Written Submission

to

Finance and Fiscal Commission: Housing Finance Public Hearings

<u>Challenges and Opportunities in Housing Finance in South Africa: An Incremental Housing Finance Perspective</u>

Date: 13-14 October 2011

Ekurhuleni Civic Centre, Ekurhuleni, Gauteng Province

Submitted by

RHLF
RURAL HOUSING LOAN FUND

(Rural Housing Loan Fund is Schedule 3A PMFA Listed Public Entity with the Mandate to Facilitate Incremental Housing Loans in Rural Areas of South Africa)

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Promote Housing Microfinance as an Appropriate Housing Finance Product for Low Income Earners

1. Introduction

The draft problem statement presents the major challenge of increasing backlog in South Africa, despite the housing delivery that has been made since the advent of democracy in 1994—estimated at 3 million units. Segmentation of the market illustrates that there is no magic bullet to so solve the housing delivery challenge, but possible solutions should be conceived as a continuum that could be appropriate for each market segment and/or that a combination of interventions can ameliorate the housing delivery problem. Specifically, we argue that incremental housing finance or housing microfinance has not been adequately accepted as a an appropriate housing finance mechanism for low income people in South Africa and this has to change if households are to be enabled to take charge of the improvement of their housing conditions. Building incrementally has been practiced and perfected among many low income communities in South Africa, especially in rural areas.

The purpose of this submission is to make an argument for incremental housing finance as part of the solutions that should be promoted in addressing delivery of sustainable human settlements in South Africa, especially in rural areas and small/rural towns. This submission first presents housing finance products in South Africa and then defines incremental housing finance, including why it is a preferred housing finance product by low income earners. The paper also looks at the issue of housing finance and affordability issues—mainly in accessing affordable housing (mortgage). We present opportunities for incremental housing finance/housing microfinance[1]. The paper also highlights challenges and constraints to the growth of the housing microfinance in South Africa. Lastly, we present a brief RHLF experience in the incremental housing finance market.

2. Housing Finance Products in South Africa[2]

- Mortgage finance
- Fully Secured or Pension Backed loans
- Unsecured housing loans
- Savings
- **PLUS,** Government subsidy

According to the Finmark Trust, pension backed loans, unsecured housing loans and savings facilitate incremental housing investment.

3. Incremental Housing Finance

Incremental housing can be described as 'a phased approach' for citizens of the country to progressively improve their housing situation in order to achieve the constitutional right to adequate housing.

[1] These terms are used interchangeably in this paper.

[2] See *Housing Finance Access Frontier—a South African case study, Finmark Trust*. Government Subsidy has been included by author since government is actively involved in financing of housing for the low income market as defined in various subsidy instruments.

For many low income households it takes a longer period of time to accumulate sufficient capital to quickly build a complete house.

The question then is how do they proceed to improve their housing situations in a reasonable time? Most households go about the task of improving their housing condition in stages. They use gradual savings, occasional windfalls and housing microloans to purchase their building materials. The building process itself occurs through the use of local builders and their own ‘sweat equity’ to incrementally build their houses. It is often done on a block by block and a wall by wall basis. These people are innovative and their solutions for housing, in the face of extreme adversity, need to be commended.

Often the land around the home continues to accumulate building materials (stockpiling) for the next improvement project. It is an on-going process. Time moves slowly in rural areas and for many low income earners, but then so too, does money, as people take repeat loans that they can afford to pay back.

Traditional mortgage funding is not available to most people in rural areas. This is due to two reasons. The first is that they invariably live on communal land. This means that they have no acceptable title which can be used as security by the banks. The second reason relates to their levels of income. Rural households are characterised by higher levels of unemployment and low levels of income. Often, they are also informally employed which makes it difficult to prove regular income. The net result is that very little or no mortgage funding flows into rural areas.

So where does this take us? It takes us back to incremental housing or to the many other phrases coined to describe the process which include progressive build, progressive housing, self-help housing and informal housing. It is estimated that 80% of housing in the developing world is built in this manner—a phenomenon that has made housing microfinance a recognised housing financing mechanism.

