TITLE:

PRE-AGREEMENT ASSESSMENT AS A MEASURE TO PREVENT RECKLESS CREDIT GRANTING

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Summary

The central thesis of this dissertation is that efficient pre-agreement assessment is a primary and effective means of preventing reckless or irresponsible lending which is one of the root causes of consumer over-indebtedness. Accordingly an examination of best practices in pre-agreement assessment of credit consumers with a view to preventing reckless lending and the resultant over-indebtedness is paramount to engaging in a meaningful discourse on the role of pre-agreement assessment in a responsible lending regime and desirable scope and extent of such assessment so as not to have a too paternalistic ‘Nanny-style’ mode of regulation that stifles the credit market and puts access to credit out of reach of many consumers.

The 2012 Financial Stability Board Principles for Sound Residential Mortgage Underwriting Practices and the 2013 World Bank Report on Responsible Lending is used to provide a framework of what would constitute broad best practices in the context of pre-agreement assessment as a responsible lending practice focused on the prevention of consumer over-indebtedness. A discussion is provided of the EU approach to creditworthiness assessment as set out in the 2008 Consumer Credit Directive and the very recent and more progressive 2014 Mortgage Credit Directive as it is submitted that especially the 2014 Mortgage Credit Directive provides a good example of creditworthiness assessment trends that are aligned with the observations made in this regard by the World Bank and Financial Stability Board as international standard setting bodies.

On the African continent South Africa can be regarded as a developing jurisdiction that has made significant strides in establishing a well-regulated credit market by introducing a comprehensive legislative framework for credit regulation in 2007 by means of the National Credit Act (NCA) \(^1\). This piece of legislation has introduced the novel concepts of “over-indebtedness” and “reckless credit” into South African law and makes extensive provision for debt relief to over-indebted credit consumers. The dissertation examines the evolution of pre-agreement assessment in terms of the South African National Credit Act in detail and

\(^1\) National Credit Act 34 of 2005 (hereinafter NCA).
also comments on some challenges to proper pre-agreement assessment. Chapter 4 examines the progress made in Lesotho in the context of pre-agreement assessment, remarking that a major drawback in this regard is the lack of a comprehensive legislative framework for credit regulation.

Ultimately best practices are extracted from the discussion in Chapter 2 to benchmark the pre-agreement procedure mandated in the South African National Credit Act 34 of 2005. The dissertation further considers any insights for Lesotho on whether it is appropriate to follow the South African example, given that it appears to follow in the footsteps of South Africa insofar as its endeavours to address reckless lending through pre-agreement assessment is concerned.
# INDEX

## CHAPTER ONE
OVER-INDEBTEDNESS AND RECKLESS LENDING

1.1 Introduction .................................................. 3
1.2 Over-indebtedness of credit consumers ....................... 3
1.3 Causes of over-indebtedness .................................. 8
1.4 Irresponsible or reckless lending as root cause of over-indebtedness ............................................. 10
1.5 Nature and scope of dissertation ............................. 13
1.6 Methodology .................................................. 14
1.7 Chapter Layout ................................................. 15

## CHAPTER TWO
PRE-AGREEMENT ASSESSMENT: BEST PRACTICES

2.1 Introduction .................................................. 17
2.2 The FSB Principles for Sound Residential Mortgage Underwriting Practices ........................................ 19
2.3 The 2013 World Bank Report on Responsible Lending ................................................................. 21
2.4 The EU Directives on Consumer Credit and on Mortgage Credit ...................................................... 28

## CHAPTER THREE
PRE-AGREEMENT ASSESSMENT UNDER THE NATIONAL CREDIT ACT

3.1 Introduction .................................................. 41
3.2 The South African credit legislation framework prior to the NCA ....................................................... 41
3.3 An overview of the reckless credit framework provided by the NCA .................................................. 46
3.4 Pre-agreement assessment in terms of the NCA ............. 51
3.4.1 The initial approach ........................................ 51
3.5 The evolution of pre-agreement assessment under the NCA ............................................................. 57
3.5.1 The joint statement by Treasury, BASA and the National Credit Regulator ...................................... 57
3.5.2 The May 2013 Draft Affordability Guidelines .......... 57
3.5.3 The September 2013 Draft Guidelines .................... 58
3.5.4 The National Credit Amendment Act 19 of 2014 ......... 62
### 3.5.6 The 2014 Draft Affordability Regulations

- Page 64

### 3.5.7 The 2015 Final Affordability Regulations

- Page 69

### 3.6 Challenges to pre-agreement assessment in South Africa

- Page 73
  - 3.6.1 The Credit Amnesty Regulations
  - Page 73
  - 3.6.2 The National Credit Register
  - Page 77

### CHAPTER 4 PRE-AGREEMENT ASSESSMENT IN LESOTHO

#### 4.1 Introduction

- Page 78

#### 4.2 Over-indebtedness of credit consumers in Lesotho

- Page 81

#### 4.3 The regulatory framework in Lesotho

- Page 84
  - 4.3.1 The Financial Institutions (Lending Limits) Regulations
  - Page 89
  - 4.3.2 The Financial Institutions (Loan Portfolio Classification) Regulations
  - Page 89
  - 4.3.3 The Credit Reporting Act
  - Page 92
  - 4.3.4 The Hire Purchase Act
  - Page 97
  - 4.3.5 The Financial Leasing Regulations
  - Page 98
  - 4.3.6 The Financial Institutions Credit Only and the Deposit Taking Micro-Finance Regulations
  - Page 98

#### 4.4 Challenges for pre-agreement assessment in Lesotho

- Page 103

### CHAPTER FIVE FINAL REMARKS, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Introduction

- Page 106

#### 5.2 Appraisal of pre-agreement assessment under the South African NCA

- Page 114

#### 5.3 Pre-agreement assessment in Lesotho: Quo Vadis?

- Page 123
CHAPTER ONE

OVER-INDEBTEDNESS AND RECKLESS LENDING

1.1 Introduction

Globally credit consumption has become an indispensable and integral part of household and individual spending. Evidence suggests that credit consumption in the advanced economies has increased by more than 600% over the past two decades. For example, as far back as 1997, more than 20% of aggregate personal consumption in the United States is reported to have been conducted using credit cards. More specifically in 1999, the aggregate household borrowing was estimated at about US $500 billion. Recent statistics on household credit consumption, especially in the advanced economies, have been very high. It is estimated that credit consumption in the United States increased by 21.27 USD billion in December of 2015, following an upwardly revised 14.02 USD billion rise in November and well above market expectations of a 16 USD billion gain. The statistics for the other countries in the European Union (EU) and the rest of the world have remained in tandem with the dynamics in the US, albeit comparatively lower.

Access to credit is considered by national authorities as a crucial measure of financial inclusion. Many international surveys use the number of retail loans as one of the key statistics when evaluating financial inclusion. Availability of credit, in general, provides the population with more options to realize their economic plans. Unfortunately access to credit also has its downside and brings new challenges to credit regulation, notably the intricate problem of consumer over-indebtedness and how to address it.

1.2 Over-indebtedness of credit consumers

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4 Ibid.
Over-indebtedness of credit consumers\textsuperscript{6} is a significant global problem. At the outset it should be noted that there is no single generally accepted definition of “over-indebtedness”. The European Commission in a recent study (hereinafter the EU Study)\textsuperscript{7} examined and compared definitions and measures of over-indebtedness in the EU countries, and set out the various views regarding what over-indebtedness entails emerging from the different socio-economic and legislative environments.

The EU Study indicates that there are many definitions and tools that are used to define and measure consumer over-indebtedness. Some make a distinction between “definitions” and “indicators” of over-indebtedness. A definition is a description of what should be regarded as constituting over-indebtedness, whereas “indicators” can be used to measure it. In some cases definitions are directly intertwined with indicators. There is however no single statistic that might serve as a measurement of a multi-dimensional phenomenon such as over-indebtedness, but a number of indicators can be used to identify the number of over-indebted households in a specific country. In this regard the EU Study refers to the following statement by the EU Economic and Social Committee:\textsuperscript{8} “The practical aim is to define a fundamentally identical framework to identify and typify situations in which households are objectively unable, on a structural and ongoing basis, to pay short-term debts, taken out to meet needs considered to be essential, from their habitual income provided by work, financial investments or other usual sources, without recourse to loans to finance debts contracted previously.”

The Study further points out that the Group of Specialists for Legal Solutions to Debt Problems at the European Council view over-indebtedness as a changing concept, which can cover at one and the same time problems with both credit and difficulties with payment of day-today bills. They define over-indebtedness as, but not limited to, “the situation where the debt ratio of an individual or a family manifestly and on a long-term basis exceeds the payment capacity”.

\textsuperscript{6} In this dissertation the word “consumer” and “borrower” will be used interchangeably. The words “credit provider”, “lender” and “creditor” will also be used interchangeably.

\textsuperscript{7} See ‘Towards a common operational European definition of over-indebtedness’, available on the European Commission website http://www.ec.europa.eu/atwork/key-documents/index_en.htm accessed 3 February 2016 (hereinafter referred to as the EU Study)

\textsuperscript{8} Ibid.
The EU governments rely mostly on two types of measures to track over-indebtedness of consumers: legal/administrative measures (such as debt settlement) and measures based on arrears in payments. In most cases both are used by the government, depending on the context. The Study provides the following examples of how over-indebtedness is viewed in various jurisdictions:

- In Austria, the Federal Ministry for Social Affairs and Consumer Protection is responsible for matters relating to over-indebtedness of credit consumers. The definition which is mostly used is that of the counselling agency called the IFS-Debt which states that “Individuals or households can be regarded as over-indebted if after deduction of current cost of living expenses like food, clothes, rent, social and cultural needs / requirements, they are not able to discharge all payment obligations.”

- In Belgium, the government focuses mainly on the definition for personal insolvency. The Bankruptcy Law\textsuperscript{10} states that an individual can be declared insolvent and benefit from debt settlement if “his/her income does not allow him/her to, in a sustainable way, pay his/her due debts”. This means a person will only be deemed over-indebted if declared insolvent and this is formally only done by a court of law following legal proceedings.

- In Finland, the Ministry of Trade and Industry is responsible for the policies on over-indebtedness and the Ministry of Justice for the preparation of the legislation related to credit issues and over-indebtedness. However, the issue is dealt with by a number of government agencies: the Advisory Council on Consumer Affairs, the Consumer Agency/Consumer Ombudsman, the National Consumer Research Centre (under the Ministry of Trade and Industry) and the National Research Institute of Legal Policy (under the Ministry of Justice). Each of these institutions/actors uses a different definition in each of its publications. For example, the report entitled “Debt adjustment brings relief – A fresh start for over-indebted Finnish households” by the National Research Institute of Legal Policy considers as over-indebted the persons who are participating in the national debt adjustment programme.

\textsuperscript{9} EU Study 8-13.
\textsuperscript{10} Bankruptcy Act of 8 August 1997.
• In France, the policies to deal with over-indebtedness are based on the Over-indebtedness Commissions. Therefore, the measure most commonly used is the legal definition of the situations which are admissible to the Household Debt Commissions. Article L.330-1 of the French Monetary and Financial Code of 2011 that applies to consumer issues states that “over-indebtedness of individuals is “characterized by the manifest inability of the debtor, who is acting in good faith, to face up to the whole of his/her non-professional debts due or accrued”.

• In Germany a private household is over-indebted if its income over an extended period is not sufficient for servicing debt on time (after deducting costs of living expenses) despite a reduction of the standard of living.

• In Ireland, the Government’s Department of Social and Family Affairs has delegated the issue of over-commitment (of credit consumers) to the Combat Poverty Agency, a statutory organisation responsible for advising the Irish Government on policies to reduce poverty in Ireland, which works together with a state-funded network of money advice services called Money Advice and Budgeting Service (MABS). MABS uses the following definition: “Households are over-indebted if they are persistently unable to meet from their income reasonable living expenses and deferred payments as they fall due”. This definition is based on the concept of arrears on a structural basis.

• In Italy, the concept of over-indebtedness is also similar to insolvency, since the debtor initiates the insolvency procedure by filing a proposal for a debt restructuring agreement which needs to be accepted by some of the creditors only, at a later date. It defines over-indebtedness as “a situation of non-temporary difficulties in regularly honouring his/her commitment using his/her income and his/her assets (real estates and other mobile properties)”.

• In Portugal, the Directorate-General for Consumer Affairs is in charge of over-indebtedness, a department of the Ministry of Economics and Innovation. The Directorate-General does not have an official definition, and it does not have publications on the subject. However, the academic institute Observatorio do Endividamento dos Consumidores (at the University of Coimbra) officially advised the government on issues relating to over-indebtedness until 2003, and continues to have great influence on the debate in Portugal. The institute uses the definition “over-indebtedness is a situation where there is a lack of income or other liquid assets that makes
people incapable of paying their debts on a structural basis”. This definition is based on arrears.

- In both Norway and Sweden, institutions use the concept of insolvency, based not on administrative records, but on calculations that the person will be unable to pay his/her debts in the foreseeable future. In Norway, the issue of over-indebtedness is handled by the Ministry of Children and Equality, which is responsible for the implementation of the Debt Settlement Act of 1992, the legislation that regulates the court-arranged solutions to debt. According to the Debt Settlement Act of 1992, a person is regarded as over-indebted if he/she meets the first condition to obtain debt settlement. In Sweden, the problem of over-indebtedness is mainly handled by the Swedish Consumer Agency. The Agency uses the following definition: “The debtor/household is insolvent”. By “insolvent” it is meant that the amount of debts have become so extensive that the debtor has no way to fulfil his obligations when loans are due, and further that the problem is persistent. In its 2004 report “Over-indebtedness - extent, causes and measures proposals” the Agency uses that definition in combination with a second definition from the Debt Relief Act, the legislation that regulates debt settlements. This definition states that the person must be “qualified insolvent” which means that the debtor has no chance to fulfil his/her obligation in the foreseeable future, similar to the Norwegian concept of insolvency.

- In the Netherlands, on the other hand, individuals are considered to be over-indebted if they meet the conditions to benefit from the debt settlement scheme called “Schuldsanering” – for that it is sufficient that an individual, in good faith, is unable to meet his/her debt commitments.

- In the United Kingdom, the government has extensively discussed over-indebtedness in the past. In its 2004 action plan on over-indebtedness, it implicitly adopted the Citizens Advice definition that a household is over-indebted when they are “unable to pay their current credit repayments and other commitments without reducing other expenditure below normal minimum levels”.

12 Debt Relief Act 1 of 2007.
13 Translated as Natural Persons Debt Rescheduling Act of 1998.
Although there is a lot of variation, the EU Study concludes that many of the definitions alluded to above contain some common core elements, which may serve as a common foundation for determining consumer over-indebtedness. For instance, the unit of measurement is, in most cases, the household, where households also include single-person units. Most of the definitions reviewed above make a reference to time (such as ‘long-term’ or ‘structural problems’), and the definitions generally include debt or contracted financial obligations. Furthermore, these definitions include a reference to cost of living expenses. Most of the definitions also refer to payment capacity, such as the ‘inability to pay the contracted obligations’.

Accordingly the most important elements/foundations of a common operational definition of over-indebtedness in the European Union are the following:

- **Household**: Households are small groups of persons (or one person) who share the same living accommodation, who pool some, or all, of their income and wealth.
- **Payment capacity**: The capacity to meet the expenses associated with the contracted financial commitments. Over-indebtedness implies an inability to meet recurring expenses.
- **Structural basis**: This is the time dimension, which holds that the definition must capture persistent and ongoing financial problems and exclude one-off occurrences that arise due to forgetfulness, for instance.
- **Standard of living**: The household must be unable to meet contracted commitments without reducing its minimum standard of living expenses.
- **Illiquidity**: The household is unable to remedy the situation by recourse to (financial and nonfinancial) assets and other financial sources such as credit.

The various definitions noted above accordingly reflect the multi-dimensional phenomenon that constitutes “over-indebtedness”. These dimensions include an economic dimension of being over-burdened with commitments and a time dimension of short-term over-commitment versus long-term structural problems, both of which are common in the definitions reviewed. There is also a social dimension relating to financial exclusion or
exclusion of participation in social/economic life in general as well as a psychological dimension in terms of the severe stress and psychological destabilization over-indebtedness can bring forth for the affected persons.¹⁵

The EU Study endeavored to develop a common over-indebtedness definition across the EU that would be applicable in varying economic circumstances within the EU and could thus be useful also in other countries. Based on the analysis of information provided by the EU member states on their national policies (if any), the study proposed that a household would be considered over-indebted "when its existing and expected resources are insufficient to meet its financial commitments without lowering its standard of living, which might mean reducing it below what is regarded as the minimum acceptable in the country concerned, which in turn might have both social and policy implications". ¹⁶

Therefore, recent studies have converged on a common set of indicators, while noting that there is no universal agreement on which indicator best captures true over-indebtedness.¹⁷ The indicators used broadly reflect four aspects of over-indebtedness and are summarized as follows:¹⁸

(a) Cost of servicing debt: Households spending more than 30% (or 50%) of their gross monthly income on total borrowing repayments (secured and unsecured); Households spending more than 25% of their gross monthly income on unsecured repayments; Households whose spending on total borrowing repayments takes them below the poverty line.

¹⁵ EU Study 41.
¹⁶ To empirically measure the level of possible over-indebtedness, the EU Study (at 41) identified the following set of criteria:
   • The unit of measurement should be the household because the incomes of individuals are usually pooled within the same household;
   • Indicators need to cover all aspects of households’ financial commitments: borrowing for housing purposes, consumer credit, to pay utility bills, to meet rent and mortgage payments and so on;
   • Over-indebtedness implies an inability to meet recurrent expenses and therefore should be seen as a structural rather than a temporary state; it has been stated that it is not possible to resolve the problem simply by borrowing more; for a household to meet its commitments, it must reduce its expenses substantially or find ways of increasing its income. Policy makers often need a practical tool to evaluate possible over-indebtedness.
(b) Being in arrears: Households being more than two (2) months in arrears on a credit commitment or household bill.
(c) Number of loans– heavy use of credit: Households with four (4) or more credit commitments.
(d) Subjective perception of burden: Households declaring that their borrowing repayments are a "heavy burden".

It is submitted that that low-income countries where microfinance is a key contributor of financial inclusion may use similar measures to the ones outlined above. For example, a recent paper by Schicks\(^\text{19}\) which analyzed over-indebtedness of micro-borrowers in Ghana, deemed borrowers over-indebted if they continuously struggled with repayment and experienced unacceptable sacrifices related to their debt. It found, significantly, that poorer micro-borrowers were more likely to be over-indebted. The risk of over-indebtedness further increased with the occurrence of adverse economic shocks to a borrower’s income or expenses. The likelihood of over-indebtedness was further found to be higher for borrowers with low returns on their investment and if borrowers used loans, at least in part, for non-productive purposes. It was also higher for borrowers with a low, debt-specific financial literacy.\(^\text{20}\)

It is clear that over-indebtedness is a global problem facing credit regulators and that it is common in affluent developed jurisdictions as well as in the poorer developing jurisdictions. If left unchecked it can eat into the health of a country’s economy and may bring about devastating repercussions. Accordingly it is submitted that the issue of over-indebtedness and how to best address it should be of paramount importance on the credit regulation agenda of all jurisdictions with credit-active consumers.

It is further submitted that legislation aimed at addressing and eradicating over-indebtedness will only be effective if it efficiently targets the origin of the “mischief” namely the “causes” of over-indebtedness as opposed to merely treating the symptoms thereof. This view has been taken by the Consumer Debt Committee of the International Federation

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\(^\text{19}\) Schicks *Over-Indebtedness in Microfinance – An Empirical Analysis of Related Factors on the Borrower Level* Centre for European Research in Microfinance (CERMi) (2012).

\(^\text{20}\) Ibid.
of Insolvency Practitioners (Insol International) as long ago as May 2001 already when it was stated that the solution to overspending and over-indebtedness is inter alia to be found in the idea that “prevention is better than cure.”

1.3. Causes of over-indebtedness

In its 2013 Report on Responsible Lending the World Bank indicated that the first driver of over-indebtedness is financial imprudence (poor decision-making) which is primarily caused by an inadequate understanding of the real cost of repaying a loan. It is stated that this may be linked to transparency of lender’s terms and conditions as well as to borrower’s financial literacy and ability to manage their finances correctly by adequately planning expenses in relation to income. It is further stated that this imprudence may also derive from psychological biases and mental shortcuts that affect consumer’s decisions and predictions about borrowing, such as the ‘over-confidence bias’ which refers to the tendency to underestimate the probability of suffering an adverse event.

According to the World Bank the second driver of over-indebtedness is the occurrence of unexpected events that modify the initial conditions in which the contract between the credit provider and consumer was concluded. This refers to aspects such as an unexpected reduction in income (for instance job loss), an unforeseen expense (such as medical costs), an increase in the cost of debt (for example an interest rate increase) as well as unexpected changes in family structure (such as divorce).

Poverty is cited as a third driver of over-indebtedness where it pushes individuals incapable of coping with their expenses to take on loans that have little chance to be repaid. It is stated that this usually happens when creditors have difficulties identifying the right debtors due to a lack of information on credit history and current financial situation. Also included

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24 Ibid.
in this category is the situation when the need for a loan arises from over-indebtedness itself, thus continuing a vicious cycle.

It is thus evident that various factors may contribute to consumer over-indebtedness. As explained by Persson, the reasons for a person becoming over-indebted “cannot be pinned down by a single explanatory model, such as the person in question being afflicted with illness, unemployment, divorce, bankruptcy and so on.”

The nature of the causes of consumer over-indebtedness accordingly span from behavioral aspects such as a propensity towards indebtedness by certain consumers to aspects such as the easy accessibility of credit in some jurisdictions whilst there is also evidence that financial exclusion may exacerbate consumer over-indebtedness, by causing consumers to loan money from unregulated and unscrupulous credit providers who extract excessive interest on such loans. Lack of financial literacy is also a prime factor contributing to consumer over-indebtedness. Economic downturn and unemployment, as can be expected, is yet another cause—the recent 2008 Global Financial Crisis is a stark reminder of this.

However it is unfortunately also true that certain irresponsible or reckless lending practices employed by credit providers largely contribute to over-indebtedness: These practices inter alia include improper marketing practices through which consumers are deceived about certain aspects of the credit that is proposed to be extended; poor or improper disclosure; lack of plain language that compromises the ability of borrowers to comprehend complex terms and excessive cost of credit which in itself is a major contributor to consumer over-indebtedness as well as failure to assess affordability prior to entering into credit agreement’s. Arguably poor credit regulation also has a role to play in the incidence of consumer over-indebtedness especially in credit markets where regulators lack the

27 See in this regard Jorgensen The Way to Over-indebtedness- Intensive Marketing, Easy Access to loans , and Insufficient Legislation” 2014 Juridica International 33 specifically with regard to “instant loans”.
28 Ibid.
30 Ibid.
regulatory will and/or enforcement tools to address irresponsible or reckless lending practices and either does not regulate these practices at all or alternatively takes a very laissez fair approach to regulation of the credit market.

1.4 Irresponsible or reckless lending as a root cause of over-indebtedness

From the aforementioned discussion it is clear that consumer over-indebtedness may be triggered by various circumstances in which the credit provider plays no role, such as for instance job loss due to illness or retrenchment due to economic downturn. However, as indicated, in many instances consumers become over-indebted as a result of credit having been extended to them despite the fact that they were unable to afford such credit. Thus certain marketing and lending practices by credit providers can be regarded as the root cause of over-indebtedness in certain instances. Where credit is extended to a consumer who is unable to afford such credit, whether it is because he simply does not have the financial means to service the repayment of such credit or because he is uneducated about the risks, costs and obligations of entering into a credit agreement resulting in an inability to repay the credit and if the credit provider is aware of the aforementioned aspects, it can generally be stated that the credit provider who despite such knowledge continues to grant the specific credit to the consumer is acting irresponsibly or to put it even stronger, “recklessly”. 31 Extending credit recklessly to a consumer can thus be branded as “egregious” conduct by a credit provider that is worthy of sanction giving its role in causing consumer over-indebtedness.

There has accordingly been a global trend in credit regulation to address the issue of irresponsible lending practices. It is to be noted that the concept of ‘responsible lending’ is broad and does not lend itself to easy definition. In the 2013 World Bank Report on Responsible Lending 32 it is indicated that ‘responsible lending’ is a policy term. Although it is used to denote a whole range of measures or regulatory tools, in effect the term itself does nothing more than to paint with a broad brush the desired goal that the legislator or

31 It is conceded that the term ‘irresponsible’ is less harsh than the term ‘reckless’ and may constitute a broader genus of behaviour of which reckless lending could be regarded a species.
32 World Bank on Responsible Lending (2013) 2.
regulator seeks to achieve. For purposes of this dissertation the concepts “irresponsible lending” and “reckless lending” will be used to signify the same type of broad behaviour or business practices by lenders, namely practices that impede repayment ability and satisfaction of credit agreement debt and which thus contribute to consumer over-indebtedness.

Focusing mainly on inducing responsible behaviour of market participants, the responsible lending policy is part of a broader context of financial sector management. Policy makers in the area of responsible lending thus tend to balance several financial sector policy objectives: financial inclusion, stability of the financial sector, integrity of financial service providers, and financial consumer protection. According to the World Bank an effective responsible lending regulatory system needs to cover five key consumer protection areas: (1) institutional arrangements; (2) disclosure (3) business practices (4) consumer redress and (5) financial capability.

In the World Bank’s 2013 Global Survey on Financial Consumer Protection, most countries indicated that they have some form of responsible lending provisions. Given the interest to prevent consumer-over-indebtedness, the World Bank Survey indicates that many regulators have been seeking ways to define rules of responsible lending. Because there are no internationally recognized standards on responsible lending, individual countries have used a wide range of regulatory approaches. Some jurisdictions rely primarily on information disclosure, expecting consumers to be capable for making adequate decisions. Others place the burden for responsible lending primarily on credit providers, requiring them to assess the suitability of the loan for each consumer. Some jurisdictions opt for more prescriptive solutions, defining interest rate ceilings, maximum debt-to-income or loan-to-value ratios or limits for penalties or late fees.

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34 World Bank Report on Responsible Lending (2013) 13. See further the discussion (at 13) regarding institutional arrangements, responsible credit disclosure and business practices; redress for over-indebtedness; financial capability and efficient enforcement.
Given its capacity to cause consumer over-indebtedness it is submitted that no credit market should tolerate irresponsible or reckless lending by credit providers and that statutory measures to prevent reckless credit granting is a necessity in the quest to promote responsible borrowing and achieve a decrease in the incidence in consumer–over-indebtedness in a credit market. It is accordingly submitted that it should be a key feature of a responsible lending regime that legislative measures exist to combat reckless lending.

In the context of prevention of irresponsible or reckless credit granting and alleviation of its ill consequences various statutory mechanisms have been applied globally. Generally these mechanisms entail a prohibition of irresponsible or reckless credit granting coupled with sanctions to be applied in instances where credit was granted irresponsibly or recklessly despite the prohibition. These sanctions include measures such as the imposition of administrative fines and cancellation of licenses upon a finding of irresponsible or reckless credit granting and may in some jurisdictions even lead to the credit agreement being unlawful and/or void. Consumers who are the victims of irresponsible or reckless credit granting are usually also offered various debt relief options to counteract the ill effects of the credit that was recklessly extended to them.\(^{37}\) However it is submitted that all the above interventions, many of which are implemented ex post, although they may deter credit providers significantly from extending credit irresponsibly or recklessly, are not sufficient on their own to curb reckless credit granting. The trend in many jurisdictions with active credit markets is accordingly to supplement the prohibition against reckless credit granting by requiring that the credit provider conduct some sort of ‘affordability assessment’ or ‘creditworthiness assessment’ prior to extending credit and to provide that if the outcome of this assessment raises red flags about the consumer’s ability to afford the intended credit the credit provider should abstain from granting the credit to the specific consumer.\(^{38}\) Thus the pre-agreement assessment process serves as an ex ante “filter” that flags those instances where the granting of credit would be irresponsible or reckless.

### 1.5 Nature and scope of dissertation


\(^{38}\) In this dissertation the terms “creditworthiness assessment” will be used to also include “affordability assessment” and vice versa.
This central thesis of this dissertation is that efficient pre-agreement assessment is a primary and effective means of preventing reckless or irresponsible lending. Accordingly an examination of best practices in pre-agreement assessment of credit consumers with a view to preventing reckless lending and the resultant over-indebtedness is paramount to engaging in a meaningful discourse on the role of pre-agreement assessment in a responsible lending regime and desirable scope and extent of such assessment so as not to have a too paternalistic ‘Nanny-style’ mode of regulation that stifles the credit market and puts access to credit out of reach of many consumers.

The 2012 Financial Stability Board Principles for Sound Residential Mortgage Underwriting Practices and the 2013 World Bank Report on Responsible Lending will be used to provide a framework of what would constitute broad best practices in the context of pre-agreement assessment as a responsible lending practice focused on the prevention of consumer over-indebtedness. A discussion will also be provided of the EU approach to creditworthiness assessment as set out in the 2008 Consumer Credit Directive and the very recent and more progressive 2014 Mortgage Credit Directive as it is submitted that especially the 2014 Mortgage Credit Directive provides a good example of creditworthiness assessment trends that are aligned with the observations made in this regard by the World Bank and Financial Stability Board as international standard setting bodies.

On the African continent South Africa can be regarded as a developing jurisdiction that has made significant strides in establishing a well-regulated credit market by introducing a comprehensive legislative framework for credit regulation in 2007 by means of the National Credit Act (NCA) \(^{39}\). This piece of legislation has introduced the novel concepts of “over-indebtedness” and “reckless credit” into South African law and makes extensive provision for debt relief to over-indebted credit consumers.\(^{40}\) The provisions relating to over-indebtedness and reckless credit appear in Part D of Chapter 4 of the Act and apply to natural person consumers. In terms of section 79(1) of the NCA, a consumer is defined as over-indebted, if “the preponderance of available information at the time a determination is

\(^{39}\) National Credit Act 34 of 2005 (hereinafter NCA).

\(^{40}\) Van Heerden in Scholtz et al Guide to the National Credit Act (Lexis Nexis 2008 et seq) par 11.1.
made indicates that the particular consumer is or will be unable to satisfy in a timely manner all the obligations under credit agreements to which that consumer is party”. As discussed in more detail in chapter 3, the provisions in the National Credit Act that are aimed at eradicating reckless credit granting hinge very strongly on the obligation of a credit provider to conduct a creditworthiness pre-agreement assessment in order to justify the granting or refusal of credit on the basis that the consumer can or cannot afford the proposed credit.

Ultimately the objective is to use the best practices extracted from the discussion in Chapter 2 to benchmark the pre-agreement procedure mandated in the South African National Credit Act 34 of 2005 and, on a more personal note, to determine which lessons the writer’s home country, Lesotho, which appears to be following largely, albeit it quite slowly, in the footsteps of the South Africa insofar as credit law development and regulation is concerned, can learn in the context of pre-agreement assessment.

1.6 Methodology

In the jurisdictions under study in this work, sources of credit regulation consist of: (i) statutes or legislation; (ii) self-regulation; (iii) opinions of writers; (iv) customary law; (v) common law; (vi) principles of equity; and (vii) case-law. However, the most pervasive source of credit regulation is statute or legislation; and it is also the most relevant to this research. Being the most relevant and pervasive primary source, it shall constitute the main focus of the research. Ancillary to this, policy documents and opinions of writers as well as case-law, as sources of credit regulation, would also engage attention.

1.7 Chapter Layout

Chapter One of this dissertation sets the scene for the study. It explores the different notions of the concept of “over-indebtedness” and reveals reckless or irresponsible credit granting as one of the root causes of over-indebtedness. It accordingly identifies pre-agreement assessment as a direct (primary) measure that can be applied to prevent reckless
credit granting. This chapter further sets out the scope and nature of the study which focuses on pre-agreement assessment and provides a road map of how the study will progress.

