“Post National Credit Act reckless lending in the South African banking industry”

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Post National Credit Act reckless lending in the South African banking industry

Abstract

One of the main aims of the National Credit Act (NCA) of 2005 in South Africa is to curtail rising consumer over-indebtedness by encouraging credit providers to adopt responsible lending practices. This research study seeks to ascertain whether the NCA's responsible lending requirements have limited reckless lending by credit providers. Data are collected by a telephonic survey amongst debt counselors and in-depth interviews amongst bank employees. Descriptive statistics are used to analyze data from the descriptive survey, while data from in-depth interviews are analyzed using the thematic approach. Credit providers have divided opinions on whether the NCA limits reckless lending practices. Debt counselors claimed that credit providers are lending irresponsibly. By contrast, insights obtained from bank employees indicate compliance. However, both agree that borrowers are not borrowing responsibly. As a result, consumer education is required to educate consumers on both the benefits and risks of borrowing. It is also recommended that lenders be audited for compliance to the Credit act.

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Introduction

A number of countries including South Africa, Australia, European Union, North America and New Zealand have been concerned about the rapid rise in consumer borrowing leading to over-indebtedness (Kempson, 2008). In line with this trend, South Africa introduced responsible lending principles through the enactment of the South African National Credit Act (NCA). One of the main objectives of the NCA was to curtail reckless lending and rising consumer over-indebtedness by encouraging credit providers to adopt responsible lending practices (Vessio, 2009).

According to the NCA (2005), a credit provider agreement will be considered reckless in the following instances:

- if the credit provider does not conduct an affordability assessment prior to entering into a credit agreement;
- if the agreement entered into after conducting the required assessments by the credit provider failed to ensure that the consumer understood the risks, costs and obligations of the agreement; and
- if credit is extended when the assessed showed that, the credit agreement will render the consumer over-indebted.

To determine whether an agreement is reckless or not, the NCA (2005) requires the courts to look at the circumstances at the time credit was granted, not the time of determination. However, the credit provider is entitled to take the consumer's word when conducting an assessment. Should the consumer lie, and the lies impact the assessment of the borrower, any reckless lending allegations brought against the credit provider may be dismissed (NCA, 2005).

The purpose of this paper was to find out whether the NCA's responsible lending requirements have limited reckless lending practices by credit providers in South Africa. Hence, explored was whether credit providers are effectively applying the responsible lending measures as enshrined in the NCA, and whether the Act had mitigated reckless lending. Specifically, the research sought to:

- identify drivers of over-indebtedness;
- ascertain financial institutions' compliance with the NCA; and
- ascertain whether the NCA had helped to curb reckless lending.

1. Literature review

This section reviews literature on reckless and responsible lending.

1.1. Reckless lending. Reckless lending describes the granting of credit to a consumer who simply does not have the means to repay the loan (Pottow, 2007; Daniel, 2004). The problem of reckless lending is global in nature. For instance, a report by uSwitch.com (2006) found that 88% of successful UK credit card applicants were not requested to show any proof of their income. At

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least 95% of cardholders had not been asked for evidence of their monthly expenses when applying for credit. The report also found that details given by applicants were not verified in 9 out of 10 applications. All of this could leave the lender with an unclear picture of the customers' ability to service debt and result in lenders issuing credit limits, which are far beyond the cardholders' annual earnings or affordability (Richards et al., 2008). According to Cattermole (2004), this resulted in a drastic increase in bad debt being written off since 2000.

In Turkey, consumers accused banks of maintaining loose standards when assessing the ability of consumers to repay (Aysan & Yildiz, 2007). In their study, Aysan and Yildiz (2007) found that banks were peddling credit cards at shopping malls and supermarkets thereby making credit cards available to anyone who was able to complete the application form. Issuing of credit cards to consumers who do not know the consequences of using credit cards entices poor, uneducated, perhaps even mentally ill consumers into accepting it (Daniel, 2006; Ramsay, 2004). Related studies by Aysan & Yildiz (2007); and Jekot (2006) also found that banks and clothing stores in the US were willing to extend credit to college students, some of whom did not have a job or credit history. These practices have been criticized as credit providers do not take into consideration applicants' credit history, as well as their income and expenditure in assessing the ability to repay.

