

Chapter 4

The Impact of Basel III Regulations on Bank's Lending and Growth Rates in Kwa-Zulu Natal

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Abstract

The purpose of this study is to evaluate the impact of new capital requirements introduced under the Basel III regulations on banks' lending rates and loan growth. The research also explores if the Basel III Accord results in a substantial decrease in the loan growth of the banking sector. Little research, if any, has been done on the new capital requirements.

A qualitative approach was followed, and 10 semi-structured interviews were conducted with credit managers and analyst using open ended questions to gather data on credit, interest rates and the cost of credit within the banking industry. Major findings of the research were that banks have become stricter with credit lending and the consequence was that the loan growth decreased over the past five years. The corresponding strategy for banks was to focus on the promotion of non-credit products to increase profitability.

Keywords: Basil I Accord, Basil II Accord, Basil III Accord, Credit Act, BRICS

Background

Proper assessment of risk is vital for a strong financial market, financial markets that can make capital available to the private sector and investments from sources of loans. Business investment is also crucial to productivity, venture capital,

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well-regulated securities exchanges, and many other financial products. To achieve these above-mentioned functions, banks need to be transparent and trustworthy. Hence, financial markets need the appropriate regulations to protect investors, capital and the economy. A weakness of the National Credit Act was identified in 2004 raise concern on the inadequate rules for the disclosure on the cost of credit. This included the charges and fees involved when taking up credit from financial institutions [1].

Literature [2]; Drumond [4] states that there are insufficient studies on regulatory capital requirements and its effect on the banks' interest rates and the growth of loans. This study makes a benefaction to the extant literature in understanding the impact of the cost of capital on lending behaviour. This study will be beneficial to banks as it provides insight into the problems that are and will be faced with. By identifying the problems, they would be able to strategise and work at ways to mitigate future risk.

Research Problem

It is critical to mitigate risk to create a stable and strong financial market. In 2004 a weakness was identified in the National Credit Act that there are inadequate rules for the disclosure on the cost of credit. For fees and charges to take up credit from financial institutions [1].

Although the effects of bank capital and lending behaviour have been debated with the introduction to Basel I the macroeconomic consequences of capital requirements have not been analysed deeply [2]. In more recent studies, it was argued that banks' capital can affect the lending behaviour and future loan growth [5]; [6]. The amount of loans granted is contingent on the regulatory requirements [2]. It roughly implies that every 1 percent increase in the monetary policy indicator leads to a decline in lending of around 1.2 percent of the average bank [2].

Within the South African context lending institutions there are constraints to granting consumers credit facilities regulated by the Credit Act as well as the Basel III regulation. The recent economic crisis caused South African banks to hold a higher amount of capital/equity which affects cost of credit, improves liquidity, increases interest rates and decreases bank profitability [7]. This study will be beneficial to banks as it will provide insight into the problems experienced and that they may face.

Literature Review

Introduction

Proper assessment of risk is vital for a strong financial market, financial markets that can make capital available to the private sector and investments from sources of loans. Business investment is also crucial to productivity, venture capital, well-regulated securities exchanges and many other financial products. To achieve

these above-mentioned functions, banks need to be transparent and trustworthy. Hence, financial markets need the appropriate regulations to protect investors, capital and the economy. A weakness of the National Credit Act was identified in 2004 raise concern on the inadequate rules for the disclosure on the cost of credit. This included the charges and fees involved when taking up credit from financial institutions [1]).

Basel Codes

The Basel Codes was developed by Basel Committee on Bank Supervision (BCBS), for regulating international banking, Basel I in 1988 and Basel II in 2004) and Basel III in 2010. The Basil Code is used to standardise banking practices, minimise credit risks and determine the minimum capital requirements for financial institutions [42]. The limitation of Basil I was that is only focussed on credit risk to the exclusion of other types of risks.

In 2009, Basel III expanded to 27 jurisdictions including Belgium, Indonesia, Unit Kingdom, United States, South Africa, Sweden, Switzerland, Turkey, Luxembourg, Spain, Singapore, Mexico, Korea, Italy, Japan, Hong Kong, Russia, Netherlands, Saudi Arabia, India, France, China, Argentina, Australia, Germany, Canada, and Brazil. The objectives of Basel III were to minimise risk and damage to the economy, handle volatility and improve transparency and disclosure [9];[10].