Chapter Two refers to some features of responsible lending as identified by Wilson and also sets out the Financial Stability Board’s Principles of Sound Residential Mortgage Underwriting and 2013 World Bank Report on Responsible Lending insofar as it relates to pre-agreement assessment in order to provide an indication of what these international standard setting bodies view as best practices in relation to creditworthiness assessment. This Chapter further considers progress made in the EU where the Financial Stability Board’s Principles and the World Bank Report on Responsible Lending informed the progression with regard to creditworthiness assessment that is apparent when one compares the provisions of the 2008 Consumer Credit Directive to the much more interventionist and comprehensive provisions of the 2014 Mortgage Credit Directive.

Chapter Three broadly sets out the responsible lending regime promoted by the South African National Credit Act. The focus of this Chapter is on the pre-agreement assessment mandated by section 81(2) of the Act and the evolution of pre-agreement assessment in South African credit law.

Chapter Four provides background on consumer over-indebtedness and credit regulation (or lack thereof) in Lesotho and sets out developments in Lesotho in the context of prevention of reckless credit granting and pre-agreement assessment as a tool to prevent irresponsible lending.

Chapter Five is the final chapter in which the study is concluded by benchmarking the South African pre-agreement assessment provisions against international best practice and makes recommendations on a suitable way forward for Lesotho insofar as pre-agreement assessment as a tool to prevent reckless credit granting is concerned.

41 See Renke “Measures in South African consumer credit legislation aimed at the prevention of reckless lending and over-indebtedness” 2011 THRHR 74 for the distinction between primary and secondary measures aimed at preventing reckless credit granting.
 CHAPTER 2

PRE-AGREEMENT ASSESSMENT: BEST PRACTICES

2.1 Introduction

In the book *International responses to issues of credit and over-indebtedness in the wake of crisis*, Wilson makes certain remarks pertaining to responsible lending. She indicates that the goal of any responsible lending practice should be first and foremost to protect consumers from the harms of irresponsible lending, in that way avoiding over-indebtedness for individuals, as well as the broader economic consequences of that over-indebtedness, including financial crisis. She is however wary that responsible lending poses the risk of being interpreted in such a way that it leads to restrictive lending practices which exacerbate financial exclusion. Accordingly she cautions that responsible lending regimes should not encourage restrictive lending practices any more than they should allow for lax lending practices, pointing out that the main cause of over-restrictive lending practices seems to be inflexible credit assessment methods. It is her view that if a responsible lending regime is not structured to encourage individualised credit assessment, then it is likely to lead to over-restrictive lending practices and to exacerbate over-indebtedness.

Wilson uses the following four criteria to assess the likely effectiveness of responsible lending regimes evidenced by a pro-active regulatory approach:

(a) a focus on responsible lending in order to avoid over-indebtedness, rather than responsible borrowing;

(b) a focus on consumer credit in general, not limited to residential mortgage loans;

(c) an encouragement of flexible, individualized credit assessment practices, or at least not an encouragement of rigid and inflexible credit assessment practices; and

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43 Wilson 126.
44 Ibid.
45 Wilson 127.
46 Wilson 128.
47 Ibid.
(d) the existence of a regulatory agency charged with enforcement, which is adequately resourced to properly monitor and enforce compliance with market conduct regulation, including responsible lending obligations.

These observations by Wilson serves as a good basis from which to proceed in establishing best practices in pre-agreement assessment. Consumers become over-indebted as a result of taking up all sorts of credit, from micro-finance to mortgages, and accordingly it is appropriate that responsible lending practices such as conducting pre-agreement assessment should apply across the broad spectrum of credit agreements even though it is appreciated that larger amounts and more severe over-indebtedness may be at stake where mortgage credit is concerned. It can also be agreed that individualized pre-agreement assessment would yield the most reliable results and of course, the requirement to do pre-agreement assessment will not be observed by credit providers if there is no enforcement agency dedicated to monitor and enforce compliance with the obligation to do a pre-agreement assessment. However, it is submitted that although responsible lending implies that it is the credit provider, as lender, who will have to bear the brunt of the responsibility to ensure that he employs lending practices that tick this box, the consumer as borrower necessarily also has to co-operate fully and truthfully in enabling responsible lending, especially in the context of pre-agreement assessment. The most meticulously crafted pre-agreement assessment methods will be ineffective and unreliable if the consumer lies and misleads. Accordingly a more balanced approach to pre-agreement assessment is advocated where the consumer is also given some responsibility for the outcome of the assessment and where lack of co-operation is sanction in accordance with the distorting impact it has on the assessment results and the credit provider’s ability to conduct a proper assessment.

Wilson’s remarks regarding responsible lending thus provide a good backdrop to the broader context of responsible lending and the specific preventative measure of pre-agreement assessment. International standard setting bodies such as the Financial Stability Board and World Bank has also commented on responsible lending, and specifically on creditworthiness or affordability assessment. Accordingly the FSB Principles for Sound Residential Mortgage Underwriting and the World Bank Report on Responsible Lending, as
discussed below, also provide good sources for extracting best practices in pre-agreement assessment as a measure to prevent irresponsible or reckless credit granting.

2.2 The FSB Principles for Sound Residential Mortgage Underwriting Practices

In March 2011 the Financial Stability Board (FSB) as international standard–setting body tasked primarily with global financial stability oversight, published a thematic review of residential mortgage underwriting and origination practices.\textsuperscript{48} Pursuant to this review the FSB released seven Principles for Sound Residential Mortgage Underwriting Practices (the Principles) in April 2012.\textsuperscript{49} These principles are intended to apply to loans to consumers that are (i) secured either by residential mortgage or by another comparable security commonly used in some jurisdictions on immovable residential property, (ii) secured by a right related to residential immovable property; and (iii) loans for which the purpose is to acquire or retain rights in residential immovable property.\textsuperscript{50} Notably the FSB stated in the introduction to the Principles that jurisdictions should seek to apply all the Principles that are relevant and that “[i]n all instances a robust and effective assessment of individual affordability must underpin any sustainable lending model.”

Principles 1 and 2 as discussed below relate specifically to creditworthiness assessment and provide as follows:

2.1 Principle 1: Effective verification of income and other financial information

It is stated that a borrower’s income capacity is a key input into effective mortgage underwriting. Thus jurisdictions should ensure that lenders verify and document each applicant’s current employment status, relevant income history, and other financial information.\textsuperscript{51} It is advised that jurisdictions should ensure that lenders make reasonable inquiries and take reasonable steps to verify a borrower’s underlying income capacity. Lenders should also maintain complete documentation of the information that leads to mortgage approval and accordingly a proper record with an adequate explanation of the

\textsuperscript{48} Available at \url{http://www.financialstabilityboard.org/publications/r_11031a.pdf} accessed on 8 August 2016.
\textsuperscript{49} FSB Principles for Sound Residential Mortgage Underwriting Practices (Hereinafter FSB Principles) available at \url{http://www.fsb.org} accessed on 8 August 2016.
\textsuperscript{50} FSB Principles 1.
\textsuperscript{51} Principle 1.1.
steps taken to verify income capacity should be readily available for supervisors.\textsuperscript{52} Incentives must further be aligned with accurate representation of borrower’s income and other financial information.\textsuperscript{53}

\subsection{2.2 Principle 2: Reasonable debt service coverage}

The FSB indicates that one of the most fundamental components of prudent underwriting is an accurate assessment of the borrower’s ability to repay the mortgage and that it is also an important factor in reducing the likelihood of consumer over-indebtedness. Thus it is stated that jurisdictions should ensure that lenders, while taking into account data protection rules in their jurisdiction, appropriately assess borrower’s ability to service and fully repay their loans without causing the borrower undue hardship and over-indebtedness.\textsuperscript{54} It is indicated that it should be ensured that lenders (i) establish appropriate processes to assess the borrower’s ability to repay the loan, (ii) review these processes at regular intervals and (iii) maintain up-to-date records of those processes. Lenders should also take into account all relevant factors that could influence the prospect for the loan to be repaid according to its terms and conditions over its lifetime. This should include an appropriate consideration of other servicing obligations, such as the level of other debt (secured and unsecured), the interest rate and outstanding principal on such debt, and evidence of delinquency. An assessment must be included of whether the loan can be expected to be repaid within the specified loan amortisation period from the borrower’s own resources (income and assets) without inducing undue hardship and over-indebtedness.\textsuperscript{55}

Under Principle 2 it is further stated that jurisdictions should ensure that lenders make reasonable allowances for committed \textsuperscript{56}and other non-discretionary expenditures in the assessment of repayment capacity. It is indicated that this could include establishing the borrower’s actual obligations, including appropriate substantiation and consideration of normal living expenses. Lenders should also include risk limits in their internal loan policies,

\textsuperscript{52} Principle 1.2.  
\textsuperscript{53} Principle 1.3.  
\textsuperscript{54} Principle 2.1.  
\textsuperscript{55} FSB Principles 3. It is also stated that temporarily high incomes should be suitably discounted and that the assessment of the borrower’s ability to repay should neither be based on the assumption that the property will appreciate in value (unless the purpose of the loan is to construct or renovate the immovable residential property) nor on an expected significant increase of the borrower’s repayment capacity.  
\textsuperscript{56} Principle 2.2
such a specifying minimum levels of residual net income after meeting obligations or fixed ratios of repayment to some measure of gross or net income (eg debt-to-income ratio or loan-to-income ratio).\(^{57}\)

Principle 2.3 entails that jurisdictions should ensure that lenders make prudent allowances for future negative outcomes. Accordingly lenders should include an increase in benchmark interest rates in the case of variable rate mortgages or an unfavourable change for a borrower in the exchange rate in case of mortgages granted in foreign currencies. Repayment calculations should take into account the highest payment currently scheduled to apply during the term of the loan rather than solely utilising the first few payments at the prevailing interest rate or foreign exchange rate. It is also indicated that lenders should consider the increase in future payments due to negative amortisation, balloon payment, or deferred payments of principal or interest.\(^{58}\)

Principle 2.4 indicates that jurisdictions should ensure that lenders provide borrowers with sufficient information to clearly understand the main elements which are taken into account to determine a borrower’s repayment capacity, the main characteristics of the loan including the costs, and risks associated with the loan in order to enable borrowers to assess whether the loan is appropriate to their needs and financial circumstances. In this regard it is stated that it is important that customer information be clear, concise, reliable, comparable, easily accessible, timely and comprehensive (i.e the information should also take into account the effect if variation in interest rates and the combined effect of the loan and any other product linked to it). This information must be provided to borrowers free of charge and effectively present the total cost of the mortgage during its lifetime, taking into account the loan terms.

2.3 \textbf{The 2013 World Bank Report on Responsible Lending}

For purposes of determining best practices regarding pre-agreement assessment in the context of credit, the World Bank’s 2013 Report on Responsible Lending provides valuable

\(^{57}\) Ibid. \\
\(^{58}\) Principle 2.3.
insights. The Report addresses pre-agreement assessment in two broad aspects, namely affordability testing and suitability testing.

### 2.3.1 Affordability testing

The World Bank Report indicates that creditworthiness assessment looks at the borrower’s ability to repay the loan. It is stated that when assessing the riskiness of a potential client – and his ability to repay the loan (creditworthiness) - income verification is the primary tool most credit providers use. In more formalized economies, most credit providers require formal confirmation of borrower’s income such as payslips and tax returns whereas less credit providers in formalized economies use other sources of information to confirm the creditworthiness of consumers such as witnesses or assessment of the consumer’s property.

The World Bank Report also indicates that some governments prescribe the minimum information credit providers must collect from customers to ensure compatibility and allow for verification of the consumer’s credit worthiness. It reports that for example in Ireland, the government in cooperation with banks and the Money Advice and Budgeting Service developed a standard financial statement that all credit providers must use to collect information about the consumer’s financial situation. Knowing what data credit providers collect enables the Central Bank of Ireland as the financial sector supervisor to develop its own scoring models and verify how well banks work with the collected data for loan scoring.

It is emphasised that credit history is an important factor for most credit scoring systems where a reliable credit history is available. Having a history of reliably using credit helps consumers get further or larger loans and, if a country has a reliable credit bureau, most credit providers verify history of potential borrowers as part of the assessment process.

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61 A network of government-sponsored advisors for people who need advice managing their money or are over-indebted.
63 World Bank Report on Responsible Lending (2013) 32 and 34. According to the World Bank Report, even when there are no credit history providers or when financial institutions are not required to report to such
Credit history verification, according to the Report, may be a part of an internal policy of the financial institution or required by the regulatory framework. It is stated that in higher-income countries with functioning credit bureaus, the requirement may be defined by regulatory rules at least for banks and possibly for larger loans from non-bank credit institutions. In lower-income or lower-capacity environments without sufficient credit history data the supervisor may list specific options that credit providers may use to verify creditworthiness of consumers. It is however cautioned that the list needs to be specific to allow for supervisory verification and to ensure that all options are relevant for the goal of the assessment, namely gauging the ability of the consumer to take on and repay the loan.\footnote{World Bank Report on Responsible Lending (2013) 37.}

It is further reported that many credit information sharing systems have also started collecting data on the use of and payment reliability of other services provided on credit, such as utilities or phone services. Accordingly lenders may have access to information about the consumer’s failure to cover his mobile phone or utility bill on time and make lending decisions based on this information as well.\footnote{World Bank Report on Responsible Lending (2013) 34.}

As part of the overall risk management requirements, the Report indicates that the supervisor may want to verify that the financial institution has adequate risk identification policies in place and verifies the documents themselves. Accordingly when the income or credit history assessment is based on information provided by the consumer, the financial institution should have policies and processes in place that will verify that the information is true and correct and that will ensure that any falsification in this regard is adequately prosecuted.\footnote{World Bank Report on Responsible Lending (2013) 39.}

The World Bank Report states that the ultimate goal of creditworthiness assessment should be the verification that the borrower has sufficient assets or income to pay back the loan. Credit providers must thus make the determination that the consumer can repay the loan by looking at both the consumer’s income and any assets that he has on hand and which providers, financial institutions still seek information about a consumer’s credit history. It is stated that especially microfinance institutions that often lack resources to both report to and seek information from a credit information sharing system often base their lending decision on a credit history of the consumer with the institution. Accordingly new clients are generally eligible for smaller repayment loans than those existing clients with a proven track record of credit.
assets either (i) may be used to cover the instalments in case his income diminishes and is insufficient to cover those instalments or (ii) may be used as collateral. Hence it is stated: “[T]he creditworthiness [test] is thus a “creditor-focused” test, looking at the probability that the creditor will be repaid in full.”\textsuperscript{67} The creditworthiness or repayment ability test (also called “affordability test”) accordingly assesses the borrower’s capacity to repay the loan. It is stated that unless the regulator provides specific guidance on cut-off limits, it may implement at least some guidance to credit providers, including what should be taken into consideration besides the loan payments itself.\textsuperscript{68} In this regard the Report refers to a 2007 Predatory Lending Law of North Carolina, US that addressed the issue of mortgage repayments together with other immovable property ownership costs by requiring the credit provider to assess whether the consumer has the ability to repay the loan according to its terms and pay applicable real estate taxes and hazard insurance premiums.

An important point that is made in the World Bank Report is that affordability testing should be used to verify the ability of the consumer to repay the debt, not only service it. Therefore, any regulatory guidance or rules on affordability testing should make clear that credit should not be considered affordable merely because the borrower is able to service the debt over a period of some years by making the minimum payments.\textsuperscript{69} By example the Report states that before the 2008 mortgage crisis in the US, many mortgage providers assessed repayment ability only on the introductory teaser rates that were substantially lower than the conditions for the rest of the mortgage. However, according to Regulation Z

\textsuperscript{67} World Bank Report on Responsible Lending (2013) 34. The World Bank Report (at 39 to 40) indicates that supervisors may also support the use of credit history and income verification through rules for loan provisioning. These rules may stipulate that provisions for loans where the financial institution verified the borrower’s income and /or credit history (if applicable in the country) may be lower than if such verification has not taken place. It is further stated that if there are provisioning advantages based on credit history verification, the credit history must be relevant for the decision making; if there are several credit bureaus, they need to exchange information between them or that lenders utilize information from all of them if the credit history of the borrowers is not shared. The supervisory agency needs to avoid a situation where credit history verification is conducted for the reason of lowering provisioning requirements rather than for the reason of adequately verifying a borrower’s credit history.

\textsuperscript{68} World Bank Report on Responsible Lending (2013) 35.

\textsuperscript{69} World Bank Report on Responsible Lending (2013) 35. It indicated that especially in recent years of economic downturn it has been seen that many consumers have been unable to pay off their debts (especially on credit cards) and have only managed to make the minimum monthly repayments.
of the Consumer Financial Protection Bureau, mortgage lenders will now have to determine the consumer’s ability to repay both the principal debt and interest over the long term.\textsuperscript{70}

The Report further states that while collateral is an important aspect in quantifying (and lowering) the riskiness of the consumer, the repossession of collateral is not considered a positive result from the point of view of responsible lending as such repossession usually has long-term negative consequences for the consumer. Also, if a credit provider has to resort to an above-average number of repossessions compared to its peers, it will often be a sign of failure of responsible lending behaviour of the lending institution.\textsuperscript{71}

As regards enforcement of affordability testing it is indicated that under its responsible lending policies, the regulator may thus require that any credit provider assesses the credit history of the consumer as well as any other relevant information. In order to allow for proper supervision of the requirements set in the context of affordability testing, the supervisor should be as specific as possible in defining the list of information the lenders should request when assessing a loan application. Here again the Report refers to the Central Bank of Ireland that issued a letter to supervised financial institutions in February 2013 in the following terms:\textsuperscript{72}

“In order to fully assess a borrower’s ability to repay a loan, the Central Bank’s expectation is that you will avail of at least one of the following:

1. Employ the services of a suitable credit bureau or credit reference agency.

2. Require the borrower to obtain information from the private dwelling mortgage lender on the payment status of their mortgage.

3. Require the borrower to provide an up to date mortgage statement covering a 12 month period.

\textsuperscript{70} World Bank Report on Responsible Lending (2013) 38. The Report indicates that the repayment ability is usually tested under the normal conditions but some regulators require more strenuous testing to account for possible protracted periods of economic problems, using scenarios such as 2% higher interest rates or significant fluctuation in the exchange rate for foreign currency mortgages.

\textsuperscript{71} World Bank Report on Responsible Lending 35.

4. Such other process employed by you to determine if the borrower is in arrears on their mortgage on non-permanent forbearance.

The borrower should also be required to provide any other additional supporting documentation required to assess creditworthiness (e.g. proof of income, current account, credit card and other mortgage statements.)"

The World Bank Report states, as an enforcement option securing compliance with affordability assessment, that when regulators see risky behaviour of financial institutions, they may forbid specific business practices. In this regard it is mentioned that, as part of the Ability-to-Repay in Qualified Mortgage Standards Under the Truth In Lending Act, the US Financial Consumer Protection Bureau (FCPB) outlawed the ‘no-doc’ or ‘low-doc’ loans (otherwise known as ‘Alt-A loans’) where some credit providers made quick sales by not requiring documentation of income, ability to repay, or sometimes even of legal status and then offloaded these risky mortgages by selling them to investors.73

It is further indicated that supervisors may also set rules on what they expect as minimum verification of the consumer’s creditworthiness and how they see the assessment process. Here again the Report referred to another letter sent by the Central Bank of Ireland to all moneylenders in March 2013, stressing that: “The Central Bank is concerned with how firms are assessing the creditworthiness of consumers and that firms may be using information gathered from consumers, without verifying the information, in order to assess creditworthiness. Firms are reminded that the responsibility rests with the firm to ensure compliance and maintain evidence in order to demonstrate how they have complied with the Regulations. Furthermore, all conclusions made during the assessment of creditworthiness should be documented by the firm for each loan concerned.”

The World Bank Report further refers in this regard to eight underwriting standards that the US Consumer Financial Protection Bureau (CFPB) has defined in 2013 that mortgage lenders in the US are required to implement.74 According to the CFPB’s Regulation Z, credit providers must look at a consumer’s financial records and verify them- they are thus responsible for the validity of the information they use to make lending decisions. At a minimum the mortgage lenders must consider the following underwriting standards:

current income or assets; current employment status; credit history; the monthly payments
for the relevant mortgage; the monthly payment of other loans associated with the
property; the monthly payment of other mortgage related obligations (such as property
taxes); other debt obligations; and the monthly debt-to-income ratio or residual income the
consumer would be taking on with the mortgage.

It is further stated that the supervisor should make it clear that it will monitor compliance
with the creditworthiness assessment rule and that it will do so regularly.\textsuperscript{75} This is because
financial institutions need to know that there is a high probability that their files will be
inspected by the supervisor and that they need to keep proper documentation of the
client’s creditworthiness assessment or face supervisory enforcement action.\textsuperscript{76}

The Report also states that failure to conduct adequate affordability checks should have an
impact on the credit provider. It indicates that in countries where the affordability check is
required, this impact may come in the form of a supervisory action against the financial
institution. Other countries may define the impact as a worse position of the credit provider
if the borrower defaults. In this context the Report refers to the example of Norway that
leaves it to the credit provider to decide how to assess borrowers. However if the credit
provider fails to conduct adequate checks it will receive only a reduced divided if the
consumer subsequently defaults and enters the debt settlement procedure provided for in
Norwegian law.\textsuperscript{77}

Finally, it is indicated that any falsification of documents as part of the income and credit
history verification should be actively prosecuted.\textsuperscript{78}

2.2 Suitability Testing

The World Bank Report further addresses the aspect of “suitability testing” which some
jurisdictions incorporate into their rules on pre-agreement assessment. The Report states
that understanding the limits in reasonable decision making, some regulators go further

\textsuperscript{75} World Bank Report on Responsible Lending (2013) 38.
\textsuperscript{76} Here again the Report refers to the February 2013 letter of the Central Bank of Ireland stating: “We expect
that all credit applications will be supported by adequate evidence to illustrate that appropriate credit
assessment has taken place and that such evidence will be retained on file and available to us in the event of
an inspection.
\textsuperscript{77} World Bank Report on Responsible Lending (2013) 38.
\textsuperscript{78} World Bank Report on Responsible Lending (2013) 40.
than merely requiring creditworthiness assessments to be conducted by lenders and require that the financial institution ensures the offered product is not only affordable but suitable to the consumer. In the case of credit products the suitability concept looks at the lending issue from the borrower’s perspective rather than from the lender’s perspective whereas the creditworthiness test (affordability test) primarily assesses the risk of the loan not being repaid in full and on time. Suitability tests, being borrower-focused, accordingly always need to look at the individual borrower’s circumstances, his life situation and how the loan will impact his financial security.\textsuperscript{79}

As an example the Report refers to the UK Financial Services Authority that has been developing a Conduct of Business Sourcebook since 2007 (the sourcebook now being further developed by the new Financial Conduct Authority) to provide the financial industry with guidance on how the supervisor expects the industry to treat customers. The sourcebook lists the rule that the financial institution needs to act in the client’s best interest as the first among its requirements that the financial institution acts honestly, fairly and professionally.\textsuperscript{80}

The World Bank Report states that generally a product’s suitability should be evaluated by three tests – consumer’s best interest, understanding of the product and long-term affordability. In the interest of an effective and affordable lending regime, all three of these

\textsuperscript{79} Ibid. For adequately testing suitability of loans, the Report states (43 to 45) that lenders need a framework with which they can model typical customers. Some lenders rely on historical data which might be risky if the institution enters new market segments or when overall economic situation significantly changes (for example after a global or regional economic crisis), some rely on general statistical information released by national statistical offices or private analysts. However, it is pointed out that national-level data tends to be too general and lacking the details to allow for adequate segmentation. Therefore the supervisor may support collection and distribution of more detailed (and anonymized) data or development of models lenders could use with sufficient confidence. According to the World Bank Report adequate suitability testing further needs to take into account where the product is sold and implement behavioural psychology insights. Especially when credit is sold to finance a specific purchase made on the spot, it is stated that many borrowers focus on acquiring the underlying product and disregard information provided to them about the loan. In the situations where attention of the consumer is limited, insights from behavioural psychology should be given specific attention to help find tools to communicate credit related information effectively.

\textsuperscript{80} The client’s best interest rule COBS 2.1.1 provides as follows: “(I) A firm must act honestly, fairly and professionally in accordance with the best interests of its client.”
tests should be combined and the results adequately documented to allow for verification, both by the lender’s internal compliance team and by the relevant supervisory agency.  

The test of “best interest” verifies whether the lender adequately understands the borrower’s situation and his future plans. As such, the financial institution needs to look at the consumer’s whole financial portfolio and understand how the loan may interact with the consumer’s financial stability and long-term goals. While the final decision will always remain with the customer, the lender should be able to evaluate the consumer’s situation and advise which product, if any, is most suitable to fulfil the specific needs of the consumer.

The test of “consumer’s understanding” looks at whether the consumer understands all the product features, benefits and risks. It combines the need for adequate information disclosure with the need for adequate explanation and guidance provided by the sales staff as the oral presentation may significantly influence how the borrower understands and uses presented information.

The test of “long-term affordability” looks at how long-term risks the consumer may face could influence his ability to repay the loan. As such it goes beyond the creditworthiness assessment conducted by the lender before the sale. While the first two tests (that of best interest and consumer understanding) are rather straightforward, the Report points out that the test of long-term affordability needs the lender to make various assumptions about the borrower’s future as well as consider potential impact of general economic development on the borrower’s ability to repay the loan.

It is however emphasized that requiring suitability testing by law-and supervising such testing is a complex issue and may require detailed supervisory guidance.

2.4 The EU Directives on Consumer Credit and on Mortgage Credit

2.4.1 The Consumer Credit Directive

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82 Ibid.
The EU Consumer Credit Directive\textsuperscript{84} was adopted on 23 April 2008 and Member States had to transpose it into national law by 12 May 2010.\textsuperscript{85} This Directive aims to foster the integration of the consumer credit market in the EU and ensuring a high level of consumer protection by focusing on transparency and consumer rights. The Consumer Credit Directive operates on the principle of full harmonisation which it deems necessary in order to ensure that all consumers in the EU enjoy a high and equivalent level of protection of their interests. This means that member states are not allowed to maintain or introduce provisions in their national legislation other than those laid down in the Consumer Credit Directive.\textsuperscript{86}

Insofar as creditworthiness assessment is concerned, Recital 26 of the Consumer Credit Directive provides that member states should take appropriate measures to promote “responsible practices” during all phases of the credit relationship, taking into account the specific features of their credit market. It indicates that those measures may include, for instance, the provision of information to, and the education of, consumers, including warnings about the risks attaching to default of payment and over-indebtedness. It is also stated that in expanding the credit market it is important that creditors should not engage in “irresponsible lending” or give out credit without prior assessment of creditworthiness, and the Member States should carry out the necessary supervision to avoid such behaviour and should determine the necessary means to sanction creditors in the event of their doing so. The Directive indicates that creditors should bear the responsibility of checking individually the creditworthiness of the consumer and that, to that end they should be allowed to use information provided by the consumer not only during the preparation of the credit agreement in question but also during a long-standing commercial relationship. It is further provided that Member States could also give appropriate instructions and guidelines to creditors and that consumers “should also act with prudence and respect their contractual obligations.”


\textsuperscript{86} Recital 9.
Recital 27 indicates that despite the contractual information to be provided, the consumer may still require assistance in order to decide which credit agreement, within the range of products proposed, is the most appropriate for his needs and financial situation. Accordingly it is stated that Member States should ensure that credit providers provide “such assistance” in relation to the credit products they offer to the consumer. It is indicated that, where appropriate, the relevant pre-contractual information, as well as the essential characteristics of the products proposed, should be explained to the consumer in a “personalised manner” so that the consumer can understand the effects that the credit agreement may have on his economic situation. Member States could further determine when and to what extent such explanations are to be given to the consumer, taking into account the particular circumstances in which the credit is offered, the consumer’s need for assistance and the nature of individual credit products.

Recital 28 provides that, to assess the “status” of a consumer, the creditor should also consult relevant databases. Accordingly Chapter II of the Directive is titled “Information and Practices Preliminary to the Conclusion of the Credit Agreement”. It inter alia provides in Article 8 for the “Obligation to assess the creditworthiness of the consumer” in the following terms:

“8.1 Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer’s creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of consultation of the relevant database. Member States whose legislation requires creditors to assess the creditworthiness of consumers on the basis of a consultation of the relevant database may retain this requirement.

8.2 Member States shall ensure that, if the parties agree to change the total amount of credit after the conclusion of the credit agreement, the creditor updates the financial information at his disposal concerning the consumer and assesses the consumer’s creditworthiness before any significant increase in the total amount of credit.”

87 It is stated that where appropriate this duty should also extend to credit intermediaries. The Consumer Credit Directive defines “credit intermediary” as any natural or legal person, not acting as a creditor, and who in the course of his trade, business or profession, offers or presents credit agreements to consumers or otherwise renders assistance to consumers by doing the preparatory work in respect of credit agreements or concludes credit agreements with consumers on behalf of the creditor for a fee. See also Renke Thesis 45.

88 Recital 29 indicates that where a decision to reject an application for credit is based on the consultation of a database, the creditor should inform the consumer of this fact and the particulars of the database consulted.
The Consumer Credit Directive does not provide a definition of “responsible practices” or “irresponsible lending”. It is however clear that the introduction by the Directive of a duty to conduct a creditworthiness assessment on the consumer prior to extending credit is regarded as a responsible lending practice. The Directive is however not prescriptive in minute detail about how this assessment process is to be conducted but merely provides for a number of aspects to be complied with during the assessment, namely that it must be conducted prior to concluding the agreement and that it is the credit provider’s responsibility to conduct the assessment on the basis of sufficient information which the credit provider must obtain from the consumer and through consultation of relevant credit databases. The consumer is responsible for making the ultimate decision on the suitability of the credit he applies for and in this regard it is merely required that the credit provider facilitates this decision by explaining the risks, cost and obligations to the consumer so that the consumer can eventually make an informed choice. The mandatory nature of the pre-agreement assessment obligation is further secured by the provision that Member States must monitor compliance with this obligation and may impose sanctions upon non-compliance. The Consumer Credit Directive is however not prescriptive regarding the nature of these sanctions. Article 23 of the Directive merely provides that Member States must lay down the rules applicable to infringements of the national provisions adopted pursuant to the Consumer Credit Directive and must take all measures necessary to ensure that they are implemented and further states that the penalties provided for must be “effective, proportionate and dissuasive.”

2.4.2 The Mortgage Credit Directive

The EU has quite recently adopted a comprehensive Mortgage Credit Directive\(^90\) that aims to develop “a more transparent, efficient and competitive internal market, through consistent, flexible and fair credit agreements relating to immovable property, while promoting sustainable lending and borrowing and financial inclusion, and hence providing a

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89 See also Renke Thesis 45.
high level of consumer protection". The Mortgage Credit Directive operates on the principle of maximum harmonisation with regards to the provision of pre-contractual information through the European Standardised Information Sheet (ESIS) and the calculation of the annual percentage rate of charge (APRC). In some other respects however it allows Member States to maintain or introduce more stringent provisions with regard to knowledge and competence requirements for staff and instructions for completing the ESIS. Recital 29 of the Directive notably states that in order to increase the ability of consumers to make informed decisions about borrowing and managing debt “responsibly”, Member States should promote measures to support the education of consumers in relation to responsible borrowing and debt management in particular relating to mortgage credit agreements. It is further indicated that a consumer may still need additional assistance in order to decide which credit agreement, within the range of products proposed, is the most appropriate for his needs and financial situation and accordingly credit providers and credit intermediaries should explain the relevant information, particularly also the essential characteristics of the product proposed to the consumer.

Recital 55 deals with creditworthiness assessment. It states that it is essential that the consumer’s ability and propensity to repay the credit is assessed and verified before a credit agreement is concluded. Such creditworthiness assessment should take into consideration all necessary and relevant factors that could influence a consumer’s ability to repay the credit over its lifetime. In particular, the consumer’s ability to service and fully repay the credit should include consideration of future payments or payment increases needed due to negative amortisation or deferred payments of principal (debt) or interest and should be considered in the light of other regular expenditure, debts and other financial commitments as well as income, savings and assets. Reasonable allowance should be made for future events during the term of the proposed credit agreement such as a reduction in income.