1.2. Responsible lending. Responsible lending describes measures aimed at ensuring that credit providers lend responsibly (The Victoria Report, 2006; Aysan & Yildiz, 2007; Pottow, 2007). Responsible lending also describes consumer credit regulation, whose objectives include the prevention of overly aggressive and unfair marketing practices such as automatic increases in credit limits, reducing minimum repayments, and sending unsolicited credit cards (Ramsay, 2004).

In France, it is a requirement that a credit provider must consult the national credit reference database administered by the Banque de France before granting credit. This is accompanied by a provision that the credit provider will bear the whole risk of lending to someone registered in the database. Furthermore, a creditor who wrongfully extends credit to a debtor with the result of "artificially prolonging the life of the company" and protracting an inevitable default is held liable for the losses incurred by other creditors (Pottow, 2007).

Germany tries to ensure responsible lending by providing guidelines on default rates. These are set lower than most rates (5% above the base / discount rate), to act as an incentive for lenders to avoid default. Beyond this, lenders are charged with a general duty of care not to create charges, which would put the over-indebted borrower deeper in debt. Lenders are also broadly prohibited from making financial demands on debtors that would drive them further into crisis (Trumbull, n.d.).

The UK Consumer Credit Act of 2006 introduced a broad requirement that in order to be considered "fit", credit providers must not lend irresponsibly. However, according to Trumbull (n.d.), the detail of what constitutes irresponsible lending is not specified. There are no requirements either to provide data to credit reference agencies or to consult such agencies.

To mitigate irresponsible lending, Pottow (2007) proposed legal consequences to a lender who allows a borrower to borrow money when the lender knows, or suspects, that the debtor could not afford to repay under ordinary circumstances (Pottow, 2007, p. 428).

1.3. Social and ethical responsibility. According to Carroll and Buchholtz (2006), all businesses have been given the license to operate in society within certain legal and ethical codes. These are embedded in the legal framework/laws setting out the basic rules of how businesses can operate in society, while ethics provide the guidelines for business practices, decisions from a moral perspective (Perreault & McCarthy, 2005; Carroll & Buchholtz, 2006). Despite having these guidelines in place, there have been criticisms levelled against various questionable business practices (Carroll & Buchholtz, 2006). Concerns about social responsibility arise, because individual firms or managers are intentionally unethical and often cheat the market (Perreault & McCarthy, 2005). In other instances, problems and criticism arise because the marketers do not fully consider the ethical principles of a decision. However, the authors argue that there is no excuse for sloppiness when it comes to marketing ethics – the moral standards that guide marketing decisions and actions. For example, businesses have been accused of being used for unethical purposes, which encourage materialism, increases the final price of a product, luring consumers into buying products and services that do not meet their actual needs and expectations (The Victoria Report, 2006). The critics of marketing point to false or misleading advertisements, extravagant pressure on consumers, and pricing tactics that deviate from morality and honesty limits (Nantel and Weeks, 1996).

According to Howell (2004), unethical lending has a number of components:

- It can include lending activities in circumstances where the consumer simply does not have the capacity to repay the loan, either at all, or without serious hardship.
- It can involve taking a security over essential household furniture – termed 'blackmail securities'.
- And unethical lending involves the imposition of excessive and unconscionable costs or unfair contract terms.

Unethical lending might also be a failure to ensure that fair, safe and non-exploitative products are available in the market.

1.4. Context of modern lending. Research into consumer behavior has shown that consumers may be influenced by inherent behavioral biases that results in the underestimation of future borrowing leading them to borrow more often than they anticipate, to their long-term detriment (Bar-Gill, 2004; Laisbon et al., 2003; Warren, 1997). These include overoptimism, underestimation of risk and hyperbolic discounting (Ramsay, 2004).

