of home ownership relative to many other countries in the European Union,

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<sup>73</sup> *Debt as a source of financial stress in Australian Households by Andrew Worthington November 2003*

<sup>74</sup> *David Leece Economics of the Mortgage Market: Perspectives on Households decision making*

significant house price volatility, high levels of mortgage and other financial indebtedness, and because it was an early 'deregulator' of financial markets) and for data reasons, since new data sets for the UK permit an exploration of the relationship between housing wealth and various forms of financial indebtedness at the household level. The UK housing market is perceived as exhibiting greater sensitivity to monetary policy than other EMU countries given its prevalence of variable rate mortgages and UK consumer spending appears to be relatively interest elastic (HM Treasury, 2003).

### **3.14 Australia**

The Australian Bureau of Statistics Social Trends, Economic Report (March 2009) reported that based on information from the Reserve Bank of Australia, over the last 18 years the total amount of debt owed by Australian households rose almost six-fold. At September 1990 the level of household debt was almost \$190 billion, increasing to around \$1.1 trillion by September 2008 in real terms (i.e. adjusted to remove the effect of inflation). Most debt was incurred to buy houses. Between 1990 and 2008, debt for investor housing increased from 11 percent to 27 percent of all household debt. Debt for owner occupier housing was consistently the largest component, ranging from 56 percent to 67 percent of debt (59 percent in September 2008). Other personal debt (for example credit card debt) halved as a proportion of all debt.

In the same report the levels of debt was compared with assets and provided context on how they have changed over time. Between September 1990 and September 2008, the ratio of total household debt to assets held by households rose from 9 percent to 19 percent. In other words, debt grew twice as fast as the total value of assets held by households. The sharp increase in the debt to asset ratio from December 2007 to September 2008 was due to a decline in the value of household assets. Among the different types of debt, housing debt as a proportion of housing assets rose from 11 percent to 29 percent, which means overall, households have come to own a relatively smaller proportion of their houses. On the other hand, the total amount of equity households' hold in their houses increased by 62 percent, from an average of \$185,000 to \$299,000 per household. Borrowing for owner-occupation and investment both contributed to the rise in housing debt. In contrast, the ratio of other personal debt to assets was around 2 percent in both periods. Some home

loans have features that enable the borrower to draw on their asset for non-housing purposes. This can help households pay for expenses such as medical bills, to buy a new car or help with living costs during a transitional phase such as unemployment. In 2005-06, almost one-quarter (24 percent) of households with a mortgage on their home had money owing on it for non-housing purposes (excluding business or investment purposes). Michael Davies, (2009)<sup>75</sup> stated that the rapid increase in housing debt has been accompanied by strong growth in house prices. House prices roughly doubled over 1987 and 1988, drifted slowly higher during the first half of the 1990s and more than doubled between 1997 and late 2003. Since then, house prices (in aggregate) have continued to increase. In the same paper the writer held that several factors have contributed to the strong growth in housing debt over recent years, the principal one being that lower interest rates in Australia allow households to borrow more when they take out their housing loan. The average size of new owner-occupier housing loans has increased from around \$65,000 (1.6 times annual household income) in 1989 to around \$250,000 (three times annual household income). But even though the average loan size has quadrupled, loan repayments as a share of household disposable income are still a little below their 1990 peak. The effect of the increase in households' borrowing capacity has been reinforced by an increase in the availability of housing finance. During the mid-1990s, specialist mortgage originators entered the housing loan market in Australia. These new institutions competed aggressively for market share by undercutting existing lenders' mortgage rates and by introducing new mortgage products such as home equity loans, interest-only loans and loans requiring little documentation. By the early 2000s, mortgage originators' market share had risen to about 10 percent. There has also been an increase in the proportion of households with owner-occupier mortgage debt. According to the latest Australian census, 35 percent of households were paying off an owner-occupier loan in 2006, up from 27 percent in 1996, with households whose oldest members were between 45 and 64 years old accounting for most of the increase. With the strong growth in housing debt over the past 15 years, household interest payments increased to a historic high of nearly 12 percent of disposable income in December 2007. This is well above the previous peak of 9 percent, which was recorded in late 1989 when mortgage rates reached 18 percent. The structure of

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<sup>75</sup> *Household debt in Australia, Bank for International Settlements papers no. 46 (2009)*

the Australian housing finance market is such that a change in the Reserve Bank of Australia's cash rate has always flowed directly through to mortgage rates. About 85 percent of outstanding Australian housing loans are at variable rates. According to the Committee on the Global Financial System (CGFS), this share is quite high by international standards. The increase in household debt has, however, made household debt payments more sensitive to changes in interest rates.

In Australia, traditionally an 80 percent LTV is the norm. If buyers do not have a 20 percent deposit, they will be required to pay for Lenders Mortgage Insurance (LMI). Lenders Mortgage Insurance provides protection to the lending institutions in the event that the borrower defaults on the Home Loan. (Mortgage & Finance Association of Australia). However, 100 percent LTV's are available to first time home buyers who are eligible for the full first home owners grant. Furthermore loan applicants who are not eligible for the first home owners grant and have no real deposit available will be required to pay purchasers stamp duty in many cases and a 105 or a 106 percent LTV will be required by these loan applicants to cover all the purchase costs that will be incurred. Loan to value ratio's can be reduced to 80 percent of the purchase price while still borrowing an actual 100 percent of the purchase price with the assistance of a security guarantor with a limited guarantee. The way in which this type of finance works is where a family member or even a friend with existing equity in another property puts up a portion or a limited security guarantee in their property to reduce the loan to value ratio in the property to be acquired.<sup>76</sup>

### **3.15 Canada**

The Canadian economy has been recession free for 17 years before the events of 2008. The last recession took place over a 12 month period between April 1990 and March 1991.

The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>77</sup> held that Canadian household debt is at an all-time high reaching \$1.3 trillion in 2008 and the escalation of debt is primarily caused by consumption motives rather than asset

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<sup>76</sup> As published on the website <http://www.finance-broker.net.au>

<sup>77</sup> The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>77</sup> embarked on a second consumer survey on the topic of household debt and consumption in Canada in a report entitled *Where Has the Money Gone The State of Canadian Household Debt in a Stumbling Economy*

accumulation. The three main indicators of household indebtedness (debt-to-income, debt-to-assets and debt-to-net worth ratios) deteriorated significantly in the past two years and particularly during 2008.

In the same report it was held that Canadian households are financing consumption activity and fuelling gross domestic product growth with unearned money as families increasingly reach for credit to finance day-to-day living expenses.

Remarks by David Wolf, Adviser on behalf of Timothy Lane, Deputy Governor of the Bank of Canada(11 January 2010 ) in an article entitled “Canada’s Housing Sector in Recession and Recovery: Beyond Bricks and Mortar” explained why Canada's housing market in general has tended to be less turbulent than housing markets in other countries. Wolf held that an important factor is Canada's housing finance and regulatory system. Canada's mortgage market is national, with similar lending conditions and mortgage products across most regions. It is dominated by domestic players, especially the six major banks, although a number of new competitors have entered the Canadian market in recent years. Canada's mortgage credit culture has tended to be quite conservative. Mortgage insurance is compulsory for federally regulated financial institutions when the loan-to-value ratio is over 80 percent. Further, mortgage insurance providers tend to set the lending standards for the industry as a whole. Only about 30 percent of mortgages in Canada are securitised, so most lenders have ongoing exposures to the mortgages they originate, and that gives them an incentive to be more prudent in their lending practices. Borrowers in Canada also have reasons for prudence: mortgage interest on primary residences is not tax deductible in Canada and (in most provinces) lenders have full recourse to borrowers in the event of default. Thus, a combination of factors contributes to a more stable mortgage market.

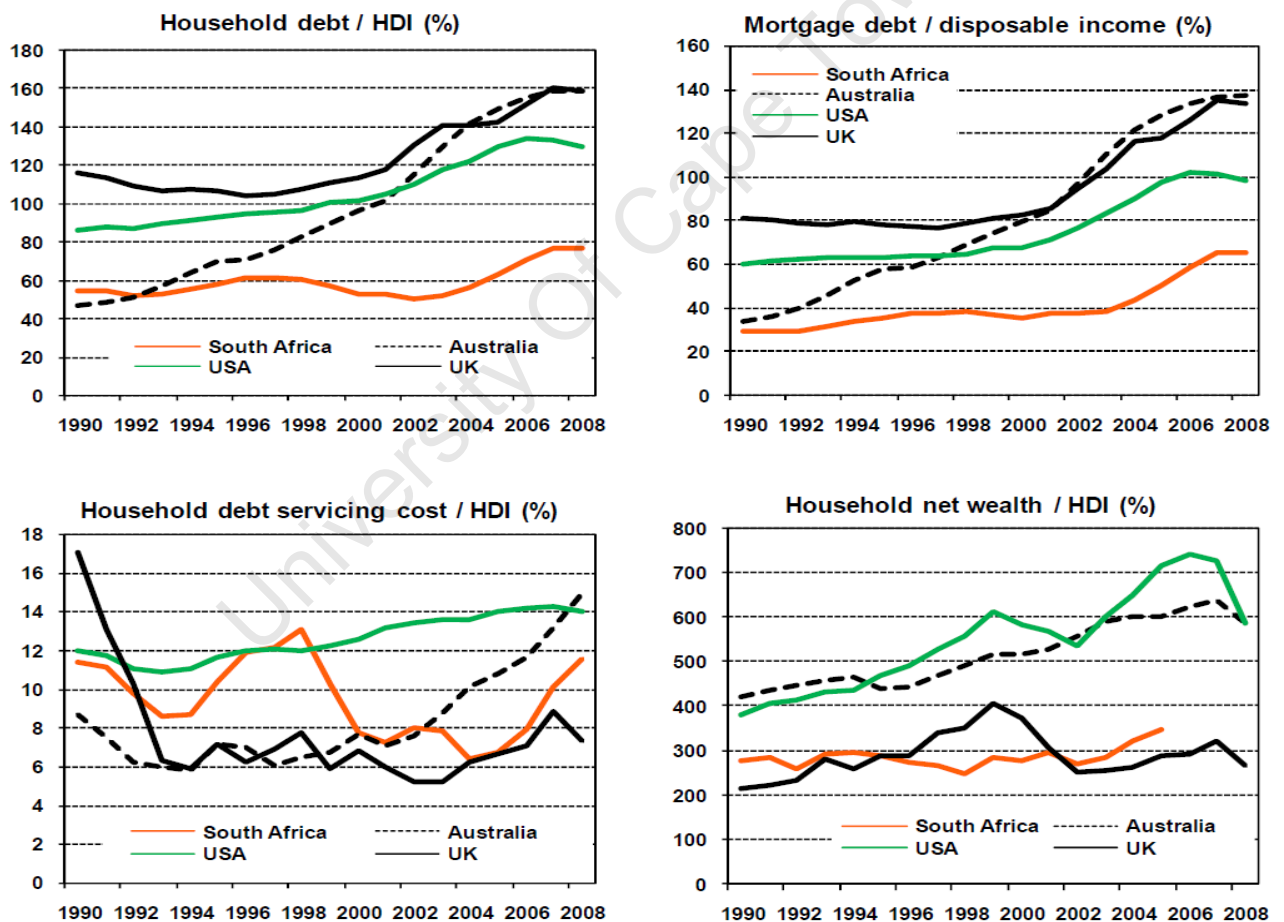
In the next section we present data that compares the household debt, mortgage debt, debt servicing costs of households and household net wealth to disposable income between South Africa, USA, UK, and Australia.