Impact of Basel III

It is indicated that most banks worldwide will be able to adhere to the capital requirements of Basel III of 7% and 8% in 2013 and 2014 respectively but towards 2019 banks may fail to meet the requirements.

The consequence of Basel III was that bank became less profitable because of lower number of loans issued. The effect of Basel III on GDP would be -0.05% to -0.15% annually [11]. To mitigate the negative effects on GDP banks may be forced to increase lending to pass the costs to the customers [19]. The higher amount of capital and equity which is a cost factor, this would ultimately impact on the increase of the interest rates to consumers and the increased required amount of the cost of credit [12]. This requires banks to retain larger amounts of liquid assets. Due to the increase of interest rates the loan growth would be on a decrease as clients are unable to repay their loans due to affordability [9].

The implementation of the Basel III Accord, slowed down the economic growth due to higher credit costs and reduced availability [13]. The consequence is that larger economies shrunk by 3 per cent as a result of Basel III than they otherwise would be five years into the future. French Banks calculated a 6 per cent impact on the economy.

Legislation

The South African consumer credit legislation had previously consisted of the Usury Act; the credit Agreements Act 74 of 1980 (hereafter “the Credit Agreements Act”) and the Exemption Notices, 1992 and 1999. There are various factors that have influenced the consumer credit market since 1968 namely the social, political and economic changes. The credit markets were criticised for out-dated legislation, inadequate consumer protection, specifically with clients in the lower-income brackets, lack of access to credit, the high cost of credit, increasing levels of consumer indebtedness, reckless lending by credit providers especially micro-lenders, intermediaries and debt collectors.

Legislative Framework

The South African Constitution

Banks must comply and adhere to rules and regulations set out and enforced by the government. The financial regulations placed by the South African Reserve Bank (SARB) have a direct impact on how financial institutions are run and governed. The South African banks must adhere to the regulatory requirements set out by the South African Reserve Bank (SARB). The Basel I, II, and III Accord is a legal framework set at the global level (by the BCBS) and most governments around the world, including those in Africa which have all incorporated it into their own banking regulation [6].

The National Credit Act provided protection for consumers that prohibits reckless credit, alleviate over-indebtedness, reduce information asymmetry, and reduce reckless credit risk extensions [43]. The Act also tackles predatory lending practices, prohibits misleading and unfair marketing and selling practices and negative option marketing. Furthermore, it also prohibits harassment of consumers at their homes to induce them into credit agreements.

Interactional Legislations on Finance

Government bonds

The Government of South Africa has to raise funds via the National Treasury in the financial market to finance the total Budget deficit during a fiscal year. Government funds are frequently raised through the taxation system. However, to raise as much funds it would require to finance the entire expenditure of the government, the percentage of taxation would be greater than what is politically and or economically tolerable. To finance any deficit (budget shortage) the government may borrow funds by issuing bonds. These bonds are issued in the domestic currency and are deemed to be the securest form of investment in that currency.

South African Reserve Bank

The SARB is the central bank of the republic and is regulated in terms of the act. The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of the balanced and sustainable economic growth in the Republic. The South African Reserve Bank, in pursuit of its primary objective, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.

The primary objective of the South African Reserve Bank is to protect the value of the currency in the interest of the balanced and sustainable economic growth in the Republic. All banking procedures and processes have to be in line with the regulation of the South African Constitution. All South African banks and financial institutions are government regulated and have to conform to regulatory acts that are imposed by the government. The South African Reserve Bank (SARB) is an independent body that sets the repo-rate to financial institutions.

Legislation and policies

A policy sets out the goals and planned activities of a ministry and department but it may be necessary to pass a law to enable the government to put in place the necessary institutional and legal frameworks to achieve their aims. Laws must be guided by current government policy.

The Financial Sector Regulation Act 9 of 2017

The Financial Sector Regulation Act No. 9 of 2017 was published in Government Gazette No. 41060 on 22 August 2017. "It wants to achieve this by establishing, together with the specific financial sector laws, a regulatory and supervisory framework that promotes certain principles and objectives".