1.5. Modern lending strategies. Some modern lending strategies have been identified which are in support of the observations made by Bar-Gill (2004) and Ramsay (2004) that lenders take advantage of consumers' intrinsic weaknesses. For instance, White (2007) found that competition among lenders led them to offer attractive introductory terms, which include:

- no annual fees;
- low or zero interest rates on purchases and balance transfers for the first few months;
- rewards, such as cash back or frequent air miles for each rand spent.

These terms would become tougher once the introductory terms expire. However, these attractive terms encourage consumers to either accept new credit, or spend more on their credit cards.

1.6. Credit information and risk management. According to Baird (2007), financial innovation, which was brought on by information technology, transformed the industry in many ways due to the increased use of sophisticated credit scoring and the international spread of credit bureaus. Previously, it was not easy for lenders to assess the ability and willingness of borrowers to repay which made it difficult to discriminate between high and low risk borrowers. The existence of credit bureaus and credit scoring has therefore enabled lenders to greatly reduce the information deficits that they faced in the consumer credit market (Ferretti, 2007).

The advances in data processing enable substantial information about debtors to be stored. It is also possible to look at a particular debtor, identify characteristics such as age, marital status, education, and length of stay with current employer, compare that debtor with others for whom there is a credit history, and make a confident prediction about the likelihood that the applicant will repay a loan (Baird, 2007, p. 312). This information is held by such institutions as credit rating agencies (CRAs), credit bureaus, trade unions and other third party institutions which manage credit databases (Olegario, n.d.). These institutions maintain a full data sharing mechanism based on the collection of information about customers of various lenders.

2. Research design and methods

Descriptive survey research and in-depth interviews were employed to investigate the effectiveness of the NCA in curbing lenders' reckless lending practices. The descriptive survey provided an excellent vehicle for the measurement of behavior and views or opinions in a large population. The use of the survey approach also gave the researcher more control over the design of questionnaires and the analysis of the data gathered.

2.1. Sample. Due to restrictions on time, money and access, the descriptive survey focused on registered debt counselors within Johannesburg. A list of Johannesburg based registered debt counsellors was obtained from the National Credit Regulator (NCR) and the simple random sampling technique was used to select respondents. In total, 30 debt counselors participated in the descriptive survey.

Respondents for the qualitative phase were people responsible for processing applications for credit within the four major banks in South Africa. From a compliance perspective, branch consultants were the ideal respondents for the qualitative phase as they are responsible for processing customer applications for credit. The judgmental non-probability sampling technique was used to select branch sales consultants. In total, four (4) branch consultants were interviewed from each of the four biggest banks, namely Absa, First National Bank, Nedbank and Standard Bank.

2.2. Data collection. Descriptive survey data were collected by way of telephone interviews while qualitative data were collected through face-to-face in-depth interviews. Telephone survey gave the researcher access to virtually all debt counsellors in the study.

Data from the descriptive survey were analyzed using SPSS, while data from in-depth interviews were grouped into various themes related to the specific research objectives.

3. Results

3.1. Drivers of over-indebtedness. Figure 1 (see Appendix) shows the drivers that had caused consumers to become over-indebted. Based on the debt counsellor's responses, the major cause of over-indebtedness was job loss or retrenchment. This was followed by family breakdown (death of partner/spouse and divorce) and poor money management skills.

3.2. NCA's effectiveness in curbing reckless lending. 63.3% of the respondents indicated that the NCA is not effective in curbing the reckless practices of financial institutions and in contrast, 23% agreed that the Act was indeed effective.