### 3.16 An international comparison of household/mortgage debt, debt service costs, net wealth and disposable income

In South Africa household debt as a percentage of disposable income in final quarter of 2008 was 76.4 percent compared to Canada's household debt at about 140 percent of disposable income, compared with about 150 percent in Britain and almost 170 percent in the United States. The level is about 90 percent among the countries that use the euro.<sup>78</sup>

The National Debt Mediation Association (May 2009) in a paper prepared by Ecoquant (Pty) Ltd held that in subsequent periods household credit and debt trends in most of the developed (particularly the English-speaking countries) have been quite similar. See Figures 7<sup>1</sup>, 7<sup>2</sup>, 7<sup>3</sup> and 7<sup>4</sup>

Figure 7<sup>1</sup>, 7<sup>2</sup>, 7<sup>3</sup>, 7<sup>4</sup>



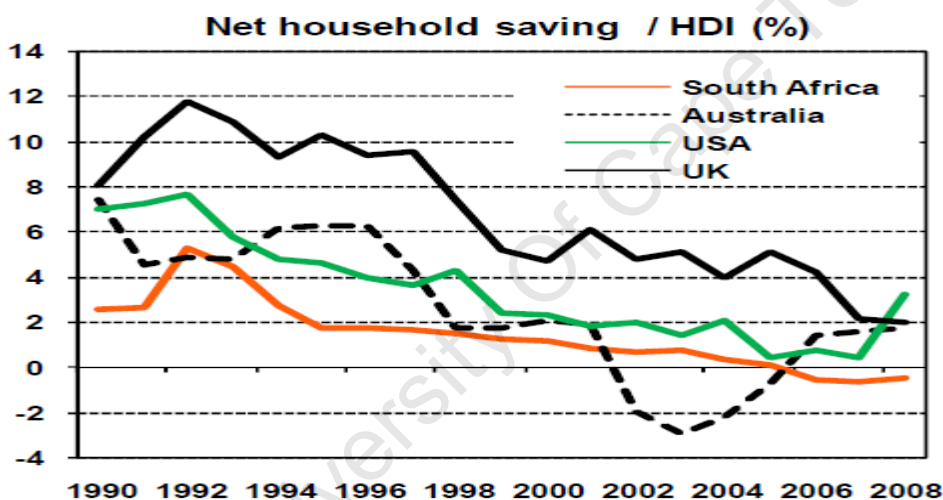
Source: National Debt Mediation

<sup>78</sup>As published on the website <http://www.theglobeandmail.com/report-on-business/household-debt-emerges-as-greatest-risk-to-canadas-financial-system/article1182320/>

Increases in the levels of household debt, mortgage debt, debt servicing costs in the period preceding the downturn in the economy in 2007 and the subsequent decline in household net wealth has led to increases in the levels of distressed consumer loans, a higher than normal numbers of insolvencies, and an increasing share of income devoted to paying interest on debt. These are signs that some households have become overextended.

According to the National Debt Mediation Association<sup>79</sup> the behaviour of the household sector has conditioned, and will continue to condition, global growth prospects. Over the last few years, the household saving rate in many industrial counties has fallen sharply, with the lowest level of savings being recorded in the English-speaking countries as depicted in figure 8.

Figure 8



Source: National Debt Mediation Association

In Canada The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>80</sup> reported that one third of Canadians do not commit any resources to savings and deteriorating economic conditions have not yet had the usual effect of encouraging increased savings. Even with the temporary relief of a credit card or line of credit, one quarter of Canadians would not be able to handle an unforeseen expenditure of \$5,000 and 1 in 10 would face difficulty in dealing with \$500 unforeseen expense. However in many emerging market economies, especially in Asia, household saving rates have stayed

<sup>79</sup> The National Debt Mediation Association (May 2009) in a paper prepared by Ecoquant (Pty) Ltd

<sup>80</sup> The Certified General Accountants Association of Canada (CGA-Canada) (2008)<sup>80</sup> embarked on a second consumer survey on the topic of household debt and consumption in Canada in a report entitled *Where Has the Money Gone The State of Canadian Household Debt in a Stumbling Economy*

resolutely high or even risen. In contrast to the industrial countries, where the focus of households has been on how assets are mounting, in some important emerging market economies the focus has rather been on liabilities, or at least contingent liabilities. The disparity between household saving rates in different groups of countries is responsible in large part for global trade imbalances. In particular, fluctuations in the US household saving rate, around a steadily declining trend, almost perfectly match movements in the US current account deficit.

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## **4 CHAPTER 4 – METHODOLOGY & DATA**

### **4.1 METHODOLOGY**

The literature discussed in the previous chapter focussed on the nature and causes of over indebtedness and the variables that contributed to the risk of becoming over indebted.

Therefore, the primary purpose of this study is to organise the literature and to highlight the key findings. The study does not reflect on the data limitations or on methodological approaches and differences between the studies.

The topic has recently been covered in depth by Anderlone & Vandone (December 2008) in a paper entitled “Households over indebtedness in the Economic Literature” that formed a complete literature and has already been published.

Daniels (2001) published literature that provided evidence to the effect that in South Africa there is a racial distribution to over indebtedness.

Finmark Trust (July 2009) developed a consumer financial vulnerability index for South African that provided insight into the main variables that contributes to consumer financial vulnerability, among South African households.

Hurwitz and Luiz (2007) published a paper entitled “Urban Working Class Credit Usage and over indebtedness in South Africa” that confirmed that poverty and race were the main causes of over indebtedness in South Africa.

The researcher has therefore cannabalised these findings and summarised the results by focussing, on the factors explaining the rise in household debt and by exploring the likely impact of a wide range of factors that contribute to this phenomenon.

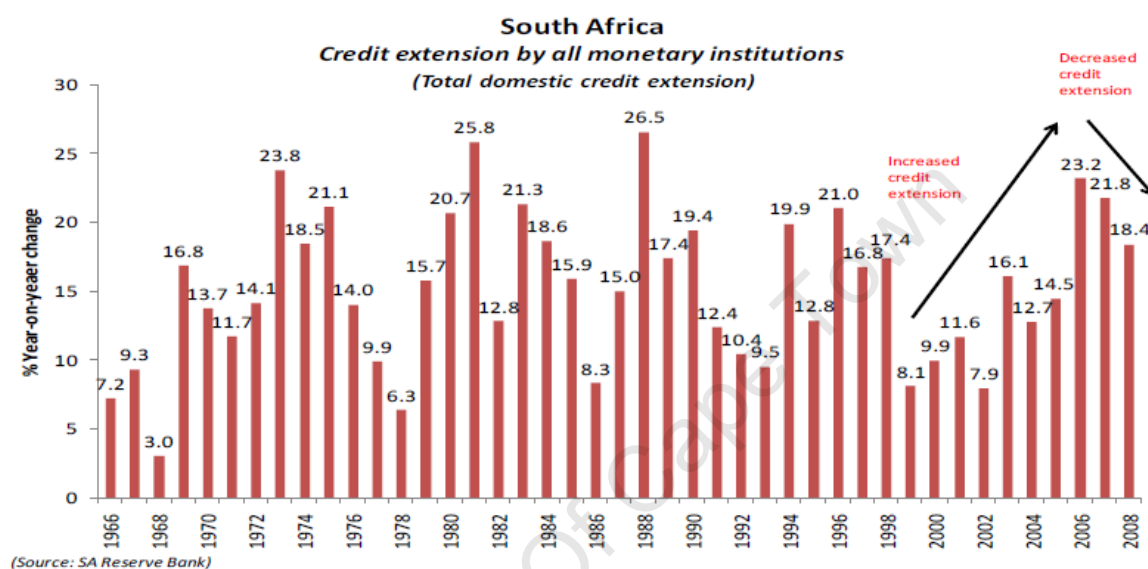
A provincial comparison was undertaken to determine whether consumers in the Western Cape Province is more indebted than consumers in the other provinces of South Africa by studying the variables that contribute to the risk of over indebtedness of households in the Western Cape.

## 4.2 DATA

In this section, the data relating to the history of credit extension in South Africa since the 1960's will be discussed as illustrated in Figure 9 below.