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91 Recital 6.
92 The APRC means the total costs of the credit to the consumer, expressed as an annual percentage of the total amount of credit. See Article 4(15).
93 Recital 7 and Article 2.
94 It is stated that it is particularly important to provide guidance for consumers who are taking out mortgage credit for the first time and that the European Commission should identify examples of best practices to facilitate the development of measures to enhance consumer’s financial awareness.
95 Recital 48.
96 See also Renke Thesis 40-45.
when the credit agreement lasts into retirement or, where applicable, an increase in the borrowing rate or negative change in the exchange rate. It is indicated that while the value of immovable property is an important element in ascertaining the amount of credit that may be granted to a consumer under a secured credit agreement, the assessment should focus on the consumer’s ability to meet his or her obligations under the credit agreement. Consequently, the possibility that the value of immovable property could exceed the credit amount or could increase in the future should not generally be a sufficient condition for granting the credit in question. Nevertheless, where the purpose of the credit is to construct or renovate an existing immovable property, the creditor should be able to consider this possibility. Member States should be able to issue additional guidance on those or additional criteria and on methods to assess a consumer’s creditworthiness, for example by setting limits on loan-to-value or loan-to-income ratios and should be encouraged to implement the Financial Stability Board’s Principles for Sound Residential Mortgage Underwriting Practices.

Recital 50 states that specific provisions may be necessary for the different “elements” that may be taken into consideration in the creditworthiness assessment of certain types of credit agreements. For example where the credit is for immovable property that will not be occupied by the consumer it will be possible to take into account future rental income derived from a lease of the property. It is also stated that the assessment of creditworthiness should not imply the transfer of responsibility to the creditor for any subsequent non-compliance by the consumer with his obligations under the credit agreement.

It is further stated that the creditor’s decision as to whether to grant the credit should be consistent with the outcome of the creditworthiness assessment. It is stated that, for example, the creditor’s capacity to transfer part of the credit risk of a third party should not lead him to ignore the conclusions of the creditworthiness assessment and making credit available to a consumer who is likely to be unable to repay it. Member States should be able to transpose this principle by requiring competent authorities to take relevant actions as part of the supervisory activities and to monitor compliance with the creditworthiness
assessment requirement. However, a positive creditworthiness assessment should not constitute an obligation for the creditor to provide credit.97

The Directive indicates that, in line with the recommendations of the Financial Stability Board, the assessment of creditworthiness should be based on information on the financial and economic situation, including income and expenses, of the consumer. That information can be obtained from various sources including from the consumer, and the creditor should appropriately verify such information before granting the credit. In that respect consumers should provide information in order to facilitate the creditworthiness assessment given that failure to do so is likely to result in the refusal of the credit that the consumer is applying for unless the information can be obtained from elsewhere. Interestingly it is stated that Member States should ensure that creditors cannot terminate a credit agreement because they realised, after the agreement was signed, that the creditworthiness assessment was incorrectly conducted due to incomplete information at the time of assessment. However it is further indicated that Member States should be able to provide that creditors are allowed to terminate a credit agreement where it can be established that the consumer deliberately provided inaccurate or falsified information at the time of the assessment or intentionally did not provide information that would have led to a negative creditworthiness assessment or where there are other valid reasons for such termination compatible with EU law. It is stated that while it would not be appropriate to apply sanctions to consumers for not being in a position to provide certain information or assessments or for deciding to discontinue the application process for obtaining the said credit, Member States should be able to provide for sanctions where consumers knowingly provide incomplete or incorrect information in order to provide a positive creditworthiness assessment, in particular where the complete and correct information would have resulted in a negative creditworthiness assessment and the consumer is subsequently unable to fulfil the conditions of the agreement.98

Recital 60 of the Directive indicates that consultation of a credit database is “a useful element in the assessment of creditworthiness”. It indicates that some Member States require creditors to assess creditworthiness of consumers on the basis of a consultation of the relevant

97 Recital 57.
98 Recital 58.
database. It is further indicated that creditors should be able to consult the database over the lifetime of the credit solely in order to identify and assess the consumer’s potential for default.99

Article 1 of the Mortgage Credit Directive accordingly provides as follows: “This Directive lays down a common framework for certain aspects of the laws, regulations and administrative provisions of the Member States concerning agreements covering credit for consumers secured by a mortgage or otherwise relating to residential immovable property, including an obligation to carry out a creditworthiness assessment before granting credit, as basis for the development of effective underwriting standards in relation to residential immovable property in the Member States…”

Chapter 6 of the Directive is entitled “Creditworthiness Assessment” and contains the general provisions regarding creditworthiness that Member States are required to transpose into their domestic laws. With regard to creditworthiness assessment Articles 18 and 20 are relevant. Article 18 bears the heading “Obligation to assess the creditworthiness of the consumer” and provides as follows:

“1. Member States shall ensure that, before concluding a credit agreement, the creditor makes a thorough assessment of the consumer’s creditworthiness. That assessment shall take appropriate account of factors relevant to verifying the prospect of the consumer to meet his obligations under the credit agreement.

2. Member States shall ensure that the procedures and information on which the assessment is based are established, documented and maintained.

3. The assessment of creditworthiness shall not rely predominantly on the value of the residential immovable property exceeding the amount of the credit or the assumption that the residential immovable property will increase in value unless the purpose of the credit agreement is to construct or renovate the residential immovable property.

4. Member States shall ensure that

99 It is indicated that such consultation of the database should be subject to ensure that it is used for the early identification and resolution of credit risk in the interest of the consumer and not to inform commercial negotiations. Pursuant to Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, consumers should be informed by creditors of the consultation of the database before they do the said consultation of the database, and should have the right to access information held on them in such database in order to rectify erase or block information that is inaccurate or has been unlawfully processed.
(a) the creditor only makes the credit available to the consumer where the creditworthiness assessment indicates that the obligation resulting from the credit agreement are likely to be met in the manner required under that agreement;

(b) in accordance with Article 10 of Directive 95/46/EC, the creditor informs the consumer in advance that a database is to be consulted;

(c) where the credit application is rejected the creditor informs the consumer without delay of the rejection and, where applicable, that such decision is based on automated processing of data. Where the decision is based on the result of the database consultation, the creditor shall inform the consumer of the result of such consultation and the particulars of the database consulted.

6. Member States shall ensure that the consumer’s creditworthiness is reassessed on the basis of updated information before any significant increase in the total amount of credit is granted after the conclusion of the credit agreement unless such additional credit was envisaged and included in the original creditworthiness assessment.

7. This Article shall be without prejudice to Directive 95/46/EC.”

Article 20 that bears the heading “Disclosure and verification of consumer information” must be read together with Article 18 and provides as follows:

1. The assessment of creditworthiness referred to in Article 18 shall be carried out on the basis of information on the consumer’s income and expenses and other financial and economic circumstances which is necessary, sufficient and proportionate. The information shall be obtained by the creditor from relevant internal or external sources, including the consumer, and including information provided to the credit intermediary or appointed representative during the credit application process. The information shall be appropriately verified, including through reference to independently verifiable documentation when necessary.

2. Member States shall ensure that credit intermediaries or appointed representatives accurately submit the necessary information obtained from the consumer to the relevant creditor to enable the creditworthiness assessment to be carried out.

3. Member States shall ensure that creditors specify in a clear and straightforward way at the pre-contractual phase the necessary information and independently verifiable evidence that the consumer needs to provide and the timeframe within which the consumer needs to provide the information. Such request for information shall be proportionate and limited to what is necessary to
conduct a proper creditworthiness assessment. Member States shall allow creditors to seek
clarification on the information received in response to that request where necessary to enable the
assessment of creditworthiness.

Member States shall not allow a creditor to terminate the credit agreement on the grounds that the
information provided by the consumer before the conclusion of the credit agreement was
incomplete.

The second subparagraph shall not prevent Member States from allowing the termination of the
credit agreement by the creditor where it is demonstrated that the consumer knowingly withheld or
falsified the information.

4. Member States shall have measures in place to ensure that consumers are aware of the need to
provide correct information in response to the request referred to in the first subparagraph of
paragraph 3 and that such information is as complete as necessary to conduct a proper
creditworthiness assessment. The creditor, credit intermediary or appointed representative shall
warn the consumer that, where the creditor is unable to carry out the assessment of
creditworthiness because the consumer chooses not to provide the information or verification
necessary for an assessment of creditworthiness, the credit cannot be granted. That warning may be
provided in a standardised format.

5. This Article shall be without prejudice to Directive 95/46/EC, in particular Article 6 thereof.”

Article 38 provides for sanctions and indicates that Member States must lay down rules on
sanctions applicable to the infringement of national provisions adopted pursuant to the
Directive and must take all measures necessary to ensure that these sanctions, which must
be “effective, proportionate and dissuasive”, are implemented.\textsuperscript{100}

The Directive further provides that Member States must ensure that consumers may not
waive the rights conferred on them by national law transposing the Directive and that the
measures adopted in transposing the Directive cannot be circumvented.\textsuperscript{101} Article 45 of the
Directive should also be noted. It is entitled “Further initiatives on responsible lending and
borrowing” and provides that by 21 March 2019, the EU Commission must submit a

\textsuperscript{100} Article 38(1). According to Article 38(2) Member States must provide that the competent authority may
disclose to the public any administrative sanction that will be imposed for an infringement of the measures
adopted in the transposition of the Directive, unless such disclosure would seriously jeopardise the financial
markets or cause disproportionate damage to the parties involved.

\textsuperscript{101} Article 41.
comprehensive report (together with legislative proposals) assessing the wider challenges of private over-indebtedness directly linked to credit activity. It is also tasked to examine the need for supervision of credit registers and the possibility for the development of more flexible and reliable markets.

2.5 The EBA Guidelines

Finally note should also be taken that in order to ensure the implementation and consistent supervision of the aforementioned provisions of the Mortgage Credit Directive across all EU member states, the European Banking Authority (EBA) has issued “Guidelines on Creditworthiness Assessment” on 1 June 2015. The EBA Guidelines apply from 21 March 2016, except the information requirements which apply from the date of publication plus one day.

The Guidelines establish requirements on the verification of the consumer’s income; documentation and retention of information; identification and prevention of misrepresented information; assessment of the consumer’s ability to meet his or her obligations under the credit agreement; allowance for the consumer’s committed and other non-discretionary expenditures; and allowance for potential future negative scenarios. In accordance with Article 16(3) of Regulation No 1093.2010 it is stated that the competent authorities and financial institutions must make “every effort” to comply with the guidelines.

Section 4 of the EBA Guidelines contains the requirements regarding creditworthiness assessment and provide as follows:

(a) Guideline 1: Verification of the consumer’s income

Guideline 1 provides that when verifying a consumer’s prospect to meet his or her obligation under the credit agreement as referred to in Article 18 of the Mortgage Credit

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102 EBA Report 3. The EBA is the European Banking Authority which is a regulatory authority that was established on 1 January 2011 tasked with overarching banking supervision on EU level. The Guidelines are based on the provisions of the Opinion of the European Banking Authority on Good Practices for Responsible Mortgage Lending (the 2013 Opinion) which was published on 13 June 2013 prior to the adoption of the Mortgage Credit Directive and which was reviewed by the EBA when developing the Guidelines (EBA Report 5).

103 EBA Report 9.

104 EBA Report
Directive, the creditor should make reasonable enquiries and take reasonable steps to verify the consumer’s underlying income capacity, his or her income history and any variability over time. In the case of consumers that are self-employed or have seasonal or irregular income, the creditor should make reasonable enquiries and take reasonable steps to verify information that is related to the consumer’s ability to meet his obligations under the agreement, including income capacity and third party verification documenting such income.\textsuperscript{105}

(b) Guideline 2: Documentation and Retention of Information

Guideline 2 provides that the creditor should maintain complete documentation of the information that leads to mortgage approval, and maintain this documentation for at least the duration of the credit agreement. The creditor should further ensure that a record with an adequate explanation of the steps taken to verify income is readily available for inspection by competent authorities and that such record at least documents the income history of the consumer.\textsuperscript{106}

(c) Guideline 3: Identification and prevention of misrepresented information

Guideline 3 stipulates that to reliably carry out creditworthiness assessments, the creditor should design loan documentation in a way that helps to identify and to prevent misrepresentation of information by the consumer, the creditor or a credit intermediary.

(d) Guideline 4: Assessment of the consumer’s ability to meet his or her obligations under the credit agreement

Guideline 4 determines that when assessing the consumer’s ability to meet his or her obligations under the credit agreement, the creditor should take into account relevant factors that could influence the consumer’s ability to meet his or her obligations and without inducing undue hardship and over-indebtedness. These factors may include other debt obligations (together with interest and the principal debt outstanding); evidence of any missed payments as well as directly relevant taxes and insurance. It is required that the creditor should establish sound processes, that are regularly reviewed, to assess the

\textsuperscript{105} Guideline 1.1 and 1.2, EBA Report 10.
\textsuperscript{106} Guideline 2.1 and 2.2, EBA Report par 10.
consumer’s ability to meet his or her obligations under the credit agreement and to maintain up-to-date records of those procedures. It is specifically provided that if the loan term extends beyond the consumer’s expected retirement age, the creditor should take appropriate account of the adequacy of the creditor’s likely income and ability to meet obligations under the credit agreement during his or her retirement. The creditor should further ensure that the consumer’s ability to meet obligations under the credit agreement is not based on the expected significant increase in the consumer’s income unless the documentation provides sufficient evidence.  

(e) Guideline 5: Allowance for the consumer’s committed and other non-discretionary expenditures

Guideline 5 deals with the consumer’s committed and other non-discretionary expenditures and provides that when assessing the consumer’s ability to meet obligations under a credit agreement, the creditor should make reasonable allowances for committed and other non-discretionary expenditures, such as the consumer’s actual obligations, including appropriate substantiation and consideration of living expenses.  

(f) Guideline 6: Allowance for potential future negative scenarios

Guideline 6 provides that when assessing the consumer’s ability to meet obligations under a credit agreement, the creditor should make prudent allowances for potential negative scenarios in future, including for example a reduced income in retirement; an increase in benchmark interest rates in the case of a variable rate mortgage, negative amortisation; balloon payments or deferred payments of principal or interest.  

From the aforementioned it thus appears that the current approach of the EU is progressively pro-active and that the EBA is intent on assisting Member States via the EBA Guidelines to ensure that creditworthiness assessment in respect of mortgage credit is aligned with the FSB Principles and the Mortgage Credit Directive (the drafters of which clearly also had regard to the World Bank Report on Responsible Lending).

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107 Par 4.1 to 4.4, EBA Report 10-11.
108 Guideline 5.1 EBA Report 11.
CHAPTER 3

PRE-AGREEMENT ASSESSMENT UNDER THE NATIONAL CREDIT ACT

3.1 Introduction

South Africa has a large number of credit active consumers which increases exponentially from year to year. Over-indebtedness is clearly a major problem in South Africa with the World Bank referring to South African consumers as “the most over-indebted in the world.”¹¹⁰ In the statistics released in the South African National Credit Regulator’s Annual Report for 2014¹¹¹ it was indicated that statistical returns obtained from credit providers and credit bureaus have revealed that the amount of credit granted to consumers has increased substantially from R1.1 trillion in 2007 to R1.4 trillion in 2014. At the time of the Report South Africa had 21.7 million credit active consumers and out of these 9.6 million (44.2%) had impaired records. The Report significantly stated that this increase has also led to “an evolution of the problem of household over-indebtedness.” It is further indicated that on average 9100 consumers at the time applied for debt counselling by virtue of their over-indebtedness.¹¹²

As set out in this Chapter South Africa has taken a pro-active approach to credit regulation which has become more comprehensive and interventionist with the enactment of the National Credit Act 34 of 2005 (hereinafter NCA or Act) that is the first piece of South African credit legislation to impose the obligation to conduct a pre-agreement assessment prior to credit granting on credit providers as a direct measure to prevent reckless credit granting and over-indebtedness.

In order to critically discuss the issue of pre-agreement assessment as a measure to prevent reckless lending in South Africa, it is necessary to contextualize the discussion by providing some historical background on the regulation of credit in South Africa. This overview will then be followed by a brief discussion of the National Credit Act (NCA) with regard to the main elements of the reckless credit framework provided by the Act whereafter the discussion will focus on the aspect of pre-agreement assessment as introduced by the NCA.

3.2 The South African credit legislation framework prior to the NCA

South Africa has for many years had a credit regulation framework, first in terms of the 1942 Hire Purchase Act 113 and thereafter in terms of the Credit Agreements Act 114 which operated together with the Usury Act and the Exemption Notices of 1992 and 1999 issued in terms of section 15A of the Usury Act. 115 The Usury Act covered money lending transactions of up to R500 000 and only capped the interest rates for these loans. 116 At the time of its repeal, the cap stood at 26 per cent per annum. The Usury Act provided that basic disclosures had to be made to the borrowers. Kelly-Louw points out it was only selective disclosures that were made and it often happened that not all the costs of credit were disclosed. 117 Over the years the Usury Act became outdated. For instance, it was drafted before credit cards, access bonds on home loans, and micro loans were available in South Africa. It is also reported that the Usury Act was also rather complicated and often misunderstood by many. 118

Notably, in 1992 the first Exemption Notice was issued in terms of section 15A of the Usury Act. 119 In terms of this notice, loans under R6 000 were exempted from the provisions of the Usury Act and the interest rates that could be charged on these loans were uncapped. Therefore, lenders could ask any interest rate they wished. This then gave birth to a large, unregulated micro-lending industry. Low-income and poor consumers with no securable

112 Hire Purchase Act 36 of 1942.
113 Credit Agreements Act 75 of 1980.
114 Usury Act 73 of 1968.
assets could not access finance in the formal financial sector and were thus forced to obtain finance in the informal financial sector where interest rates and other costs of credit were left unregulated and often too high. At some point it was recorded that certain lenders went so far as charging interest rates of 30 or more per cent per month totaling 360 per cent per year. The micro-lending industry employed extreme and unregulated money-collecting procedures. These procedures inter alia consisted of lenders obtaining and holding consumers’ bank cards and private identification numbers and then drawing a monthly amount from the consumers’ bank accounts to service their loans. It is reported that sometimes they would give consumers only a small cash amount to enable them to fund their normal living costs. They often left them with no money at all.

The Credit Agreements Act that subsequently replaced the Hire Purchase Act dealt with instalment sale and lease transactions and did not apply to money-lending transactions. This Act regulated the agreement itself, for example with its written format, and the deposit that was required. Kelly-Louw indicates that requiring payment of a deposit was used as a way to determine if a person could afford to enter into a credit agreement. However, in an attempt to side-step this requirement, it often happened that the credit grantor (that is, the seller) paid the deposit on behalf of the consumer (the buyer).

While the Credit Agreements Act was mainly concerned with the contractual aspects of credit agreements, the Usury Act thus aimed to regulate the financial aspects of such contracts. Although the Credit Agreements Act did not deal with money-lending transactions as did the Usury Act, their scopes overlapped.

In the late 1990s and early 2000s it became clear that the levels of consumer overindebtedness in South Africa had spiraled out of control and that many consumers, particularly consumers from the low- and middle-income groups, were in a position where they could no longer properly service their debts. The mechanisms for preventing overindebtedness at that time were either non-existent or ineffective. Neither the Credit Agreements Act nor the Usury Act contained any specific measures aimed at prevention.

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120 Campbell, ‘The Excessive Cost of Credit on Small Money Loans under the National Credit Act 34 of 2005’ (2007) 19 SA Merc LJ 251 at 252.
121 Kelly-Louw Prevention 223.
122 Ibid.
123 Ibid.
and/or alleviation of over-indebtedness in the context of credit agreements. Providing debt relief to already over-indebted consumers, for example by the granting of an administration order in terms of section 74 of the Magistrates Court Act\textsuperscript{124} or via the mechanisms available in terms of the Insolvency Act\textsuperscript{125}, was also hampered by the deficiencies of the available mechanisms, which were limited in their operation, did little to assist already over-indebted consumers and did not effectively promote their rehabilitation.\textsuperscript{126}

It was time for a new and comprehensive approach to regulating credit and also to addressing the growing problem of consumer over-indebtedness. Accordingly the South African Law Commission embarked on a process to reform South Africa’s credit legislation. Some of the most important objectives of this new consumer credit legislation identified by the South African Law Commission were that it should address the consumer’s unequal bargaining position, curb the exercise of remedies by credit providers, educate consumers, and provide them with relevant information. Given the considerable imbalance of power between credit providers and consumers, low education levels, poorly informed consumers, weak disclosure and deceptive marketing practices, it was found that many South African consumers have concluded unaffordable credit contracts. One of the main lacunae in the previous credit dispensation was that the existing legal framework provided no effective protection against over-indebtedness.\textsuperscript{127} The role that reckless lending and borrowing play in causing or contributing to consumer over-indebtedness was highlighted and it was stated, with regard to the proposed new credit policy framework, that ‘[r]eckless credit extension will be curbed by introducing a general requirement that all credit providers should do

\textsuperscript{124} Magistrates Court Act 32 of 1944. See also Boraine, Van Heerden and Roestoff ‘A comparison between formal debt administration and debt review – the pros and cons of these measures and suggestions for law reform (Part 1)’, 2012 De Jure 254 (hereinafter Boraine, Van Heerden and Roestoff) and Coetzee LLD Thesis par 4.2 regarding the administration order procedure and its shortcomings.

\textsuperscript{125} Insolvency Act 24 of 1936.

\textsuperscript{126} For an overview of these problems see Boraine, Van Heerden and Roestoff 2012 De Jure 45.

affordability assessments prior to approving any credit facility’.\textsuperscript{128} It was accordingly proposed that the envisaged new credit legislation should be ‘shifted from price control to protection against over-indebtedness, and to the regulation of predatory lending practices’.\textsuperscript{129}

To address all the problems identified in the South African credit market Parliament passed the comprehensive and radical National Credit Act (NCA) which came into full effective operation on 1 June 2007 and repealed the outdated credit regulation framework established by the Credit Agreements Act and Usury Act.

The NCA introduced a range of direct and indirect measures designed to prevent consumer over-indebtedness and to prevent credit providers from granting credit to consumers who cannot afford to repay the credit extended to them. These measures range from increasing the level of consumer awareness regarding the risks associated with using credit, improving consumers’ financial literacy, and ensuring that credit providers make full and proper disclosures of information that will enable consumers to make informed decisions before buying goods to direct debt relief measures such as a debt review procedure, facilitated by debt counsellors, that can be accessed by over-indebted consumers and indirect debt relief mechanisms such as the statutory in duplum rule, aimed at curbing the escalation of various costs whilst a debtor is in default, as contained in section 103(5).\textsuperscript{130}

The National Credit Act also established two new consumer credit institutions, the National Credit Regulator (NCR) and the National Consumer Tribunal; made it compulsory for credit providers, credit bureaux, and debt counsellors to register with the NCR; and placed caps on interest rates and other costs of credit.\textsuperscript{131}

\textsuperscript{131} See s12 to 25 regarding the establishment, functions and operations of the National Credit Regulator; s 26 to 34 regarding the establishment, functions and operations of the National Consumer Tribunal and s43 to 59 regarding registration of credit providers, credit bureaux and debt counsellors. It is to be noted that the registration of Payment distribution agents was later provided for by the introduction of s44A to the NCA by virtue of s 12 of the National Credit Amendment Act 19 of 2014.
The National Credit Regulator has a broad mandate and is the primary authority responsible for the enforcement of the NCA. One of its tasks is to monitor the credit market with regard to levels of consumer indebtedness.

It is clear from the above statistics that consumer credit is an integral part of modern South African society. The increased access to consumer credit in South Africa since the advent of democracy in 1994 has unfortunately also spurred a very high incidence of over-indebtedness under South African consumers. To address this problem the NCA has introduced some proactive measures that can be used to curb the high incidence of over-indebtedness amongst South African credit consumers. As will be discussed below, the provisions of the Act relating to prevention of reckless credit granting, and specifically the obligation to conduct a pre-agreement assessment, plays a pivotally important role in combatting reckless credit granting and the over-indebtedness that often results from such conduct.

3.3 An overview of the reckless credit framework provided by the NCA

In the context of over-indebtedness and reckless credit, the following purposes of the NCA as set out in section 3 are pertinent:

(a) to promote responsibility in the credit market by encouraging responsible borrowing, avoidance of over-indebtedness and fulfilment of financial obligations by consumers;

(b) to discourage reckless credit-granting by credit providers and contractual default by consumers; and

(c) to address and prevent over-indebtedness of consumers, and provide mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations.

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132 See s12 to 18 of the NCA.
133 S 13(c)(iv).
134 S 3 (c) (i).
135 S 3 (c) (i).
136 S 3 (g). See Van Heerden and Boraine, 'The interaction between the debt relief measures in the National Credit Act 34 of 2005 and aspects of insolvency law,' 2009 PELJ 47. See also Boraine and Van Heerden “Some observations on reckless credit in terms of the National Credit Act 34 of 2005” (2010) THRHR 650; Van Heerden and Boraine “The Money or the Box: perspectives on reckless credit in terms of the National Credit
To achieve these goals, the NCA has added a new dimension to credit regulation by introducing measures aimed at preventing reckless credit-granting (which notably is a more robust term than “irresponsible lending” but basically refers to the same concept), sanctions to be applied in certain instances of reckless credit, and debt relief measures to deal with the problem of over-indebted consumers resulting from reckless lending.\(^{137}\) The concepts of reckless credit and over-indebtedness are dealt with in Part D of Chapter 4 of the Act and apply to natural person consumers only.\(^{138}\) Reckless credit granting can be raised in respect of a wide range of credit agreements, secured and unsecured, which includes but is not limited to, mortgages agreements.\(^ {139}\) It can however not be raised in respect of pre-existing credit agreements that were entered into before the Act came into operation. It can also not be raised in respect of the following types of credit agreements: a school loan or a student loan; an emergency loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement or a temporary increase in the credit limit under a credit facility.\(^ {140}\)

As indicated the prevention of consumer over-indebtedness is the main rationale behind the introduction of the reckless credit provisions in the NCA. A consumer is “over-indebted” for purposes of the NCA if the preponderance of available information at the time a determination (of over-indebtedness) is made indicates that the particular consumer “is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer’s:\(^ {141}\)

(a) financial means, prospects and obligations; and

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\(^ {137}\) The concepts of reckless credit and over-indebtedness are dealt with in Part D of Chapter 4 of the Act and apply to natural person consumers only.

\(^ {138}\) Reckless credit granting can be raised in respect of a wide range of credit agreements, secured and unsecured, which includes but is not limited to, mortgages agreements.

\(^ {139}\) It can however not be raised in respect of pre-existing credit agreements that were entered into before the Act came into operation. It can also not be raised in respect of the following types of credit agreements: a school loan or a student loan; an emergency loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement or a temporary increase in the credit limit under a credit facility.

\(^ {140}\) As indicated the prevention of consumer over-indebtedness is the main rationale behind the introduction of the reckless credit provisions in the NCA. A consumer is “over-indebted” for purposes of the NCA if the preponderance of available information at the time a determination (of over-indebtedness) is made indicates that the particular consumer “is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer’s:

(a) financial means, prospects and obligations; and

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\(^ {141}\) For the definitions of the various types of credit agreements mentioned in s 78(2), see s 1 of the NCA.
(b) probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, as indicated by the consumer’s history of debt repayment.”

In order to ensure that the reckless credit provisions properly serve their main function of preventing reckless credit granting that triggers and/or exacerbates consumer over-indebtedness the Act provides expressly that reckless credit granting constitutes prohibited conduct142 in terms of section 81(3) of the Act. As a direct (primary) measure to prevent reckless credit granting the Act further makes it mandatory that a credit provider first do a pre-agreement assessment of the aspects relating to the creditworthiness of the consumer as set out in section 81(2), as discussed hereinafter, before entering into a credit agreement with a consumer.143

This pre-agreement assessment obligation is central to the notion of reckless credit as contained in section 80 of the NCA which provides that credit is reckless if:144

“..at the time that the agreement was made, or at the time when the amount approved in terms of the agreement is increased145, other than an increase in terms of section 119(4)-

(a) the credit provider failed to conduct an assessment as required by section 81(2), irrespective of what the outcome of such an assessment might have concluded at the time; or

(b) the credit provider, having conducted an assessment as required by section 81(2), entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that-

(i) the consumer did not generally understand or appreciate the consumer’s risks, costs or obligations under the proposed credit agreement; or

(ii) entering into that credit agreement would make the consumer over-indebted.”

142 “Prohibited conduct” is defined in s1 as an act or omission in contravention of this Act, other than an act or omission that constitutes an offence under this Act, by (a) an unregistered person who is required to be registered to engage in such an act; or (b) a credit provider, credit bureau or debt counsellor.”

143 Renke LLD Thesis 429 submits that s81(2) must be one of the most important (if not the most important) sections in the NCA given its purpose to prevent reckless credit.

144 S 80 (1).

145 Author’s emphasis.
Section 80 thus provides for three situations that may give rise to reckless credit, or put otherwise, for three “types” of reckless credit. The first type arises where there is a failure to do a pre-agreement assessment. Types two and three refer to situations where the mandatory pre-agreement assessment was conducted but the credit provider then recklessly disregarded the outcome of the assessment by extending credit to a consumer who, as indicated by the assessment, did not generally understand the risks, costs and obligations under the credit agreement (type two) or who would become over-indebted as a result of entering into the specific reckless credit agreement (type three).  

When a determination has to be made by the court or the National Consumer Tribunal whether a specific credit agreement is ‘reckless” or not, section 80(2) provides that the person making such determination must apply the criteria for reckless credit set out above as they existed “at the time the agreement was made”. Accordingly it appears that the question whether reckless credit was granted entails a set-point or static, determination that focuses on the time that the agreement was entered into. No regard may be had for the ability of the consumer to meet the obligations under that specific credit agreement or to understand or appreciate the risks, costs and obligations under the proposed credit agreement at the time of such determination. As pointed out by Van Heerden this means that if the consumer has subsequent to entering into the reckless credit agreement become educated about the risks, costs and obligations of the said agreement it will make no difference to the fact that at the time that the credit agreement was “made” (i.e of entering into the credit agreement) the consumer did not generally understand those risks, costs and obligations. Also even if the consumer could afford the credit but no assessment was done prior to entering into a credit agreement, the credit so extended will still be reckless - in such instance the recklessness will be of a per se nature- stemming from the failure to do the necessary pre-agreement assessment. Further, it is clear from section 80(2) that where a credit provider entered into a credit agreement with a consumer despite the pre-agreement assessment having revealed that the specific credit agreement would cause the consumer to become over-indebted if he enters into it, the credit so extended will be regarded as

146 See Van Heerden in Scholtz et al Guide to the National Credit Act par 11.5.
reckless even if the consumer at a later stage becomes able to “meet the obligations under that credit agreement”.¹⁴⁹

Various remedies are provided by the Act to alleviate the position of a consumer to whom credit has been granted recklessly. A full discussion of these remedies are beyond the scope of this dissertation and accordingly a brief overview will be provided to drive the point across that the enforcement of the reckless credit provisions in the NCA is supported by the sanctions attached to reckless credit granting, also in the form of intrusive remedies provide to consumers who were the recipients of the ill-fated credit. In the context of civil relief, the NCA provides that, despite any provision of law or agreement to the contrary, whenever a credit agreement is being considered in any proceedings before the court or the National Consumer Tribunal, the court or Tribunal may declare that the credit is agreement reckless.¹⁵⁰ If a court or the Tribunal declares that a credit agreement is reckless, it may make an order:¹⁵¹

(a) setting aside all or part of the consumer’s¹⁵² rights and obligations under that agreement, as the court determines may be just and reasonable in the circumstances; or

(b) suspending the force and effect of that credit agreement in accordance with section 83(3)(b)(i).

In the instance that a court or the Tribunal declares that a credit agreement is reckless, because entering into the agreement made the consumer over-indebted, it must further

¹⁴⁹ Note should also be taken of s80(3) that provides as follows: When making a determination in terms of this section, the value of:
(a) any credit facility is the credit limit at that time under that credit facility;
(b) any pre-existing credit guarantee is-
(i) the settlement value of the credit agreement that it guarantees, if the
(ii) the settlement value of the credit agreement that it guarantees, discounted by a prescribed factor; and
(c) any new credit guarantee is the settlement value of the credit agreement that it guarantees, discounted by a prescribed factor.

¹⁵⁰ S 83. It is to be noted that prior to the enactment of the National Credit Amendment Act 19 of 2014 these civil remedies could only be administered by a civil court. However s25 of the Amendment Act extended the powers mentioned in s83 also to the National Consumer Tribunal. See further the discussion by Van Heerden on the extended powers of the Tribunal in Scholtz et al Guide to the National Credit Act par 11.5.