Financial Crisis

The financial crisis had originated in the US and had affected the world. In 2002, six million lower-income households were given mortgages with high-interest rates and longer repayment periods. The interest rates were initially very low to attract more households. These sub primes were converted into securities which were traded on the financial markets around the world. The problem had arisen when many of these households failed over years to make repayment to these mortgage bonds. Because of the way global markets were intertwined, this has affected the entire international market. In early 2007, British clients had lost confidence and were afraid of losing their savings which had resulted in many clients withdrawing all their savings and investments from the bank. This had led to the world financial crisis, the reduction

and job losses in and around the world as well as South Africa [14].

The Banking Sector in South Africa is well regulated. The execution of the Second Basel Accord regulation was in January 2008. The South African Reserve Bank (SARB) started to publish benchmark overnight with the banks' interest rates in 2001. South African Reserve is independent and operates in much the same way as the Western central banks influencing interest rates and controlling liquidity through those interest rates. However, the spread of South African bonds contributed to the financial market crisis and risk aversion had been on the rise [15].

Factors that Influenced the Consumer Credit Market

Consumer credit behaviour transformed significantly and in recent years is the rise of the use of credit to finance their day to day expenses. Lower-income markets are restricted due to affordability related to socio-economic limitations [16]. Therefore, consumers with different demographics and economic backgrounds may have different perceptions towards debt. Technology has also contributed to the increased use of credit as financial institutions have made it very easy with a “click of a button” to attain credit through digital platforms [16].

Loan growth in Sub- Saharan Africa

The loan growth in Sub-Saharan Africa was fast growing in Nigeria, Ghana and Kenya in 2012. However, South Africa was still undergoing recovery. In 2002, credit developments across Sub-Saharan African countries started to experienced swift growth of credit in banks in the private sector [17]. Excessive booms of credit growth tend to have a direct relationship and appear to be driven by large rises and ebbs of global financial flows and debt crisis [18].

Liquidity of banks

According to [19] and [20] strong liquidity is as important as strong capital requirements which were highlighted in the recent financial crisis. Banks that possessed adequate capital still experienced difficulties due to lack of liquidity.

Further Changes to the Basel III Win Liquidity Ratio

The Net Stable Ratio had been designed to ensure that banks became more liquid and resistant to liquidity risk by avoiding or minimising them from wholesale funding sources [23] & [21]. The Net Stable Ratio is calculated by dividing a banks available stable funding. As per regulatory requirements (The Basel III Accord) banks must maintain a ratio of at least 100 % [23].

The Liquidity coverage ratio (LCR) was also introduced under the Basel III Accord for any liquidity issues that may arise. The purpose of the liquidity ratio is to

ensure that assets of superior quality so that it can be converted to cash easily (to meet the cash requirements of 30 days. The LCR must not be less than 10 percent [22].

However, the liquidity coverage ratio (LCR) (Which requires banks to hold a buffer of liquid assets) to combat short-term liquidity issues [23]. These strict requirements placed on banks made it difficult to comply. In South Africa specifically, it is a problem as our retail deposit market is small which places a problem for banks to source funding that has a high ASF factor [23]. In South Africa, wholesale funding makes up around 40% of banks funding, the initial version of the NSFR, published in 2010. It was argued that banks would not reach this requirement of 100% but would manage to reach 80% - 90% hence, SA will face multiple challenges trying to reach 100% liquidity ratio [23].

The Fourth Industrial Revolution

In the era of the 4th industrial revolution banks too must restructure their operations to maximise new technologies. According to Ohene-Afoakwa & Nyanhongo [24] banks too must adopt technological strategies and systems to be scalable, agile and be responsive in real time. Even in the granting of loans banks systems must be integrated to allow for data driven decisions.

Overview of the banking regulations in the BRICS member countries

The Bank for International Settlements [25] reveals that banks are required to conduct sufficient due diligence...when dealing with financial and monetary operations. In the BRIC, the state has a majority stake in the banking sector (75% in India, 69% or more China, 45% in Brazil and 60% in Russia).

BRICS Banks are cognisant that the impairment of credit worthiness caused the global financial crisis. An analysis of the financial crisis demonstrates that operational risk framework was inadequate, and losses occurred due to misconduct and inadequate systems and control. Hossain [26] proposed that BRICS partnership adopts the Basel III Accord for macro-economic reasons, to become more resilient and positively contribute to GDP albeit some of the limitations.