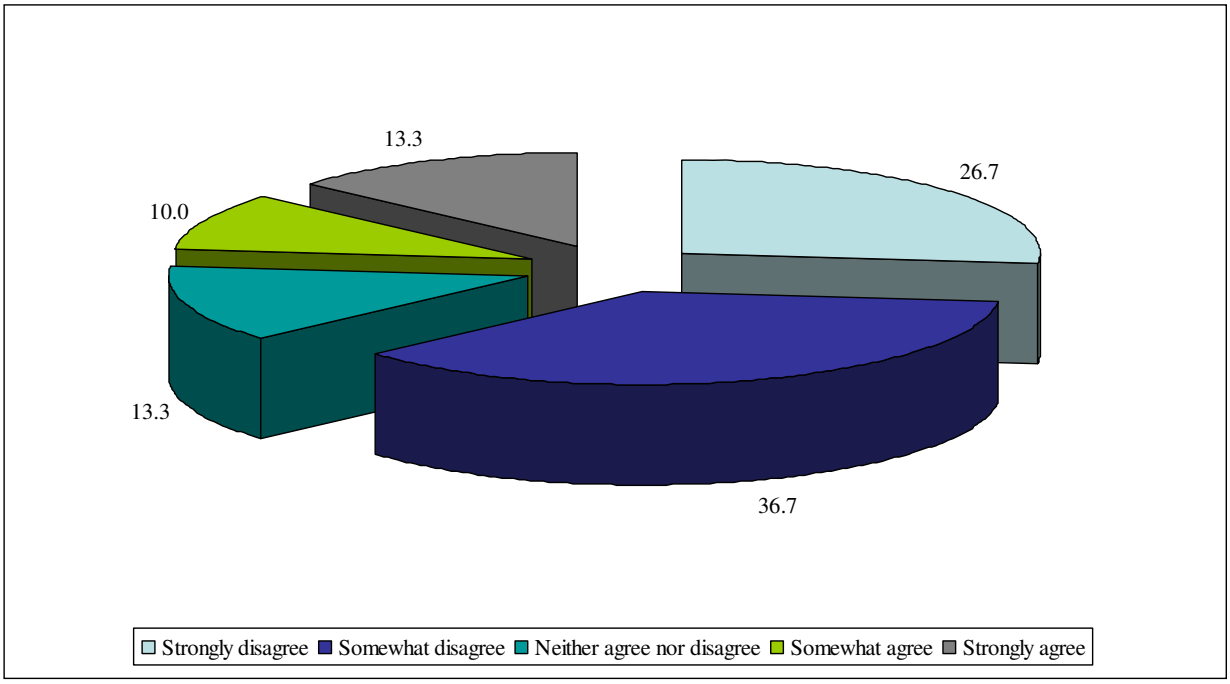

Fig. 2. NCA's effectiveness in curbing reckless lending practices

Figure 3 shows that 25.3% of the cases of over-indebtedness were caused by reckless lending practices.