¹⁵¹ S 83 (1) (a).

¹⁵² Van Heerden and Boraine, ‘The interaction between the debt relief measures in the National Credit Act 34 of 2005 and aspects of insolvency law,’ (2009) PELJ 41 emphasise that however, before making such an order, the court must consider the consumer’s current means and ability to pay his or her current financial obligations that existed at the time the agreement was made, as well as the expected date when any such obligation under a credit agreement will be fully satisfied, assuming the consumer makes all required payments in accordance with any proposed order.
consider whether the consumer is over-indebted at the time of the court or Tribunal proceedings; and if so, it may make an order suspending the force and effect of that credit agreement until a date determined by the court or Tribunal; and restructuring the consumer’s obligations under any other credit agreements, in accordance with section 87 of the NCA.153

Suspension of a credit agreement is provided for by section 84 which provides as follows:

“(1) During the period that the force and effect of a credit agreement is suspended

(a) the consumer is not required to make any payment required under the agreement;

(b) no interest, fee or other charge under the agreement may be charged to the consumer; and

(c) the credit provider’s rights under the agreement, or under any law in respect of that agreement, are unenforceable, despite any law to the contrary.

(a) all the respective rights and obligations of the credit provider and the consumer under that agreement-

(i) are revived; and

(ii) are fully enforceable except to the extent that a court may order otherwise; and

(b) for greater certainty, no amount may be charged to the consumer by the credit provider with respect to any interest, fee or other charge that were unable to be charged during the suspension in terms of subsection (I) (a).154

The egregiousness of reckless credit granting is further underpinned by additional sanctions that can be imposed on a credit provider who has engaged in this prohibited conduct. In addition to the civil remedies set out in sections 83 and 84 of the Act, the National Consumer Tribunal can also make an order canceling the registration of a credit provider.

153 S 83(3). See further s 83(4) that provides as follows: Before making an order in terms of subsection (3), the court must consider-
(a) the consumer’s current means and ability to pay the consumer’s current financial obligations that existed at the time the agreement was made; and
(b) the expected date when any such obligation under a credit agreement will be fully satisfied, assuming the consumer makes all required payments in accordance with any proposed order.
154 For a detailed discussion regarding the interpretation of section 84 see Van Heerden and Boraine Money or box 47.
who engages in reckless credit granting \(^{155}\) and may also impose an administrative fine upon such a credit provider. \(^{156}\)

Now that the basic legislative framework provided by the NCA has been set out and the point has been made that the reckless credit provisions operate in a regulatory landscape where various mechanisms exist to enforce compliance with these provisions, the scene is set for probing in more detail into pre-agreement assessment as mandated by the NCA. At this point it would be appropriate to indicate that whereas the initial approach to implementation and compliance with the pre-agreement obligation might have struck one as a bit laissez faire the tsunami of developments that subsequently occurred as from May 2013 indicates a very pro-active and somewhat paternalistic approach by the regulator. It is further submitted that the reader will be left without a clear impression of the magnitude of the developments that occurred in this context within a relatively short time span if these developments are not comprehensively recorded in this dissertation. Accordingly, the discussion below will deal in detail with all the interventions that took place in the context of pre-agreement assessment from the date that the NCA came into operation until the extensive provisions that currently regulate this mechanism.

### 3.4 Pre-agreement assessment in terms of the NCA

#### 3.4.1 The initial approach

As indicated above, in order to prevent and curb reckless credit granting the NCA has not only prohibited reckless credit granting but has also, as a direct (primary) measure, introduced a mandatory pre-agreement assessment requirement. The obligation to conduct such pre-agreement assessment is set out in section 81(2) which states that a credit provider must not enter into a credit agreement without first taking *reasonable steps* \(^{157}\) to assess the proposed consumer’s -

\(^155\) S 150.

\(^156\) S 151(1) states that: The Tribunal may impose an administrative penalty in respect of prohibited or required conduct in terms of this Act. See also Van Heerden and Renke” Perspectives on the South African Responsible Lending Regime and the Duty to Conduct Pre-agreement Assessment as a Responsible Lending Practice” (2015) *Insolvency International Law Review* 67 (hereinafter Van Heerden and Renke).

\(^157\) Author’s emphasis.
“(a) general understanding and appreciation of the risks and costs of the proposed credit, and of the rights and obligations of a consumer under a credit agreement;
(b) debt repayment history as a consumer under credit agreements;
(c) existing financial means, prospects and obligations”. 158

In addition, it has to be assessed whether there is a reasonable basis to conclude that any commercial purpose may prove to be successful if the consumer is applying for credit for a commercial purpose. 159

Section 81 also imposes certain obligations on a consumer during pre-agreement assessment. It provides that, when applying for a credit agreement, and while the application for credit is being considered by the credit provider 160, the prospective consumer must “fully and truthfully” answer any requests for information made by the credit provider as part of the assessment. 161 Failure by the consumer to comply with this obligation may trigger the provisions of section 81(4) that provides that for all purposes of the Act, it is a “complete defence” to an allegation that a credit agreement is reckless if the credit provider establishes that the consumer failed to fully and truthfully answer any requests for information made by the credit provider as part of the assessment and a court or the Tribunal determines that the consumer’s failure to do so materially affected the ability of the credit provider to make a proper assessment. 162 A number of aspects should be noted about this complete defence: first, it must be established that the credit provider did indeed conduct a proper pre-agreement assessment as contemplated by section 81(2), to which the consumer did not respond fully and truthfully – if it cannot be established that the credit provider conducted such a proper pre-agreement assessment the fact that the consumer failed to fully and truthfully answered any requests for information asked by the credit provider becomes immaterial. 163 Second; the two requirements set by section 81(4) must

158 S 81(2)(a)(i)-(iii).
159 S 81(2)(b).
160 Author’s emphasis.
161 S 81(1).
162 See the discussion by Van Heerden in Scholtz et al Guide to the National Credit Act par 11.6. See also Kelly-Louw “A Credit Provider’s complete defence against a consumer’s allegation of reckless lending” (2014) SA Merc LJ 26 (Hereinafter Kelly-Louw Defence).
163 For example; if the credit provider only assessed the consumer’s financial means, prospects and obligations but did not assess his understanding of the risks, costs and obligations under the agreement and did not have regard to his debt repayment history then the credit provider cannot be said to have complied with the pre-
both be met before a credit provider will be able to rely on this complete defence against reckless credit.\textsuperscript{164} The NCA does not mention specific aspects that would indicate “materiality” as referred to in section 81(4).\textsuperscript{165} The courts have however indicated that not every failure by a consumer to fully and truthfully answer the credit provider’s request for information as part of the prescribed assessment will entitle the credit provider to the complete defence mentioned in s 81(4) NCA.\textsuperscript{166} Van Heerden and Boraine submit that in each specific instance the facts of the particular matter and the extent of the untruthfulness of the consumer will have to be considered in order to determine whether it can be said that the credit provider’s ability to make a proper assessment was materially influenced.\textsuperscript{167}

The courts have also afforded some interpretation to the provisions of section 81(4): In \textit{Horwood v Firstrand Bank Ltd} \textsuperscript{168} the court rejected the consumer’s contention that the credit provider was not entitled only to rely on information provided by the consumer to the credit provider and which seemed to suggest that the credit provider was enjoined to verify the information that was supplied to the credit provider on the consumer’s behalf. The court held that, absent indications that would reasonably alert a credit provider to the contrary, a credit provider is entitled to accept for the purpose of the section 81 assessment the veracity of the information provided to it by or on behalf of a prospective consumer. The court indicated that where a credit provider has taken the required “reasonable steps to assess” the relevant matters referred to in section 81(2), the credit agreement is not a reckless one in terms of section 80(1), whether or not the assessment was tainted by a consumer’s incomplete or untruthful answers. The court further remarked that the complete defence provided for in section 81(4) is a defence which may be raised in addition to one that the credit provider’s assessment obligations under section 81 have been met.

\begin{flushleft}
\textsuperscript{164} Van Heerden in Scholtz et al \textit{Guide to National Credit Act} par 11.5. See further Kelly Louw Defence 31. \\
\textsuperscript{165} Van Heerden and Boraine Money or Box 24. In \textit{Horwood v FirstRand Bank Ltd} [2011] GPJHC 121 (21 September 2011), the court indicated (par 6) that not every failure by a consumer to fully and truthfully answer the credit provider’s request for information as part of the prescribed assessment will entitle the credit provider to the complete defence mentioned in s 81(4) NCA. The question as to what would constitute such materiality was however left open by the court (par 15). \\
\textsuperscript{166} Ibid. \\
\textsuperscript{167} Ibid. \\
\textsuperscript{168} [2011] ZAGPJHC 121 (21 September 2011) par 14.
\end{flushleft}
In *Absa Bank Ltd v COE Family Trust and Others*\(^{169}\) the court indicated that section 81(4) needs to be read together with section 81(2) with the effect that, if an assessment as contemplated by section 81(2) was not undertaken in the first place, then section 81(4) is of no relevance. It should be noted that the mere fact that an assessment was undertaken is not sufficient as prerequisite for the credit provider being able to raise a defence in terms of section 81(4). It is only where such an assessment meets the requirements of section 81(2) that a credit provider can thereafter competently invoke the provisions of section 81(4).

Van Heerden and Boraine further point out that the assessment required by section 81 is more comprehensive than a mere affordability assessment as the consumer’s general understanding of the risks, costs and obligations should also be assessed and it should be evident from the assessment that regard was also had to the consumer’s debt repayment history.\(^{170}\) It is however to be noted that although the NCA requires that the credit provider takes reasonable steps to assess the aspects as listed in section 81(2)(a) and (b), it did not initially set out what these reasonable steps are.\(^{171}\)

No specific pre-agreement assessment model was initially prescribed by the Act. Section 82 of the NCA merely provided that a credit provider may determine for itself the evaluative mechanisms and models or procedures to be used in meeting its assessment obligations under section 81, provided that any such mechanisms, model or procedure results in a fair and objective assessment. Vessio opines in this regard that the wording of section 82 is interesting in that the positive responsibility appears to be on the credit provider to ask the correct information gathering questions.\(^{172}\)

It must however be noted that section 61(5) of the NCA provides that a credit provider may determine for itself any scoring or other evaluative mechanism or model to be used in managing, underwriting and pricing credit risk, provided that any such mechanism or model is not founded or structured upon a statistical or other analysis in which the basis of risk

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\(^{169}\) [2012] SA 184 WCC. See also *AFGri Bedryfs Bpk v Gribnitz* [2014] AZPAPPHC 186 (3April 2014) par 7.

\(^{170}\) Ibid.

\(^{171}\) Van Heerden in Scholtz *et al* *Guide to the National Credit Act* par 11.6.

\(^{172}\) Vessio “Beware the Provider of Reckless Credit” (2009) TSAR 274.
categorisation, differentiation or assessment is a ground of unfair discrimination prohibited in section 9(3) of the Constitution.\textsuperscript{173}

Initially this right of the credit provider to determine its own evaluative mechanism was subject to the right of the NCR to pre-approve the evaluative mechanisms, models and procedures to be used for assessment purposes in respect of developmental credit agreements and to publish guidelines proposing evaluative mechanisms, models and procedures to be used in respect of other credit agreements.\textsuperscript{174} It was provided that a guideline published by the NCR would not be binding on a credit provider, except with regard to developmental credit or if so ordered by the National Consumer Tribunal.\textsuperscript{175} It was further provided that if the Tribunal finds that a credit provider has repeatedly failed to meet its obligations under section 81, or customarily uses evaluative mechanisms, models or procedures that do not result in a fair and objective assessment, the Tribunal, on application by the NCR, may require that credit provider to apply any guidelines published by the NCR or apply any alternative guidelines consistent with prevalent industry practice, as determined by the Tribunal.\textsuperscript{176}

From the date on which the Act came into operation until May 2013, the South African National Credit Regulator did not issue any guidelines regarding pre-agreement assessments in terms of section 81(2). In view thereof that for a number of years after the coming into operation of the Act there were no specific prescribed pre-agreement assessment models imposed on credit providers and also no assessment guidelines issued by the National Credit Regulator credit providers free to determine their own assessment models for pre-agreement assessment save for having to meet the requirements that the assessment had to comply with section 81(2), not be discriminatory and have a fair and objective result. Due to the lack of guidelines regarding what would constitute proper pre-agreement assessment for purposes of section 81, Van Heerden and Renke indicate that the South African courts have played a major role in not only resolving credit related disputes but also in clarifying some of the provisions of the NCA: In \textit{SA Taxi Securitisation (Pty) Ltd v Mbatha}\textsuperscript{177} the court

\textsuperscript{172} The Constitution of the Republic of South Africa, 1996.
\textsuperscript{173} S 82(1). See further Van Heerden and Renke 75.
\textsuperscript{174} S 82(3) NCA.
\textsuperscript{175} S 82(2)(a) and (b) NCA.
\textsuperscript{176} 2011 (1) SA 310 (GSJ) par 37.
\textsuperscript{177} 2011 (1) SA 310 (GSJ) par 37.
remarked that while one purpose of the National Credit Act is to discourage reckless credit, the Act is also designed to facilitate access to credit by borrowers who were previously denied such access. Consequently, an over-critical armchair approach by the court towards credit providers when evaluating reckless credit, or the imposition of excessive penalties upon lenders who have recklessly allowed credit, would significantly chill the availability of credit especially to the less affluent members of our society.

In *Horwood v Firstrand Bank Ltd*\(^{178}\) it was held that whether or not a credit grantor has taken the required reasonable steps to meet its assessment obligations is in the light of the wording of section 81(2) and 82(1) to be determined objectively on the facts and circumstances of any given case.

In *National Credit Regulator v Hirst*\(^{179}\) it was alleged before the Tribunal that the credit provider contravened section 81(2) of the Act because no evidence was found to show that the credit provider took reasonable steps to assess the financial means, prospects and obligations of consumers or obtained information or any proof relating to the debt repayment history of consumers or conducted credit bureau checks to determine the debt repayment history of consumers or asked consumers to list their expenses. The Tribunal held that the assessment prescribed by section 81(2) is peremptory and held that the relevant credit agreements constituted reckless credit.

In *Absa Bank Ltd v De Beer*\(^{180}\) the credit provider advanced money to the consumers (who were pensioners) and whose daughter signed as surety. The consumer testified that he was not asked for any statement of income and expenses. A fire at the credit provider’s warehouse premises destroyed all its source documentation regarding the different loan agreements entered into between the parties. The court found that the consumer was clearly over-indebted as a result of the said credit that was extended to him. It also transpired that at the time that the consumer applied for the credit the credit provider took into account not only the income of the consumer and his wife to whom he was married in community of property but also that of his daughter who stood surety. The consumers inter

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\(^{178}\) 2011 ZAGPJHC 121 (21 September 2011).
alia raised the defence to the bank’s claim that the credit was granted recklessly coupled with a conditional counterclaim that (all) the credit agreements be set aside alternatively suspended in terms of the NCA. The court held that the credit provider was unable to rely on the section 81(4) defence because there was no evidence that the defendants provided incomplete or untruthful information to the bank.\(^\text{181}\) It also held that no proper assessment was conducted by the credit provider as it was “irrational” to take the surety’s income into account to determine whether the consumer could afford the credit. It further held that the assessment also fell foul of section 81(2)(b) as it indicated that the credit provider could not realistically have believed that the consumer’s farming venture (being the commercial reason the credit was applied for) could realistically be successful.\(^\text{182}\)

3.5 The evolution of pre-agreement assessment under the NCA

3.5.1 The joint statement by Treasury, BASA and the National Credit Regulator

The concept of affordability assessment in order to prevent reckless credit finally came under the spotlight in November 2012 when a joint media statement was issued by the Minister of Finance and the Chairperson of the Banking Association of South Africa (BASA) entitled ‘Ensuring Responsible Market Conduct for Bank Lending’\(^\text{183}\) It was agreed that BASA, the National Credit Regulator and the National Treasury would formulate a standard to measure affordability which could then be incorporated into regulations as minimum standards.\(^\text{184}\)

3.5.2 The May 2013 Draft Affordability Guidelines

\(^{181}\) Par 28.

\(^{182}\) Par 63.


\(^{184}\) Joint Statement 3. The joint statement was only binding on member banks of the Banking Association of South Africa (BASA) but other credit providers such as non-bank micro-lenders and retailers, were also encouraged to conform to the good practices committed to by the Banks.
Following the above joint statement, the National Credit Regulator issued a public notice in May 2013 in which certain broad draft affordability guidelines (not “regulations” as per the aforementioned Joint Statement) were proposed namely that:

(a) credit applicants prove their claimed discretionary income when it is above the norm for a person with their gross income and that such norms be determined as a percentage of gross income bands;
(b) credit providers consider all the credit applicant’s income, expenses and debt repayments when doing an affordability assessment;
(c) credit providers refrain from lending to the maximum of the consumer’s discretionary income and leave a margin of at least 25 percent of their discretionary income for adverse changes in the economy or the consumer’s circumstances;
(d) credit providers use the credit applicant’s current information as stored on one or more credit bureaux;
(e) credit providers process applications for credit within seven days from assessing an applicant’s credit information as stored on credit bureaux; and
(f) credit providers share credit application information on credit bureaux to allow for better affordability assessments to be made by other credit providers and to reduce credit application fraud.

Van Heerden and Renke remark that these broad guidelines represented a “wish list” that indicated the direction that the regulator intended to take in its endeavours to eventually come up with a more comprehensive set of regulations as envisaged in the 2012 joint statement.

3.5.3 The September 2013 Draft Guidelines

The National Credit Regulator followed up on the May 2013 Draft Guidelines in a circular during September 2013 entitled ‘Affordability Assessment Guidelines’. Once again it must

186 Van Heerden and Renke 76.
be noted that these provisions pertaining to affordability assessment were issued as (non-binding and thus unenforceable) guidelines, grooming credit providers for the introduction of regulations at a later stage.

The September 2013 Draft Guidelines were significantly more comprehensive than those which appeared in May 2013 and would apply to all credit providers and to all credit agreements to which the Act applies but not to a credit agreement in terms whereof the prospective consumer or consumer is a juristic person as defined in the Act. These Guidelines would also (in line with section 78(2) of the Act) not apply to the following credit agreements: a developmental credit agreement; a school loan or a student loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement; an emergency loan; a temporary increase in the credit limit under a credit facility; a unilateral credit limit increase under a credit facility in terms of section 119(1), 119(4) and 119(5) of the Act; and a pre-existing Credit Agreement in terms of Schedule 3 item 4(2) of the Act. It also provided that where indicated, parts of the Guidelines would have limited application to secured credit agreements.  

A number of significant definitions not contained in the National Credit Act was introduced to facilitate the application of the Guidelines. ‘Joint prospective consumers or joint consumers’ would mean the prospective consumers or consumers that are co-principal debtors and jointly and severally liable with regard to the same credit agreement and applies jointly for the credit agreement. Prospective consumers or consumers married in community of property that apply separately for a credit agreement and sureties were specifically excluded from the aforesaid definition. ‘Discretionary income’ was defined to mean gross income less statutory deductions (such as income tax and UIF) less necessary expenses (at a minimum as defined in the guidelines) less all other committed payment obligations including such obligations as may appear in the credit applicant’s credit records as held by any credit bureaux. ‘Allocatable income’ meant gross income less statutory deductions (such as income tax and UIF) less necessary expenses (at a minimum as defined

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188 Draft Guideline 1. Van Heerden and Renke 77.
189 Draft Guideline 2. Van Heerden and Renke 78.
190 Ibid.
in the Guidelines) whilst ‘allocatable income buffer’ was defined to mean a percentage of
the allocatable income which credit providers are required to allow for changes in the
consumer’s financial circumstances. ‘Necessary expenses’ referred to the prospective
consumer’s minimum living expenses in regard to food, transport and accommodation as
determined in accordance with paragraph 5.2 of the guidelines as discussed hereinafter.
‘Unsecured term credit agreement’ meant a credit transaction (excluding a pawn
transaction; discount transactions, incidental credit agreement, instalment agreement,
mortgage agreement, secured loan and lease) in respect of which the deferred amount is
not secured by a pledge of movable property, cession of a thing of value or rights, mortgage
over immovable property, suretyship or other personal security or a right in property other
than credit insurance. ‘Secured credit agreement’ was defined as ‘a credit agreement in
respect of which the deferred amount is secured by a pledge of immovable property,
cession of a thing of value or rights, mortgage over immovable property, suretyship or other
personal security or a right in property other than credit insurance.’

The September 2013 Draft Guidelines stated specifically that the assessment envisaged by
section 81 is more comprehensive than (merely) assessing the probability of default by a
consumer\(^\text{191}\) and that the guidelines were intended to establish ‘calculation norms’ for
credit providers to take the reasonable steps in assessing the prospective consumer’s
existing financial means, prospects and obligations as contemplated in section 81(2)(a)(iii) of
the Act.\(^\text{192}\) The Guidelines accordingly required credit providers to take reasonable steps to
assess the prospective consumer’s allocatable income as well as his discretionary income to
determine whether the consumer has the financial means and prospects to pay the
proposed credit instalments.\(^\text{193}\) Credit providers were further required to take reasonable
steps to validate income by referring to the prospective consumer’s payslips and/or bank
statements and/or by obtaining other credible information either written or
electromagnetically recorded, of the prospective consumer’s income. The guidelines
indicated that where the prospective consumer’s monthly income shows variance, the

\(^{191}\) Draft Guideline 3. Van Heerden and Renke 78.
\(^{192}\) Ibid.
\(^{193}\) This also applies to joint prospective consumers or joint consumers.
average income over the period of not less than three months preceding had to be utilised.\textsuperscript{194}

With regard to the calculation of existing financial obligations\textsuperscript{195} a Table 1\textsuperscript{196} was inserted in the Guidelines, which Table set out the minimum living expense norms (necessary expenses), broken down by annual gross income, that could be accepted by credit providers, absent evidence to the contrary, when credit providers calculate the existing financial obligations of prospective consumers in terms of section 81(2)(a)(iii) of the Act.\textsuperscript{197}

An explanation of how to apply the Table was also provided.\textsuperscript{198} It was further provided that where prospective consumers claim to have transport, accommodation or food expenses which are cumulatively less than that set out in Table 1, they should be required by the credit provider to evidence their claimed lower necessary expenses by means of appropriate documentation.\textsuperscript{199} In respect of unsecured term credit agreements, credit providers were required to ensure that the prospective consumer disclosed necessary expenses equal or exceeding those reflected in Table 1, alternatively the credit provider was required to obtain credible written evidence that the prospective consumer’s disclosed necessary expenses were below those set out in Table 1.\textsuperscript{200} The guidelines further stipulated that any credit

\textsuperscript{194}This also applies to joint consumers or joint prospective consumers.

\textsuperscript{195}Draft Guideline 4 and 5. The aforementioned principles with regard to existing financial obligations also apply to joint prospective consumers or joint consumers.

\textsuperscript{196}Table 1

<table>
<thead>
<tr>
<th>Annual Gross Income</th>
<th>Annual Fixed Factor + % of Income above Band Min</th>
<th>Annual Fixed Factor (Food, Transport, Accommodation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min</td>
<td>Max</td>
<td></td>
</tr>
<tr>
<td>R0</td>
<td>R14,400</td>
<td>0</td>
</tr>
<tr>
<td>R14,400.01</td>
<td>R75,000</td>
<td>R14,400</td>
</tr>
<tr>
<td>R75,000.01</td>
<td>R300,000</td>
<td>R18,500</td>
</tr>
<tr>
<td>R300,000.01</td>
<td>R600,000</td>
<td>R40,500</td>
</tr>
<tr>
<td>R600,000.01</td>
<td>High</td>
<td>R65,100</td>
</tr>
</tbody>
</table>

\textsuperscript{197}Par 5.2.1 of the September 2013 Guidelines.

\textsuperscript{198}The following example was provided to illustrate how Table 1 operates: should the prospective consumer have an annual gross income of R24,000, the credit provider may not accept annual necessary expenses of less than R14,400 plus R648 (being 6.75% of R9,600) unless same is evidenced as required in the Affordability Assessment Guidelines. It was further provided that Table 1 will be periodically reviewed by the National Credit Regulator.

\textsuperscript{199}Par 5.2.2 of the September 2013 Guidelines.

\textsuperscript{200}Par 5.2.3 of the September 2013 Guidelines. The guidelines mentioned that examples of credible evidence would include but would not be limited to payments reflected on bank statements, lease agreements, home
provider that entered into an unsecured term credit agreement with a consumer where such consumer’s necessary expenses were below that set out in Table 1, without credible evidence in support of same, could be referred by the National Credit Regulator to the National Consumer Tribunal on the basis that they had lent recklessly as that concept is envisaged in section 80(1)(b)(ii) of the Act. 201

In respect of the consumer’s debt repayment history as consumer under credit agreements (which will usually be reflected on the credit record of the consumer as held by one or more Credit Bureaux) it was provided that credit providers had to take into consideration all debt, including monthly debt repayment obligations in terms of credit agreements, as reflected on the prospective consumer’s credit profile held by a credit bureaux when calculating the prospective consumer’s allocatable income and discretionary income and in making an affordability assessment. 202 This affordability assessment calculation had to include the minimum payments due under credit facilities. 203 In addition credit providers had to ensure that these requirements were performed during the seven business days immediately prior to the initial granting of credit or to the increasing of a credit limit. 204

As a measure to prevent double counting when calculating allocatable income the guidelines provided that where credit agreements are entered into on a substitutionary basis, in order to pay off one or more existing credit agreements credit providers should record that the credit being applied for was to replace other existing credit agreement/s and that the credit provider had to take reasonable steps to ensure that such credit is properly used for such purpose. 205 Guidelines on Credit Literacy were also laid down as part of the Affordability Assessment Guidelines, 206 and provided that credit providers had to take reasonable steps to display such credit literacy posters and make available such credit

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201 Par 5.2.4 of the September 2013 Guidelines. As indicated by Van Heerden and Renke 79 all other Credit Agreements and more specifically Secured Credit Agreements were excluded from this provision.
202 Par 5 and 6 of the September 2013 Guidelines. The aforementioned principles with regard to debt repayment history under credit agreements also apply to joint prospective consumers or joint consumers.
203 Par 6.2 of the September 2013 Guidelines.
204 Par 6.3 of the September 2013 Guidelines.
205 Par 7.1 of the September 2013 Guidelines.
206 Par 8.
literacy materials to their clients and prospective consumers, as the National Credit Regulator issued from time to time.\textsuperscript{207} It was also indicated that credit providers must perform such credit literacy surveys as the National Credit Regulator may require from time to time.\textsuperscript{208}

Finally it was indicated that the abovementioned Guidelines on Affordability Assessment should be read with the Credit Provider’s Code of Conduct to Combat Over-indebtedness, also dated September 2013.\textsuperscript{209}

3.5.4 The National Credit Amendment Act 19 of 2014

The Affordability Guidelines that were being “experimented” with by the Regulator could however only be taken to the next level of mandatory compliance and dedicated enforcement if the NCA was amended to introduce these guidelines by way of regulations. Van Heerden and Renke point out that various problems manifested themselves during the initial years that the National Credit Act was in operation as a result whereof the NCA Amendment Act was eventually approved a couple of months after the September 2013 Draft Guidelines.\textsuperscript{210} The NCA Amendment Act \textit{inter alia} introduced significant amendments to the assessment mechanisms and procedures set out in section 82. It amended section 48 of the National Credit Act to provide for the Minister of Trade and Industry to prescribe criteria and measures to determine the outcome\textsuperscript{211} of affordability assessments.\textsuperscript{212} The NCA was further amended to provide that the Minister must, on recommendation of the National Credit Regulator, make affordability assessment regulations.\textsuperscript{213} Section 82(3) and (4) of the Act was deleted and section 82(1) and (2) substituted to provide that a credit provider may determine for itself the evaluative mechanisms or models and procedures to be used in meeting its assessment obligations under section 81, provided that any such

\textsuperscript{207} Par 8.1 of the September 2013 Guidelines.
\textsuperscript{208} Par 8.2 of the Affordability Assessment Guidelines.
\textsuperscript{209} Par 9.1 on page 6 of Affordability Assessment Guidelines.
\textsuperscript{210} Van Heerden and Renke 79.
\textsuperscript{211} Van Heerden and Renke 79 point out that this provision is incorrectly phrased as the Minister can provide the methodology and requirements for conducting pre-agreement assessment but clearly not the “outcome” thereof.
\textsuperscript{212} S 15(c).
\textsuperscript{213} S 24 of the NCA Amendment Act.
mechanism, model or procedure results in a fair and objective assessment which “must not be inconsistent with the affordability assessment regulations” made by the Minister.  

Accordingly Van Heerden and Renke indicate that the aforesaid amendments meant that, once the Amendment Act came into operation and affordability regulations were issued, the evaluative models previously used by credit providers were required to be aligned with the affordability assessment regulations issued by the Minister. Once issued by way of regulations, these affordability assessment ‘guidelines’ would then be binding on credit providers, contrary to the previous position under section 82(3) that guidelines published by the National Credit Regulator were not binding. Hence Van Heerden and Renke remark that the affordability assessment regulations as discussed below, accordingly provide a “benchmark” against which a credit provider’s compliance with its pre-agreement assessment duty in terms of section 81 will be measured. They point out that, as a minimum, these regulations lay down certain standard requirements which pre-agreement assessments will have to meet (from the operative date of the final affordability assessment regulations as indicated below) in order to comply the obligation that the NCA imposes on the credit provider to refrain from reckless credit granting.

3.5.6 The 2014 Draft Affordability Regulations

On 1 August 2014 a comprehensive set of draft regulations on various matters including regulations on affordability assessment, were published for public comment. Chapter 1 of the aforesaid regulations contained the following amplified and expanded set of definitions: ‘Allocatable income’ was more comprehensively defined than in the September 2013 Draft Guidelines and meant gross income less statutory deductions such as income tax, unemployment insurance and maintenance payments, less necessary expenses (as defined in the regulations). A definition of ‘Credit Cost Multiple’, which did not appear in

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214 S 24 of the NCA Amendment Act. See also s 15(b) of the NCA Amendment Act (n22) which provides for the amendment of the current s 48 to the effect that with regard to registration of credit providers the compliance by a credit provider with a prescribed code of conduct as well as the affordability assessment regulations made by the Minister on the recommendation of the National Credit Regulator, may be considered.

215 Van Heerden and Renke 80.

216 Government Notice R. 597 in Government Gazette 37882 of 1 August 2014—hence, the ‘2014 Draft Regulations’.

217 As set out by Van Heerden and Renke 81.
the September 2013 Draft Guidelines, was also inserted, referring to the ratio of the total cost of credit to the advanced principal debt, that is, the total cost of credit divided by the advanced principal debt expressed as a number to two decimal places. ‘Credit Profile’ meant the consumer’s payment profile, including adverse information held by a credit bureau. ‘Payment profile’ meant a payment profile as defined in regulation 17(5), referring to a consumer’s repayment history in respect of a particular transaction. The definition of ‘Discretionary income’ was also amplified to mean gross income less statutory deductions such as income tax, unemployment insurance fund, maintenance payments less necessary expenses (at a minimum defined in the regulations); less all other committed payment obligations including such as may appear from the credit applicant’s credit records as held by any credit bureau which income is the amount available to fund the proposed credit instalment. ‘Gross income’ was defined as all income earned without deductions from whatever source. ‘Joint consumers’ indicated consumers that are co-principal debtors who are jointly and severally liable with regard to the same credit agreement and apply jointly for the credit agreement excluding the surety or a credit guarantor under a credit guarantee. The exclusion of consumers married in community of property who apply separately for credit which appeared in the September 2013 Draft Guidelines was omitted from the aforesaid definition. ‘Necessary expenses’ were more comprehensively defined than in the September 2013 Draft Guidelines which only referred to expenses in regard to food, transport and accommodation, to mean the ‘consumer’s minimum living expenses as determined in accordance with regulation 23A(9) together with any other necessary living expenses excluding debt repayments.’ Van Heerden and Renke further point out that the definitions regarding unsecured term credit agreements and secured term credit agreement which appeared in the September 2013 Draft Guidelines were omitted from the draft regulations.