Why do the rural poor and low income earners prefer the incremental approach?

- First, formal institutions such as banks and conventional building contractors do not participate in the incremental housing process in rural areas.
- Second, even if the banks and contractors were willing to participate in rural areas, security of tenure remains a thorny issue. As a result rural people do not have title to land that they could use as security to access mortgage finance.
- Third, incremental housing approach allows for the irregular nature of income flowing into rural areas, such as transfers from breadwinners living in urban areas—i.e. remittances.
- Fourth, incremental housing gives a household significant control over the building process. A household becomes an owner-builder or micro housing developer and takes pride in driving the building process
- Fifth, low levels of incomes prevailing in rural areas and amongst the working poor means that they cannot build a complete house all at once. As a result, the most feasible way of building a house is through a progressive build process that can take a longer time.

So why are housing micro finance loans taken out? It usually occurs in instances where the household is already in the process of addressing their housing needs but wishes to fast track the process. The housing micro loan, in effect, opens up a bottleneck, to allow the speedier delivery of housing improvements. Importantly, affordability of these housing microfinance loans becomes a key factor since low levels of income of the rural working poor means that they cannot afford a loan amortised over a twenty year period.

The benefits of housing microfinance can be summarised as follows:

- It allows households to build in stages—a progressive building process enabled by repeat access to a housing loan.
- Loan requirements such as land title are not required—collateral is not required to back up a loan (unsecured lending).
- Additional capital allows improvements to take place at a quicker rate, thereby improving general living conditions in terms of health, safety and general comfort.
- It assists households in purchasing big ticket items to supplement their own savings.
- It creates an asset both in terms of reduced future housing costs and also culturally from a family gathering place perspective.
- Housing improvements have a multiplier effect for the local community through the use of local labour and suppliers.
- Housing micro loans are often used for home based businesses which can become sustainable sources of future income that contribute significantly in improving the quality of life of a household.

4. Housing Finance and Affordability

The fundamental challenge in bringing housing finance to low-income households is affordability. Poor households in urban as well as rural areas often find themselves stuck between escalating real estate values and building material prices on one hand and stagnating real wages and rapidly rising costs of daily essentials, food and transport on the other.

Research by Finmark Trust (Figure 1) illustrates the affordability conundrum: It takes a minimum household income of R 8,000 p.m. to service a mortgage bond priced at prime with a 30% installment-to-income ratio that would buy a 40-80 m^2 entry-level house priced at R220, 000. For 90% of South African households such a mortgage is out of reach in terms of income. Whether there is housing stock to buy at this low price would be the second challenge. Figure 2 illustrates how the affordability gap in conventional mortgage finance has worsened between 2004 and 2008 with the double impact of escalating house prices and rising interest rates. In the current economic climate, it is unlikely that the situation would have improved. In fact, it is likely to have worsened even with the interest rates at record low levels.

In consequence, the 90% of South African households below R 8,000 p.m. (this amount is much higher in current terms) must rely on traditional incremental home building over time, using own savings and much sweat equity—apart from relying on government subsidy instruments to those who qualify. Small and relatively short-term home loans that do not require mortgage collateral can be an important catalyst in getting these households through financial bottlenecks and into a decent home faster.