### 4.2.1 History of Credit Extension in South Africa

Figure 9



Johan van den Heever<sup>81</sup> held that it should be kept in mind that credit ceilings were in force from the late 1960s to 1972, moderating the rate of growth in bank credit extension. Credit growth picked up strongly from 1972 as the ceilings were lifted, but at the same time nominal disposable income rose vigorously on account of a rising gold price and accelerating inflation. (Inflation reached double-digit levels from 1974, and only returned to a single-digit, level in the early 1990s.) Accordingly, the increase in the household debt ratio was fairly moderate. From 1976 to 1980 credit ceilings were again imposed, curtailing the rate of growth in bank credit extension. When they were finally abolished in September 1980, credit-hungry consumers streamed to the banks to take up credit that had previously not been available. Another, gold boom, rising levels of employment and income, low interest rates and financial liberalisation blunted sensitivity to borrowers' creditworthiness and fuelled strong increases in household debt in the early 1980s. Following the rapid increase in the household debt ratio up to the mid-1980s, a sharp tightening of monetary policy and

<sup>81</sup> Johan van den Heever *Household debt, interest rates and insolvencies in South Africa*, 54 IFC Bulletin No 261

a deterioration of economic prospects dampened household's appetite for debt. The prime overdraft rate, which serves as a benchmark lending rate, was raised very rapidly in 1984 to a level of 25 percent per annum. In addition, financial sanctions were imposed on South Africa, damaging economic prospects and confidence. In this process the debt ratio declined significantly.

Van der Heever stated that in the late 1980s the upward trend in the debt ratio was resumed as banks developed innovative financial products such as flexible mortgages. In addition, the repeal in the late 1980s and early 1990s of discriminatory legislation opened up the opportunity for black South Africans to acquire businesses and real-estate in previously forbidden areas, and to make use of the banking system including its credit facilities on a greater scale than before. The upward trend in the debt ratio continued until 1996, levelling off as a tight monetary policy was maintained. However, following the Asian crisis of 1998 interest rates were raised quite rapidly to new record levels, with the prime overdraft rate rising as high as 25.5 percent per annum. This suppressed expenditure, dampened real-estate activity and prices, caused construction activity to slow, and stopped households' use of credit in its tracks. Despite a considerable reduction in interest rates from 1999 to 2001, households remained hesitant to increase their borrowing. A comparatively moderate tightening of interest rates in 2002 also contributed to subdued growth in household debt. The debt ratio only started rising again by 2003, as interest rates were lowered. Rising house prices reinforced the demand for and supply of mortgage finance, while the ready availability of such finance, alongside strong consumer confidence, contributed to rising house prices. Robust final consumption expenditure simultaneously raised the demand for other types of finance. The increases in the household debt ratio has been sustained from 2003 to the present day, with successive new record highs being reached.

The South African Reserve Bank's (SARB) Annual Report (31 March 2009) held that the longest business cycle upswing on record for South Africa, with its starting point in September 1999, formally came to an end 99 months later in November 2007.

In 2008 SARB reported that the events that led to the downturn and the economy losing

momentum were the interruptions in the electricity supply and later a general cooling off of final consumption expenditure by households, partly related to high debt levels, higher interest rate policies and reduced consumer confidence. This loss of momentum was exacerbated by export volumes, which fell sharply towards the end of 2008 and in the first half of 2009, resulting in the first contractions in real gross domestic product in a decade. Growth in total loans and advances extended to the private sector slowed noticeably throughout 2008 and slipped to near-record lows in early 2009. In the main, the combined effect of high borrowing costs emanating from the lagged effect of the tighter monetary policy stance phased in from June 2006, and strict credit conditions introduced by the banks during 2008 forced the household sector to scale down and postpone their borrowing requirements causing a deceleration in the demand for consumer credit.

The broadening of access to banking products and services has allowed increasing numbers of households to borrow and increase their debt levels over time and servicing such debt encumbers a significant proportion of a household disposable income.<sup>82</sup> Therefore, in this section we will be discussing the data that measures household debt.

#### **4.2.2 Debt Service Ratio**

Household debt is often expressed as a ratio of annualised disposable income of households. The Debt Service Ratio (DSR) is a ratio of minimum debt payments, not total debt, to income.<sup>83</sup> An increase in debt income ratios makes households more vulnerable to interest rate shocks.

The National Debt Mediation Association (NDMA)(2009)<sup>84</sup> reported that whilst absolute and relative debt levels have soared, debt servicing costs have, until recently, remained well contained since the late 1990's. This was very different from the 1985 and 1998 experiences when debt servicing costs reached levels exceeding 13 percent of disposable income. This figure only approximates interest costs, and not principal repayments on debt.

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<sup>82</sup> *Notes on the costs of servicing household debt, SA Reserve Bank Quarterly Bulletin, by J Mokoena, September 2008*

<sup>83</sup> *Household Debt to Disposable Income US, Federal Reserve Bulletin October 2003*

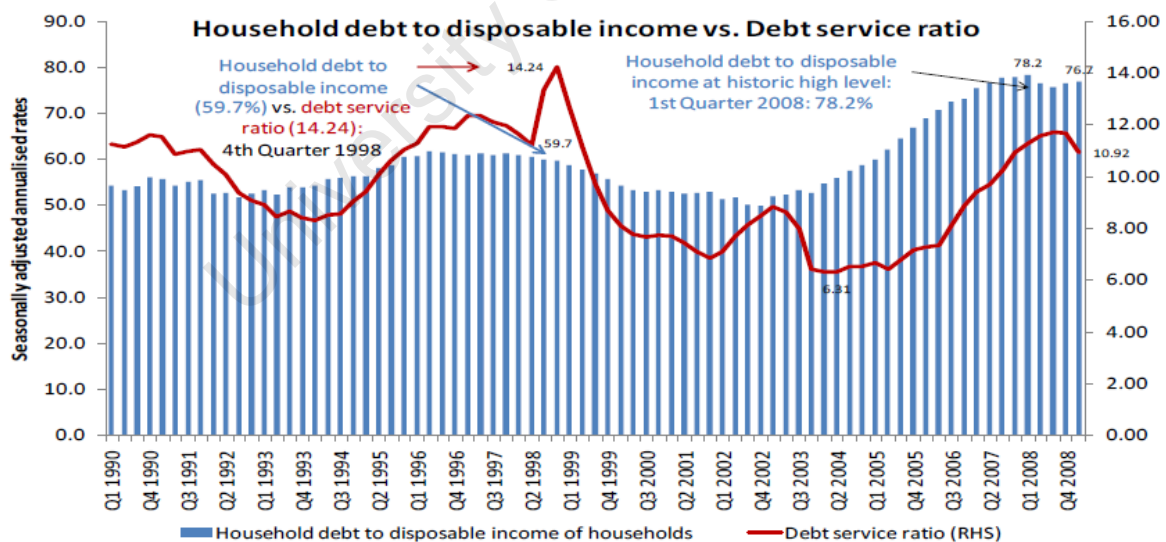
<sup>84</sup> *Consumer Vulnerability Review – Prepared by Ecoquant (Pty) Ltd for the National Debt Mediation Association (NDMA)(May 2009)*

But by mid-2007, this ratio had again reached double digits. On 23 October 2007, Business day reported that rising interest rates and inflation have pushed debt service costs as a share of disposable income for consumers above 10 percent for the first time in eight years, In the same article it was reported that this key ratio is set to creep higher in the next few months as the effect of this year's past two rate hikes made themselves felt, putting more pressure on household finances.<sup>85</sup>

Mokoena J, (2008) stated that owing to innovative, flexible credit products, which may make refinancing debt comparatively easy, these elevated debt-service ratios may, however, overstate the true cash-flow impairment faced by households arising from the need to service their indebtedness. There are numerous avenues that may be used to effectively postpone the repayment of capital on amounts borrowed. The capital and interest measures of debt service cost should therefore be used with caution.

Figure 10 depicts this ratio for South African data, covering the period from quarter one 1990 to quarter four of 2008.

Figure 10



<sup>85</sup> As published on the website: <http://allafrica.com/stories/200710230488.html>

First National Bank (FNB)<sup>86</sup> in a report published on their website stated that although it was as far back as 2004 that the household debt service ratio (cost of servicing debt as a percentage of disposable income) started to rise, it was from 2007 that far more severe household sector financial stress began to set in, with sharply rising consumer price inflation eating into disposable incomes and the combination of a steadily rising debt burden as well as rising interest rates leading the debt service ratio up towards cyclically high levels. As a result of such deterioration, the household sector started to moderate its borrowing growth as from 2006. This process was arguably sped up by banks themselves as from 2007 when the National Credit Act (NCA) was implemented, interest rates continued to rise, and non-performing loans looked set to become problematic. Fortunately, the drop in interest rates since December 2008 appears to have arrested the upward progression of this ratio.

It was only by the second quarter of 2008 that household sector credit growth had declined to such a level relative to nominal disposable income growth that enabled the household debt-to-disposable income ratio to start declining, essential in order to improve credit quality in these weak economic times. However, in the final quarter of 2008, after two quarters of decline in the debt-to-disposable income ratio, we saw a slight uptick from 75.6 percent previously to 76.4 percent. This, despite ongoing decline in household sector credit growth, is reflective of the weak economic situation, which caused nominal disposable income growth to suddenly slow more sharply in the 4th quarter. Nominal disposable income growth declined sharply in the 4<sup>th</sup> quarter as the domestic economy headed towards recession with its first quarter of negative growth. Using seasonally adjusted figures (which are used in calculating quarterly household debt-to-disposable income, one sees a significant fall in year-on-year growth in nominal household disposable income from 13.6 percent in the 3rd quarter to 10.6 percent in the fourth quarter. This is a significant drop, and goes hand in hand with a sizeable decline in nominal wage bill growth, the result of slowing employment growth, and probably also due to cutbacks in the discretionary component of remuneration that is linked to the business cycle and company financial results.