The 2014 Draft Regulations were provisionally inserted into the existing body of Regulations published in terms of the NCA. regulation 23A entitled ‘Criteria to conduct Affordability Assessment’. These draft regulations apply to current, prospective and joint consumers; all

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218 Ibid.
219 Ibid.
credit providers and all credit agreements to which the Act applies (subject to regulation 23A(2)).\textsuperscript{221} Similar to the September 2013 Draft Guidelines it is stated that the regulations do not apply where the consumer is a juristic person and it excludes all the credit agreements previously excluded by the September 2013 Draft Guidelines from its ambit.\textsuperscript{222} As pointed out by Van Heerden and Renke, the Draft Regulations however expand on the excluded credit agreements mentioned in the September 2013 Draft Guidelines by providing that the regulations do not apply to any change to a credit agreement and/or any deferral or waiver of an amount under an existing credit agreement\textsuperscript{223} or to Mortgage Agreements that qualify for the Finance Linked Subsidy Programs developed by the Department of Human Settlements and credit advanced for housing that falls within the threshold set from time to time.\textsuperscript{224}

In respect of existing ‘financial means and prospects’ the 2014 Draft Regulations, similar to the September 2013 Guidelines, stipulate that a credit provider must take practicable steps to assess the consumer or joint consumers’ allocatable income as well as their discretionary income to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments.\textsuperscript{225} Similarly, it also provides that a credit provider is required to take steps to validate gross income by referring to recent three months consumer’s pay slips; recent three months bank statements and any other similar credible information.\textsuperscript{226} Where the consumer’s monthly gross income shows material variance, the average gross income over the period of not less than three months preceding the credit application must be utilised.\textsuperscript{227} Interestingly Van Heerden and Renke point out the 2014 Draft Regulations refer to ‘practicable’ steps instead of ‘reasonable’ steps as was indicated in the September 2013 Draft Guidelines and required by section 81 of the Act.\textsuperscript{228} Probably the view here was that practicable steps can be equated with reasonable steps although it is submitted that it would be prudent to rather follow the wording of the Act in this regard.

\textsuperscript{221} Reg 23A (1).
\textsuperscript{222} Reg 23A (2)(a)-(l).
\textsuperscript{223} In accordance with s 95 of the Act—reg. 23A (2)(j).
\textsuperscript{224} Reg 23A (2)(k).
\textsuperscript{225} Reg 23A (3).
\textsuperscript{226} Reg 23A (4).
\textsuperscript{227} Reg 23A(5).
\textsuperscript{228} Van Heerden and Renke 81.
The 2014 Draft Regulations, like the September 2013 Draft Guidelines, also require the cooperation of the consumer in the pre-agreement process by requiring the consumer to accurately disclose to the credit provider all financial obligations to enable the credit provider to conduct the affordability assessment. The consumer is further required to disclose authentic documentation (i.e. reliable documentation) to the credit provider for purposes of the affordability assessment. Insofar as the consumer’s existing financial obligations are concerned, the credit provider is required to make a calculation of the consumer’s existing financial means, prospects and obligations as envisaged in sections 78(3) and 81(2)(a)(iii) of the Act. More or less similar to the September 2013 Draft Guidelines the credit provider may, however, on an exceptional basis, where justified, accept the consumer’s declared necessary expenses which are lower than those set out in Table 1 which has been revised and differs from the Table previously contained in the September 2013 Draft Guidelines. This revised Table sets out specific information based on the consumer’s monthly (not annual as per the previous Table) which it is submitted, gives a clearer indication of the consumer’s monthly living expenses in relation to the usually monthly instalments that he will be required to pay if he takes up the proposed credit. However the explanation provided in the September 2013 Draft Guidelines on how to apply the Table was omitted and thus a credit provider wished to use the Draft Regulations would clearly be uncertain how to apply it as it cannot merely be taken for granted that the application had to follow the example in the September Guidelines although it is submitted that is the most likely implication. Like with the September 2013 Draft Guidelines a credit provider may however accept lower monthly necessary expenses

<table>
<thead>
<tr>
<th>Monthly Gross Income</th>
<th>Minimum Factor</th>
<th>Monthly Fixed Income Above Band Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>Maximum</td>
<td></td>
</tr>
<tr>
<td>R0.00</td>
<td>R800.00</td>
<td>R0.00</td>
</tr>
<tr>
<td>R800.01</td>
<td>R6,250.00</td>
<td>R800.00</td>
</tr>
<tr>
<td>R6,250.01</td>
<td>R25,000.00</td>
<td>R1,541.67</td>
</tr>
<tr>
<td>R25,000.01</td>
<td>R50,000.00</td>
<td>R3,375.00</td>
</tr>
<tr>
<td>R50,000.01</td>
<td>Unlimited</td>
<td>R5,425.00</td>
</tr>
</tbody>
</table>

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than that prescribed by Table 1 only if a questionnaire\textsuperscript{233} (and not merely credible written evidence as required by the September 2013 Guidelines) is completed by the consumer or joint consumers.\textsuperscript{234}

The 2014 Draft Regulations further prescribe that when conducting the affordability assessment, a credit provider must calculate the consumer’s allocatable and discretionary income; take into account all debts, including monthly debt repayment obligations in terms of credit agreements as reflected on the consumer’s credit profile held by a registered credit bureau; and take into account maintenance obligations arising from statutory deductions or necessary expense.\textsuperscript{235}

With regard to the consumer’s debt repayment history as a consumer under credit agreements the draft regulations require the credit provider to take such history into account as is also required by section 81(2)(a). The credit provider is tasked to ensure that this requirement is performed within seven business days immediately prior to the initial granting of credit or the increasing of an existing credit limit; and within 14 business days with regards to mortgages.\textsuperscript{236}

Similar to the September 2013 Draft Guidelines a subregulation relating to avoiding double discounting in calculating the consumer’s allocatable income a provision is contained in the 2014 Draft Regulations.\textsuperscript{237} In addition it is prescribed, with regard to disclosure of credit cost

\begin{footnotesize}
\begin{enumerate}
\item Annexure B to the 2014 Draft Regulations contained the ‘Declaration of Consumer’s necessary expense questionnaire. The questionnaire included a declaration whereby the consumer/s completing the questionnaire is reminded that in terms of section 81(1) of the National Credit Act when applying for a credit agreement and while that credit agreement is being considered by the credit provider, the prospective consumer must fully and truthfully answer any requests for information made by the credit provider as part of the assessment and that misrepresentation of facts will be dealt with in terms of the applicable law. Part 1 of the questionnaire dealt with the consumer’s details. Part 2 addressed the consumer’s necessary expenses and requires the consumer to indicate the relevant income band that applies to him and to set out the amount of his declared monthly expenses. Part 3 provided for the consumer to disclose in detail his expenses in respect of accommodation, transport, food, education, medical costs, water and electricity and maintenance.
\item Reg 23A(9).
\item Reg 23A(10).
\item Reg 23A(11).
\item Reg 23A(12).
\end{enumerate}
\end{footnotesize}
multiple and the total cost of credit,\(^{238}\) that a credit provider must disclose to the consumer the credit cost multiple and total cost of credit in the pre-agreement statement and quotation.\(^{239}\) It must be ensured that the credit cost multiple disclosures for credit facilities must be based on one year of full utilization up to the credit limit proposed and that the attention of the prospective consumer is drawn to the credit cost multiple and that the cost of credit, as disclosed, is understood by the consumer.\(^{240}\)

The 2014 Draft Regulations also provided for specific redress: it stated that a consumer who is aggrieved by the outcome of affordability assessment may at any time lodge a complaint in terms of section 134\(^{241}\) or 136\(^{242}\) of the National Credit Act with the credit provider for dispute resolution.\(^{243}\) The credit provider is then obliged to resolve the complaint within fourteen days, presumably from the date that it was lodged.\(^{244}\) If the grievance is not addressed by the credit provider, the consumer can thereafter approach the National Credit Regulator.\(^{245}\)

Van Heerden and Renke point out that it is important to note that the 2014 Draft Regulations did not make any specific distinction between unsecured term credit agreements and secured term credit agreements for purposes of the section 81 assessment. It also did not contain a provision similar to the September 2013 Draft Guidelines that a credit provider who enters into an unsecured term credit agreement where the consumer’s living expenses are below the prescribed limit may be charged with reckless lending.\(^{246}\) It appears therefore that the regulations contain requirements for assessment that have to be applied by a credit provider across the board during the section 81 assessment and that

\(^{238}\) ‘Cost of credit’ is not defined in the regulations. S 101 of the NCA deals with cost of credit and sets out the various costs that may be charged in respect of a credit agreement to which the Act applies. See Renke LLD thesis 489.

\(^{239}\) Reg 23A (13)(a). The total cost of credit that must be disclosed may include the principal debt, interest, initiation fee (if any), service fee aggregated to the life of a loan and credit insurance (depending upon discretion of the consumer aggregated to the life of a loan)—reg 23A(13)(d).

\(^{240}\) Reg 23A(13)(b) and (c).

\(^{241}\) S 134 provides for alternative dispute resolution.

\(^{242}\) S 136 provides that any person may submit a complaint regarding an alleged contravention of the Act to the National Credit Regulator in the prescribed manner and form. It further provides that the National Credit Regulator may initiate a complaint in its own name.

\(^{243}\) Reg 23A(14)(a).

\(^{244}\) Reg 23A(14)(b).

\(^{245}\) Reg 23A(14)(c).

\(^{246}\) See par 5.2.4 of the September 2013 Draft Guidelines.

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the nature of the credit, namely whether it is secured or unsecured, is not determinative of compliance with these regulations—thus the regulations apply to secured and unsecured credit alike.

Chapter 6 of the 2014 Draft Regulations further stipulated that the regulations are binding to the extent of their application and that failure by the credit provider to comply would inter alia amount to prohibited conduct or reckless lending conduct and failure to comply by the consumer would inter alia amount to misrepresentation.

3.5.7 The 2015 Final Affordability regulations

On 13 March 2015 the National Credit Amendment Act was eventually put into operation. On this date the final “National Credit Regulations including Affordability Assessment Regulations” were published.\(^{247}\) These regulation were however met with much trepidation and criticism by credit providers and accordingly the Minister of Trade and Industry extended the date on which these final affordability regulations would come into operation to 13 September 2015 in order to give credit providers opportunity to bring their assessment models in line with the regulations.\(^{248}\)

As a result of the amendments introduced by the National Credit Amendment Act as discussed above these final regulations are binding subordinate legislation that constitute the minimum standards which credit providers will have to comply with in conducting the pre-agreement assessment in respect of credit agreements entered into after 13 September 2015.\(^{249}\)

There is not much difference between the final affordability assessment regulations and the 2014 Draft Regulations. The final affordability regulations also only apply when credit

\(^{247}\) National Credit Regulations including Affordability Assessment Regulations published in GG No 38557 of 13 March 2015.

\(^{248}\) Here you must refer to the Government gazette where the notice of postponement was published

\(^{249}\) Van Heerden in Scholtz et al Guide to the National Credit Act par 11.6. Where allegations of reckless credit are made based on a s 81-assessment which was conducted prior to 13 September 2015 the original considerations where no binding guidelines for the assessment existed, will apply.
agreements governed by the National Credit Act are entered into with natural person consumers and like the 2014 Draft Regulations, it is also indicated that certain credit agreements are exempt from the application of the final Affordability Regulations. Also like in the 2014 Draft Regulations, no distinction is made between secured and unsecured credit agreements.

The final Affordability Regulations, like the 2014 Draft Regulations, require a credit provider to take "practicable" steps to assess the consumer or joint consumer's discretionary income in order to determine whether the consumer has the financial means and prospects to pay the proposed credit agreements. For purposes of determining the consumer's discretionary income the credit provider is also compelled to validate the consumer’s gross income and the specific documentation to be obtained for such verification is indicated with regard to consumers that receive a salary from an employer, those who do not and consumers that are self-employed. Where the consumer's monthly gross income shows material variance, the average gross income over the period of not less than three pay periods preceding the credit application must be used.

The final Affordability Regulations also require the consumer to co-operate in the assessment process by requiring the consumer to accurately disclose to the credit provider all financial obligations so as to enable the credit provider to conduct the affordability

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250See Reg 23A(2). These exempt agreements include a developmental credit agreement; a school loan or a student loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement; an emergency loan; a temporary increase under a credit facility; a unilateral credit limit increase in a credit facility in terms of sections 119(1)(c); 119(4) and 119(5) of the Act; a pre-existing credit agreement in terms of schedule 3 Item 4(2) of the Act; any change to a credit agreement and/or any deferral or waiver of an amount under an existing credit agreement in accordance with section 95 of the Act and mortgage credit agreements that qualify for the Finance Linked Subsidy Programs developed by the Department of Human Settlements and credit advanced for housing that falls within the thresholds set from time to time.

251Reg. 23A(3) states: A credit provider must take practicable steps to assess the consumer or joint consumer's discretionary income to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments.

252"Discretionary Income" means Gross Income less statutory deductions such as, income tax, unemployment insurance fund, maintenance payments and less Necessary Expenses less all other committed payment obligations as disclosed by a consumer including, such as may appear from the applicant's credit records as held by any Credit Bureau which income is the amount available to fund the proposed credit Instalment.

253Reg 23A (3).

254Reg 23A (4).

255Reg 23A(5).
assessment and must for such purpose also provide authentic documentation to the credit provider.\textsuperscript{256}

The credit provider is obliged by regulation 23A (8) to make a calculation of the consumer’s existing financial means, prospects and obligations\textsuperscript{257}. When calculating the consumer’s existing financial obligations the regulations compel the credit provider to utilize the minimum expense norms table (a slightly further revised Table 1 as set out below) contained in the regulations which table is broken down by monthly gross income.\textsuperscript{258}

Regulation 23A (10) provides that the following methodology has to be applied when using the Table:

- The credit provider must ascertain the consumer’s gross income;
- Thereafter statutory deductions and minimum living expenses must be deducted to arrive at a net income, which must be allocated for the payment of debt instalments;
- When existing instalments are taken into account, the credit provider must calculate the consumer’s discretionary income that will be available to enable the consumer to satisfy any new debt.

\textsuperscript{256}Reg. 23A (6) and (7).
\textsuperscript{257}S78(3) and 81(2)(a)(iii).
\textsuperscript{258}Reg. 23A(9).The word “must” is used. In the table contained in the August draft regulations these income bands were broken down by annual income but this position was revised subsequent to criticism that the said bands foreclosed access to credit to certain consumers.

\textbf{Table1. NCR minimum expense norms}

<table>
<thead>
<tr>
<th>Income band</th>
<th>Minimum income</th>
<th>Maximum income</th>
<th>Band midpoint</th>
<th>Statutory deductions at band midpoint</th>
<th>Minimum monthly fixed factor</th>
<th>Monthly fixed factor: % of amount above band minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>R0.00</td>
<td>R800.00</td>
<td>R400.00</td>
<td>R8</td>
<td>R0.00</td>
<td>100%</td>
</tr>
<tr>
<td>2</td>
<td>R800.01</td>
<td>R6 250.00</td>
<td>R3 525.00</td>
<td>R32.50</td>
<td>R800.00</td>
<td>6.75%</td>
</tr>
<tr>
<td>3</td>
<td>R6 250.01</td>
<td>R25 000.00</td>
<td>R15 625.00</td>
<td>R1891.72</td>
<td>R1 167.88</td>
<td>9.00%</td>
</tr>
<tr>
<td>4</td>
<td>R25 000.01</td>
<td>R50 000.00</td>
<td>R37 500.00</td>
<td>R8513.72</td>
<td>R2 855.28</td>
<td>8.20%</td>
</tr>
<tr>
<td>5</td>
<td>R50 000.01</td>
<td>Unlimited</td>
<td>-</td>
<td>-</td>
<td>R4 905.38</td>
<td>6.75%</td>
</tr>
</tbody>
</table>
It is important to mention here that again the example previously provided in the September 2013 Draft Guidelines regarding the application of the Table has been omitted with the result that it is unclear exactly how the Table should be utilised. As indicated by Van Heerden and Beyers, nowhere in the final regulations is an explanation provided of the purpose of the monthly fixed factor in the Table and exactly how the amounts in the Table should be calculated to assess the affordability of a consumer.\footnote{Van Heerden and Beyers 47.}

Like the September 2013 guidelines and the 2014 draft regulations the final Affordability Regulations provide that the credit provider may on an exceptional basis, where justified, accept the consumer’s declared minimum expenses which are lower than those set out in Table 1, provided that a questionnaire, which is set out in Schedule 1 to the Regulations, is completed by the consumer or joint consumers.\footnote{Reg. 23A (11). The words’ the questionnaire set out in the Schedule, as issued from time to time...’ which appears to signify that the questionnaire may be amended from time to time.}

When conducting an affordability assessment regulation 23A(12) in somewhat repetitive fashion, obliges the credit provider to

- Calculate the consumer’s discretionary income;
- Take into account all monthly debt repayment obligations in terms of credit agreements as reflected on the consumer’s credit profile held by a registered credit bureau; and
- Take into account maintenance payments and other necessary expenses.

Like its “predecessors” the final affordability assessment regulations specifically oblige the credit provider to take into account the consumer’s debt repayment history as a consumer under credit agreements as envisaged in section 81(2)(a). This makes sense as such history will reveal the consumer’s exposure in terms of existing credit obligations which plays a pivotal role in determining affordability. The credit provider must ensure that this requirement is performed within seven (7) business days immediately prior to the initial
approval of credit or the increasing of a credit limit, and within fourteen business days with regards to mortgages.\textsuperscript{261}

In order to avoid double counting in calculating the consumer’s discretionary income where a credit agreement is entered into on a substitutionary basis in order to settle one or more existing credit agreements, it is also provided like in the Drat Regulations, that a credit provider must record that the credit being applied for is to replace other existing credit agreements.\textsuperscript{262}

The affordability assessment regulations further mandate the disclosure of the credit cost multiple and the total cost of credit to the consumer.\textsuperscript{263}

Finally, it is to be noted that these final Affordability Regulations have not yet been tested by the South African courts. One can however agree with Van Heerden who submits that courts will in future have to scrutinize the credit provider’s compliance with these regulations during its pre-agreement assessment and that such compliance will impact on whether the credit provider conducted a proper pre-agreement assessment which would entitle him in the circumstances as envisaged by section 81(4), to rely on the complete defence against reckless credit.\textsuperscript{264}

### 3.6 Challenges to pre-agreement assessment in South Africa

The aspect of pre-agreement in South Africa and the role that it plays in the context of prevention of credit may however be strained and even impeded by some interventions undertaken or obligations neglected by government. Accordingly a mere discussion of

\textsuperscript{261}Reg. 23A (13)(a) and (b).
\textsuperscript{262}Reg. 23A (14)(a). In addition Reg. 23A (14)(b) states that the credit provider must take practicable steps to ensure that such credit is properly used for such purposes.
\textsuperscript{263}In terms of regulation 23A(15) a credit provider must:

(a) Disclose to the consumer the credit cost multiple and the total cost of credit in the pre-agreement statement and quotation;
(b) Ensure that the credit cost multiple disclosures for credit facilities is based on one year of full utilization up to the credit limit proposed;
(c) Ensure that the attention of the prospective consumer is drawn to the credit cost multiple and that the cost of credit as disclosed, is understood by the prospective consumer;
(d) Disclose a total cost of credit which includes but is not limited to the following items: the principal debt; interest, initiation fee (if any); service fee aggregated to the life of a loan; and credit insurance aggregated to the life of a loan, as set out in section 106 of the Act.

\textsuperscript{264}See Van Heerden in Scholtz et al Guide to the National Credit Act par 11.6
section 81 and the final Affordability Regulations will not paint a complete picture of the pre-agreement assessment process in South Africa if the reader is not also alluded to the possible impact of aspects such as credit amnesty granted by Government and to the fact that South Africa to date not yet has a central or national credit register.

3.6.1 The Credit Amnesty regulations

With regard to consumer credit history certain interventions by the South African Government occurred which also impacted on pre-agreement assessment as contemplated by the National Credit Act. These interventions came in the form of credit amnesty that had the effect of wiping out certain historical credit information pertaining to consumers. The rationale behind the credit amnesty was to increase access to credit especially for previously disadvantaged consumers whose credit history impeded their access to credit.

In this regard Kelly-Louw\textsuperscript{265} points out that before the introduction of the NCA, the consumer credit information held by credit bureaux in South Africa was to a large extent unreliable, incomplete and incorrect; consumer-credit records kept by credit bureaux were in a dismal state, and many consumers were “blacklisted” without their knowledge and without an opportunity to challenge the correctness of the adverse information being reported to the credit bureaux.\textsuperscript{266} Consumers could also not easily access the credit information kept by credit bureaux and it was practically impossible for a consumer to have incorrect or adverse credit information corrected or removed. Consumers also did not have an automatic right to access or challenge information and records kept by credit bureaux. In general therefore, consumers only discovered that they had adverse credit records when they tried to apply for credit and their applications were declined because of it.\textsuperscript{267}

In order to correct this unfortunate situation, regulations were issued in terms of the NCA to provide for the removal of consumer credit information that met certain criteria and assisted with the verification and review of certain adverse and negative consumer credit

\textsuperscript{266}Ibid.
\textsuperscript{267}Ibid.
information that was kept by the different credit bureaux in the past (the 2006 Amnesty Regulations).²⁶⁸

What was initially thought to be a once-off provision of credit information amnesty, resulted in a second and much more encompassing amnesty during the time that the affordability regulations were being developed. The DTI was of the view that as a limited number of consumers benefited from the first amnesty, due to the monetary caps and lack of consumer education accompanying it, a further amnesty was necessary. On 26 February 2014 therefore, the Minister of Trade and Industry published the Removal of Adverse Consumer Credit Information and Information relating to Paid Up Judgments Regulations (the 2014 Amnesty Regulations).²⁶⁹

In general the 2014 Amnesty Regulations relate to the once-off removal of certain adverse consumer credit information from the credit records, including payment profiles, of all consumers, kept by all the registered credit bureaux²⁷⁰ as at 1 April 2014. Regulation 1 provides that “adverse consumer credit information” for purposes of these regulations means:

(a) adverse classifications of consumer behaviour are subjective classifications of consumer behaviour and include classifications such as ‘delinquent’, ‘default’, ‘slow paying’, ‘absconded’ or ‘not contactable’;

(b) adverse classifications of enforcement action, which are classifications related to enforcement action taken by the credit provider, including classifications such as ‘handed over for collection or recovery’, ‘legal action’, or ‘write-off’;

(c) details and results of disputes lodged by consumers irrespective of the outcome of such disputes;

(d) adverse consumer credit information contained in the payment profile represented by means of any mark, symbol, sign or in any manner or form.

²⁶⁸ ibid.
²⁶⁹ Published in GN R144 in GG 37386 of 26-02-2014.Kelly-Louw Credit Amnesty 115.
²⁷⁰ Kelly-Louw Credit Amnesty 115.
The 2014 Amnesty Regulations also provided for the once-off, as well as on-going, removal of information relating to “paid up judgments” of consumers. Regulation 1 defines “paid up judgments” as civil court judgment debts, including default judgments, where the consumer has settled the capital amount under the judgment.  

Regulation 3(d) of the 2014 Amnesty Regulations provides that a credit provider is not permitted to use adverse consumer credit information and information relating to paid up judgments, that have been removed in terms of these regulations, for “any reason, including credit scoring and assessment” of consumers.

In terms of their application, the 2014 Amnesty Regulations affect the credit bureau reports of a consumer, who is a natural person, stokvel or a specific type of trust and who is a party to a credit agreement to which the NCA applies.

Kelly Louw argues that the 2014 Amnesty Regulations do not entail (nor should they be so interpreted) that a consumer’s debt repayment history should be totally destroyed. Credit bureaux are still required (and allowed) to maintain a record of a consumer’s monthly payments and his payment profile. The 2014 Amnesty Regulations simply remove certain adverse credit information and information relating to paid up judgments from a consumer’s credit bureau report so that they are no longer reflected therein.

She concludes that the NCA, in its current form, places a duty on a credit provider to take reasonable steps to assess the consumer’s debt repayment history, but fails to stipulate

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271 Kelly Louw Credit Amnesty 119 states that it is not clear what is meant by the term “capital amount” or exactly which amounts the term includes as neither the NCA nor any other regulation issued in terms of the Act, defines the term’s precise meaning. The NCA refers to and defines only the term “principal debt” Kelly Louw further states that the 2014 Amnesty Regulations are also completely silent about the payment (settlement) of the interest component and any other costs (for example, legal costs) in connection with the judgment debt. She therefore argues that from a literal reading of the definition, it seems that a consumer would only have to pay the outstanding capital amount if he wishes to benefit from the amnesty. Even if that is the intended meaning of the term, it should be remembered that the consumer is still liable for the payment of the interest, despite details regarding the “paid up judgment” being removed from his credit record.

272 Kelly-Louw Credit Amnesty 115. There is nothing in these regulations to prevent the 2014 Amnesty Regulations from also applying to the credit bureau reports of a juristic person who qualifies as a consumer and who is also a party to a credit agreement in respect of which certain parts of the NCA applies. There is also nothing in the NCA itself that states that the provisions in the Act dealing with consumer credit information do not or could not also apply to juristic persons. Kelly Louw states that although it can probably be argued that section 70(1) of the NCA, that defines “consumer credit information”, refers more to the information concerning natural persons than to juristic persons. In principle, however, the 2014 Amnesty Regulations apply also to the credit records of certain juristic persons held by credit bureaux.

273 Ibid.

274 Ibid.
what these reasonable steps are or which documents and records a credit provider may use during its assessment. Section 82(1), as amended by the Amendment Act, still gives a credit provider some leeway to create its own evaluative mechanisms or models and procedures to be used in meeting its assessment obligation under section 81. Therefore, one way in which a credit provider may conduct this assessment is for it to consult its own internal records it keeps on a consumer. Another is to obtain a credit report on the consumer from a registered credit bureau. In the Affordability Regulations, great emphasis is placed on the important role that credit bureau reports of consumers\textsuperscript{275} play in credit providers conducting proper affordability assessments. For this to prove successful though, it is vital that the credit reports received from credit bureaux are reliable and complete.

As regards credit amnesty regulation 3(d) which prohibits Kelly-Louw remarks that it is, however, uncertain, if this removed adverse information may still be used by a credit provider to conduct the statutory assessment of a consumer where it obtained such information not from any credit bureau report, but from its own internal credit records for a specific consumer (for example where a consumer is an existing customer). It would not make sense to impose a statutory duty on the credit provider to assess the debt repayment history of a consumer, but to also simultaneously prohibit it from consulting its own internal records to do so. It will surely amount to gross reckless lending if a credit provider simply grants credit to one of its existing customers without first consulting its own records to determine the customer’s repayment history with the credit provider. The only interpretation of regulation 3(d) that would make sense is that it simply forbids a credit provider to use the information “that ha[s] been removed in terms of these regulations” and was obtained specifically from a credit bureau.

Kelly-Louw points out that the 2014 Amnesty Regulations do not provide for the removal of qualifying adverse credit information which the credit provider keeps in its own internal records and was collected over time by the credit provider itself. She thus argues that it would not make sense if the regulations required a credit provider to turn a blind eye to its own adverse credit information concerning one of its existing customers. The regulations censor only certain information which the credit provider receives from credit bureaux, and not the information that the credit provider obtains from its own internal records. This view

\textsuperscript{275} Par 5 at 20.
is supported by the decision of the court in *Horwood v FirstRand Bank Ltd* 276 where the court alluded to the fact that a different level of assessment was required from a credit provider when it conducts an affordability assessment for an existing customer as compared to when doing so for a new customer. 277

### 3.6.2 National Credit Register

Van Heerden and Renke point out that section 69 of the NCA provides for the establishment of a National Register of Credit Agreements to which credit providers must report details regarding the consumer and the specific credit agreement upon entering into or amending a credit agreement. 278 The credit provider must also report the particulars of the termination and satisfaction 279 of any agreement so reported and must report instances where a transfer of rights has occurred. 280 In the alternative to reporting to the National Credit Register credit providers must report the aforesaid information to a credit bureau registered in terms of the Act. 281 They indicate that such a National Credit Register has not yet been established and accordingly credit providers report the required information on credit agreements to a number of credit bureaux that are registered with the National Credit Regulator. Renke indicates that positive information as well as adverse information such as the granting of judgments in respect of credit agreements is reported to these credit bureaux. 282 Unfortunately not all credit providers comply with this reporting obligation with the result that the consumer’s profile with the credit bureaux might not necessarily be hundred per cent accurate. 283

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277 Although a credit provider is thus permitted to use the adverse credit information it has obtained from its own records, regulation 3(e) clearly prohibits a credit provider from resubmitting such old information (i.e. the adverse information and paid up information that was removed in terms of the 2014 Amnesty regulations) to a credit bureau. This prevents a recycling of old information.
278 Van Heerden and Renke 82. S 69(2)(a) to (e) sets out the information that must be reported.
279 S 69(3).
280 S 69(4).
281 S 69 read with s 43.
282 Van Heerden and Renke 82.
283 Ibid.
CHAPTER 4

PRE-AGREEMENT ASSESSMENT IN LESOTHO

4.1 Introduction

A vast amount of research undertaken indicates that credit extension is an important driver of economic growth and that countries that have grown much faster than others tend to have strong credit extension. Prior to 2009, loans extended to the private sector in Lesotho were quite low. As a share of total deposits, credit to the private sector was roughly 30.0 per cent in 2009, implying that the majority of banks’ assets were mostly held either as excess reserves or a build-up in banks’ foreign assets. Lesotho still lags behind in comparison with other countries in sub-Saharan Africa. For instance, credit as a share of Gross Domestic Product (GDP) is presently 3.2 per cent in Lesotho compared with 21.0 per cent in Swaziland. The following factors were believed to be the inhibiting factors to growth in credit extension in Lesotho:

• Mismatch of the maturity structures of banks’ assets and liabilities (short-term deposits versus long-term financing requirements);

• Information asymmetry: lack of information by borrowers to allow efficient screening of credit applications;

• Lack of access to finance and knowledge about products offered by banks to the public.

Credit extension by commercial banks as well as by a lot of non-bank credit providers increased noticeably in recent years, as will be seen later in this chapter. A number of factors have led to the recent surge in credit extension, namely: the returns on financial assets such as treasury bills and bonds have been quite low on the back of the generally low interest rate environment since the inception of the global financial crisis. This is confirmed by transfer of funds by banks from South Africa for lending domestically. Also, the growth

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1 Credit is defined under Financial Institutions Credit Only and Deposit Taking Micro-Finance Institutions Regulations 51 of 2014 as “the granting of a loan, the creation of debt any form of deferred payment.”
3 Ibid 37.
4 Ibid.
5 Three of the four commercial banks operating in Lesotho are subsidiaries head-quartered in South Africa.
in some sectors of the economy, mining sector, construction, wholesale and retail, and real estate within the economy have led to a huge leap in credit extension. The introduction of a hybrid range of credit products by commercial banks has also contributed to the growth in credit extension as did the latest policy interventions including enactment of the Land Act;\(^6\) which permits households to use land as collateral, amendment of married person’s law.\(^7\) Other contributing factors were the establishment of the commercial court by the Government of Lesotho;\(^8\) the introduction of the partial credit guarantees schemes \(^9\) and the increase in banks’ deposits (thus boosting the lending capacity of commercial banks).

However, despite these developments, extension of credit continues to lag behind other countries within the same income category as Lesotho due to limited uptake of formal credit. Only 16.6 per cent \(^10\) of adults access credit through formal credit providers, with most of these being through retailers and just 3.8% \(^11\) access credit from commercial banks.

The above trends thus mean that access to credit in Lesotho is largely provided through micro lenders and informal mechanisms rather than formal and regulated financial institutions. This is further indicated by the fact the banks dominate the total credit market (by value) which is a clear indication that bank lending is focused primarily on corporates and high net-worth individuals, rather than the mass individual market.