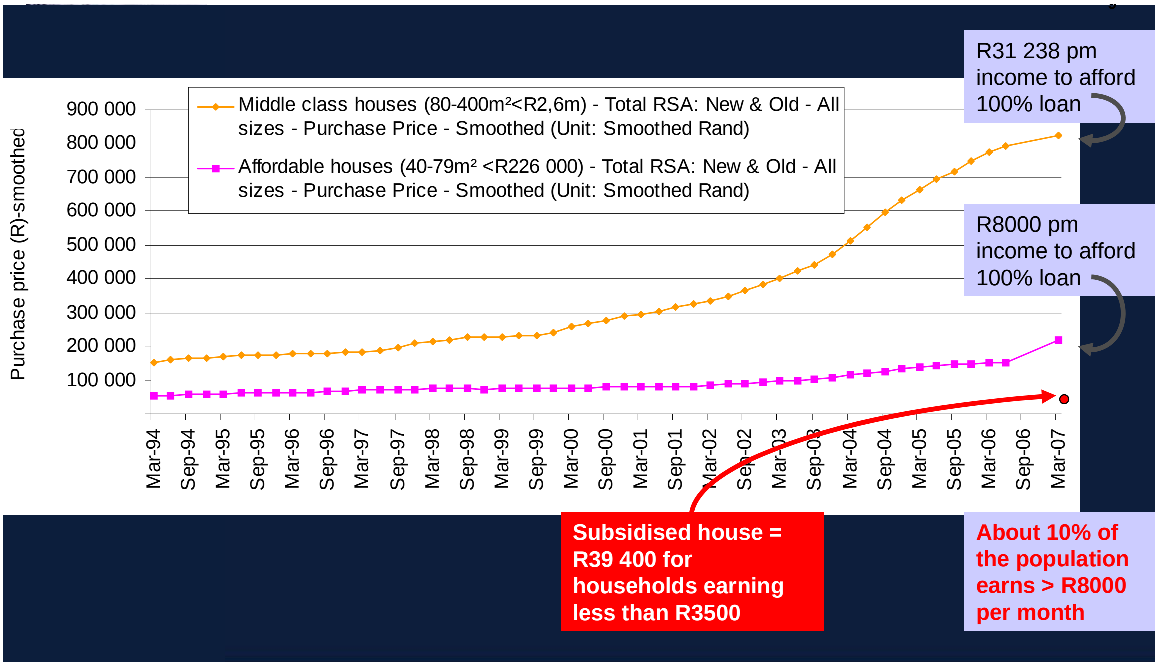

Figure 1: Affordability of Mortgage Finance. Source: FinMark Trust.

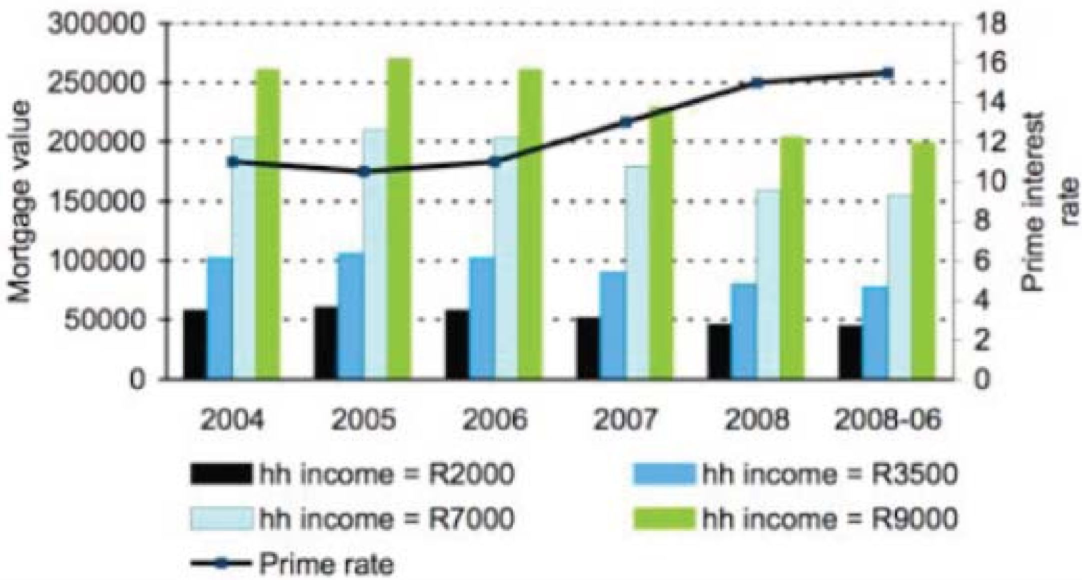

Figure 2: Affordability by Household Income. Source: Access Housing 6/2008.