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<sup>86</sup><https://www.fnb.co.za/downloads/home/MortgageHouseholdDebtMarch2009.pdf> website: <https://www.fnb.co.za/downloads/home/MortgageHouseholdDebtMarch2009.pdf>

The responsiveness of household debt servicing to changes in central bank policy rates depends in part on the prevalence of variable rate loans.<sup>87</sup> The fall in mortgage and non-mortgage interest payments since the onset of the financial crisis in South African can be attributed to a decline in the level of debt outstanding, a change in the composition of this debt and lower interest rates on some types of credit. Households in South African have not been able to take full advantage of the decline in interest rates as the drop in house prices has prevented consumers from refinancing existing mortgages.

In the next section the debt to disposable income ratio as a measurement of households' debt levels is discussed.

#### **4.2.2 Debt to disposable income ratio**

Anderloni & Vandone<sup>88</sup>(2008) held that the main statistically significant factor in predicting debt problems is the level of debt to income ratio.

Del Rio and Young (2005)<sup>89</sup> found that, although there is no clear point at which debt becomes a problem, there is a strong link between the level of debt to income ratio and the probability of debt being somewhat of a burden or a heavy burden.

Similarly, Rinaldi and Sanchez-Arellano (2006)<sup>90</sup> found that an increase in the ratio of indebtedness to income is associated with higher levels of arrears.

ABSA<sup>91</sup> held that although interest rates have been cut by 500 basis points since late 2008, with prime and mortgage interest rates back to their mid-2006 levels of 10.5 percent that resulted in lower debt repayments, the household sector continued to experience financial strain. Households still have to deal with a relatively high ratio of debt to disposable income as depicted in figure 11 mainly as a result of low growth in their nominal income on the back of deteriorating business conditions and major job losses in most sectors of the economy.

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<sup>87</sup> As published on the website <http://www.rba.gov.au/publications/smp/boxes/2009/nov/b.pdf>

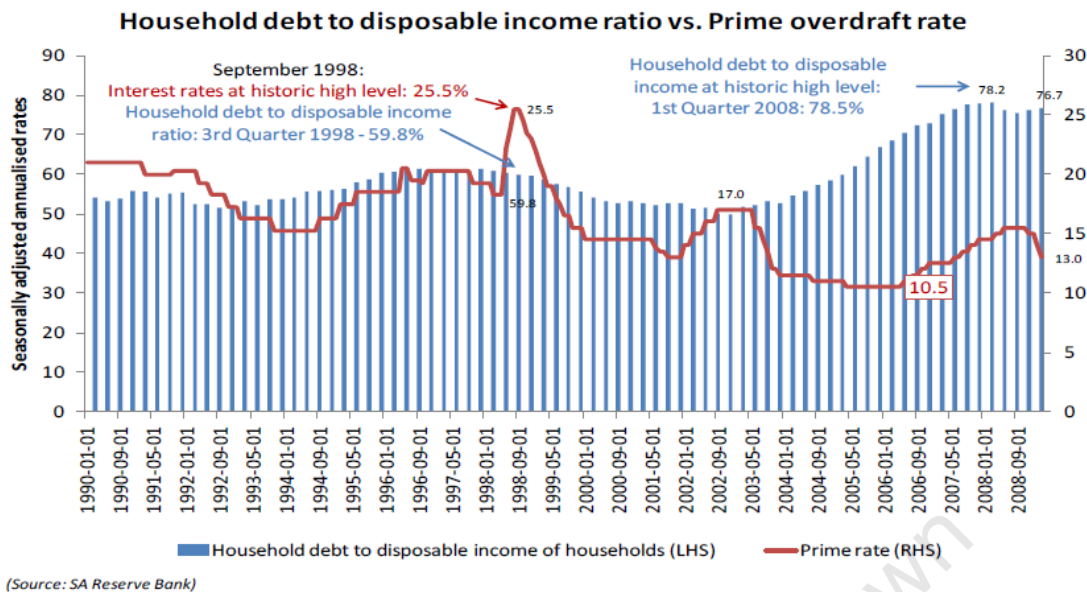
<sup>88</sup> *Households over-indebtedness in the Economic Literature* by Anderloni & Vandone, December 2008

<sup>89</sup> *The determinants of unsecured borrowing* by Del Rio and Young, 2005

<sup>90</sup> *The Determinants of Consumer Credit: A Review of the Literature*, by Rinaldi and Sanchez –Arellano, 2006

<sup>91</sup> *ABSA Home Loans, Mortgage debt reflects economic and property market conditions*, 4 September 2009

Figure 11



The household debt to disposable income level in South Africa at 78.5 percent recorded during the first quarter of 2008 means that for every R100 available to households R78.50 was used to repay debt. The high level of household debt to disposable income makes South Africans highly vulnerable to interest rate shocks.

Household debt has grown dramatically relative to disposable income over recent years, as has concern that this level of debt poses a threat to the health of global economies. In South Africa 40.59 percent of consumers are over-indebted.<sup>92</sup>

“In previous cycles when interest rates were high, consumers would access more credit to pay off current debt. The implementation of the National Credit Act has, however, to a large extent closed down on these sources of credit. The question, however, arises whether this has effectively led to the creation of a bad debt bubble as consumers who had previously taken up credit to pay off other debts now started missing payments and became bad debtors.”<sup>93</sup>

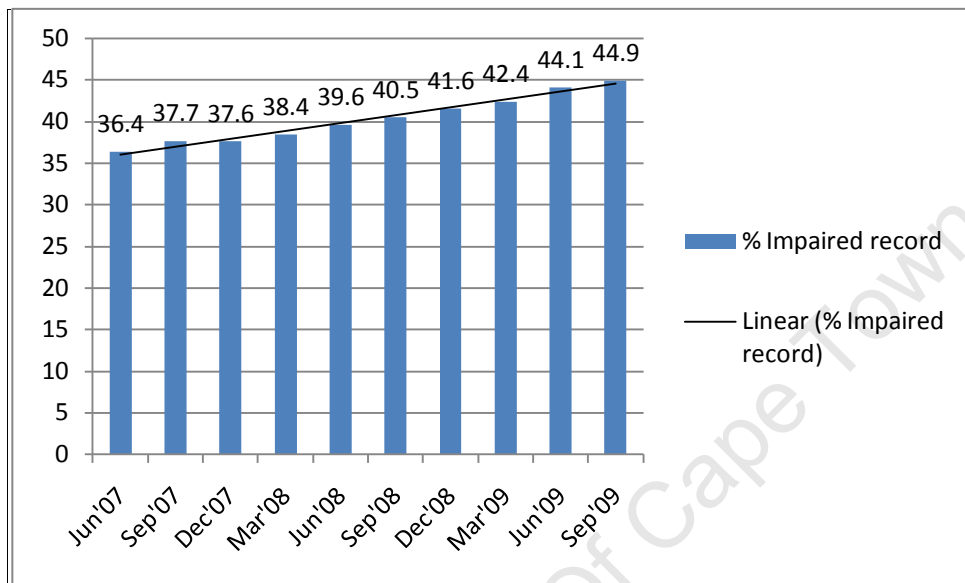
<sup>92</sup> Credit Bureau Monitor – 3<sup>rd</sup> Quarter September 2008

<sup>93</sup> As published on the website: <http://www.hg.org/article.asp?id=5752>, National Credit Act – one year down the line – South Africa by Simone Monty & Jade Mann

The Credit Bureau Monitor (September 2009)<sup>94</sup> reported that the number of consumers in South Africa with impaired credit records has been increasing since June 2007. The rate of increase became more prominent since 2008 as reflected in figure 12.

Figure 12

### Consumers with impaired record



Source: National Credit Regulator

Four out of every ten employed South Africans are unable to cope with account payments, and at least one-fifth of civil servants are under garnishee orders, to which they are locked into for the next four years according to Statistics SA data, which shows that the number of civil summonses issued for debt increased by more than 10 percent from February to May 2009.<sup>95</sup>

The National Debt Mediation Association (2009)<sup>96</sup> in a consumer vulnerability review held that rising insolvencies (of individuals) nearly always accompany any deterioration in economic conditions. Very often, a person can become insolvent when his / her income is

<sup>94</sup> National Credit Regulator(NCR)National Credit Bureau Monitor (September 2009)

<sup>95</sup> As published on the website: <http://www.businessreport.co.za/July 24, 2009>

<sup>96</sup> Consumer Vulnerability Review – Prepared by Ecoquant (Pty) Ltd for the National Debt Mediation Association (NDMA)(May 2009)

no longer sufficient to finance expenditure, especially when such expenditure relates to the financing of debt commitments.

Marlene Heymans, an independent consultant, presented findings of research on behalf of the Finmark Trust on early indicators - signs that could help lenders and policy makers to recognise looming problems. Early warning signs included behavioural patterns of financially distressed consumers, which she "gleaned from discussions with debt counsellors and from an analysis of data of a small sample of debt counselling cases". In the first phase, she said: "Borrowers use all available credit card and overdraft facilities and draw on their mortgage facilities or obtain a second bond. They use up savings, withdraw money market investments and sell shares. They borrow from family and micro-lenders and explore consolidation options if they have fixed property for security." This behaviour is largely reflected in banks' credit figures and in surveys of consumer behaviour. In the second phase, borrowers "start defaulting on debt, are erratic about paying municipal services and rent, miss premiums on insurance policies or surrender them, fall behind in school fee payments, cell phone and store accounts and then start pawning jewellery and electronic goods". In the third phase, people fall behind on car and mortgage payments and may make arrangements to reschedule loans or ask for help from a debt counsellor. Finally, they are forced to sell possessions and may face debt judgments, for which data is available from banks as well as in court.<sup>97</sup> During the period 2000-05, insolvencies in South Africa had mostly shown a declining trend, averaging -18.4 percent per year during this period. However, insolvencies started to increase at the end of 2005, and by mid 2008, had escalated by a rate of no less than 66.5 percent per annum.

It is now relevant to determine the impact of one of the major components of debt viz. mortgage loans on the debt levels of South African consumers.