Most Basotho accessing credit thus do so through informal providers or family and friends.\(^12\) Although only a relatively small proportion of adults access credit through formal channels, the large number of adults that access credit through other channels indicates that this is

\(^6\) 8 of 2010.
\(^7\) Legal Capacity of Married Persons Act 9 of 2006. Available from Lesotho Legal Information Institute website [www.lesotholii.org](http://www.lesotholii.org). The Act removed the traditional legal requirement of women from having to obtain spousal consent for every credit transaction and introduced a requirement for both spouses to obtain each other’s consent for certain types of borrowings such as fixed property loans.
\(^8\) Commercial banks were previously reluctant to extend credit in large scales because the judicial recovery system was inefficient and too slow. With the establishment of a dedicated commercial court for commercial disputes, banks have increased their credit risk appetite resulting in more credit being extended by commercial banks in Lesotho.
\(^9\) The Government of the Kingdom of Lesotho operates a credit guarantee scheme where it stands as a guarantor for individuals applying for loans from banks in certain projects identified by the Government such as youth development projects, senior government and statutory officers.
\(^10\) Which translates into 190,000 Basotho.
\(^11\) Which translates into 40,000 Basotho adults.
\(^12\) See FinMark Diagnostic report, Demand, Supply, Policy and Regulation ‘Making Access Possible qualitative demand report: Lesotho,’ 2014 at 91 (hereinafter FinMark Report).
not due to a lack of demand for credit. The 2013 CBL Report records that 21 per cent\(^\text{13}\) of Basotho access informal credit only and a further 25.9 per cent\(^\text{14}\) access credit from family and friends only.\(^\text{15}\)

It is further to be noted that salaried employees, as the target market with the highest average income and the most regular income, dominate the formal credit market.\(^\text{16}\) About 30 per cent\(^\text{17}\) of salaried employees access credit from regulated providers and account for 25 per cent of total regulated users, despite making up just 14 per cent of the total population. It is important to highlight that while the bulk of credit consumers in Lesotho access credit through the informal sector, this sector is highly unregulated or in some instances inadequately regulated and it is submitted that in these circumstances credit providers escape the regulatory radar regarding reckless lending practices.

Geographical dynamics also come into play in the access to credit in Lesotho. Bank credit is strongly skewed towards urban inhabitants. According to the 2013 CBL report 25,000 of urban adults access credit from banks whereas only 2.2 per cent (which is 15,000) of rural dwellers access credit from banks. This may indicate the focus by banks on higher net-worth individuals who are more likely to reside in urban areas, but may also point to difficulties of access to formal credit for the much larger rural population.\(^\text{18}\)

### 4.2 Over-indebtedness of credit consumers in Lesotho

It is to be noted that one of main reasons for taking up of credit by consumers in Lesotho is for servicing existing loans.\(^\text{19}\) It is reported that 3.2 per cent of Lesotho adults apply for credit in order to pay off another existing loan. It is submitted that accessing credit to

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\(^{13}\) Which translates into 250,000 adults out of a total country population of +1.8 million people in terms of the Lesotho Bureau of Statistics 2014 data.

\(^{14}\) Which translates into 215,000 adults.

\(^{15}\) See FinMark Report 90.

\(^{16}\) FinMark Report 89.

\(^{17}\) 45,000 adults.

\(^{18}\) The total population of Lesotho is 1.8 million people according to the Lesotho Bureau of Statistics. Available from www.bos.gov.ls (Accessed on 03.07.2016)

\(^{19}\) See FinMark Report 88. See also the Labour Court of Lesotho LC/Rev/115/07 - Standard Lesotho Bank and Mosobelo Moseeuanye respondent et al- where the applicant had been charged with being in breach of the bank’s (employer) lending procedure in that he contracted further debts inside his loans consolidation period, which was intended for his rehabilitation. This was held to be a serious breach in line with clause 4.0 of the staff handbook that clearly stipulated that he was expected to conduct his financial affairs in a reasonable manner.
service existing loans should be considered a symptom of over-indebtedness whether or not arising out of reckless lending. It will however be indicated in this chapter that over-indebtedness in Lesotho is mainly a result of reckless lending both in the formal and informal sectors.

The problem of reckless lending which leads to consumer over-indebtedness in Lesotho was highlighted by Mr Mike Edgcumbe, a senior Standard Lesotho Bank official, Personal and Business Banking, in the 2013 Public Eye Newspaper. Edgcumbe wrote that the growing trend of "irresponsible lending" among local financial institutions has become a cause for concern. He stated that some financial organisations that operate in Lesotho are not taking into account the debtors’ repayment ability when approving loans. and remarked “We have seen this in the way some of our (the Standard Lesotho Bank’s) existing clients who already have loans with the Bank, and then approach other financial services suppliers to acquire more loans, above and beyond their income and ability to pay. This is without taking into account all of the client’s repayments of loans and other commitments, when determining if the client can afford to repay the new loan. The result is that the client pays the microloan, normally deducted directly off their salary, with only the balance then being remitted to their bank account; and more often than not there is no longer enough money to repay their personal loans, home loan or vehicle loan.”

Edgcumbe further submitted that it is the responsibility of financial institutions to ensure that the welfare of credit consumers is considered before granting any loans and stated: “As a responsible financial services provider and lender, our plea to the public is that they do not get into additional loan agreements, without assessing their current indebtedness and commitments. They should closely check all their repayments before taking a new loan to ensure that they can afford to repay and have a balance as sufficient take-home pay. We further encourage employer institutions not to encourage their staff to take many loans with various institutions, as over-indebtedness and stress over inability to pay all have an impact on productivity of staff, and the livelihoods of their families."

21 Ibid. He remarked: "We would like to highlight a very worrying trend that is starting to occur in Lesotho. We have observed a trend of reckless lending practices by some industry players which do not take into account the ability of the public to repay their loans, and still have enough to support their daily living. This kind of lending is not in the interest of clients, and creates a cycle of indebtedness.”
The Governor of the Central Bank of Lesotho (CBL), Dr. Retseleisitsoe Matlanyane, also raised a similar concern about the problem of reckless lending in Lesotho and the resultant consumer over-indebtedness. Speaking during the launch of a 2015 Money Week Campaign in Maseru in October 2015, Dr. Matlanyane indicated that a lot still had to be done to ensure that formal financial services reach the masses. It is submitted that this must have been in acknowledgement of the fact that the majority of reckless lending occurs in the less regulated or unregulated informal money lenders/credit providers where no pre-agreement affordability assessments are performed at all. Dr Matlanyane noted further that among those who have access to financial services, about 70 percent have access to informal financial services while the remaining 30 have access to formal financial services. She thus concluded that there is a prevalent over-indebtedness in the Basotho society that still needs to be addressed.

A recent study conducted in Lesotho confirms that access to finance is notoriously problematic for locally owned, private Small and Medium Enterprises (SMEs). The study showed that 71 per cent of micro enterprises and 56 per cent of small enterprises reported problems in accessing external funds. The most commonly mentioned factors that make access to finance problematic are the lack of appropriate collateral and high interest rates. As a result, the study held that the phenomenon of 'discouraged borrowers' is very significant in Lesotho. In the absence of bank financing, SMEs often turn to moneylenders. These moneylenders lend at rates sometimes in excess of 25 per cent per annum; when finance does not come forward, investment plans are postponed until enough cash can be raised internally. These trends in the SMEs space are equally true for the individual market.

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22 Money Week is an annual CBL roadshow aimed at raising financial literacy and awareness through activities that give the public information on basic issues related to money handling.
23 Dr. Matlanyane pointed out that a large part of the population of Lesotho is still excluded from the formal financial services and added “For example, CBL handles complaints from the clients as much as other financial institutions do. Most times one finds that the complaints we handle emanate directly from lack of financial literacy and education, both among our population and other players in the market.”
24 European Union delegation to the Kingdom of Lesotho-Remarks by the Head of the Delegation of the European Union to Lesotho, H.E. Ambassador Hans Duynhouwer on the occasion of seminar, ‘Improving access to credit under credit guarantees,’ Maseru, 24 July 2012 (European Delegation Study).
26 Ibid.
where the same moneylenders extend credit at exorbitant interest rates without conducting any due affordability assessment of borrowers.\textsuperscript{27}

A diagnostic report by FinMark in 2014 presented a comprehensive analysis of the financial inclusion environment in Lesotho as part of the Making Access Possible (MAP) Lesotho initiative. The implementation of MAP in Lesotho was officially requested in August 2013 by the Government of Lesotho, via the Ministry of Finance. The report also highlighted the limited uptake of formal credit thereby forcing the majority of Basotho to take up credit with informal and mostly under-regulated or unregulated lenders who do not practice responsible lending.

The study further outlined reasons why Basotho take on credit and it was found that the primary use of credit amongst Basotho is for “living expenses when you do not have money”, i.e. consumption smoothing, which is important for the target markets earning irregular or low incomes. It has been noted above that one of the chief reasons why many Basotho take on credit is for servicing existing debt and this is a clear sign of debt recycling arising out of over-indebtedness of credit consumers.

4.3 The regulatory framework for credit in Lesotho

The FinMark report indicated that the credit market in Lesotho is fragmented and probably one of the most underdeveloped financial sectors, especially for the low income market.\textsuperscript{28} In like manner, regulation of the credit market in Lesotho is equally fragmented while in some instances it is non-existent as will be shown later in this chapter. As remarked above, in the rural areas, access to formal credit is almost non-existent, and access depends on informal and community based financial services. In the urban areas, supply of credit is more tailored towards formally employed people. Besides the banks, the main providers of credit are non-bank credit institutions, registered money lenders, Non-Governmental Organisations (NGOs), Savings and Credit Cooperatives, village savings and loan associations\textsuperscript{29}, and

\begin{itemize}
\item \textsuperscript{27} Ibid.
\item \textsuperscript{28} European Delegation Study 92.
\item \textsuperscript{29} Also referred to as stokvels.
\end{itemize}
unregistered money lenders.\textsuperscript{30} There are two types of regulated money-lending institutions operating in Lesotho:

- Credit institutions (licensed under the Financial Institutions Act of 2012 as Type III institutions)

- Formal money-lenders (licensed under the Money Lenders Act of 1989).\textsuperscript{31}

Licensed credit institutions are limited to Lesotho’s capital, Maseru and target the employed market. However there are a large number of unlicensed money-lenders spread throughout the country. A large proportion of formal personal credit is also supplied by retailers and just like in the informal money lenders space, these retailers are not regulated and can charge as high and exorbitant interest rates as they please.\textsuperscript{32}

According to the Finmark report, access and usage of credit from \textit{machonisas}\textsuperscript{33} surpasses all other channels (both formal and informal). \textit{Machonisas} are reported to be playing a dichotomous role in Basotho society as they are seen as a beneficial, helpful ‘friend’ but are also resented for being expensive places to borrow from and being a contributing factor for respondents’ endless cycle of debt. They also use aggressive and sometimes violent tactics to get their money back from defaulting customers.\textsuperscript{34}

Informal credit has no eligibility barriers hence no regulatory buffer against reckless credit granting, such as the requirement of pre-agreement affordability assessment, exists in this unregulated sphere. Generally no proof of income, ID or proof of address is required to access formal credit. Most \textit{Machonisas} are willing to loan money regardless of employment status. However, customers also face associated risks when accessing credit from informal

\textsuperscript{30} Commonly referred to as \textit{Machonisas} both in South Africa and Lesotho.

\textsuperscript{31} FinScope 2011 shows that 10 per cent (120,000) of Basotho adults borrow from money-lenders. The qualitative demand-side analysis revealed that the use of \textit{Mashonisas} or informal moneylenders is entrenched in Basotho society.

\textsuperscript{32} See FinMark Report 101.

\textsuperscript{33} The word machonisa is a Zulu word meaning to “sink” and is used in the credit debt context to mean to sink into debt. See De Waal ‘Today’s loan shark feeding frenzy, tomorrow’s revolution’ available from www.dailymaverick.co.za/article Accessed on 24 July 2016. Although licenced by the Licensing division of the Ministry of Trade, \textit{Machonisas} remain unsupervised in the manner they extend and collect credit.

\textsuperscript{34} FinMark Report 101. The most common occurrences are of moneylenders sending their employees to customers’ homes to confiscate household appliances specified as collateral when the loan was first taken out. “They come to your house and take your fridge or your kettle when you don’t have the money to pay,” reported one female borrower in the FinMark report. Others mention instances when moneylenders would threaten or actually use violence to compel customers to pay up.
sources such as that ID documents and ATM cards may be withheld until the loan is repaid and that intimidation may be used against individuals with outstanding loans.\(^{35}\) Furthermore, the interest rates charged by informal moneylenders are substantially higher than those charged by formal providers hence borrowers run the risk of being dragged into a spiral of increasing debt if they cannot quickly pay off their loans.\(^{36}\) Focus group discussions indicated that interest rates charged by informal money lenders are on average 20 per cent month, but can range from 15 per cent to as high as 30 per cent per month.\(^{37}\)

There is however some measure of regulated credit take-ups in Lesotho. This relates to uptake of formal credit. In Lesotho, the main sources of formal credit are commercial banks, financial cooperatives, licensed microfinance institutions, licensed money lenders, (non-bank) financial institutions and retail stores. Arguably, some of these could be regarded as ‘semi-formal’ as they are registered but not currently supervised.\(^{38}\)

The adequacy of the credit regulation that does exist is unfortunately questionable. Although formal moneylending is regulated in Lesotho there is a lack of effective regulation and supervision of money-lenders, and inconsistent monitoring even across formal credit provider types.\(^{39}\) The FinMark Report found that the CBL, as central bank of Lesotho, that is \textit{inter alia} tasked with regulation of the credit market, does not monitor all types of registered credit providers.\(^{40}\) In recent years there has been a rapid increase in bank lending and a reduction in liquidity. In terms of the FinMark Report, significantly the banks’ Non-performing Loan Books (NPL) ratio rose from 2.5 per cent in the second quarter of 2012 to 3.5 per cent in the following quarter.\(^{41}\) The FinMark report found further that the rise in the NPL books across all the commercial banks in Lesotho is a direct indication that even the consumers of formal credit, obtained through commercial banks, are also over-indebted.\(^{42}\)

Whilst the absolute level of NPLs is still low, with about 40 per cent of participants in the survey indicating outstanding debt obligations, this is still a significantly large number of over-indebted borrowers in a market small as Lesotho.

\(^{35}\) FinMark Report 101. 
\(^{36}\) Ibid. 
\(^{37}\) Ibid. 
\(^{38}\) Ibid. 
\(^{39}\) Ibid. 
\(^{40}\) FinMark Report 101. 
\(^{41}\) Finmark Report 99. 
\(^{42}\) Ibid.
There are also a lot of unregulated/informal credit take-up, other than lending from machonisas, which include: those who borrow money from their employers, savings groups, informal savings groups, unlicensed money lenders, community-based organisations, burial societies as well as registered Rotating Savings and Credit Groups (RSCGs). As indicated above, there are also those without regulated or unregulated services who borrow money from family or friends that they have to pay back. These types of group lending at the grass roots level are supposed to be registered and regulated under the Societies Act but they do not register and there is no supervision in this market. These institutions are permitted to open deposit accounts but regulation and supervision is as good as non-existent as participants in this sector engage in a lot of lending at excessive interest and without any affordability checks prior to extending credit to borrowers often leading to consumer over-indebtedness.

Whereas the Ministry of Finance is the financial sector policymaker, the regulatory system for the Lesotho financial system is based in the Central Bank of Lesotho (CBL). The CBL is responsible for regulating banks and non-bank financial institutions (NBFIs), as well as the payments system and capital markets.

On the payments systems front, the Payment Systems Act whose object is to ensure that Lesotho has a safe, reliable and sound interbank payment system, excludes all non-bank payment methods and as such some of the rather unconventional collections methods used by money lenders in the informal financial sector are left unregulated. Payment methods that are used by some of the money lenders tend to also contribute to consumer over-indebtedness as they would go to the extent of taking borrowers’ assets which have not been placed as collateral and would sell them at much lower prices than their market value.

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43 FinMark Report 101.
44 Societies Act 20 of 1966.
45 FinMark Report 102.
46 Ibid.
47 Lesotho uses a single financial sector regulator model being the Central Bank of Lesotho.
48 Including credit-only and deposit-taking Micro-finance institutions (MFIs), insurers, money lenders, money transfer operators, etc.
49 Payment Systems 55 of 2014.
50 FinMark Report 101.
The Lesotho system therefore differs from other systems, which often have two financial sector regulators. The CBL derives its authority from the Central Bank of Lesotho Act, which sets out the general powers and responsibilities of the Bank.

However, a certain amount of detailed regulatory responsibilities are set out in a range of other legislation. The most far-reaching instrument of CBL legislation is the Financial Institutions Act (FIA). In the preamble to the FIA it is stated that it is “An Act to repeal and replace the Financial Institutions Act, 1999, to provide for the authorisation, supervision and regulation of banking and non-banking financial institutions, agents of financial institutions and ancillary financial service providers and for related matters”. Essentially thus the FIA provides the framework for prudential supervision of banks and non-bank financial institutions. It contains a provision in section 71 which bears the heading “credit requirements” but on closer inspection of this section it is evident that it has nothing to do with credit regulation per se but rather with regulation of credit risk by the central bank who is also referred to as the “Commissioner” in terms of the FIA. The powers of the CBL (Commissioner) to issue regulations in terms of FIA is set out in section 72 although it needs to be remarked at this point that it is unclear from a reading of section 72 exactly where the

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51 For example the envisaged Twin-Peaks model system in South Africa as set out in the Financial Sector Regulation Bill tabled before Parliament on 27 October 2015.

52 2 of 2000.

53 Financial Institutions Act 21 of 2012, the 2012 FIA repealed and replaced the 1999 FIA.

54 S71 of FIA provides as follows: “Credit Requirements

(1) A Director or officer of a licensed institution shall not give any credit facility in excess of the credit limit, or outside the scope of any terms and conditions, imposed on him or her by the licensed institution, or in contravention of any directions given to him, or any agreement made with him, by the licensed institution.

(2) The Commissioner may, by written notice, direct a licensed institution to-

(a) submit any information relating to its policy and procedure for the grant of any credit facility;

(b) submit a report on the limit or the terms and conditions imposed, the directions given, and the agreements made, in relation to the authority of every director or officer of the institution authorised to give credit facilities or exercise any power in respect thereof; or

(c) make such amendments to the policies or procedures referred to in paragraph (a), or to make such variations in the matters mentioned in paragraph (b), as the Commissioner deems to be fit and proper, either generally, or in relation to any class of director or officer, and such amendments and variations shall be binding on the institution and its directors and officers.”

55 S2 of FIA defines “Commissioner” to mean the Central Bank of Lesotho established by the Central Bank of Lesotho Act 2000
power to make regulations pertaining to various aspects of credit is derived from as most of the aspects mentioned in this section pertain to prudential aspects.

Nevertheless, there are many regulations promulgated under the FIA which give effect to some of the provisions of the FIA. A few of these regulations, which are relevant for purposes of this dissertation, will be examined below. The first of these regulations are the Financial Institutions (Lending Limits) Regulations of 1999\textsuperscript{56} which are intended, \textit{inter alia}, to prevent a financial institution from making unduly large exposure to a single borrower or a group of connected borrowers.\textsuperscript{57}

\subsection*{4.3.1 The Financial Institutions (Lending Limits) Regulations}

Regulation 5(1) provides that a financial institution must have an adequate management information system that shall enable it at all times to identify large exposures within its loan portfolio and to ensure compliance at a consolidated level (head or main office and branches) with the following lending limits under section 25 of the Financial Institutions Act 1999 - 25 per cent of unimpaired capital and reserve account for total direct or indirect advances, credit facilities or financial guarantees to any person, single borrower, or group of connected borrowers, subject to certain exclusions enumerated in the Act and one per cent of unimpaired capital and reserve account for aggregate direct or indirect unsecured advances or credit facilities to any one of its directors or officers or to any other related persons.\textsuperscript{58}

Although these regulations are primarily aimed at managing concentration risk of financial institutions, it is submitted that they have a secondary effect of minimizing borrowers’ over-indebtedness. Overly lending to a single borrower can lead to that borrower taking more debt than they need and it can in turn lead to over-indebtedness of the said borrower. These regulations are however limited in that they do not provide guidelines or directives

\textsuperscript{56} Financial Institutions (Lending Limits) Regulations available from the CBL website http://www.centralbank.org, accessed on 20 February 2016 (hereinafter referred to as the FIA Lending Limits regulations).

\textsuperscript{57} FIA Lending Limit Reg 3 states that “The Regulations are intended to prevent a financial institution from making unduly large exposure to a single borrower or a group of connected borrowers or to any one of its directors or officers or to any other related persons under section 25 (1) (c) (ii) and (iii) of the Financial Institutions Act 1999 and to ensure that all insider loans and advances made by a financial institution are on terms not more favourable than those afforded other borrowers.”

\textsuperscript{58} 25 (1) (c) (ii) and (iii) of the Financial Institutions Act 1999.
on whether and how a financial institution should conduct pre-agreement affordability assessments of borrowers and it is submitted further that even though lending can be capped within the single borrower limits imposed by the regulations, if affordability tests of the borrower have not been done by the lender prior to concluding a credit agreement, that can still amount to reckless lending and in turn lead to over-indebtedness of the borrower.

4.3.2 The Financial Institutions (Loan Portfolio Classification) Regulations

Another set of regulations under the FIA worthy of examination for purposes of this dissertation are the Financial Institutions (Loan Portfolio Classification) Regulations which apply to all registered financial institutions in Lesotho. These Regulations are intended to ensure that:

(a) all loans and advances from financial institutions are regularly evaluated using objective classification criteria;

(b) the accounting treatment of accrued but uncollected interest on non-performing accounts of financial institutions is in accordance with internationally-accepted accounting principles; and

(c) the allowance for loan losses or provisioning is maintained at an adequate level at all times.

The regulations further stipulate that a financial institution must establish and adhere to adequate policies, practices and procedures for evaluating the quality of its loan portfolio and the adequacy of its provisions for probable losses. All financial institutions are further required to conduct a qualitative appraisal of their loan portfolios comprising all loans,

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60 FIA Portfolio Reg 4 states that: “these Regulations apply to all licensed financial institutions in Lesotho.”
61 FIA Portfolio Reg 3.
62 FIA Portfolio Reg 5(1). In terms of regulation 14, the loan portfolio must be classified into the 5 categories listed in regulation 18 using the criteria stated in that regulation. The criteria must be used by a financial institution for loan portfolio review as at 30th June and 31st December of each year and by the examiners of the Central Bank of Lesotho for loan classification purposes
overdrafts, receivables, and other extensions of credit at least quarterly coinciding with the end of a calendar quarter.\(^{63}\)

Notwithstanding sub-regulations (1) and (2) above, a summary of the consolidated (head or main office and branches) loan portfolio review as at 30 June and 31 December of each year must be prepared and submitted to the Central Bank not later than the end of the following month in the prescribed form as set out in the Schedule and each review must cover at least 70 per cent of the loan portfolio and, must include the following:\(^{64}\)

(a) large loans to single borrowers or a group of borrowers above 1 per cent of the loan portfolio;

(b) all past-due accounts;

(c) all non-performing accounts;

(d) all identified problem accounts; and

(e) large off-balance sheet commitments above 1% of the loan portfolio.

The basis of the loan portfolio classifications is set out in regulation 15(1) of the FIA Portfolio Regulations. In general, it is stated that the evaluation of each account must be based upon the creditworthiness of the particular borrower. The focus of the assessment must be the ability of the borrower to repay the account and the assessment must reflect all relevant factors as of the evaluation date that affect the collectability of principal and interest on the loan. These factors include the debtor’s payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects. Significant departure from the primary source of repayment may warrant adverse classification\(^{65}\) even if a loan is current and supported by underlying collateral value or

\(^{63}\) FIA Portfolio Reg 5(2).

\(^{64}\) FIA Portfolio Reg 5(3).

\(^{65}\) Although the phrase adverse classification is not defined in both the FIA and the Regulations, a closer reading of the Financial Institutions (Loan Portfolio Classification) Regulations would lead one to conclude that adverse classification means categorising the loan as potential non-performing loan or a bad debt. Reg 5.(1) states that ‘A financial institution shall establish and adhere to adequate policies, practices and procedures for evaluating the quality of its loan portfolio and the adequacy of its provisions for probable losses; read with Reg 8 which states that ‘An account shall be reported as non-performing when – (a) for a loan or an account with fixed repayments dates – (i) the principal or interest is due and unpaid for 3 months or more; or (ii) the interest charges for 3 months or more have been capitalised, refinanced, or rolled-over; (b) for an overdraft or
guarantees.\textsuperscript{66} Adverse classification may also be appropriate if repayment terms originally were too liberal or if a delinquency has been technically cured by modification of terms, refinancing or additional advances.\textsuperscript{67}

It is further stated that the loan classification exercise must not depend on the amount or quality of collateral pledged.\textsuperscript{68} Collateral shall be regarded as a secondary source of repayment and therefore will only be considered in assessing the amount of provision required.\textsuperscript{69}

If a financial institution fails to comply with these Regulations in a flagrant manner which results or threatens to result in an unsafe and unsound financial condition, the CBL may pursue any remedial measures at its disposal, including requiring the financial institution to take any or all of the following measures:\textsuperscript{70}

(a) require the infusion of additional capital to absorb probable losses in the loan portfolio;
(b) suspend lending, investment or other credit extension operations;
(c) restrict declaration or payment of dividends or remittance of profits;
(d) stop establishment of new branches or facilities; and
(e) prohibit payment of bonuses, salary incentives, management fees or other discretionary compensation to directors or officers.

It is clear that these regulations focus on the after-the-fact credit risk management of financial institutions and would therefore not address the pre-credit granting reckless lending practices by financial institutions. Although these regulations serve as a credit risk management mechanism and have the force of the regulatory compliance from the CBL, they do not enforce responsible lending by credit providers falling under the supervision of

\textsuperscript{66} Reg 15 (5).
\textsuperscript{67} Reg 15 (5).
\textsuperscript{68} Reg 16(1).
\textsuperscript{69} Reg 16(2).
\textsuperscript{70} Reg 27.
the CBL as the determination of the collectability of loans and credit worthiness of the borrower is performed as an after the fact exercise when the loan has been in existence for some time and not before a credit agreement is concluded. The regulations can therefore not substitute a proper pre-agreement affordability regulatory model for consumer credit.

**4.3.3 The Credit Reporting Act**

As the financial sector in Lesotho evolves and new institutions and products develop, the regulatory framework is slowly being updated and modernised. These reforms center around both institutional capacity and legal reform. Like many countries that have passed laws on credit bureaus and that have issued guidelines and regulations, Lesotho has also enacted a credit bureau enabling law in the form of the Credit Reporting Act (CRA).  

One of the purposes of the CRA is to regulate the use of customer credit information for risk management purposes by credit providers and the establishment of Lesotho’s first credit bureau system and to promote participation of the consumer in the credit reporting system by providing for consumer rights. The intention of the CRA is inter alia to promote responsible lending by credit providers. The CRA applies to all credit providers in the Kingdom of Lesotho and the CBL is responsible for enforcing compliance with the provisions of the CRA. One of these supervisory functions of the CBL under the CRA is to monitor levels of consumer indebtedness and incidences of over-indebtedness.

In terms of the CRA a registered credit bureau may receive credit information from the following sources: an organ of state; a provider of goods and services; a credit provider; a provider of financial services; an insurance provider; educational institutions; an employer; debt collectors; and the consumer to whom the information belongs.

In terms of sections 22 to 23 of the CRA, aside from supplying a credit bureau with a consumer’s name, address, date of birth, telephone number, ID number and place of work,

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71 6 of 2011.
72 The Preamble of the Credit Reporting Act states that that CRA provides for the regulation of the credit reporting system in accordance with international standards and information protection principle and as provided for in legislation relating to data protection, and for the use of credit information (of credit consumers- my emphasis) by credit providers for credit risk management and the Central Bank of Lesotho and for licencing of a private credit bureau operators and for the provision of technical credit bureau services.
73 Chapter 2, s7.
74 S8 (e).
75 Ss 19 (1) (a) to (k).
credit providers must ensure that the information supplied to a credit bureau is accurate, complete, not misleading and updated regularly. They must also ensure that submitted information is secure so as to prevent unlawful access to the information and must give notice to a consumer prior to submitting adverse information about the consumer to the credit bureau.

Interestingly section 30 of the CRA states that a credit provider must, prior to extending credit, take “reasonable steps” to assess the prospective consumer’s ability and likelihood to satisfy the debt obligation by considering the consumer’s debt repayment history; and financial means, prospects and other obligations. There is however no mention in the CRA regarding assessment of the consumer’s understanding of the risks, costs and obligations related to the proposed credit before the credit agreement can be entered into.

Failure by a credit provider to comply with the pre-agreement assessment requirement is an offence under the CRA.\footnote{S 30 (3).} Section 40 of the CRA gives a blanket penalty of a fine not exceeding M250,000 for any offence committed under the CRA. It is further to be noted that the CRA provides that a credit provider “may” access credit information from a registered credit bureau to meet these assessment obligations. The use of the word “may” with regard to access of credit bureau information however means that it is not obligatory for a credit provider to conduct credit history checks from credit information held by a credit bureau. Apart from the fact that it is questionable whether the CRA is the appropriate piece of legislation to house the requirement that credit providers conduct pre-agreement assessments on consumers before extending credit, it is further submitted that this discretion on the part of credit providers may have the effect that some credit providers may not conduct efficient credit history and repayment checks on prospective borrowers thereby resulting in inefficient and unreliable affordability assessments.

The CRA is not comprehensive with regard to its provisions pertaining to pre-agreement assessment requirements and by not containing more comprehensive prescriptions in this regard it gives a lot of leeway to credit providers to determine how to do pre-agreement assessment in respect of credit hence it is submitted that reckless lending is not suitably prevented. Another challenge with the CRA relates to the reliance that is placed by credit
providers on the customer credit data processed by the credit bureau - the integrity of this data in Lesotho has been under the spotlight and criticized by not only the consumers but even by some of the credit providers themselves. A further challenge with the credit data processed by the credit bureau is its incompleteness at this stage since most of the micro-finance players are neither participating in the bureau by way of providing their own borrowers’ credit performance information nor accessing other credit providers’ customer information in order to conduct affordability assessments of prospective borrowers. It is therefore clear that the CRA although making some attempt at regulating pre-agreement assessment in order to curb reckless lending and the resultant consumer over-indebtedness lags far behind South Africa and what can be regarded as international best practice in the context of pre-agreement assessment as indicated in Chapter 2.

The single regulator model poses yet another challenge for credit regulation and specifically development of proper pre-agreement assessment mechanisms in Lesotho. The wide span of regulatory responsibility borne by the CBL means that, at times, it suffers from capacity constraints and cannot effectively dedicate the necessary energy to credit law reform. Furthermore, the process of drafting and passing new legislation is very slow.

It is also noteworthy that even in the more formal credit market, the FIA does not contain any interest rate cap. Financial institutions are therefore left with the discretion of charging high, sometimes excessive interest rates which often lead to over-indebtedness of borrowers who would otherwise have afforded the credit extended to them if interest rates charged were reasonable. Financial institutions generally design their own credit scoring criteria, without any supervisory or regulatory guidelines or oversight and due to lax enforcement by the CBL occasioned by capacity restraints, they often get away with granting credit without performing proper affordability assessments and with charging unreasonable interest rates which only lead to consumer over-indebtedness.

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77 This has constantly been raised by representatives from the credit providers community in various stakeholder engagements between the CBL and credit providers wherein I am one of the founding 3 directors of the Credit Providers Association of Lesotho. See website of the Ministry of Trade and Industry, Company Registry Department. www.obfc.org.ls/registry. (Accessed 15.03.2016)

78 This was presented to the Credit Providers Association on 20 November 2011, at a progress report on the work of Compuscan, a private credit bureau company engaged by the CBL for provide credit bureau services in Lesotho. (Unpublished)

The only interest rate cap currently in place is under the Money Lenders’ Act, but it is not enforced in practice. Moneylenders regulated under the Money Lenders Act are subject to “regulatory forbearance”, in that the CBL has only enforced its regulatory powers to a limited extent due to limited capacity, thereby effectively allowing them to operate in a virtually unregulated manner. The Money Lenders Act includes a prohibition on advertising and promotion, and a cap of 25 per cent, per annum on interest rates on loans. Both of these conditions are ignored by money-lenders and there appears to be no attempt at enforcement. It is submitted that although this does not give rise to systemic credit risks, it may lead to consumer protection and regulatory credibility being undermined.