The implications of the Basel III accord could slow down the economy, increase capital adequacy, and comprehensively manage risk. Another insight is that the implementation of Basel III accord is country and context specific.

Research Methodology

An exploratory qualitative research design was chosen to study the impact of Basel III regulations on bank's lending and growth rates. The research setting was the eThekweni Municipality. Purposive sampling to specifically target 10 credit managers

that assess credit. The inclusion criteria were that the credit managers have accreditation and have three years' continuous technical experience in credit assessment. The data collection instrument that was used was an interview guide, 10-indepth interviews were conducted and the data was analysed used thematic analysis. The data was coded, extract the themes, review of the themes, and name the themes.

Discussion of the Research Findings

Ten participants were interviewed for this study. The ten banking professionals had more than ten years banking experience and at least five years in a credit/business manager's role. From these managers, 5 or (50%) were females and 5 or (50%) were males, 6 or (60%) were senior credit managers and 4 or (40%) were senior business managers. Those participants with over 30 years of experience represent 40% of the sample size. Those participants with 20-25 years of experience represented 30% of the sample size each, with the group having 30% representing 10 years' experience. All ten participants or 100% of the sample size were employed in the banking sector in the credit division.

Main Themes, Sub-Themes and Synopsis

Three themes emerged from the study, namely, difficulties experienced, the Basel III Accord Regulation requirements and bad debts. **Theme one** generated sub-themes, namely credit criteria, lack of financial information, credit regulation, affordability and collateral. **Theme two** generated a number of sub-themes, namely, increased interest rates, increased cost of capital affecting consumers and businesses, stringent on lending, increased cost of capital affecting banks and bank regulation affecting the industry. **Theme three** generated two sub-themes, namely, provision for bad debt and profitability of bad debt.

Theme One: Lessons in implementing Basel III

Under these theme research participants shared their experience in assessing short and long-term credit facilities and alluded to some of the difficulties in this regard.

Credit Criteria

Credit regulations has ushered in tighter control for granting credit and a list of credit criteria is used to assess the granting of credit facilities. **Research participant 1** stated, "The economic downturn has affected clients' disposable income adversely" In addition, another issue is that "Many new start-up businesses that require credit facilities do not have credit history of no credit profile with the bank or any

other financial institution and therefore find it challenging to obtain a credit facility”.

Credit applications are scored using a scoring model and a benchmark of 60. An applicant scoring below 60 requires further information to motivate the application. Another requirement is that client's applying for a credit facility must provide liquid security in addition to the financial statement, personal balance sheets and cash flow statements. Participant 2 claimed that “the system does not specify the reason for rejection of a credibility facility and this requires an improvement of the system”

Lack of Financial Information

According to participant 3 “there must be adequate information from the client on how the business operates and the cash flow that is required”. Participant 1 too agreed, a lack of financial information and background makes it difficult for the credit manager to fully assess the credit application”. Participant 3 also lamented that, “credit managers have different levels of mandate and therefore the credit manager would have to motivate the application to the next level for approval with a motivation for supporting the application for credit”. Similarly, Rozbach [27] argued that are varying degrees of sophistication across banks that is used to evaluate the credit application. Furthermore, Rozbach [27] claimed that some banks have a subjective evaluation process whilst others have a statistical credit scoring model.

Participant 9 said “Clients do not have the knowledge and financial background to understand how the credit process works which makes it difficult for credit managers to obtain the correct information to proceed with a credit application. “Clients are unable to provide basic financial statements, income statements and also do not understand the requirements of the National Credit Act” (Participant 9). Participant 7 claimed that “Clients often used a facility for the incorrect purpose and do not specify what the facility is needed for so they can be directed to the correct product”

Credit Regulation

“The National Credit Act regulations play a big factor” as clients request more credit than they can actually afford, and their expenses are not in line with their income. Their expenses exceed their income, making this a factor when trying to assist to attain a credit facility” (Participant 8).

Affordability of Attaining New Credit

In order to attain a credit facility, a client's affordability to repay a facility must be assessed. When credit managers were asked about the difficulties experienced with attaining new credit facilities for clients, there was an overwhelming response on the reason why credit is difficult to attain.