ABSA<sup>98</sup> held that the ratio of outstanding household mortgage debt to disposable income came in at 49.5 percent in the second quarter of 2009 as depicted in figure 13, unchanged from the first quarter. This was the net result of trends in the growth of mortgage advances

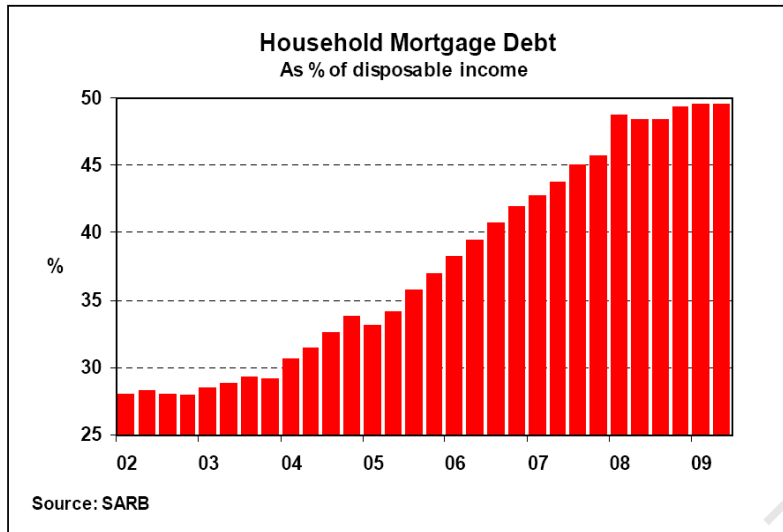
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<sup>97</sup> As published on the website: <http://www.busrep.co.za/index.php?fArticleId=4571202>- Household debt animal not tamed yet - analysts August 22, 2008 by Ethel Hazelhurst

<sup>98</sup> ABSA Home Loans, Mortgage debt reflects economic and property market conditions, 4 September 2009

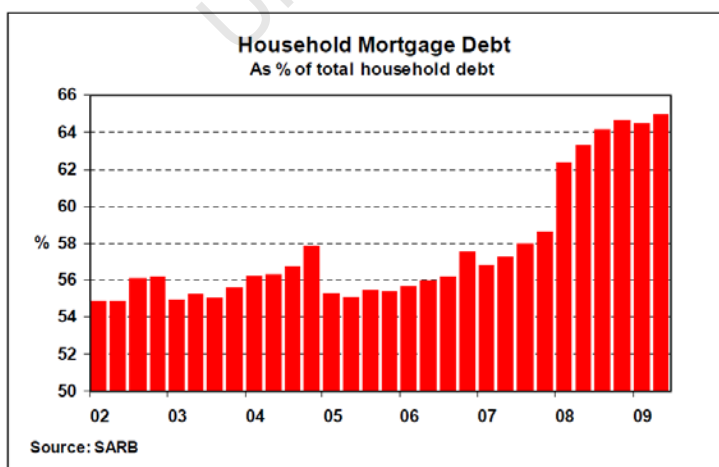
to households and their nominal disposable income in the second quarter of the year compared with the first quarter.

Figure 13



ABSA<sup>99</sup> held that the cost of servicing household mortgage debt as a percentage of disposable income was at a level of 5.8 percent in the second quarter, markedly down from 6.9 percent in the preceding quarter and 7.6 percent in the fourth quarter of 2008, mainly driven by lower interest rates. The ratio of household mortgage debt to total household debt as depicted in figure 14 was, at 64.9 percent, somewhat higher in the second quarter of 2009 than in the first quarter (64.5 percent). These trends reflect the tough economic and property market conditions experienced in the first half of the year.

Figure 14



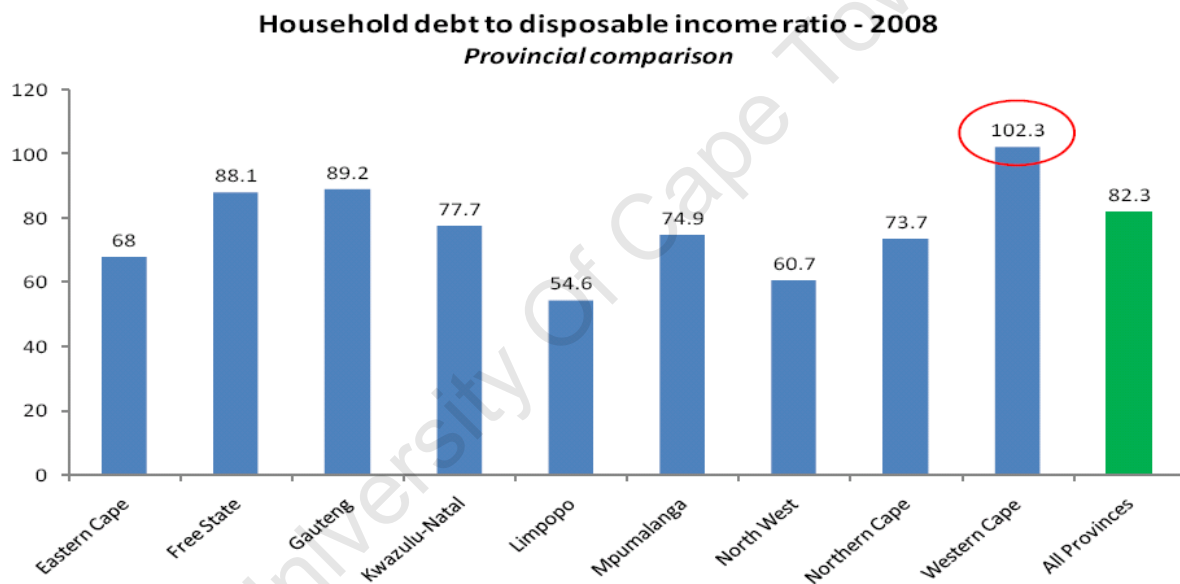
<sup>99</sup> ABSA Home Loans, Mortgage debt reflects economic and property market conditions, 4 September 2009

The following section discusses the existence of any provincial variation with regards to the level of indebtedness of consumers in South Africa. This section is relevant as a central aspect of the thesis is whether consumers in the Western Cape Province are more indebted than consumers in the other eight provinces in South Africa.

### 4.2.3 Household debt to disposable income – Provincial trends

Recent data (2008) as depicted in figure 15 reflect that the household debt to disposable income ratios for the various provinces in South Africa indicate that the Western Cape is the most indebted province in South Africa.

Figure 15



(Source: Bureau of Market Research - UNISA)

The Western Cape Province is home to just under, 10 percent of South Africa’s households. Measured by its total current household income, it is the third richest province in South Africa, after Gauteng and KwaZulu-Natal. However, in per capita income terms Western Cape residents are, on average, the most affluent of all South Africans. Despite this, the province is still marred by high poverty rates, unemployment and inequalities in the distribution of income between various population subgroups, although not to the same degree as other regions in South Africa. There are vast differences in poverty and unemployment rates between racial groups, and although income inequality in the province is lower than in the rest of South Africa, it is still high according to international standards.

Approximately 59.9 percent of the population is Coloured, while the remainder are made up of Black (23.4 percent), White (16.1 percent) and Asian (0.6 percent) people. Poverty rates vary greatly between racial groups. There is virtually no poverty among White people, and only 7.0 percent of the Asian population is poor. In sharp contrast the poverty rates for Coloured and Black people are 22.8 percent and 50.1 percent respectively.<sup>100</sup>

#### 4.2.4 Consumer Financial Vulnerability – Provincial Variation

Table 3 provides a breakdown of CFV by population group. The Finmark study held that few differences with regard to financial vulnerability were found in respect of the different population groups, although the White and Indian population groups show somewhat lower CFV than do Africans and Coloureds. The reasons for this could be that (1) the dramatic growth of the black middle class postdemocracy has narrowed the black-white welfare gap considerably (SAIRR 2007), (2) the increasing uptake of credit among African and Coloured consumers (SAARF 2009) as well as (3) the fact that population group for many years was a proxy for a host of socioeconomic variables (i.e. education, living standards, employment, etc), which have been addressed to a larger or lesser extent during the past two decades (Presidency 2008).

Table 3

##### FINANCIAL VULNERABILITY BY POPULATION GROUP

Population group	Income vulnerability	Savings vulnerability	Expenditure vulnerability	Debt servicing vulnerability	CFV index
African	5.58	5.75	5.66	4.46	5.20
Asian/Indian	5.95	5.01	5.11	4.16	4.82
Coloured	6.52	5.79	6.03	4.35	5.63
White	5.55	5.83	4.55	3.84	4.84
<b>Total</b>	<b>5.64</b>	<b>5.74</b>	<b>5.54</b>	<b>4.37</b>	<b>5.16</b>

Source : Finmark Trust

<sup>100</sup> A profile of the Western Cape : demographics, poverty, inequality and unemployment, by : Pauw, Kalie Du Plessis, Lozelle, 2005

The results of the Finmark study found that Coloured people were the most financially vulnerable population group in South Africa.

Daniels (2001)<sup>101</sup> focused on those provinces that showed the greatest variation from the national mean and reported that as far as income groups are concerned, it was evident that there is repeated representation of the Western Cape as the most indebted province at the lower end of the income distribution, with Gauteng becoming prominent towards the middle and upper end, and Mpumalanga and the Eastern Cape becoming prominent at the top end.