Reckless lending practices appear to be prevalent under micro-lenders in Lesotho. For many years micro-lenders have been getting away with not only neglecting to conduct affordability assessments of prospective borrowers but also with charging excessive

81 Ibid fn84.
82 S16 states: (1) No person shall knowingly send or deliver or cause to be sent or delivered to any person except in response to his written request any circular or other document advertising the name, address or telephone number of a money-lender, or containing an invitation. (a) to borrow money from a money-lender; (b) to enter into any transaction involving the borrowing money from a money-lender; or (c) to apply to any place with a view to obtaining information or advice as to borrowing any money from a money-lender (2) Save as hereinafter provided, no person shall publish or cause to be published in any newspaper or other printed paper issued periodically for public circulation, or by means of any poster or placard, an advertisement advertising any such particulars, or containing any such invitations, as mentioned in subsection (1): Unlawful use of moneylender’s licence, provided that, an advertisement in conformity with the requirements of this Order relating to the use of names on money-lenders’ documents may be published by or on behalf of a money-lender, (a) in any newspaper or in any such paper as aforesaid; or (b) by means of a poster or placard exhibited at any authorized address of the money-lender, if it contains no addition to the particulars necessary to comply with the said requirements except any of the following particulars, (i) any authorized address at which he carries on business as a money-lender; the telegraphic address and telephone number thereof; (ii) the address at which he formerly carried on business; (iii) a statement that he lends money with or without security, and of the highest and lowest sums that he is prepared to lend; and (iv) a statement of the date on which the business carried on by him was first established. (3) No money-lender or any person on his behalf shall employ any agent or canvasser for the purpose of inviting any person to borrow money or to enter into any transaction involving the borrowing of money from a money-lender, and no person shall act as such agent or canvasser, or demand or receive, directly or indirectly any sum or other valuable consideration by way of commission or otherwise for introducing or undertaking or to introduce to a money-lender any person desiring to borrow money. (4) Where any document issued or published by or on behalf of a money-lender purports to indicate the terms of interest upon which he is willing to make loans or any particular loan, the document shall express the interest proposed to be charged in terms of a rate per centum per annum or show the rate per centum per annum represented by the interest proposed to be charged as calculated in accordance with the Schedule. Prohibition of unauthorized dealings In money Restrictions on moneylending ads. (5) A person who contravenes this section commits an offence and is, in respect of each offence for which he is convicted, liable to a fine of M2,000 or to imprisonment for a period of 2 years. (6) Where it is shown that a money-lending transaction was brought about by a contravention of any provision of this section, the transaction shall, notwithstanding that the moneylender was duly licensed under this Order, be void and unenforceable unless the money-lender proves that the contravention occurred without his consent or connivance.
83 See par 3.2 of chapter 3.
amounts over and above the principal amounts they lend to borrowers, often leading to over-indebtedness of borrowers and “debt recycling” with the majority of borrowers going from one money lender to the other. This reckless lending practice was eventually challenged by some borrowers in 2009 and came before the Lesotho Court of Appeal in the same year.

The court in Afrisure Finance and Another v Lechaka and Others was tasked with, inter alia, deciding whether initiation, administration, collection and membership fees and insurance premiums charged to borrowers and paid to lenders were prohibited under section 20 (1) of the MLA. The interest charged by the money lender in respect of the loans it granted to the applicants and which was in excess of 25 per cent per annum was declared null and void and unlawful. It was declared that the first respondent was not entitled to recover charges in respect of the administrative fee, insurance and initiation fee from the applicants in as much as the said charges were in conflict with the terms of the Money Lenders Order. It was held further that the interest charged by the money lenders exceeded the rate of 25 per cent per annum, or the corresponding rate in respect of any other period. The court held that it would presume for the purposes of section 13 of the MLA that the interest charged was excessive and that the transaction was “harsh and unconscionable”. It is submitted that this can be regarded as a clear pronouncement by the appeal court that lending by the money lenders in excess of the prescribed interest rate of 25 per cent amounted to reckless lending.

The court held further that where proceedings are taken in any court by a money-lender for the recovery of any money lent after the coming into operation of the MLA, or the enforcement of any agreement, or security made or taken after the coming into operation of the Act; and there is evidence which satisfies the court that the interest charged in respect of the sum actually lent is excessive, or that the amounts charged for expenses, inquiries, fines, bonus, premium, renewals or any other charges, are excessive, and that, in

84 Ibid fn 84 at 101.
85 See Afrisure Finance and Another v Lechaka and Others, Makhulong Multi Finance (Pty) Ltd t/a B. Blue Financial Services v Nona and Others, Select Management Services Lesotho (Pty) Ltd v Ratlali and Others (C of A (CIV) 29/09, C OF A (CIV) 30/09, C of A (CIV).
86 Ibid. fn 80.
87 Par 29.
89 Par 41 to 44.
either case, the transaction is “harsh and unconscionable”, or is otherwise such that a court of equity would give relief then the court may:

(a) reopen the transaction, and take an account between the money-lender and the person sued;

(b) notwithstanding any statement or settlement of account or any agreement purporting to close previous dealings and create a new obligation, reopen any account already taken between them;

(c) relieve the person sued from payment of any sum in excess of the sum adjudged by the court to be fairly due in respect of such principal, interest and charges, as the court, having regard to the risk and all the circumstances, may adjudge to be reasonable;

(d) and if any such excess has been paid or allowed in account by the debtor, may order the creditor to repay it and may set aside either wholly or in part, or revise or alter any security given or agreement made in respect of money lent by the money-lender and if the money-lender has parted with the security, may order him to indemnify the borrower or other person sued.90

4.3.4 The Hire Purchase Act

On the asset finance front, there is inadequacy of regulation in Lesotho in addressing reckless lending as well. There are two pieces on legislation in this regard. I wish to firstly highlight provisions of the Hire Purchase Act 91 (HPA) which regulates hire purchase agreements92 and instalment sale agreements93. Section 4 of the HPA, stipulates that before

90 Par 13.
91 27 of 1974.
92 S 2(1) of the Hire Purchase Act defines Hire Purchase Agreement as any agreement whereby goods are sold on condition that ownership in such goods shall not pass merely by the transfer of the possession of such goods, and the purchase price is to be paid in instalments, two or more of which are payable after the transfer; and includes any other agreement which has or two or more agreements which together have the same import, whatever form such agreement or agreements may take.
93 S 2(1) of the Hire Purchase Act defines Instalment Sale Agreements as any agreement of purchase and sale whereby ownership of the goods sold passes upon delivery, and the purchase price is to be paid in instalments, two or more of which are payable after delivery, and under which the purchaser is prohibited from alienating or encumbering the goods sold until the full purchase price has been paid and the full purchase price becomes payable if the purchaser alienates or encumbers the goods sold and the seller would be entitled to the return of the goods if the purchaser fails to comply with any one or more provisions thereof; and includes any other agreement which has or two or more agreements which together have the same import, whatever form such agreement or agreements may take.
any agreement is entered into, the prospective seller must state in writing to the prospective buyer, otherwise than in any note or memorandum of the agreement, a price at which the goods to which the agreement relates may be purchased from the seller for a cash amount in money. Apart from this duty of disclosure of the purchase price, there is no requirement to perform an affordability assessment of the prospective buyer by the seller and this aspect has also not been addressed by amending the Hire Purchase Act in this regard. It is not surprising therefore that a lot of furniture shops and other asset finance credit providers in Lesotho have taken advantage of this lacuna in the legislation and are advancing reckless credit to consumers only to repossess the same assets a few months into the instalment agreement because the consumer became over-indebted as a result of that particular credit agreement and cannot afford the instalment payments.

4.3.5 The Financial Leasing Regulations

The CBL has recently issued Financial Leasing Regulations which apply to all financial leasing transactions: Regulation 6 states that a lessor and lessee are free to determine terms of their lease financial lease agreement. Regulation 32 stipulates that a financial leasing company, being the credit provider, must design, adopt and put in place systems and processes addressed to identify, manage and mitigate inter alia credit risks. The regulations require financial leasing companies to employ a credit risk management system that uses a universal methodology which assesses credit risks by determining the following factors: probability of default of the borrower (lessee); loss given default and exposure at default. It is required that the financial leasing company must calculate, in terms of its internal processes and guidelines which must be given by the commissioner, a “probability of default” of each lease. Although the timing of the assessment is not expressly stipulated in the regulation, it can be assumed that this should be done prior to concluding a financial leasing agreement by the lessor and lessee. This deduction is drawn from Regulation 33(5)

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94 22 of 2013.
95 Reg 2 of the Financial Lease Regulations 22 of 2013 defines a Finance Lease as a contract between as lessor and a lessee, having as its main purpose the conveyance of use of an asset, with or without to purchase all or part of the asset, as specified under regulation 5, (Regulation 5 lists characteristics of a financial lease such as identity of the parties, description of the asset, rental amounts, duration of the lease etc) and includes a sub-lease, sale and lease-back transaction and micro-lease.
96 Defined under Reg 33 (1) as the likelihood that a financial lease will not be paid or will fall into default.
97 Defined under Reg 35(1) as the amount actually at risk in the event of default.
98 Guidelines have not been issued yet.
which states that the information about the credit history of a prospective lessee and nature of their investment should be taken into account in calculating a “probability of default”. While it is encouraging that these regulations provide expressly that financial leasing companies should perform some form of assessment prior to concluding leasing agreements with prospective lessees, it is clear that the intention of the regulations are primarily to help credit providers to manage their credit risks and are not aimed at preventing reckless credit granting and curbing lessees’ over-indebtedness.

4.3.6 The Financial Institutions Credit Only and the Deposit Taking Micro-Finance Regulations

The only piece of legislation which regulates extension of credit and seeks to expressly regulate reckless lending in Lesotho is the 2014 Financial Institutions Credit Only and the Deposit Taking Micro-Finance Institutions Regulations, issued pursuant to the Financial Institutions Act of 2012. It must be noted however that these regulations apply only to deposit taking micro-finance institutions and credit only micro-finance institutions and to those which have been licensed as such by the Regulator.

There are three important sections of these regulations for purposes of this study which are examined below: In Part III, regulation 11(1) regulates protection of credit consumer rights; regulation 12 regulates right of credit consumers to information; and regulation 14 regulates protection of credit consumers from reckless lending practices. Regulation 11 provides for non-discrimination of credit applicants and sets out various grounds which would constitute discrimination. It goes further to indicate that a borrower who does not have a source of income or is unemployed would not be deemed to have been discriminated against if turned down by a credit provider. Sub-regulation 5 states that a credit provider (licensee) may reject a borrower’s application for a credit facility on the basis

99 Deposit Taking Micro-Finance business means a business carried on as a principal business of acceptance of deposits from low income members of the public and employing such deposits wholly or partly by lending or extending credit for the account and risk of the person accepting those deposits, including provision of short-term loans to small or micro-enterprises and low income households, usually characterized by the use of collateral substitutes such as group guarantees or compulsory savings-Part I section 2 of the Regulations.

100 Credit – only micro-finance institution is defined under Reg 2 as a business which is licenced to provide uncollateralized short-term loans to small or micro-enterprises and low income households and which does not take deposits from the public-Part I section 2 of the Regulations.

101 Regulation 11(3) (c).
of an affordability assessment which may determine that the borrower may not have the financial means to meet the obligations of the credit agreement.

There is furthermore a duty of disclosure on credit providers imposed by regulations 13 and 16.\textsuperscript{102} Prior to entering into a credit agreement with a licensee, a borrower has the right to a free printed copy of the pre-agreement quotation and statement in one of the official languages of Lesotho.\textsuperscript{103} Subsection 2 goes further to state that the terms of a written credit agreement provided to a borrower must clearly show the terms of the agreement and a prospective borrower must be given an opportunity to peruse the terms of the agreement prior to entering into a credit agreement. It is submitted that this duty imposed upon credit providers to disclose the terms of the intended credit agreement prior to entering into the credit agreement with a prospective borrower may serve the purpose of affording the borrower an opportunity to weigh the pros and risks, including the risk of not being able to afford the repayments of the credit obligations, prior to entering into the credit agreement.

Regulation 14 constitutes a landmark provision in the context of credit regulation in Lesotho as it provides for the regulation of reckless lending with a view to curbing consumer over-indebtedness for the first time in the credit history of Lesotho. The Financial Institutions Credit Only and Deposit Taking Micro-Finance Institutions Regulations of Lesotho bear noticeable resemblances to the South African NCA. The regulations define credit agreements that would be considered reckless\textsuperscript{104} and those that shall not be deemed to be reckless\textsuperscript{105} and set out factors which would determine whether a credit agreement is reckless or not. Accordingly it is provided that a credit agreement shall be deemed reckless for purposes of these regulations if:

(a) as part of the application process, at the time of granting the loan or increasing the limit on an existing loan, a licensee fails to perform a reasonable assessment of the borrower’s affordability and ability to meet the obligations in terms of the agreement;

\textsuperscript{102} Regulation 16 prescribes the type of information which credit providers must disclose in writing to a borrower upon signing of a credit agreement and these include: nature of the agreement; the amount of credit applied for; the total charge for credit including fees, charges and interest; the total amount payable; the timing and frequency of the repayments and the amounts of repayments etc.

\textsuperscript{103} Being either Sesotho or English.

\textsuperscript{104} Reg 14(1).

\textsuperscript{105} Reg 14(2).
(b) a licensee fails to collect information to reasonably corroborate a borrower’s existing financial means and obligations’

(c) a micro-finance service provider enters into a credit agreement with a borrower despite the fact that the borrower’s loan application assessment indicated that by entering into such a credit agreement, the borrower would not be able to fulfil the obligations of the credit agreement or would be over-indebted;

(d) a licensee fails to demonstrate or explain the terms and conditions of the agreement including the total cost of credit to the borrower.

As indicated, the Regulations stipulate that as part of the application process, at the time of granting the loan or increasing the limit on an existing loan, the credit provider must perform a reasonable assessment of the borrower’s affordability and ability to meet the obligations of the credit agreement. While no court has yet interpreted what this means in terms of the timing of the pre-agreement assessment, it is submitted that a reasonable interpretation of the above text “as part of the application process, at the time of the granting of the loan” means that the pre-agreement affordability and ability assessment of the prospective borrower by the credit provider must be conducted prior to concluding a credit agreement and during the loan application and approval processes.

The Regulations thus place the obligation to perform an affordability assessment on the credit provider although prospective borrowers also have a role to play in the assessment process in terms of furnishing complete, truthful and accurate information or documents for purposes of enabling the credit provider to conduct the affordability assessment.106

From the text of regulation 14 that provides the definition of what would constitute a reckless credit extension, especially the first three incidents outlined above, it would appear that Regulation 14 seeks to prevent reckless lending through imposing an obligation on credit providers to perform a reasonable pre-agreement assessment of a prospective borrower which assessment must be conducted through collection of information to reasonably corroborate a borrower’s existing financial means and obligations. It further appears that the pre-assessment has to occur pursuant to the credit provider having

106 Reg 14 (2).
explained the terms and conditions including cost of credit to the consumer although it is possible to interpret Regulation 14 too indicate that this explanation can also be provided during the assessment. Although the Regulations do not provide for credit to constitute reckless credit the assessment indicates that the consumer does not understand the risks, costs and obligations related to the proposed credit it appears that the requirement that the credit provider explains these aspects at least point to the intention that it will serve to facilitate an understanding by the consumer of these risks. It is therefore submitted that apart from the obligation to perform a pre-agreement assessment of the borrower’s affordability and ability to meet the obligations of the credit obligations, there is an extra layer of duty imposed by Regulation 14 on the credit provider to collect information on the borrower’s financial means to repay and also to provide certain relevant explanations of aspects that may impact on such ability to repay. It is however not clear what would constitute information “reasonable to corroborate a borrower’s existing financial means and obligations” as the Regulations provide no further guidance in this regard. It is submitted further that from the same text, it would appear that Regulation 14(1)(a) read with Regulation 14(2) imposes a duty on the prospective borrower to furnish information on their existing financial means and obligations to the credit provider in order to enable the credit provider to perform a pre-agreement assessment. Thus insofar as collection of information is concerned, both parties have obligations: the credit provider to collect certain information (which arguably has to be collected not only from the consumer but also from other sources) and the consumer has the obligation to furnish certain information to the credit provider. It is submitted that logically the credit provider will request certain (reasonable) information form the consumer and the consumer must then provide this information and related documents that must be complete, truthful and accurate.

It is further to be noted that the Regulations provide credit providers with defences to any claim of reckless lending if the following factors exist:¹⁰⁷

(a) if a borrower failed to furnish the licensee with all the required information or supporting documentation to allow for a reasonable assessment of the borrower’s affordability and ability to meet the obligations of the credit agreement;

¹⁰⁷ Ibid.

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(b) if a borrower provided the licensee with incomplete, false or inaccurate information to perform a reasonable assessment of the borrower’s ability to meet the obligations of the credit agreement.

It is clear therefore that failure to disclose key information by the consumer provides a defence against allegations of reckless credit granting to credit providers although the Regulations are silent on the obligation on the credit provider to verify information provided by the borrower.

At face value, the reckless lending provisions in the aforesaid regulations seem to go quite some way in terms of preventing consumers in Lesotho from taking up too much credit in the first place and becoming over-indebted in the process. It is furthermore comforting that the issue of the prevention of reckless lending has at least received some attention, even though not comprehensive in nature. A surprising feature of the Regulations is however that they do not provide for any remedies to a credit consumer to whom credit has been extended credit recklessly, nor do they provide for any sanction to a credit provider who is found to have extended credit recklessly. Presumably one will have to fall back on the CRA which makes reckless lending an offence. One can accordingly ask whether this fragmented approach to the regulation of reckless credit is at all appropriate?

The regulations do not prescribe any model or methodology according to which the pre-agreement assessment must be conducted save to state that a credit provider may establish a mechanism to “reasonably assess” a borrower’s ability to meet the obligations in terms of the agreement if the method is “fair and objective”. It is however provided that the Commissioner may publish specific guidelines or instruments on how this assessment should be performed.\(^{108}\) It is further provided that where guidelines have been published failure by a licensee to apply these guidelines shall be deemed reckless lending.\(^{109}\) To date no guidelines have been issued and published to give more uniform guidance on what would constitute a “reasonable assessment of the borrower’s ability to meet their credit obligations”.

\(^{108}\) Reg 14 (3).
\(^{109}\) Reg 14 (4).
Unlike in South Africa where there is a number of court decisions that have sought to provide a certain degree of clarity on at least the assessment criteria in section 81(2) (although not yet on the final Affordability Regulations), there has not been any litigation regarding the Lesotho Regulations and they have thus not been tested. Furthermore there is a serious lack of consumer awareness of the rights set out in this piece of law and thus consumers are unable to challenge some of the practices of reckless lending by micro finance credit providers and enforce their rights as provided by in the regulations.

4.4 Challenges: The lack of a comprehensive legislative framework for credit regulation and lack of a dedicated regulator

The 2014 Finmark Report significantly refers to the “regulatory hiatus” in Lesotho and states: 110 “In addition, the implementation of new legislation and the ability of financial institutions to take advantage of new opportunities are being held up by the lack of regulations needed to give effect to the legislation. Furthermore, the weakness of regulation for financial services provision by cooperatives has led to prudential concerns, and consumer protection concerns have arisen with regard to moneylenders under the old Moneylenders Act. More generally, even where regulations relating to financial services provision exist, enforcement has been patchy, leading to uncertainty and the persistence of undesirable practices.”

As far back as 2004, in the Central Bank of Lesotho Supervision Annual Report, 111 the CBL held that the Money Lenders Act 1989 (as amended) had remained stagnant and failed to take into account developments in the industry. 112 The report further noted that due to its old age and impracticability, the MLA has also failed to provide for more comprehensive and enhanced supervision of the industry. 113 Consequently, there is lack of a coordinated system of deterrence against abuse within the credit industry. There are a number of unlicensed money lenders in the industry charging interest rates as high as 40 per cent per month whom the law does not reach. Crucial, however, is the fact that even those that have been licensed still charge high rates in order to sustain the high credit risk prevalent in this

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111 CBL 2004 Annual Supervision Report.
112 Par 3.2.1 at 9.
113 Par 3.2.1 at 9.
industry. The interest rate provided in the law is rather low (25 per cent, per annum) considering the fact that money lenders use their own capital and do not require collateral.\textsuperscript{114} The interest rate has also resulted in the distortion of the money lending business because lenders do not comply with the prescribed rate, and borrowers driven by desperation, agree to the unlawful rates.\textsuperscript{115}

There is uncertainty in the market stemming from the co-existence of credit institutions under both the MLA and the FIA, and from the lack of clarity over when those registered under the MLA will be required to migrate to licensing under the FIA. As pointed out in this chapter, the financial services regulatory environment is highly fragmented. The CBL’s supervisory powers are limited and do not extend into other sectors which provide credit, such as retailers. The CBL’s powers are also curtailed by capacity constraints even for the financial services sector itself as well as by lack of inadequate laws especially regulating credit extension in Lesotho. There is also a lack of effective and coordinated regulation and supervision of moneylenders.

As also pointed out earlier in this chapter, the pace of law making or reforms is also very slow in Lesotho and to date the MLA is still in place with its limitations and no reformative action has been taken about this state of affairs.

The practice of developing laws in a fragmented fashion is therefore still continuing and Lesotho seems to be far from developing a comprehensive piece of credit law that will holistically address issues of reckless lending as well as consumer over-indebtedness. The haphazard approach to introducing a pre-agreement assessment requirement for the few regulated moneylenders lacks the support of a broader more comprehensive framework inter alia addressed at curbing reckless lending and proper deterrence and enforcement facilitated by effective sanctions. Accordingly the pre-agreement assessment requirement that functions against the backdrop of the half-hearted attempts to regulate reckless lending is without the teeth that is needed to properly combat reckless lending.

Historically the banking sector in Lesotho has been criticised for being unadventurous and not providing sufficient credit; however, in recent years credit has grown rapidly. The CBL

\textsuperscript{114} CBL 2004 Annual Supervision Report at 5 to 6.
\textsuperscript{115} Ibid fn114 at 6.
does not monitor all types of formal credit in Lesotho and therefore this leads to inconsistent monitoring across formal provider types and this lack of a uniform and comprehensive regulation of credit providers does not help with curbing reckless lending at a large population scale because even if banks can conduct borrower affordability tests, money lenders will continue to lend recklessly to the same bank customers leading to a cycle of over-indebtedness.

It is also important for Lesotho to reconsider whether a single financial sector regulator is still ideal in view of the challenges outlined above. Whereas the Ministry of Finance is the financial sector policymaker, the regulatory system is based around the Central Bank of Lesotho. The CBL is responsible for regulating banks and non-bank financial institutions (NBFIs – including credit-only and deposit-taking MFIs, insurers, money lenders, money transfer operators, etc.), as well as the payments system. The primary instrument of regulatory legislation is the Financial Institutions Act (FIA), 2012, which establishes the CBL as the regulator of banks and a wide range of NBFIs. Other important legislation includes the Insurance Act, the Credit Reporting Act, and the Payments Systems Act. The only other significant financial sector regulator is the Department of Co-operatives, which is responsible for Savings and Credit Cooperative Organizations (SACCOs) and its effectiveness is questionable and it is not clear how its functions interface with the supervisory duties of the CBL with regards to the provision of financial services.

A further regulatory/supervisory problem is the current absence of supervision over Boliba. Boliba currently falls under the authority of the Department of Cooperatives (DoC), but is not prudentially supervised. At the end of the day, it is submitted that Lesotho needs to develop one comprehensive credit law regulating prevention of reckless lending inter alia through effective pre-agreement assessment guidelines and applying to all forms of credit.

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116 Section 4 of the FIA 2012 stipulates that the FIA shall apply to deposit and non-deposit taking financial institutions; while the Preamble of the FIA states that the FIA provides for authorisation, regulation and supervision of banking and non-banking financial institutions, agents of financial institutions and ancillary financial service providers and for related matters.
117 Of 2014.
118 6 of 2011.
119 55 of 2014.
120 Finmark Report 22.
121 Boliba Multipurpose Co-operative is a co-operative society which accepts deposits from the public and extends credit as well although it does not fall under the regulation of the FIA.
of credit providers whether formal or informal and administered by a single regulatory / supervisory body.
5.1 Introduction

Pre-agreement assessment or screening, especially to assess affordability, is an essential component of responsible lending. It is essential that this process occurs prior to the granting of credit as it serves as a filter to eventually determine whether a consumer should be allowed to take up specific credit or not. However, it can only properly fulfil its function as a mechanism to prevent consumers from becoming over-indebted if the assessment process is adequately developed to facilitate a reliable determination of the consumer’s ability to afford and repay the debt. From the discussions provided in this dissertation it has been seen though that pre-agreement assessment is a broader concept than merely assessing affordability given it hinges on other aspects as well such as the consumer’s understanding of the risk and cost of credit and his obligations under a credit agreement as well as “suitability” of credit. It has also been indicated that saddling the credit provider with the obligation to assess the suitability of the credit to the consumer is very onerous hence it appears best to rather require the credit provider to provide sufficient information to the consumer to facilitate an informed decision by the consumer himself regarding the suitability of the credit he is applying for. It is further clear that proper pre-agreement assessment presupposes the existence of a reliable system of credit history verification, whether by means of an integrated credit bureau system or in the form of a central credit register.

Wilson’s remarks on responsible lending set the scene for gauging some broad indicators of responsible lending regimes in which context pre-agreement assessment has a pivotally important role. Notable in this regard is the emphasis she places on individualised assessment and also the importance of monitoring of compliance by a dedicated enforcement agency.

Going back to the drawing board, the FSB Principles of Sound Residential Mortgage Underwriting offers some valuable indicators as to what would constitute best practices in
creditworthiness assessment. Although the FSB Principles relate to mortgage credit it is submitted that the Principles embody practices that can also be effectively applied in the context of unsecured credit as well - the bottom line being that it is not only consumers of secured credit that face the risk of becoming over-indebted. Thus the Principles advocate the following best practices:

(a) Income plays a definitive role in the context of affordability. However in order for an assessment to be complete and reliable income should also be verified and such verification should be documented. Although the Principles advocate income history verification it is submitted that such an exercise would be extremely burdensome and onerous to a credit provider as there is usually no central register or bureau that keeps this information as is the case with credit history, and accordingly the requirement of income history verification cannot be regarded as best practice unless one interprets it restrictively to merely refer to requiring income validation for the three months prior to the assessment.

(b) The focus of the assessment should be on the consumer’s ability to repay the debt without undue hardship and without becoming over-indebted. Put differently, the credit provider needs to assess whether the consumer can afford to repay the debt on the terms and conditions as set out in the agreement.

(c) Creditworthiness assessment is essentially a forward-looking exercise that not only considers the debtor’s ability to repay at the moment he applies for the loan but also considers whether the debtor is likely to be able to repay the debt over the lifetime of the credit agreement.

(d) A creditworthiness assessment is broader than merely assessing affordability as it is also necessary that the credit provider provide sufficient explanations to the borrower regarding the implications of taking up the specific credit failing which the borrower might have a distorted view of his risks, costs and obligations under the agreement which incorrect view may eventually compromise his ability to afford the credit.

The 2013 World Bank Report on Responsible Lending, which makes no distinction between secured and unsecured credit, in essence confirms the observations made by the FSB and points toward the following best practices in pre-agreement assessment:
(a) Income verification is paramount in conducting a reliable assessment.

(b) It is the responsibility of the credit provider (and credit intermediaries, where applicable) to identify and collect the necessary information for purposes of pre-agreement assessment – in this regard the credit provider should have mechanisms in place to verify the correctness of information.

(c) In some jurisdictions the minimum information that must be collected by credit providers is prescribed and in some instances standard forms are issued for such purposes.

(d) Full and precise information regarding the consumer’s current commitments and overall financial position must be collected.

(e) It is the responsibility of credit providers (and intermediaries, where applicable) to ensure that the information provided by the consumer is supported by documentary evidence.

(f) Consulting consumer credit history obtained from a reliable credit bureau (or credit register, if one exists) is vital – other data regarding payment of mobile phone accounts and utility bills may also assist in providing a clearer picture of the consumer’s payment patterns.

(g) The overall objective of the assessment should be to establish that the consumer has sufficient income to repay (and not merely “service”) the debt – in this regard it is not advisable to take the consumer’s assets into calculation as they cannot generally be accessed to repay the debt and usually only becomes a factor when the debtor defaults and enforcement proceedings is instituted in terms whereof execution against the consumer’s assets follows.

(h) The income of sureties and their financial position is not taken into account to assess the actual prospective consumer’s ability to afford and repay the debt as the guarantee provided by a surety is only called upon once the consumer defaults.

(i) The pre-agreement process and conclusions drawn from this process must be documented by the credit provider – this will enable the regulator, upon inspection, to satisfy itself as to whether a specific pre-agreement assessment was properly conducted.
(j) From an enforcement perspective a regulator that prescribes the collection of information for pre-agreement assessment purposes and steps for conducting pre-agreement assessment by credit providers should prescribe these requirements in specific terms in order to facilitate monitoring of compliance therewith.

(k) Failure to conduct a credit assessment should have (serious) consequences for the credit provider.

(l) In order to provide comprehensive pre-agreement assessment the creditworthiness assessment should be combined with suitability testing that focuses on the consumer’s best interest, understanding of the product and long term affordability.

Other than providing indicators of what would constitute best practices in the context of pre-agreement assessment, it is to be noted that, like the FSB Principles, the World Bank Report is not prescriptive regarding exactly how a pre-agreement assessment must be conducted. It is also silent on the aspect of the time period prior to the extension of credit that is most suitable for pre-agreement assessment. It is submitted however that in this regard a uniform time period, applicable to all applications for credit, regardless of whether they are secured or unsecured would be most advisable. The gist of this contention is that the time period should be such that it enables proper pre-agreement assessment without enabling credit providers to do the assessment over a protracted period of time during which the accuracy of the information they obtain regarding the consumer may be compromised and during which time the consumer may incur other debt not disclosed at the time that the pre-agreement assessment information was obtained. It is further submitted that the risk of the consumer incurring other debt in the meantime applies equally to consumers who have applied for secured credit as those who apply for unsecured credit hence it is not necessary, as is the case currently in South Africa, to have different time periods applying to mortgage credit as opposed to other types of credit.

The observation by the World Bank that creditworthiness assessment is essentially a “creditor-focused” test whereas suitability testing is a “borrower focused” test is open to criticism. It is submitted that essentially the whole pre-agreement assessment process is by its nature borrower focused as it is premised on information regarding the consumer and his financial situation. The objective is of course to determine whether the consumer can repay...
the proposed credit but it is submitted that this objective does not make pre-agreement a creditor focused exercise at all. The person whose ability to repay is at stake, namely the consumer as borrower, and his financial situation, is the central focus of pre-agreement assessment.

It is further submitted that although the best practices extracted by the World Bank can be supported, a more balanced approach to pre-agreement assessment than is apparent from the World Bank Report is necessary given that consumers are privy to their own financial situations and reliable pre-agreement assessment requires full and truthful disclosure by a consumer of his complete financial situation and anything that may impact on his ability to repay the proposed credit that he is applying for.