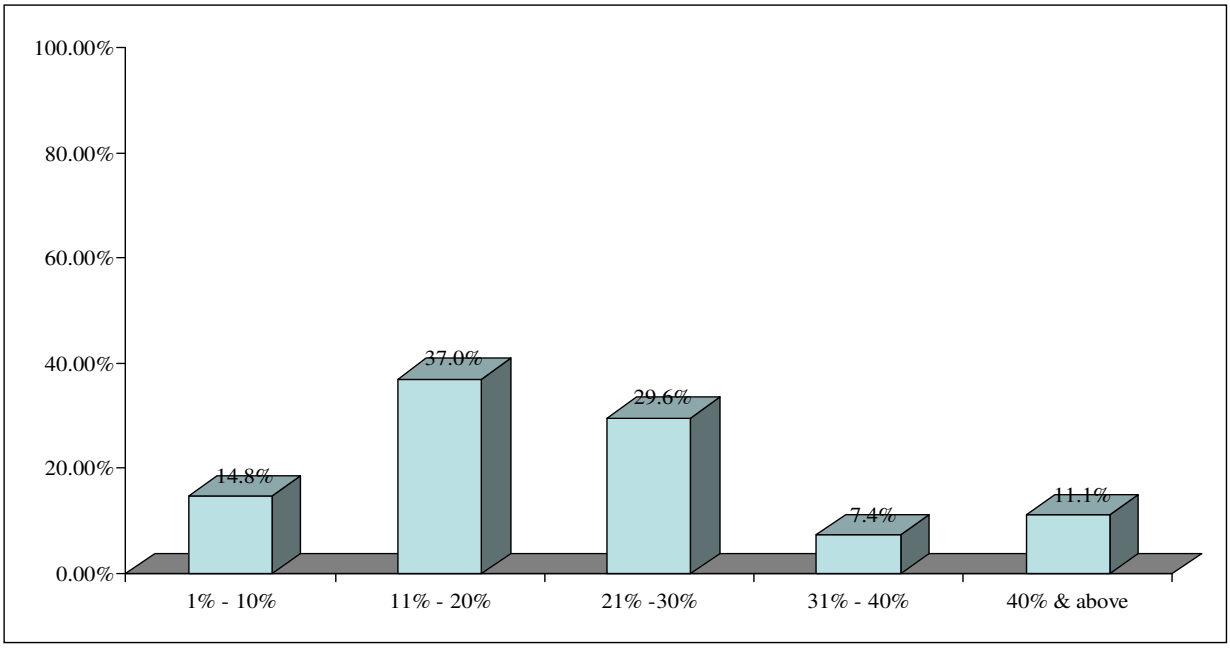

Fig. 3. Percentage of cases caused by reckless lending

3.3. Compliance with the NCA. When asked to name specific reckless lending practices, the majority of debt counsellors (86.3%) claimed that lenders did not perform an affordability test and over half (60%) claimed that lenders did not ask for borrowers' expenses (see Figure 4).

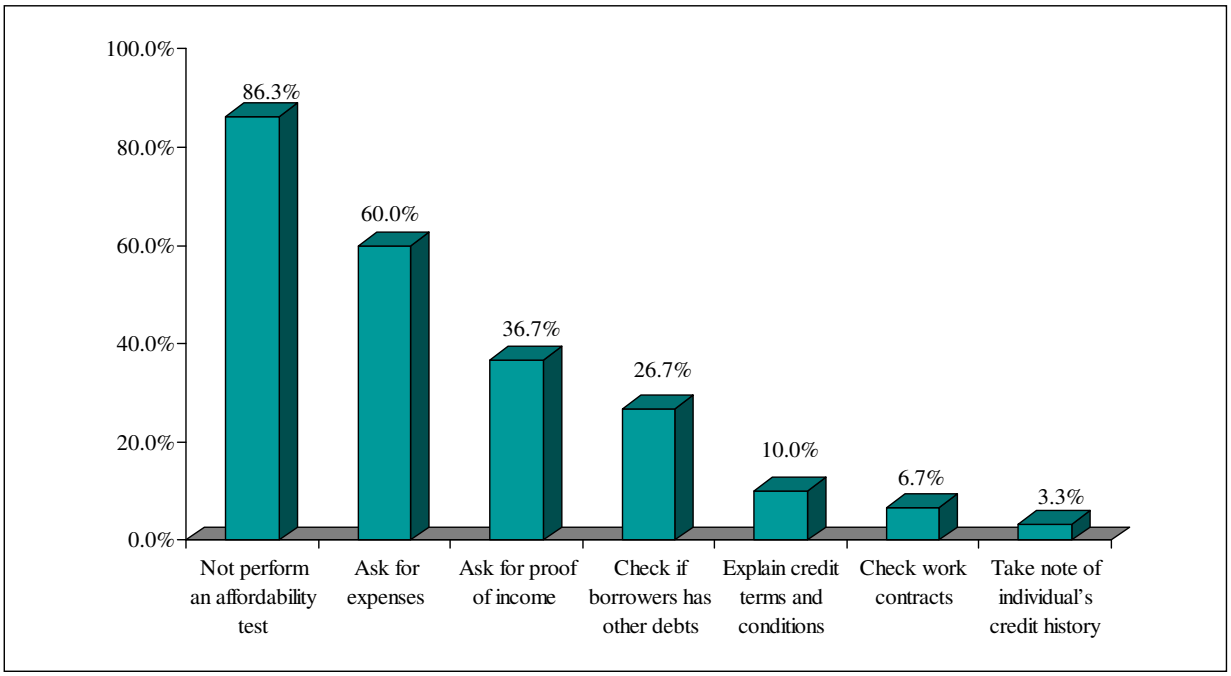

Fig. 4. Specific reckless lending practices

According to debt counsellors, lenders are not performing affordability tests based on NCA guidelines. They cited cases related to increase in new applications for credit, unsolicited credit limit increases and sending out of pre-approved credit such as credit cards and store cards for clothing or furniture.