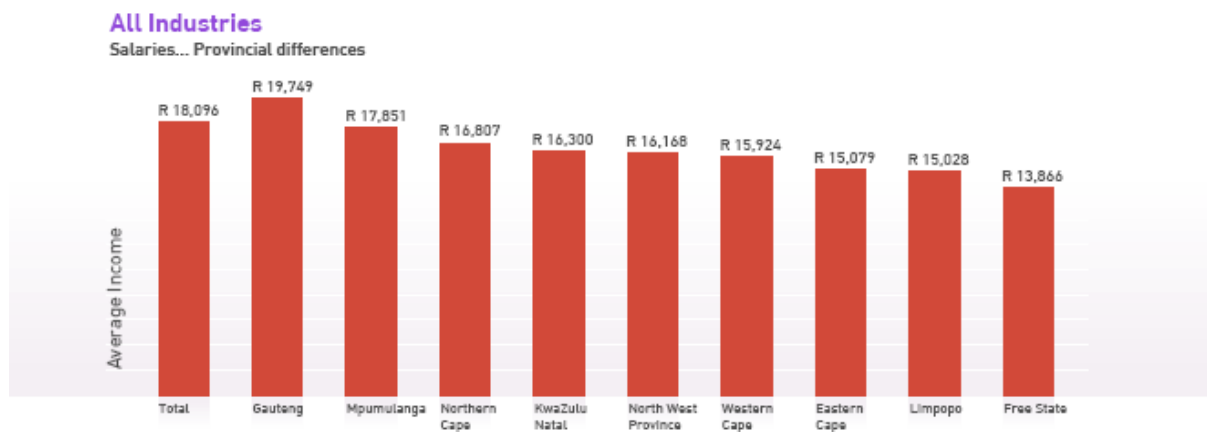
Mpumalanga is often the least indebted province at the lower and middle-end of the income distribution, with the North West, the Northern Province and the Northern Cape the least indebted provinces at the top end of the distribution. In the same paper the researcher stated that one of the reasons that may explain the Western Cape and Gauteng's dominance among the more highly indebted provinces is the fact that finance is probably more widely available in these areas.

Provincial differences in salaries as depicted in figure 16 ranks consumers in Gauteng Province as earning the highest salaries followed by Mpumalanga, the Northern Cape, KwaZulu Natal, the North West Province with the Western Cape Province ranked just above the Eastern Cape, Limpopo and the Free State. However in terms of household debt to disposable income ratios the Western Cape Province ranks above all of the other provinces in South Africa.

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<sup>101</sup> *Consumer Indebtedness Among Urban South African Households: A Descriptive Overview by Reza Daniels, September 2001*

Figure 16



Source: Careers24 2007 Salary Survey

Household income has a significant bearing on household expenditure. A Central Statistical Service survey (1997) of earnings and spending in South Africa during 1995 indicated that a large proportion of the average South African household income is spent on essential products and services like food and housing. Households spend an average of 59 percent of their annual expenditure on four items:

- food: 18 percent
- housing: 16 percent
- income tax: 15 percent
- transport: 10 percent

The poorest households, however, spend almost 75 percent of their total annual disposable income on food, power and other energy sources. This leaves them with very little left to spend on housing.

Households headed by Blacks have the lowest average annual incomes, followed by households headed by Coloureds. Households headed by Whites have the highest average annual incomes. Twenty-three percent of Black households earn less than R500 per month, compared to 11 percent of Coloured and 1 percent of both Indian and White households. By

contrast, 65 percent of White households earn more than R4 000 per month, compared to 45 percent Indian, 17 percent Coloured and 10 percent of Black households.<sup>102</sup>

In this section we determine whether variables such as house prices, race and poverty in the Western Cape are impacting on the debt levels in the Province.

Aron, Muellbauer and Prinsloo(2006)<sup>103</sup> held that from 2003 to the end of 2005, South Africa has seen exceptionally strong house price rises, alongside rising income, reductions in nominal interest rates, and buoyant consumer and business confidence.

#### **4.2.5 House Prices in South Africa – Provincial Comparison**

Considering the disparities in development, income and urbanisation between South Africa's provinces, it is not surprising to also find significant differences in average house prices between the regions. It is to be expected that house prices in the poorer provinces, such as Limpopo, Mpumalanga, KwaZulu-Natal and the Free State, may be below the national average. The dwindling importance of gold mining activity has affected employment and general economic activity in provinces such as the Free State and North West, although the escalation of international platinum prices has possibly more than offset the low gold-price effect in the latter province. A province such as the Western Cape has benefited from tourism as well as from foreign buyer interest owing to the weaker rand. In more localised developments, illegal cross-border inflows of foreign citizens, especially from Zimbabwe and Mozambique, have resulted in an escalation of squatting in and around cities and caused downward pressure on formal property prices in some areas, notably certain suburbs of cities in Gauteng, Limpopo, Mpumalanga and KwaZulu-Natal.<sup>104</sup>

Figure 17 represents ABSA's mean house price averages per province since 1991. The statistics are based on Middle class houses/both new and old/All sizes/Purchase price – Smoothed (Unit: Smoothed Rand)

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<sup>102</sup> As published on the website: <http://www.housing.gov.za>

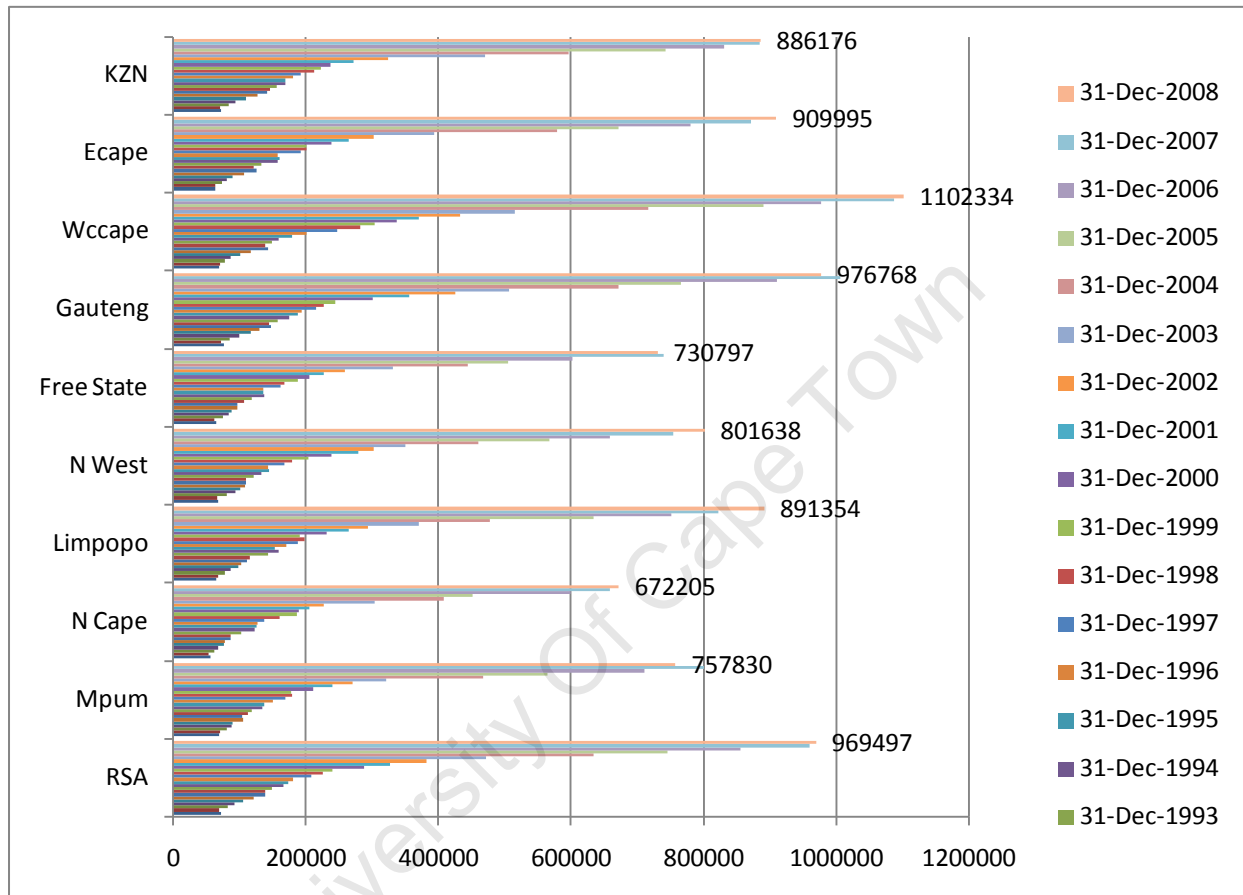
<sup>103</sup> *Estimating household-sector wealth in South Africa* by J Aron, J Muellbauer and J Prinsloo, *Quarterly Bulletin June 2006*

<sup>104</sup> *The Absa residential property market database for South Africa - key data trends and implications, BIS Papers No 21* by Christo Luüs, 2001

Absa uses statistical smoothing techniques to remove outliers (houses on either end of the price scale) as well as seasonal factors, such as the Christmas and Easter holiday periods when property sales tend to cool off. (Absa economist Jacques du Toit).

Figure 17

**ABSA's house price index for South Africa**



Source : ABSA Bank

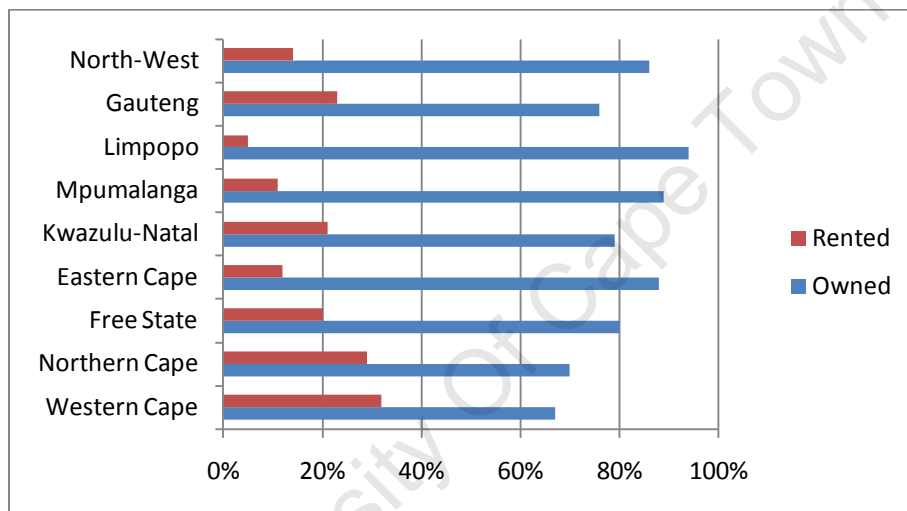
House prices in South Africa reflect a persistent upward trend that became more significant since the beginning of 2005.