In the end it is submitted that whilst the focus should be on devising pre-agreement assessment that provides a detailed and accurate assessment of the consumer’s ability to repay the debt, Wilson’s cautionary remark that the downside of such an approach may be that it results in too restrictive lending practices and foreclosure of access to credit should also be heeded. Further, pre-agreement assessment is about more than just weighing up income and expenses and debt obligations. It is submitted that part of what would constitute good pre-agreement assessment practices, would also be to assess the consumer’s understanding of his risks, cost and obligations under the credit agreement as this understanding is pivotal to the consumer’s ability to make an informed choice on whether to take up the credit and also plays a significant role in his ability to repay. This implies that the credit provider must first provide the consumer with sufficient information regarding the risks, costs and obligations associated with taking up the specific credit. Accordingly it is submitted that pre-agreement assessment can only be reliable if the consumer is fully aware of the financial implications of the proposed credit. In the context of pre-agreement assessment the consumer’s credit history also has a vital part to play: not only does it show a behavioral pattern such as for example that the consumer is a person who is a “serial debt defaulter” but this credit history also reflects whether the consumer is
au fait with the obligations, risks and rights to taking up credit—which informs the extent of his understanding of the responsibilities that come with taking up credit.¹

The progression in the EU approach to creditworthiness assessment that occurred from 2008 when the Consumer Credit Directive was issued to 2014 when the Mortgage Credit Directive was issued is quite remarkable. In comparison to the Consumer Credit Directive the Mortgage Credit Directive is far more progressive with respect to its provisions on creditworthiness assessment. This difference must of course be appreciated against the backdrop that the Mortgage Credit Directive is a much more recent Directive than the Consumer Credit Directive and was clearly informed by the aftermath of the 2008 global financial crisis that was triggered by the housing bubble in the US markets, thus magnifying the dangers of credit risk, especially in the context of immovable property.² Mortgage credit also generally have bigger financial implications and hence it can trigger more severe over-indebtedness. The drafters of the Mortgage Credit Directive also had the benefit of being able to consult policy documentation such as the FSB Principles and the World Bank Report on Responsible Lending which set out various indicators of best practice in creditworthiness assessment.

The Mortgage Credit Directive indeed affords some serious attention to the importance of pre-agreement assessment. Not only does it impose mandatory pre-agreement assessment, but it also seeks to “responsibilize” consumers by indicating that consumers should be educated on the aspect of responsible borrowing and debt management. Clearly the drafters of this Directive, with the hindsight of lessons learnt from the 2008 Global Financial Crisis, saw the prudence in also requiring consumers to borrow responsibly as merely placing all the responsibility upon lenders to engage in responsible lending practices. Like the Consumer Credit Directive the Mortgage Credit Directive keeps the obligation to make the final call on the suitability of the relevant credit on the consumer and merely requires the credit provider to explain the effect of taking up the particular credit to the consumer in order to facilitate the decision regarding suitability.

¹ Clearly where a consumer has a number of credit agreements that appear on his credit history as held by a credit bureau it justifies the inference that the consumer knows the risks, costs and obligations that come with taking up credit.

The Mortgage Credit Directive not only imposes an obligation on the credit provider to assess the consumer’s creditworthiness but also to verify information obtained during the assessment process. Important to note is the requirement that the procedures and information on which the assessment is based should be established, documented and maintained- which will make it easier for the regulator and for courts to ascertain whether there was proper compliance with the creditworthiness assessment requirement in a given instance. The creditworthiness assessment should also take a “long view” and not just test the consumer’s immediate ability to service the debt. This requirement ties in neatly with the indication in the World Bank Report on Responsible Lending that it is ability to repay that must be assessed and not merely ability to service- accordingly the Directive requires that all necessary and relevant factors that could influence the consumer’s ability to repay the credit “over its lifetime” be assessed, emphasising the need to look at the consumer’s ability to service and fully repay the debt.

An innovative feature of the Mortgage Credit Directive is the requirement that the creditworthiness assessment should include a consideration of future payments or payment increases that may be need due to retirement, where applicable and other adversities such as interest hikes and economic downturn. It thus appears that the Directive requires the incorporation of some sort of “adversity buffer” into the assessment process to provide reprieve in the event of future adversities during the lifetime of the agreement that could negatively impact on the consumer’s ability to repay.

It is also to be noted that the Directive requires the credit provider to have regard to regular expenditure, debt and other financial commitments by the debtor that may impact upon his ability to repay the debt. The focus on “regular” expenses as aforesaid is understandable as it can certainly not be expected of the credit provider to anticipate all other “irregular” expenses by the consumer that might arise over the lifetime of the agreement.

Although the Directive provides that for purposes of the assessment regard should be had to the consumer’s income, assets and savings it makes it clear that the value of the immovable property that is being acquired with the credit that is applied for should as a general rule not be taken into account. This is a sound approach given that the value of the immovable property will only really be relevant once the consumer defaults and...
enforcement is proceeded with. Although the Directive is not prescriptive in the sense that it does not impose limits on the amounts that can for instance be taken into account in respect of living expenses or does not provide a list of exactly which expenses have to be taken into account it does give Member States some leeway to control the percentage of a consumer’s income that may be encumbered by credit repayment as it provides for Member States to be able to impose limits on loan–to-value or loan-to-income ratios. This is prudent given that the ultimate objective of pre-agreement assessment is to prevent irresponsible lending that causes consumers to become over-indebted.

The credit provider is given the responsibility to only grant credit to the consumer if it is clear from the assessment that the consumer can afford the credit—accordingly that it is “likely” that the credit will be repaid. It is also the responsibility of the credit provider to collect the relevant information that is required for purposes of sufficient assessment. In this regard the co-operation of the consumer is also mandated by the Directive which requires the consumer to facilitate the assessment by providing information to the credit provider. The credit provider can however not only rely on the consumer’s say so but must consult credit databases and verify information otherwise provided thus ensuring the likelihood of a more reliable assessment. The consumer’s role in the context of responsible lending and borrowing is further enhanced by providing that where the consumer intentionally provides incorrect or falsified information in order to avoid a negative outcome on the assessment, such consumer may be sanctioned. The drawback is unfortunately that the credit provider will be required to prove intent on the part of then consumer which entails a very difficult onus.

The drafters of the Directive also heeded the fact that a consumer’s financial situation is dynamic and accordingly the mere fact that the consumer could have afforded specific credit at one point does not necessarily mean that the consumer will also be able to afford further credit advanced to the consumer at a later stage such as when the consumer applies for a second mortgage - hence the prudent insertion of the obligation to re-assess when increases in credit are considered. The drafters were also mindful that some credit providers may have ulterior motives in obtaining more information that is reasonably necessary for

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3 However it does retain some flexibility in that future lease income generated by the property can be taken into account in those instances where the consumer is not going to occupy the property.
purposes of the assessment, hence the requirement that only information that is necessary, sufficient and proportionate be collected. Accordingly it seeks to minimize the risk that the consumer’s personal information is compromised. As stated above, an assessment cannot fulfil its function if the information that is being assessed is not reliable. Accordingly the requirement that the credit provider must precisely inform the consumer in a “clear and straightforward way” (thus in plain language) what information the consumer must provide himself and within what time frame facilitates the smooth and reliable conduct of the assessment. The requirement that measures be introduced to make consumers aware of the need to provide not only correct but also complete information is also prudent. The reliability of the information collected for purposes of assessment is further enhanced by imposing obligations also on credit intermediaries and appointed representatives to submit accurate and verified information to the creditor and to also, like the creditor, warn consumers of the consequences of failure to provide information or verification of information.

It thus appears that the EU is now, since the 2008 Global Financial Crisis far more pro-active in its approach to responsible lending and that the creditworthiness assessment measures introduced by the Mortgage Credit Directive is a clear indication of the more interventionist regulatory approach to creditworthiness assessment and serves as a good benchmark jurisdiction in this regard. The EBA Guidelines which serve to ease the transposition of the creditworthiness assessment requirements into laws of Member States also evidences that the regulator is exhibiting the regulatory will to assist transposition of these provisions in order to enhance protection of consumers against irresponsible lending.

5.2 Appraisal of pre-agreement assessment under the South African NCA

At the outset it can be remarked that South Africa as a developing country has certainly made great strides in combatting reckless lending by filtering out ineligible transactions through the mechanisms of pre-agreement assessment. The progress in this regard is quite remarkable if one bears in mind that approximately ten years ago consumers in South Africa had no protection against reckless credit granting and no dedicated debt relief to address the ills inflicted upon them by irresponsible and reckless credit extension. It is also remarkable that South Africa already had these measures to combat reckless lending in
place in June 2007 and provided for mandatory pre-agreement assessment prior to the initiatives that the EU took in this regard with their 2008 Consumer Credit Directive and their much later 2014 Mortgage Credit Directive. Without having had the benefit of the FSB Principles or the 2013 World Bank Report at the time that it was drafted it is fair to say that South Africa did quite a good job when it enacted the reckless lending provisions in the NCA and that the pre-agreement assessment provision also measures up quite well.

When one has regard to section 81 as the core provision on which the South African pre-agreement assessment regime is based it appears to address the main elements that underlie best practices in pre-agreement assessment. It requires a holistic approach that is wider than merely calculating income and expenses in order to obtain a figure that can be used to justify the granting of the credit. On the contrary, it appears that section 81 facilitates a comprehensive assessment of not only affordability in the basic sense but also aspects that are otherwise peculiar to the consumer and that may impact his ability to repay the debt he is applying for (and also on the suitability of the credit), such as whether he understands exactly what taking up the proposed credit will entail and whether his credit record shows a pattern of default or whether it indicates a pattern of regular payment in addition to proving the credit provider with the necessary detail about the scope of the consumer’s exposure. Clearly the consumer’s credit history also serves to corroborate the consumer’s explanation of his financial position or could otherwise alert the credit provider to untruthfulness in the disclosures made and the information provided by the consumer during the assessment. Also, the requirement that the viability of a commercial venture should be assessed where credit is applied for towards such a purpose, makes good common sense. If it is patent from an assessment that the venture is doomed to fail the credit provider should then decline to grant the consumer such credit as it will only lead to or contribute to the consumer’s financial demise.

One can accordingly conclude that from a principle-based perspective the substratum of the South African pre-agreement obligation as set out in section 81 (2) appears sound and aligned with best practices identified by the FSB and World Bank insofar as the latter two bodies indicate that an assessment of the consumer’s ability to repay should be made and verified as well as that relevant credit history information need to be consulted during this process.
The credibility of the pre-agreement assessment as a regulatory priority in the context of addressing the root cause of over-indebtedness is also supported by a framework that facilitates monitoring of compliance by the regulator. In this regard due and proper enforcement by the regulator is fortified by the network of remedies that mandate compliance with the pre-agreement assessment whilst at the same time deterring non-compliance. South African credit providers are aware that if they fail to conduct pre-agreement assessments when obliged to do so they will be visited with an array of severe sanctions ranging from civil remedies that can inter alia see the undoing of the agreement or forfeiture of interest and other charges as well as cancellation of registration which can effectively put a credit provider out of business and also the imposition of a hefty administrative fine that may hurt the credit provider financially, especially if it is a small credit provider. Then there is also the “name and shame” element of being found to have engaged in the “adultery” of reckless lending and its accompanying reputational damage - very much a “scarlett letter” hanging around the neck of the non-compliant credit provider.

When one further measures the pre-agreement process in terms of the NCA against the best practices as extracted from Chapter 3 and summarized in paragraph 2 above, the following further observations can be made:

(a) As indicated in the FSB principles as well as the World Bank Report, income also plays a definitive role in the context of pre-agreement assessment in South Africa and in order for the assessment to be reliable the consumer’s income should not only be ascertained but also verified. There can be no doubt that should an assessment reveal that a consumer has a good credit history and knows and understands his risks, costs and obligations as a credit consumer his application will (or at least ought to) be declined if the assessment reveals that he has no income or insufficient income to service and repay the debt hence removing him from the realm of (further) over-indebtedness. As indicated the FSB Principles however appear to take matters quite a bit further by requiring “income history” verification which in South Africa may seem daunting if one has regard to the fact that many consumers have been in informal type of employment arrangements where their income history over a lengthy period might not be available at all. It is however submitted that maybe a common-sense approach to this requirement set by the FSB is most apt and that this requirement can possibly be construed to refer to quite a “brief” income history verification such as the 3
month period that the final Affordability regulations cater for- which then ticks the box for South Africa’s approach to pre-agreement assessment to be in conformity with international best practice. Also important in this context is that verification of income is pivotal to reliability of the assessment and in this respect the South African approach cannot be found wanting.

The FSB principles stress that what needs to be assessed is whether the consumer will be able to repay (and not merely service) the debt on the terms or conditions as set out in the agreement without undue hardship and without becoming over-indebted. Section 81(2) does not expressly provide that the credit providers must assess the aspects mentioned in the section, namely the consumer’s understanding of the risks, costs and of the proposed credit, his credit history and his existing financial means, prospects and obligations to determine whether this objective will be met. Although one may argue that this is indeed what section 81(2) implies it is submitted that any uncertainty in this regard can best be laid to rest by amending section 81(2) to indicate this objective of the assessment.

As regards the view of the FSB that the consumer’s ability to repay the loan over its lifetime must be assessed it is submitted that this is something that is indeed very difficult to assess with any amount of certainty. Anything can happen over the lifetime of a credit agreement that could erode even the best intentions that a consumer may have had to repay the credit agreement taking into account his income and expenditure at the time he applies for the credit and what he expect these income and expenses will be in future. Accordingly it is submitted that creditworthiness assessment can never be a failsafe tool as a person that might have been creditworthy at the time he applied for credit may stumble onto hard times such as job loss or illness that makes him unable to repay that debt. In such case the NCA does not unreasonably attribute such ill fortune to reckless credit granting, as is clear when one looks at the definition of reckless credit provided in Chapter 3 above. Therefore it is further submitted that this FSB Principle ought to be seen in context - surely it would not only be unreasonable but also impossible for a credit provider to cater for each and every eventuality during the assessment process that could possibly befall a consumer over the lifecycle of a credit agreement. And indeed this is probably an easier task when assessing a consumer on a two year loan as opposed to a twenty year mortgage. The best sense to be made of this FSB Principle is accordingly to say that it is the “likelihood” of repayment that
must be assessed—which appears to speak more to the aspect of “probability of default” which is not the exact same as determining affordability. Hence it is submitted that the fact that the South African pre-agreement process is “static” in the sense that it requires an assessment of inter alia “existing” financial means, prospects and obligations is not to be shunned because that is what the credit provider is “reasonably” able to determine at the time of entering into the agreement and without the benefit of a crystal ball. It is indeed noted that many sophisticated credit providers have more sophisticated methods of modelling a variety of scenarios that may occur but in the end there is no guarantee that those predictions will realize. Thus it is best to keep the test for reckless credit simple by not complicating the pre-agreement process with layers of conjecture over which neither the credit provider nor the consumer have any control.

Although not stated in section 81 it has to be borne in mind that the NCA has a significant number of provisions that require the credit provider to inform the consumer of aspects like the cost of credit. Thus the reckless credit provisions and the duty to conduct a pre-agreement assessment is cast against a bigger backdrop that mandates certain disclosures that would serve to inform a consumer better on the implications of the credit he seeks to take up. However, it is conceded that these mandatory disclosures may not necessarily serve to prevent the consumer falling into the trap of reckless credit granting. Accordingly the South African legislature could consider mandating the credit provider during the pre-agreement assessment to disclose certain information to the consumer that would serve the decrease the incidence of consumers who enter into reckless credit agreement due to a general lack of understanding the implications of such credit. That the legislature had something like this in mind with the final affordability regulations can in any event be surmised from the requirement that the credit cost multiple and cost of credit be disclosed to the consumer.

In the context of pre-agreement assessment to support responsible lending it appears that it has been accepted that is the consumer who is most in need of protection and accordingly that it is the credit provider, usually with deeper pockets and more bargaining power, that must bear the brunt of the responsibilities for proper assessment. The writer has no objection to this viewpoint and regards it as justified. In the South African context, other than contemplated in the EU, the legislature however seems to have favoured a far more
interventionist approach as it is not merely stated that the credit provider should take “reasonable steps” to do a section 81(2) prior to extending credit but the credit provider is also told in minute detail (unfortunately also with some lacunae such as the lack of an explanation for applying Table 1) how he should approach the aspect of pre-agreement assessment by inter alia setting out the methodology that must be followed to determine the consumer’s discretionary income that can be applied towards the proposed credit and by prescribing fixed monthly living expense amounts for a number of different income bands. Although one could argue that not all credit providers in South Africa are big banks with sophisticated systems and that prescribing how the pre-agreement is to be conducted will create uniformity across the board there are as many if not more objections to this prescriptive and essentially restrictive approach. One main concern is that the use of income bands may foreclose certain consumers from access to credit.\textsuperscript{4} Whilst this appears to be true insofar as the first income band in Table 1 is concerned it is submitted that this apparently bad consequence is mitigated by the flexibility built into the assessment procedure in the form of the questionnaire that the credit provider can get the consumer to complete in those instances where the consumer’s monthly living expenses are less than those indicated in Table 1 for his specific income band. But then of course there is also the argument by Van Heerden and Beyers that the whole Table 1 can be questioned on the basis that there is no opportunity for differentiation and that surely a 20 year old single person who for instance falls in the second income band and still lives with his parents would have vastly different living expenses than a 40 year old married man with a stay at home–wife, three dependents and a mortgage who fall into the same income band, yet they will have to be treated the same for purposes of Table 1 if they fall within the same income band.\textsuperscript{5} Another concern is that Table 1 may actually perpetrate abuse because it may happen that credit providers merely take into account the consumer’s living expenses as the amount indicated in the Table (being capped at a minimum) in the assessment instead of the consumer’s “actual” living expenses that may be higher than the amounts indicated in the Table.\textsuperscript{6}

Van Heerden and Beyers are also concerned about the apparent lack of an “adversity buffer” in the regulations. They point out that Table 1 poses the further challenge that it is

\textsuperscript{4} Van Heerden and Beyers 17.
\textsuperscript{5} Van Heerden and Beyers 17.
\textsuperscript{6} Van Heerden and Beyers 17.
unclear how the division of income bands were decided upon, or exactly what the fixed monthly income factor represents and whether it possibly includes some form of an adversity buffer. With regard to the latter they remark that it rather appears that the percentages reflected as the minimum fixed factor possibly refer to something other than an adversity buffer especially if considered against the initial statement in the May 2013 guidelines that an adversity buffer of 25% of the consumer’s discretionary income was envisaged. No mention is made of an adversity buffer elsewhere in the regulations and in any event they submit that, having regard to the May 2013 guidelines, the initial intention was that the adversity buffer should be calculated with regard to the consumer’s discretionary income thus implying that the minimum fixed factor in Table 1 does not translate into an adversity buffer. The likelihood that the Table can be abused by credit providers to justify granting credit to consumers whose minimum expenses are taken as the amounts reflected in the Table has also been pointed out. Accordingly this could be a basis that credit providers could challenge the regulation upon- alleging that it is vague –or even that it is discriminatory for actually being non-discriminatory when it comes to the application of the income bands in Table 1. Of course the fact that the regulations fail to provide the explanation of how to apply Table 1 could also be challenged as too vague and accordingly it would be prudent to amend the Final Affordability Regulations to cure this defect.

Something that neither section 81(2) nor the regulations spesifically address is the obligation to actually document the assessment process and the steps taken during this process. One could of course argue that it is logical that credit providers should do so in order to be able to prove that they did a proper assessment but this cannot necessarily be gainsaid from the provisions of section 81(2) read with the regulations. Thus it is submitted that it would be better to indicate in the regulations (as additions or amendments to the regulations do not require to undergo the protracted processes that underlie primary legislative amendments) that the credit provider is obliged to document the assessment process and keep such records for at least five years (or even longer in the case of a mortgage agreement).

The “recent trend” in pre-agreement assessment, as noted in the World Bank Report, to also consult other data such as mobile phone accounts and utility bills to provide a clearer
picture of the consumer’s repayment patterns are most likely already being done by South African credit providers as such aspect can be accommodated within the broader framework of other debt obligations of the consumer that must be taken into account for purpose of eventually determining his discretionary income as per Regulation 23A.

As indicated in the FSB Principles calculation of assets should not generally form part of the assessment process because realization of assets usually only come into play upon default by the consumer and cannot generally be stated to contribute towards the consumer’s ability to repay credit agreement debt whilst the agreement is in force. Fortunately the South African approach to pre-agreement assessment appears to have grasped this aspect as it does not per se require an assessment of the consumer’s assets in the context of his ability to afford and repay the debt but rather focuses on the regularity of his income as a primary means to service and repay the debt.

Something that section 81(2) and the final Affordability Regulations also do not specifically address is the role that collateral plays during the assessment process. From the World Bank Report it appears that it is best practice *not* to take the income of sureties into account during assessment of the prospective consumer’s ability to repay. The same logic as with regards to the role the consumer’s assets in the context of pre-agreement assessment applies- collateral will generally not be utilized for repayment of the debt whilst the agreement is still in force (which is the desired outcome seeing that pre-agreement assessment is intent on preventing default and over-indebtedness). The case of *Absa Bank Ltd v De Beer* ⁷ as discussed in Chapter 3 indicates that the courts appreciate that collateral does not mean that the actual consumer who is being assessed will be able to repay the debt and thus that collateral should be left out of the pre-agreement assessment calculation. However it is submitted that it would nevertheless be prudent for the regulations to expressly stipulate that collateral must not be taken into account for purposes of calculating the prospective credit consumer’s discretionary income during pre-agreement assessment.

Notably the World Bank Report on Responsible Lending indicates that where regulators prescribe the collection of information and steps for conducting pre-agreement assessment

it must be done in specific terms so that the regulator is better able to monitor compliance with the prescribed information and assessment steps. Having regard to the evolution of pre-agreement assessment in South Africa from the point where credit providers could develop their own evaluative methods subject to non-binding guidelines by the regulator (which guidelines never materialized until May 2013) to the point where, currently, credit providers can still develop and use their own assessment models as long as it is consistent with the final Affordability Assessment Regulations, it is clear that the National Credit Regulator is now probably in a much better position where it can do a “tick box” evaluation of whether the credit provider complied with its assessment duty as envisaged by section 81(2) read with the final Affordability Regulations. The courts as adjudicators is probably also now in a better position to judge whether there was proper pre-agreement assessment and are likely to first check the broader aspects, namely whether the credit provider had regard to the aspects mentioned in section 81(2) and then dissect the assessment process for proof of compliance with the affordability regulations. In fact, it is highly likely that the regulator and courts alike will skip the murky question regarding assessment of the consumer’s understanding of his rights, costs and obligations as contemplated in section 81(2) and zoom in on whether the credit provider assessed affordability and consulted credit bureau in the exact mandated in the final Affordability Regulations.

Regarding the serious consequences for the credit provider that non-compliance with pre-agreement assessment should pose, as indicated by the World Bank Report on Responsible lending, it is clear that South Africa is on par with international best practice. It has actually (Like the EU did much later in the Mortgage Credit Directive) gone further by also attempting to ensure that the consumer provides reliable information hence the requirement in section 81(1) that the consumer, when applying for credit and while that application is being considered, must answer “fully and truthfully” any requests for information by the credit provider. Not only does the duty continue for the whole time period that the agreement is being conducted, meaning that the consumer must also inform the credit provider if changes in his financial situation occur between the time that the assessment is done and before a decision on the outcome of the credit application has been made, but if the consumer is not truthful and the requirements of section 81(4) is met the credit provider will have a complete defence against reckless credit and the consumer will
forfeit the protection of the reckless credit remedies provided for by the NCA. Thus, compliance by the credit provider as well as by the consumer is promoted through the introduction of effective sanctions: for the creditor the civil remedies in section 83 and 84 that may cause him dearly in financial terms as well as cancellation of registration and an administrative fine is on the cards – and for the consumer, the complete defence awarded to the credit provider leaving the consumer cut off from the remedies in section 83 and 84 of the Act.

It has also been indicated that The World Bank Report stated that the credit provider must assess a credit provider again (re-review) if he applies for more credit at a later stage. The NCA already incorporates this sound practice albeit not in section 81 but in section 80 which not only refers to the time that the agreement was made but also to “the time when the amount approved in terms of the agreement is increased.”

This brings one to the aspect of “suitability testing” – it has been indicated that the World Bank Report on Responsible Lending pointed out that this aspect is quite complex to assess and the EU’s approach to “suitability” confirms this. As pointed out the EU in the mortgage Credit Directive leaves the aspect of suitability testing to the consumer and merely requires that the credit provider give the consumer sufficient information to facilitate an informed decision by the consumer as to whether he should take up the credit or not.8 By comparison the aspects of suitability testing mentioned in the World Bank Report, namely the consumer’s best interest, understanding of the product and long term affordability, appears to have some overlap with the provisions of section 81(2)(a) relating to the consumer’s understanding of the risks, costs and obligations of the proposed credit. The assessment of long term affordability is however a complex aspect that, as indicated above, can never be assessed with certainty and actually boils down to an assessment of likelihood to repay over the long term. In line with the approach of the EU, it is submitted that to impose an obligation on the credit provider in section 81(2) read with the final Affordability Regulations to take responsibility for determining whether the credit applied for is suitable to the consumer would be too onerous and the decision on suitability of the credit applied for should remain with the consumer, as is currently the case in South Africa.

8 See also Mak 5.
Thus, in conclusion it can be stated that the pre-agreement assessment process provided for by the NCA and the final Affordability Regulations appear to be sound from a responsible lending and borrowing perspective, even though some may regard it as overly paternalistic and unreasonably manipulating the risk-appetite of some credit providers. There is however the valid concern that the Regulations can be challenged on the basis as indicated by Van Heerden and Beyers and accordingly it is proposed that the Regulations be amended to tackle these concerns, probably by getting rid of Table 1 and by introducing some sort of adversity buffer into the assessment process. The distinction between the 14 and 7 day period where mortgage credit and other credit is applied for appears artificial and should also be abandoned. Finally, it is hoped that aspects like the credit amnesty achieve its aim of opening up access to (responsible) credit rather than distorting to picture of the consumer’s debt history to the detriment of accurate pre-agreement assessment.

5.3 Lesotho and pre-agreement assessment: Quo Vadis?

Given that, as indicated in Chapter 4, Lesotho appears to follow the South African trends in the context of reckless credit and pre-agreement assessment it can be asked what insights there are, emanating from this research, that Lesotho could take from this research. The pertinent point about credit regulation in Lesotho is that there exists no comprehensive piece of credit legislation that can provide the broader framework into which the attempts at regulating reckless credit through pre-agreement assessment is integrated. Without such a comprehensive legislative framework the collective mechanisms that support the reckless credit provisions as part of a larger tapestry of credit regulation is absent and it is submitted that this necessarily compromises the effective enforcement of the pre-agreement assessment obligations imposed by the CRA and the Financial Institutions Only and Deposit Taking Micro-Finance Regulations. Then of course, the other point to be made is that although a good start the legislative provisions regarding pre-agreement assessment that do currently exist in Lesotho need to be expanded upon and aligned with international best practice.

Although a small country, Lesotho also suffers from the ills of consumer over-indebtedness. Against the background of its fragmented approach to credit regulation Lesotho has nevertheless sought to introduce some measures to address reckless lending although it appears that these measures focus mainly on prevention of reckless credit granting and not also on alleviation of consumer over-
indebtedness occasioned by such reckless credit granting. In this context the obligation on credit providers to conduct a pre-agreement assessment is awkwardly placed in the Credit Reporting Act and further borne out by the Financial Institutions Credit only and the Deposit Taking Micro-Finance Regulations, issued in terms of the Financial Institutions Act. This oddity of the Regulations being issued in terms of an Act (The Financial Institutions Act) which is prudential in nature and does not deal specifically with credit regulation casts some doubt over the legality of the reckless credit provisions in the Regulations seeing that their primary legislative origin in terms of enabling legislation appears unclear.

However, despite the aforementioned perceived glitch it is submitted that one must at least acknowledge the endeavours by Lesotho to do something about irresponsible or reckless lending to consumers – albeit that this regulation only reaches the small portion of consumers who take up formal credit. The provisions relating to pre-agreement assessment in the Credit Reporting Act, although appearing misplaced, at least informs credit providers of this obligation prior to extending credit and although it does not make credit history consultation mandatory it at least sanctions non-compliance with the pre-agreement assessment obligation by making it an offence hence deterring non-compliance. Section 30 of the CRA thus provides for entry-level pre-agreement assessment that focuses on the likelihood that the consumer will be able to repay the debt timeously (obviously within the term of the agreement) and requires the credit provider to have regard to the consumer’s financial means, prospects and obligations (although no definition of these concepts are provided). In addition to these mandatory steps it however provides the credit provider with a discretion to consult credit bureau history on the consumer – and lack of which can unfortunately compromise the reliability of the assessment. Then there is also the further challenge of the reliability of credit bureau information per se - which is clearly a matter that screams for regulatory attention.

It is important to appreciate that the pre-agreement assessment process functions with reference to what is regarded as reckless credit granting in a specific jurisdiction hence the way that a jurisdiction defines reckless credit speaks directly to the elements of pre-agreement assessment that is introduced to prevent and deter such reckless credit granting. By the time that the 2014 Credit only and Deposit Taking Microfinance Regulations saw the light the drafters of these regulations (which are binding subordinate legislation) appears to have had wider regard to the aspect of reckless lending and appears to have borrowed substantially from the NCA. That they have not embarked on a robust “cut and paste” exercise however becomes clear when one looks at the Lesotho definition of reckless credit provided in Regulation 14 as opposed to the definition provided in section 80 of
the NCA. From a reading of Regulation 14 it appears that, like in South Africa, failure to conduct a pre-agreement assessment will lead to credit being reckless. However, failure by the credit provider to corroborate a consumer’s existing financial means, prospects and obligations also making the credit so extended reckless. Although this specific ground of reckless credit is not expressly provided for in section 80 of the NCA one could probably argue that this is the effect that the verification requirement in the South African final Affordability Regulations will have in any event. Like in South Africa the fact that a pre-agreement assessment was conducted will not take the credit provider out of the realm of reckless credit if, despite having done an assessment, he disregarded the outcome of the assessment which indicated that extending the proposed credit to the consumer would make the consumer over-indebted. The Lesotho definition of reckless credit also, unlike the South African definition contained in section 80 of the NCA, explicitly requires the credit provider to explain the terms and conditions of the proposed credit as well as the total cost of credit to the consumer. Although not expressly stated in section 80 of the NCA one would however be justified in inferring that the NCA also imposes a similar obligation on the credit provider through the final Affordability Regulations (read together with section 81) that mandate disclosure of the credit cost multiple and costs of credit. The requirement that the assessment be “reasonable” is not explained in the regulations but one would probably be able to argue that this reasonableness refers to proper collection of relevant information by the credit provider against the backdrop of the credit provider explaining aspects such as terms and conditions and cost of credit.

Regulation 14 also requires a re-assessment granting an increase on a loan which, as appears from the World Bank Report, is a feature of best practice in pre-agreement assessment. The idea of responsible borrowing has also hit home in Lesotho and accordingly it is commendable that consumers are also roped in to facilitate proper and reliable pre-agreement assessment as the incidence of reckless credit granting will best be minimized where both parties co-operate fully and truthfully in the assessment process. The introduction of defences for the credit provider against allegations of reckless lending also appears at first glance to differ to some extent from the defence available to credit providers in terms of section 81(4) of the NCA as the Lesotho defence can be raised if the consumer fails to provide necessary information regarding affordability or provides incomplete, false or inaccurate information that eventually has the result that the credit provider is unable to perform a reasonable assessment of the consumer’s ability to meet the obligations of the credit agreement.

It is regrettable that the consumer protection initiative that was taken in the Regulations were not augmented by providing for specific civil remedies for consumers to whom reckless credit has been
extended. This is probably because of the lack of a proper debt relief framework within which some of these remedies ought appropriately to be situated. Nevertheless it is submitted that the legislature should at least provide for civil remedies relating to the complete or partial setting aside setting aside of reckless credit agreement or suspension of the force and effect of such agreements as this would go a long way into curbing reckless credit granting. The gist here is that pre-agreement assessment, in order to be efficient, should operate within a network of integrated remedies that facilitate and incentivise compliance with the pre-agreement assessment obligation—otherwise pre-agreement assessment becomes a “toothless tiger” that is unable to filter out reckless credit granting.

5.4 Conclusion

Pre-agreement assessment is the critical cog in the machinery that serves to prevent and deter reckless credit granting. This process hinges upon other facilitating mechanisms such as disclosure of information by the credit provider as well as the consumer and also verification of the information collected from the consumer given the paramount importance of ensuring that the assessment process is reliable. Incorporation of best practices as identified in the FSB Principles and the World Bank Report is instrumental in honing a pre-agreement assessment process into becoming the primary instrument in the fight against reckless credit granting. It has been demonstrated that South Africa has developed a pre-agreement assessment process in the NCA and the final Affordability Regulations that meet international best practice. Accordingly it is submitted that Lesotho, who is in the initial phase of embracing responsible lending can indeed look towards the reckless credit and pre-agreement assessment provisions in the NCA for guidance on developing a resilient and efficient regime aimed at combatting reckless credit.
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