3.4. Reckless borrowing. A question was posed to the debt counsellors whether it was the fault of the borrowers to be over-indebted. An unanimous response from the debt counsellors indicated that it was the fault of the borrowers to be over-indebted. When asked to elaborate, debt counsellors cited the reasons given in Table 1.

Table 1. Reasons why it is borrowers' fault

Borrowers tend to underestimate the impact of their regular expenses
Poor finance management
Borrowers don't give accurate information to creditors about current expenses
Individuals not willing to pay back on debt
People live beyond their means and buy things they can barely afford through debt
Borrowers skip certain months and therefore accrue a sizeable interest burden
Poor debt management skills
Borrowers stopped paying back debt for no apparent reasons
Engage into new debt without finish paying up old debt
Based borrowings on future cash flows that did not materialize
Lack of financial discipline
Loans meant for productive purposes were not used for that purpose
Clients exaggerated their income / Borrowers don't give accurate information to creditors about current expenses
Spend the money recklessly
Don't read terms and conditions of loans properly

These reasons can be divided into three main categories: lack of money management skills, negligence and dishonesty.

4. Findings from in-depth interviews

Results from in-depth interviews indicated that financial institutions are complying with the NCA's requirements for responsible lending. Bank employees request specific mandatory documents from clients, which are used to support credit applications. This information is verified and checked for consistency. Banks also check the clients' credit history and then proceed to perform risk and affordability assessments. Based on the assessments, applications of high-risk clients are declined, as well as those of clients whose affordability outcome is a deficit of income over expenses. Applications where the amount applied for is more than the clients' affordability are also declined. In this case, banks offer the client a lower amount that the client can afford.

5. Discussion

5.1. Drivers of over-indebtedness. Debt counselors ranked poor access to credit as the biggest driver of over-indebtedness. This is in line with Hartfree and Collard's (2014) finding that people who are considered to have poor credit risks are less likely to have access to mainstream credit. As a result, they are forced to resort to more expensive forms of credit, thereby increasing the risk of over-indebtedness.

Job loss and economic downturn also ranked number 1 as drivers of over-indebtedness. Retrenchments and unemployment also came up in the qualitative research as factors driving overindebtedness. This is believable in light of the economic conditions that South Africa had been experiencing during the period of the study. Related to the eco-

nomic downturn were high inflation and interest rates, which were mentioned by bank employees in the in-depth interviews.

Disney et al. (2008) and The Victoria Report (2006) classified these causes under sudden changes in circumstances. That is, consumers may experience financial shocks to their income, which are unforeseen and difficult to anticipate (Disney et al., 2008; The Victoria Report, 2006). These shocks may affect all income groups and can move consumers from a stable financial position in which they are able to meet all of their credit commitments, to one in which they are unable to repay their debts (Hartfree & Collard, 2014).

Borrowers' poor money management skills and borrowers not living within their means were also ranked high on the causes of over-indebtedness. These two drivers also came out strongly in in-depth interviews. In this instance, consumers were accused of deluding themselves about their capacity and do not always give honest reasons what they need the money for, as well as not always using the money for what they borrowed it for. That is, not acting in good faith.

Borrowers' poor money management skills and borrowers not living within their means were also found to cause over-indebtedness in the European Community (BERR, 2007). According to the BERR, people lacking essential financial skills, including the ability to budget sensibly may take on too much debt to their detriment. Disney et al. (2008) coined this financial imprudence.

5.2. Compliance with the NCA's responsible lending requirements. Findings were varied on whether financial institutions were complying with the NCA's responsible lending requirements.