Absa ranks the Western Cape as SA's most expensive provincial property hub, with an average house price of R947 190. Gauteng comes second at R866 567, with KwaZulu-Natal ranking third at R814 179.<sup>105</sup>

<sup>105</sup> As published on the website: <http://www.Fin24.com> House price data - who's right? Nov 02 2006 11:59 by Garth Theunissen

Not surprisingly, given that house prices are the highest in the Western Cape, figure 18 depict that the least amount of households in the Western Cape own their houses compared to households in the various other provinces in the country. Anderloni & Vandone(2008)<sup>106</sup> stated that in broad terms, living in rented accommodation is associated with a higher likelihood of being in financial difficulties. The median wealth of home owners will be greater than the median wealth of renters with comparable incomes. In the Western Cape 67 percent of households own their homes compared to 79 percent of households in KwaZulu Natal and 76 percent of households in Gauteng.

Figure 18



Source: Database - All Media and Product Survey 2008A

Professor Tim Besley, a member of the Monetary Policy Committee<sup>107</sup> urged caution in assessing the link between house prices and consumption growth and cites evidence that ‘consumption growth of renters is associated with house price growth just as strongly as the consumption growth of owners’. But there may be a role for housing collateral in affecting overall credit conditions available to households allowing them greater flexibility to smooth through fluctuations in their disposable income.

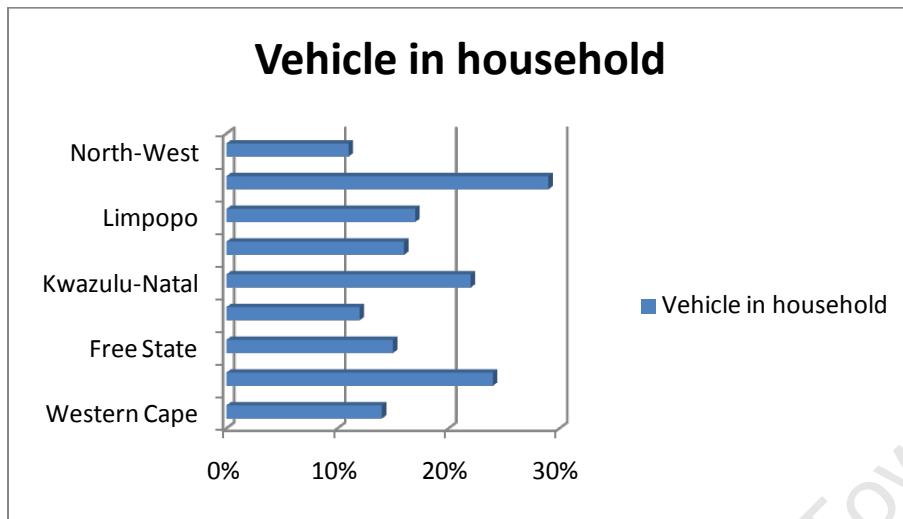
Not only do fewer households own their homes in the Western Cape but an analysis of recent data reveal that households in the Western Cape also own fewer vehicles than

<sup>106</sup> Households over-indebtedness in the Economic Literature by Anderloni & Vandone, December 2008

<sup>107</sup> Bank of England, Quarterly Bulletin 2007 Q3

households in Gauteng, KwaZulu Natal , Limpopo, Mpumalanga and the Northern Cape. See figure 19.

**Figure 19**

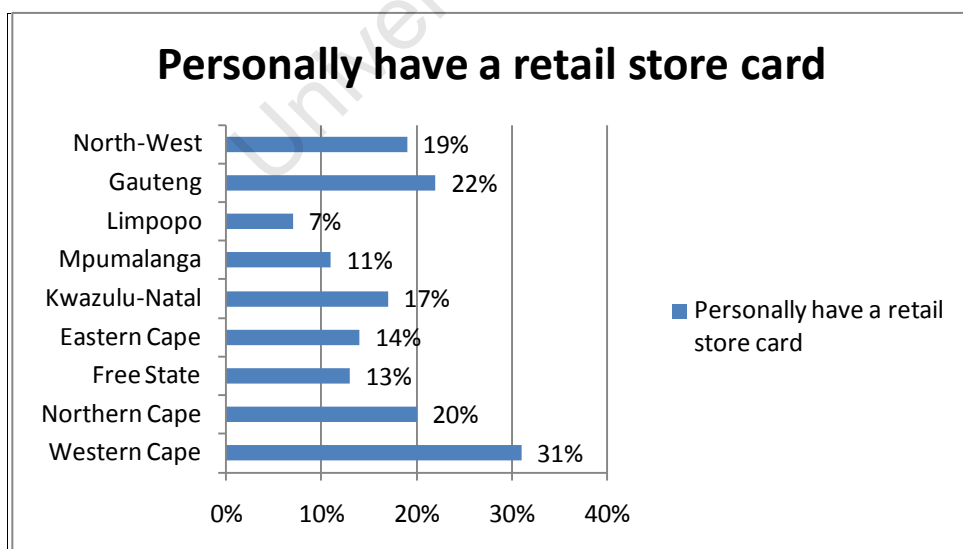


Source: Database - All Media and Product Survey 2008A

14 percent of households in the Western Cape have a vehicle in the household compared to 29 percent in Gauteng and 22 percent in KwaZulu Natal.

Figure 20 depicts that more consumers in the Western Cape have a retail store card than in any of the other province in South Africa.

**Figure 20**



Source: Database - All Media and Product Survey 2008A

According to the Department of Trade and Industry (DTI), most of South Africa's R362 billion credit markets consist of mortgages, vehicle finance and overdrafts at moderate rates, but the bulk of South Africa's consumers do not have access to these products. Most only qualify for in-store cards, hire purchase or micro-loans, all at higher rates.<sup>108</sup> Micro loans are targeted at the middle to low-income section of households.

The top reasons for micro-lender loans were funerals, debt consolidation, family emergencies and education. It is of great concern that the 'repayment of other debts/accounts' was in the top five reasons for borrowing. The study held that lenders were aware that their customers were sometimes 'robbing Peter to pay Paul', but few would expect the degree to which customers are using the advances to pay other creditors. This practice indicates a deep systemic risk.<sup>109</sup>

In table 4 a provincial comparison of Micro Loans per income group highlights the fact that in the Western Cape micro loans are more prevalent in the income categories from R2500-R10 999 compared to Gauteng and KwaZulu Natal.

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<sup>108</sup> Hurwitz, Ingrid and Luiz, John (2007) "Urban Working Class Credit Usage and Over-Indebtedness in South Africa". *Journal of Southern African Studies* 33: 1, 107-131

<sup>109</sup> Hurwitz, Ingrid and Luiz, John (2007): "Urban Working Class Credit Usage and Over-Indebtedness in South Africa". *Journal of Southern African Studies* 33: 1, 107-131

## 4.2.6 Micro Loans – Provincial Comparison

Table 4

Micro Loans	Total	Western Cape	Northern Cape	Free State	Eastern Cape	Kwazulu-Natal	Mpumalanga	Limpopo	Gauteng	North-West
Total	100%	10%	2%	6%	15%	20%	7%	11%	21%	7%
Up To R799	7%	2%	8%	11%	15%	9%	8%	5%	3%	6%
R800-R1399	17%	6%	23%	22%	27%	21%	17%	14%	9%	20%
R1400-R2499	17%	10%	24%	21%	20%	19%	17%	24%	10%	14%
R2500-R4999	19%	20%	19%	19%	14%	16%	24%	28%	17%	26%
R5000-R7999	13%	21%	7%	12%	9%	9%	13%	15%	15%	13%
R8000-R10999	10%	17%	5%	7%	7%	8%	9%	7%	13%	9%
R11000-R19999	10%	16%	6%	6%	5%	10%	7%	4%	18%	9%
R20000+	7%	7%	7%	3%	2%	7%	5%	3%	15%	3%

Source: Database - All Media and Product Survey 2008A

The statistics presented in the above mentioned graphs serves as evidence that a large proportion of household income in the Western Cape is spent on essential products and services. Consumers' in the Western Cape is left with very little disposable income to spend on housing and other durable goods.

In the next section we determine whether race and poverty is a contributing factor to the high levels of debt in the Western Cape Province.

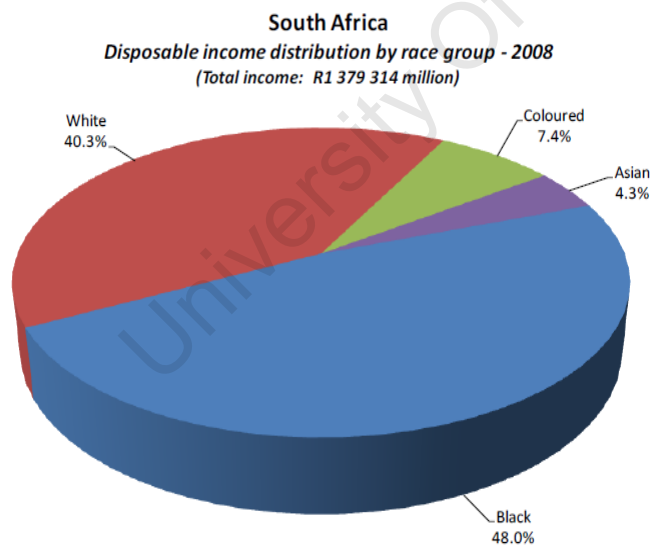
In the Western Cape there are approximately 1.43 million workers of which Black and Coloured workers are typically found in the lower-skilled occupation groups, while White workers are more concentrated around the higher-skilled occupations. Since there are very few Asian workers in the Western Cape no conclusions could be drawn about their skills

distribution. Much still needs to be done in the Western Cape to bring the racial composition of the workforce more in line with the provincial-level population composition at all skills levels.<sup>110</sup>

The majority of Coloureds continue to hold semi-skilled and unskilled positions and are the most likely to have only a matric qualification. For the same job level Whites earn an average salary of R18 000, Blacks R13 000, Indians R17 000 and Coloureds R12 000.<sup>111</sup>

National trends in respect of disposable income and unemployment rates as depicted in figures 21 and 22 reflect that Coloured people have the lowest disposable incomes at 7.4 percent and the second highest unemployment rate at 19.8 percent with Black South Africans having the highest levels of unemployment at 27.2 percent. According to a Careers24 2007 Salary Survey, Black-headed households have the lowest average annual incomes, followed by households headed by Coloureds.