Participant 4 highlighted multiple reasons why clients do not attain a facility. "Clients lack the affordability and collateral in order to obtain the credit facility that they require. Financial statement, income statements and balance sheets are required by the bank. Overall, the client has to have a very good business case and present in extreme detail his projections in order to attain a facility" (Participant 4).

Participant 1 had raised the issue about following credit regulations, clients not having credit history as well as the economic downturn verse disposable income. Participant 2 described "the scoring model described to have "many glitches" when trying to score for a credit facility. Clients are also unable to provide security. Participant 3 explained that financial information is needed. Participant 8 and 5 and 1 explained the difficulties experienced which was lack of banking and financial knowledge by clients which, clients also wanting more credit that they can afford. Client's expenses exceed their income.

These are two critical areas, affordability and collateral normally gives clients problems (Participant 8).

Participant 4 also expressed the importance of collateral required to attain a credit facility: "In most cases for overdrafts and loans collateral is needed. So you want to see the financials so we can see the track record to see that the client actually needs to funds and it is repayable" (Participant 4).

Participant 9 explained the negatives that would affect the granting of credit adversely:

"Clients are over indebted; most of them have ITC listings which causes blockages" (Participant 9).

The above findings are supported by the above statement in literature "The National Credit Act was amended in 2004 to correctly assess a client's capacity to pay back credit, ensure all costs of credit is disclosed to the client when taking up credit and interest rates and within the requirements of the National Credit Act" [28].

The following participants explain their difficulties to approve a credit facility to a client:

"In many instances overdrafts when clients come for overdraft facilities and they have arrears with other service providers. We have to ensure those are paid up before we lend. That is where the difficulties lie in order to lend you again" (Participant 5).

"It is not difficult because we approve our facilities in three minutes provided the client has good turnover, no ITC and no dishonors" (Participant 10).

The scoring model on the banking system is purely behavior driven. If there is adequate turnover on the clients account (Participant 6).

Another participant stressed the importance of financial information in order to grant the correct credit facility. This participant explained that when granting a

facility the bank has to be able to recoup funds in event of the client defaulting

“In the case of the client defaulting in repayment of the property the bank needs to be able to recoup the funds that were lent to a client on credit to fund the property. It is dependent on the market at the time of selling the property” (Participant 3). “The biggest difficulty in that would be your debt service cover. Clients are unable to prove affordability in terms of debt service cover and long-term ability to afford to repay and sustain” (Participant 6).

Participant 1, 5, 8 and 9 explained that due to the clients' lack of knowledge in banking, they are unable to produce financial statements. Participant 4 discussed the difficulty when clients' request incorrect credit facilities like a personal loan or overdraft to finance a vehicle, yet the bank offers asset based finance.

Collateral Required for Banks to Grant Credit

When credit analysts and managers score for a facility such as equipment (equipment is different from land and buildings), the customer can have assets of consequence. “A client can have a house worth R10m and can be bond free but if the financials of his business do not show a good credit turnover and does not show capability of servicing the new debt then the bank would not finance this debt” (Participant 2). The approval of a credit facility is based entirely on affordability. This is a great problem faced by business managers. In the past (25 years ago) credit managers used to lend without collateral. With regard to long term loans, if the banking system approves the loan then in this case the bank would not ask for security. However, for judgmental credit, the loan guide stipulates collateral of 50% if it is over a judgmental credit (fixed property/cash). Many clients do not have collateral and the turnover to attain a credit facility as a result the facility will be declined.

Business Loans - If it does not score on the scoring system (if the FRD is too low) then 50% collateral is required. The question is if the client had 50% collateral then why would he want to borrow from the bank? With the collateral there are many other requirements. The bank would require balance sheets, income statements and other financial documentation. All these documents need to be in order to satisfy the credit department in order to approve the facility needed (Participant 2). Often, if the turnover or the conduct of account does not look good, the bank requires securities.

The following participant explains the resistance of collateral by clients:

“Most of the time the client does not want to give securities even though the business is conducted correctly and the business is growing we can give back the security. The client can then use the security given back to invest or use it at a later stage. So attaining security from the client is a problem” (Participant 7). “The hardest thing is collateral, clients do not have collateral. Whether it is an investment or policy there is nothing to offer” (Participant 9).