This failure to perform an affordability test represents a departure from NCA responsible lending guidelines, which require credit providers to assess applicants on the following in order to avoid reckless credit:

- General understanding are appreciation of the risk and costs of the proposed credit, and the rights and obligations of a consumer under a credit agreement.
- Debt repayment history under other credit agreements.
- Existing financial means, prospects and obligations.

The majority of cases of reckless lending were related to new applications for credit and limit increases. The limit increases were criticized, as some consumers did not fully understand the financial implications of accepting a limit increase. This leads consumers into financial difficulty because their credit limit is increased progressively to a level they cannot afford (The Victoria Report, 2006).

This departure from legal guidelines had implications on the ethical and social responsibilities of financial institutions (Howell, 2004). By contrast, findings from the in-depth interviews indicated compliance with NCA guidelines. Respondents described an application and approval process that had both human and technological aspects to make it fully proved. The document requirements, verifications, bureau checks, risk scoring and assessments conducted indicated financial institutions that committed to the NCA.

5.3. Effectiveness of NCA in curbing reckless lending. The NCA introduced deterrents where all credit providers have a duty to guard against reckless credit by adhering to the act's responsible lending requirements (NCA, 2005). There is no recourse for the credit provider if the credit agreement is declared reckless credit irrespective of what the outcome of the assessment might have been prior to entering into a credit agreement. These refer to instances where credit providers do not apply NCA guidelines, for example, not performing an affordability assessment.

As in the preceding discussion, findings varied between the descriptive survey and in-depth interviews. When asked directly whether the National Credit act is effective in curbing lender's reckless lending practices, the majority of respondents (63.3%) disagreed. They gave the following reasons, some totally unrelated to reckless lending:

- over-indebtedness on the rise;
- credit is given to individuals with an unsatisfactory record;
- cases are on the increase;
- credit checks are not satisfactory;
- levels of debt of households increasing at higher rate than income;
- no thorough affordability tests;
- business of debt counselling is booming, reflecting a systematic problem in the Act.

Furthermore, 86% of respondents claimed that banks did not perform affordability tests. Banks did not ask for expenses and proof of income nor explain credit terms and conditions nor take note of an individual's credit history with new applications for credit and limit increases suggesting that the NCA has had limited success in curbing lenders' irresponsible lending behavior.

On the other hand, findings from the in-depth interviews show that banks are not lending recklessly. Rather, the fault lies with consumers who are not providing accurate information needed to

perform the assessments. The NCA does state that the credit provider is entitled to take the consumer's word when conducting an assessment. However, if the consumer lies and the lie affects the assessment, any reckless lending accusations against the credit provider may be dismissed (NCA, 2005).

Half of the respondents (53%) agreed that the NCA does reduce reckless lending. This compared well with the debt counsellors claim that on average, reckless lending caused about 25% of the cases of over-indebtedness that they had encountered. This may be a true state of affairs in light of the rigour banks have put in place around the credit application process.

5.4. Reckless borrowing. Research results from the counsellors on the culpability of borrowers in driving over-indebtedness were unanimous. There were two parts to this finding; poor money management skills and consumers behavioral biases. This result concurred with the Victoria Report (2006) and Ironfield-Smith et al. (2005) who also found that people with poor money management skills became over-indebted in Australia and the UK. Closely linked to poor money management skills was negligence by borrowers not reading their terms and conditions properly, using borrowed funds to expensive items (living beyond their means). Dishonesty, which was the third piece of the puzzle, was closely related to negligence. Dishonesty also came out strongly during in-depth interviews.

Negligence and dishonesty can be explained in part by literature on the characteristics of borrowers. In the evolution of lending, there is a record of people borrowing to finance lavish parties and fancy clothes (Boorstin, 2004; Calder, 1999). Even then the use of credit to satisfy an immediate need or wish that had little or no future value was considered immoral. This may explain why borrowers are not being honest about the purpose of the loans. Literature on the characteristics of borrowers revealed that consumers might be subject to behavioral biases such as imperfect will power and optimism. Some consumers suffer from imperfect self-control, or an underappreciated weakness of the will, which leads them to borrow despite previous resolve not to (Bar-Gill, 2004). Another bias underlying the underestimation of future borrowing is the optimism bias where consumers tend to underestimate the likelihood of adverse events that may force them to borrow (Bar-Gill, 2004). These include job loss, death of a partner, and so forth. Imperfect will power and optimism led consumers to swipe their credit cards more often than they anticipate, to their long-term detriment.