**Figure 21**



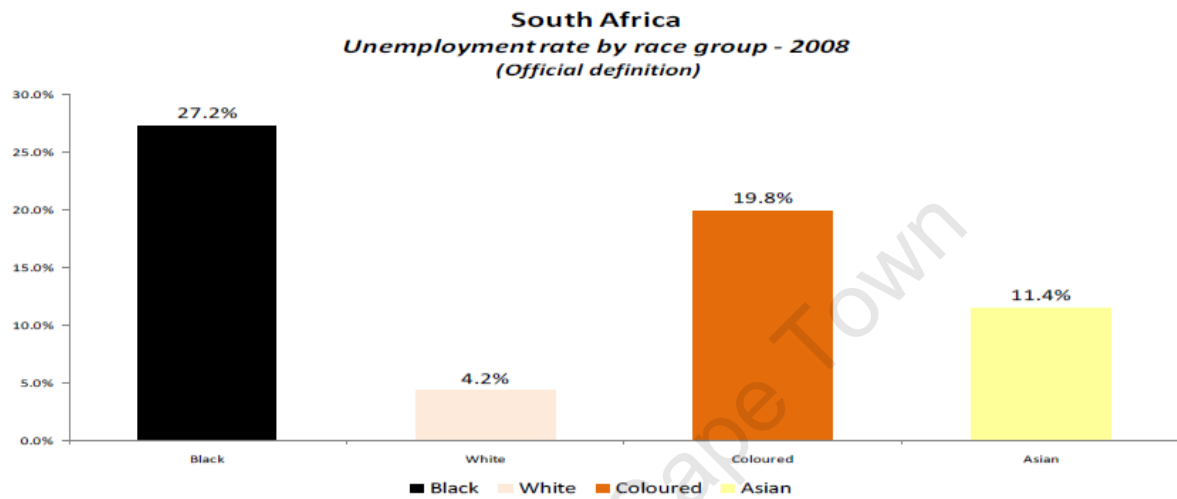
(Source: Global Insight ReX, July 2009)

<sup>110</sup> *A profile of the Western Cape : demographics, poverty, inequality and unemployment, by : Pauw, Kalie Du Plessis, Lozelle, 2005*

<sup>111</sup> [http://: www.news24.com](http://www.news24.com) SA Salary Survey released, 2009-01-26 by Verashni Pillay

South Africa's high unemployment rate, estimated at around 30 percent of the economically active population, clearly implies that income will be skewed, and that a significant portion of households are not able to afford even meagre housing facilities.<sup>112</sup> "Figure 22 illustrates the unemployment rates among the various race groups in South Africa.

Figure 22



<sup>112</sup> *The Absa1 residential property market database for South Africa - key data trends and implications* Christo Luüs, BIS Papers No 21

## 5 CHAPTER 5 – RESULTS

This chapter focuses on the results obtained from the research into the nature and causes of indebtedness and the following observations summarises the results from the review into the nature and causes of over indebtedness in South Africa with particular emphasis on consumers in the Western Cape.

The study confirmed that poverty and race were the main causes of over indebtedness in South Africa however it was evident that there were additional variables that contributed to the risk of becoming over indebted.

A review of the literature established that financial deregulation from the beginning of the 1980s', the reduction in interest rates, both in nominal and in real terms and the rise in wealth-to-income ratios contributed largely to the increase in the household-debt-to-income ratio in South Africa over the past three decades.

A study on the relationship between consumption and several components of wealth for a panel of 14 main emerging economies revealed that wealth effects are statistically significant and relatively large: a 10 percent rise in housing prices leads to an increase in private consumption of between 0.25 percent and 0.49 percent; an increase of 10 percent in stock prices is associated with a 0.29 percent to 0.35 percent increase in consumption; and when money wealth rises by 10 percent, consumption increases by 0.41 percent to 0.50 percent.

The lifecycle hypothesis was confirmed in this study with literature suggesting that younger people are more indebted and have higher levels of consumption credit.

The study confirmed that the factors contributing to the high levels of indebtedness in the Western Cape are the vast differences in the poverty and unemployment rates between the racial groups in the Province.

The study highlighted the fact that the Western Cape Province has the highest level of household debt to disposable income ratio amongst the provinces in South Africa.

The literature reviewed ranked the Western Cape as SA's most expensive provincial property hub, with the province having benefited from tourism as well as from foreign buyer interest owing to the weaker rand.

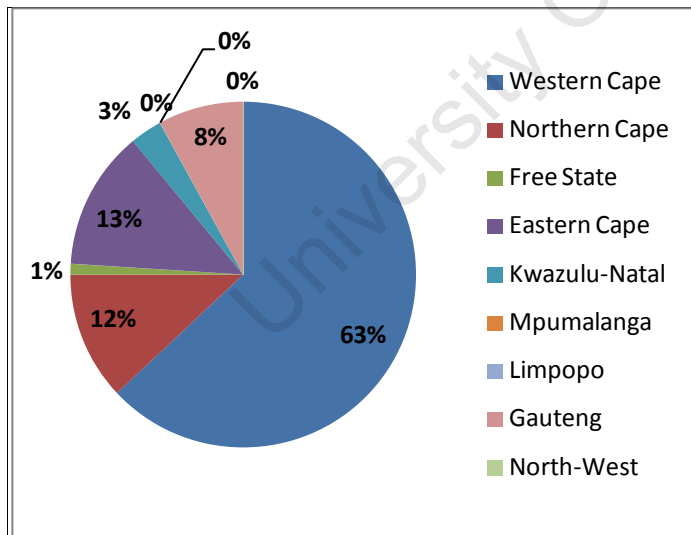
As far as racial groups in the Western Cape are concerned Coloureds and Blacks comprises 83 percent of the population with a poverty rate of 72.9 percent, there is no poverty recorded among Whites in the province as illustrated in Table 5.

**Table 5**

Race	Percentage	Poverty Rate
Coloureds	59.9%	22.8%
Blacks	23.4%	50.1%
Whites	16.1%	Zero
Asians	0.6%	7%

Figure 23 reflects that on a national basis 63 percent of Coloured people reside in the Western Cape Province.

**Figure 23**



Source: Database - All Media And Product Survey 2008A

As far as income groups are concerned, the lowest average annual increases recorded are amongst Black headed households followed by households headed by Coloureds. In the Western Cape 23 percent of Blacks earn less than R500pm whilst 11 percent of Coloureds earn less than R500pm.

Salaries in the Western Cape rank as the fourth lowest out of the nine provinces in South Africa with Gauteng represented at the top end of the scale and the Free State at the bottom end of the scale. As far as disposable income is concerned nationally Coloureds have the lowest disposable incomes at 7.4 percent followed by Asians at 4.3 percent.

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## 6 CHAPTER 6 – CONCLUSION

The debt trap in South Africa has been fuelled by lower wage levels coupled with easy access to credit. Furthermore a combination of the wealth effect experienced by an exponential rise in the value of house prices and equities exacerbated by a low interest rate environment led to increased consumption expenditure.

However during 2008/9 the personal balance sheets of households experienced severe pressure due to a subsequent decline in the value of house prices brought upon by the subprime crisis first experienced in the US housing market, the bottoming out of the equities market and a simultaneous increase in interest rates together with reduced risk appetite from commercial banks to grant further credit.

The study revealed that although debt levels of households in South Africa soared to recent record high levels, the household debt as a percentage of income of South African households were at a lower level than the debt levels of households in the USA, UK, Canada and Australia. Although access to credit will stimulate the economy and accelerate the recovery from the effects of the recent recession, the provisions of the NCA in SA restrict commercial banks' ability to lend to consumers who are over indebted. The provisions of the NCA will therefore, hamper the ability of consumers to avail themselves of credit in the short term in order to speed up the recovery process.

Poverty and race continues to play a pivotal role in the imbalances that gives rise to the high levels of indebtedness in South Africa. These imbalances are even more pronounced at a provincial level. The province with the highest level of household debt to disposable income recorded in South Africa is the Western Cape this despite the fact that it is the third richest province in the country and in per capita income terms Western Cape residents are, on average, the most affluent of all South Africans. More alarmingly is the fact that 72.9 percent of the 83 percent of its Coloured and Black population live in poverty whilst no poverty levels are recorded amongst the 16 percent of its White minority population.

It is the view of the writer that the high levels of debt in the Western Cape can be linked to the majority of its population being Coloured (59.9 percent) and Black (23.4 percent) as the highest unemployment rates are recorded among Blacks and Coloureds in South Africa. Several surveys have highlighted the fact that Coloureds earn the lowest salaries of all the

population groups in South Africa and that they are also the most financially vulnerable racial group in South Africa.

The study confirmed that households in the Western Cape are more indebted than households' in any of the other provinces in South Africa. Further evidence highlighted in support of this fact is the high proportion of renters to owners, the low percentage of households who own vehicles and the high percentage of households that use retail store credit cards and the facilities of micro lenders in the Western Cape. These characteristics are all indicative of the fact that the majority of households in the Western Cape still do not have access to traditional credit markets for the financing of mortgages, vehicle finance and overdrafts and most only qualify for in-store cards, hire purchase or micro-loans, all at higher rates.

The study highlights the fact that racial imbalance is the main cause of over indebtedness in the Western Cape. It is the view of the writer that the Western Cape Province faces serious socio-economic challenges in the redistribution of wealth among the population groups in the province.

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