Theme 2: The Basel III Accord Regulatory Requirements

In this section the rising interest rates, the increased cost of credit affecting businesses and consumers and banks will be discussed. Also, the banking regulation and its stringent lending criteria is affecting the financial industry is also covered.

Increased Interest Rates

Interest rates are normally based on risk and as risk has changed substantially, the prime rate has increased. Previously, a client could get a home loan at prime -2. The situation is not easy anymore as there is more risk involved in credit lending and as a result client would not get a rate below prime. Banks are adding on to their margins in terms of the interest rates so one of the key reasons for this is that in a way client have to be wary when taking up credit facilities. The type of clientele would determine the interest rate. If the customer is at a high risk the interest rate would ultimately be higher. If there is a client who has good credit history by looking at the way they manage their accounts and financials then the risk and interest rate would be much lower (Participant 1).

The South African Reserve Bank (SARB) wants to stimulate growth by maintaining low interest rates. When times are good and people spend lavishly, interest rates increase in an attempt to curb the spending. Currently the interest rates have not increased for a reason. Besides the rating industry that is looming and things could change for the worse the reserve banks are trying to stimulate the economy. In the interest of stimulating the economy they either decrease or increase the rates to curb spending (Participant 3). If they are borrowers it is undoubtedly going to affect them from a cost perspective.

Even though interest rates are on the rise, consumers need their houses and cars hence, they will settle for the high interest rates as they have no other option. "It will affect the banks positively because banks would gain more from every client than we did in the past. Banks would gain fees, monthly account fees, NCA fees as well as facility fees on the type of lending (Participant 9)."

Increased Cost of Credit Affecting Consumers and Businesses

Participants were probed on interest rate increases and how it has affected consumers and businesses that require credit facilities. Their responses were as follows:

The bank will always lend on the basis of affordability. Its fine to ask for an increase but in doing so the impact of the repayment of the interest and to pay back suppliers (will the business be able to pay back?) (Participant 3).

Lending rates have been on the upward trend. In line with inflation and other factors credit has become expensive, although interest rates have fluctuated with the

repo-rate over the past year. "Five years ago, the bank had been very moderate with interest rates but now it moved upward which has started to drill a hole in the pocket of the client, credit has become more expensive. When a client comes in with a pre-approved credit facility and goes to another bank for a better interest rate because of the upward trends, disposable income that remains with clients has been reduced" (Participant 4).

The above findings are supported by literature. "The Basel III requires banks to hold an amount of capital and liquidity when credit is disbursed to a consumer [33]. "Due to the recent financial crisis the lack of liquidity and insufficient capital during the recent financial crisis hence the introduction of the Basel III had been implemented to rectify the short coming of the Basel II Accord which requires banks to hold higher capital and therefore causing the cost of credit to become higher" [29].

The banks lend against risk verse return so when the interest rate goes up our client's interest rates increase but are lending and lend above prime rate so the bank also makes profit. Consumers are paying a higher rate and in desperate times they are willing to pay the high interest rate. With businesses it is also costing them more to finance the debt (Participant 5). Businesses - this would affect their cash flow and the daily running. Some businesses close down as interest rates have increased (Participant 7).

This would also affect the JSE because investors will only put money into a country that interest rates are high. Interest rates affects the country, the client and the bank. In the past five years banks have lowered their targets because they have realised that interest rates are high, borrowing power has lessened and clients demand for credit have decreased (Participant 10).

Increased Cost of Credit Affecting Banks

The participants were probed on how increased cost of credit has affected banks. Their responses were as follows:

"The clients complain about the current interest rates as interest rates are changing all the time. Clients expect interest rates to remain the same. The bank has to change the rating. The interest rates given to the client is determined by the financials produced and most importantly the way the account is conducted. Most clients do not like to accept credit facilities with increased interest rates as they are unable to afford the repayment and are reluctant to agree to a loan with a high interest rate. With the way the economy is going it is a problem with small businesses as they cannot pay back facilities with high interest rates" (Participant 7).