Conclusion

The discrepancy between the findings on whether banks are lending recklessly can be explained by the fact that debt counsellors are basing their opinion only on claims made by consumers. These claims may not be a true representation of what actually transpired as very few cases had been heard in the courts to substantiate the claims. To mitigate this, the research recommends that the custodian of the Act, the Department of Trade and Industry, conduct random audits to check lenders' compliance against specific reckless lending practices.

Findings on the characteristics of borrowers suggest a combination of inherent behavioral biases and low levels of financial literacy among others. Over-indebtedness arising from the credit environment can only be effectively contained if borrowers act in good faith. However, there is a need to educate consumers on both the benefits and risks of borrowing in order to encourage responsible borrowing behavior, and improve financial literacy for those with poor money management skills. This can be a combined effort involving the government and the credit / financial industry.

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Appendix

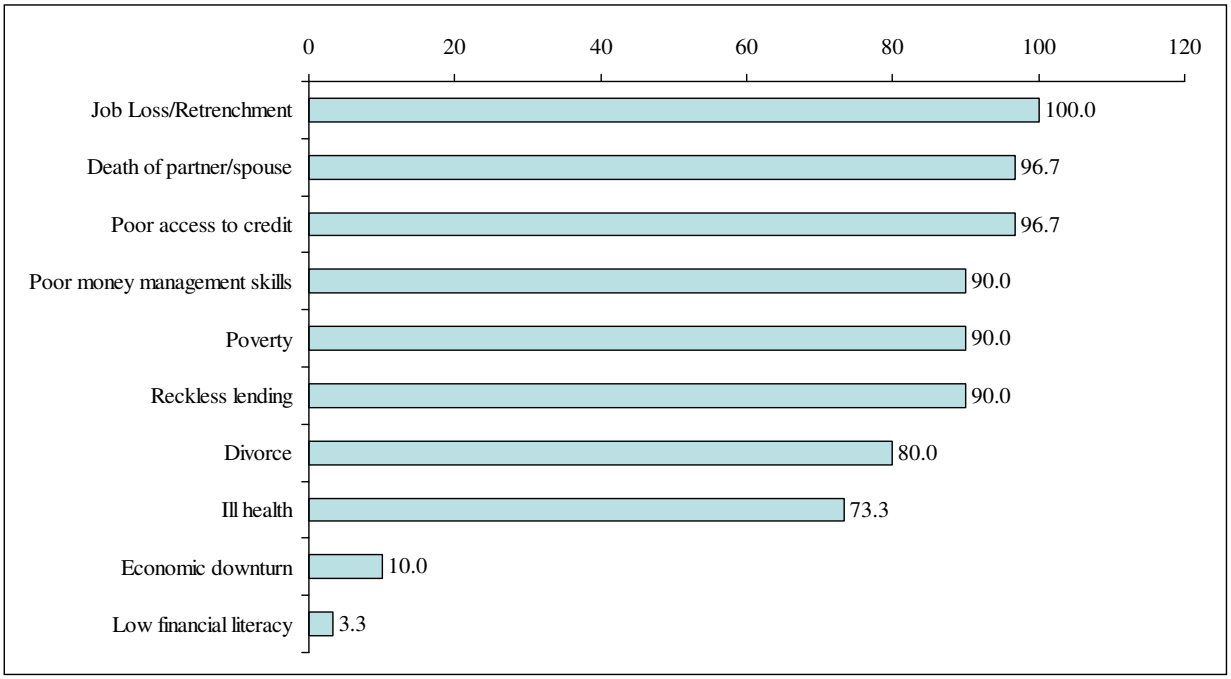

Fig. 1. Drivers of consumer over-indebtedness in SA