There is a further, less recognized benefit of incremental housing finance: Small home improvement loans not only augment the immediate housing conditions of the household, they also often transform a sub-standard home into a marketable asset. On the back of this asset, the household can join the upwardly mobile housing mainstream, where families trade-up into better homes leveraging the equity from their first home. Thus, incremental housing finance can create markets in starter homes that allow families to upsize as well as down-size their homes at different points in their lives. Unlocking this market can provide the sorely needed affordable housing stock, without which a seamless housing life-cycle cannot work.

Incremental Housing Finance / Housing Microfinance should not be seen only as financing home improvement without adding to the housing stock or living space of households. In many instances it does and it can do more if it is promoted as an appropriate housing finance mechanism for low income earners both in rural areas and urban areas such as in informal settlements.

5. Opportunities for Housing Microfinance in South Africa

It is difficult to put hard numbers to the market size of the housing microfinance product in South Africa. However, as shown in the preceding section this market is huge given the low income levels of many households who cannot afford affordable housing mortgage finance. Areas that present opportunities for housing microfinance in South Africa are:

- **Delivered Government Subsidy Houses:** Many people who have acquired government subsidized housing aspire to extend the size and/or improve quality of their housing and living conditions. This is the case in both rural areas and urban areas as people invest in their housing when incomes improve or household size increases.
- **The rural traditional housing market:** Households residing on communal land largely depend on using own savings plus loans from various sources to improve their housing conditions. RHLF has serviced this market since inception and has not even scratched the surface of this huge market. Because of low income levels in rural areas plus lack of title to land, the housing microfinance is a more realistic mechanism to help people in rural areas to improve their housing conditions and build quality houses.
- **Professionals residing on communal land:** Many teachers, nurses, police officers, etc. working in rural areas are taking bigger unsecured housing loans to build bigger and quality houses rather than relocating to nearest urban houses. Delivery of water and electricity in many rural areas across the country contributes to making rural areas habitable. Added to these professionals, are migrant workers working in urban areas but who still invest in building bigger and quality houses in rural areas where they come from for security and comfort of their dependents—a trend that may be in decline due to urbanization in the long run.
- **Informal settlements Upgrading:** The drive by the government to eradicate informal settlements present another opportunity for the beneficiaries of service sites in that not all of them will qualify for subsidy for top structure nor qualify for mortgage finance. For many of these beneficiaries, the realistic opportunity to improve their living conditions is access to housing microfinance.

6. Constraints and Challenges to the Growth of HMF

Some of the challenges that constraint of the incremental housing finance industry faces are as follows:

- **Land tenure:** This is a major challenge in most urban areas when people settle in informal settlements and erect shacks. Processes to formalise informal settlements can potentially open up opportunities for demand of incremental housing finance as people feel secure to invest in the improvement of their housing condition and connecting to infrastructure services.

- **Regulatory framework:** Currently incremental housing finance is reported as part of unsecured loans by the NCR. It may be useful to create a separate sub-category for this developmental loan purpose with a view of differentiating the industry as a subsector of unsecured lending. This can lead to opening up of investment into the sector, especially from investors who are looking for socially desirable investment opportunities when credible information becomes available about the size and growth of the industry.
- **Scale of the sector:** The sector is still small and is thus not yet recognised as a viable option to address housing needs of the working poor. The market for housing microfinance is huge in the context of the housing needs in South Africa. Both public and private sectors need to collaborate to build this sector.
- **Vulnerability of the market:** Because the housing microfinance focuses on low income earners, it is susceptible to adverse economic conditions and in most instances the low income earners are the first to bear the brunt of being retrenched.
- **Too few people work in South Africa:** There are too few people who work in South Africa and the few that are working have too many mouths to feed (high dependency ratio). The result of this is that those who work have limited disposable income that could be used to improve household housing conditions.
- **High cost of credit:** Due the unsecured nature of these micro loans the interest rates and fees charged by the credit providers are very high. (Currently interest rates are capped by the NCA at Repo rate *2.2 +20% per year = 32.1% plus fees). The high interest is of course used to of set the high bad debts experiences by the credit providers. In essence the good payers are subsidizing the bad ones. Alternatives should be investigated to reward the good payers for paying back their loans. This will assist them to borrow more and to invest more in their houses.
- **High levels of indebtedness:** The current high levels of indebtedness are prohibiting persons from taking on further debt to use in the building of their own homes.
- **Capital/Funding:** There is limited funding that is invested into the industry. There is a need for a dedicated effort for the DFIs and the private sector to invest in the HMF sector in order to address human settlements needs and economic development.
- **General economic health of South Africa**: Many of the issues relate to economic development. If the economy grows people are employed and they can borrow to improve their own living conditions.
- **HMF is not yet well recognised as an appropriate housing finance mechanism**: The whole culture in SA needs to be changed and people must be empowered to take charge of improving their own living conditions. HMF must be “sold” as a viable method of attaining or improving a house. Put differently, government must promote housing microfinance vigorously as it does with ‘Affordable Housing’. The point is that affordable housing is appropriate for a particular market segment, while Housing Microfinance is also appropriate for a particular market segment. In each case, we want to enable low income earners in SA to drive the improvement of their housing and human settlements conditions.

7. RHLF Experience in Facilitating Access to Incremental Housing Finance

As a human settlement development finance institution, RHLF was established in 1996 to enable low income earners in rural areas and small towns to access credit so that they can incrementally improve their housing conditions. Because rural South Africa is especially poor and housing conditions are varied and difficult, RHLF has always aimed at developing innovative approaches and loan products that support a wide range of incremental home improvements, extensions and solutions for water, energy and waste management. The objective is to maximize individual choice in determining housing priorities and life styles.

End-user loans supported by RHLF may be used for the purpose of buying, building or improving fixed property on which members of the borrower household live. Within this broad definition, specific uses include:

- Construction or completion of formal or traditional housing structures;
- Purchase of building materials, payment for labour, purchase of prototype plans or any expense related to house construction/improvement;
- Fixed improvements/extensions related to household on-site production (including small business space and backyard rental housing) or to upgrade security/fencing;
- Connections to water, sewerage and electricity. This might include individual contributions to shared infrastructure, such as communal water sources or energy generation;
- Water harvesting, non-water borne sewerage, and energy efficient retrofits, including solar energy, insulation and other energy innovations;
- Purchase of land by individuals or groups for residential purposes;

As at the end of March 2011, RHLF has, via its intermediaries, facilitated a little over R852 million covering over 280, 000 incremental housing finance loans. This is small compared to the opportunities that the market presents. However, because incremental housing loans are unsecured, it is plausible that many other financial institutions (banks and non-bank lenders) have disbursed large amounts of money into the market.

8. Concluding Remarks

In this short paper, we have focused more highlighting issues pertaining to housing microfinance/unsecured housing loans/incremental housing finance. Not unlike other housing finance products, housing microfinance has its own challenges, but at the same time there are huge opportunities for the housing microfinance to address housing needs of low income earners in South Africa, both in urban and rural settings. Therefore, various stakeholders need to "***Promote Incremental Housing Finance as an Appropriate Housing Finance Mechanism for Low Income Earners".*** However, incremental housing finance has its own challenges that need to be addressed. Accordingly, it must be emphasized that housing microfinance is not presented here as a panacea for all housing delivery challenges in South Africa, but we argue that it is an appropriate in enabling many low income earners to incrementally improve their housing conditions over time. HMF gives opportunity to those who do qualify for government subsidy or who cannot afford mortgage finance an opportunity to achieve their housing dreams too.