"It still comes down to regulation, we are guided by regulation so if the government comes down and says that we need to tighten our step with lending, it is unfortunate that consumers are going to feel that they are at a disadvantage but it is to build the economy up and consumers to be sustainable over the next few years" (Participant 8).

The above findings are supported by Keefe & Pfleiderer [30] who maintains that “the Basel III introduced several standards designed to reduce the probability of systematic crisis caused by liquidity distress at individual financial institutions. Basel III was introduced in response to the financial crisis of 2007/2008” [31].

Banks Stringent on Lending

The participants were probed on the banks policies and regulations and how it has affected the credit lending process. Most of the responses leaned towards banking regulation such as the National Credit Act (NCA) and the Basel III Accord as well as securities needed in order to grant a credit facility. The responses are as follow:

The following participant explained that the prime lending rate changes due to external factors and currently scoring for credit is used by a scoring model on the banking system. The participant also explained that credit is priced to risk and credit regulation and has reduced reckless lending, making it difficult to attain a credit facility.

“It is also factored into the ratio to price higher. Consumer side of things to a much greater degree I would say because I think in terms of the consumer market prior the National Credit Act (NCA) all banks and all lending institutions went on a drive to grant credit facilities and sometimes with a certain amount of recklessness” (Participant 6).

The next participant discussed securities required for credit lending, credit regulation is also highlighted by this participant and due to this an increased amount of loans are being declined. Clients have investments that help them as security in terms of lending. The banks benefit in terms of growing assets (Participant 9). Decline in the amount consumers can afford credit and to also be wary of the interest rate. Banks have to set aside more funds for liquidity purpose in terms of the Basel III Accord. They have to take into account: liquidity, operational risk, and lending risk hence, it has become stricter. Interest rates are higher. Loans have declined over the past couple of years (Participant 1).

Participant 3 and 2 explain that regardless of increased interest rates, clients who are in need of credit will still take the credit facility. Credit regulation is also highlighted by these participants.

“From the early 2000’s household debt accumulated in South Africa, the debt has far exceeded the growth in the household disposable income. This led to concerns regarding the sustainability of household debt”. The above statement supports the argument that consumers cannot afford to service their debt as the debt is much higher than their disposable income. The increase of interest has adversely affected the cost of lending which consumers have to ultimately pay for.

Banks Regulation Affecting the Industry

Banks in many countries can only lend to a certain degree due to government legislation. The legislation that has been implemented in the past three to five years has affected banks across South Africa. South Africa has eighteen biggest banks namely: Standard Bank, FirstRand Bank, Absa, Nedbank, Investec, Capitec, African Bank, Grinrod Bank, Mercantile Bank, Bidvest Bank, Sasfin, Albaraka Bank, Ubank, HBZ Bank, South African Bank of Athens, Tyme Digital, Habib overseas Bank and Discovery Bank. The South African Reserve Bank (SARB) has set a required minimum reserve ratio of 2.5 per cent [32].

The following participant highlighted that consumers are at a great disadvantage due to increased interest rates which is governed by government regulation to banks. Banks are guided by certain regulations that are put into place. Banks are guided by regulation and if the government requires banks to tighten on their lending, it is unfortunate that consumers are going to feel that they are at a disadvantage, however, this is the banks strategy to strengthen the economy to maintain sustainability over the next few years” (Participant 8).

“It is all about being competitiveness and how things are sold to the client. Right now the client has the monopoly, he can dictate and shop around so they can get the best offering. “You have your big four banks that are constantly negotiating rates (Win and lose some)” (Participant 4).

The interest rates have fluctuated over the past years and it is due to the volatility of the South African market. It is influenced by the government; politically if the country is stable the rates will remain constant. If there is a slight change in the political environment (referring to the changes of finance ministers), it would result in a ripple effect which also includes the Global markets. The rates have changed and are also linked to inflation so this has contributed to the interest rates not decreasing. Remember, higher interest rates affect inflation directly (Participant 2).

At the middle credit lending level, the policies implement and capital adequacy has been determined at higher levels in the bank. It does affect the bank - for any money that they lend out they must reserve money so that when the client needs money down the line or depositors need their funds, this makes it difficult for the bank. “In our space we are not limited by that” (Participant 4). “When we are lending credit, capital is very important in the balance sheet. So, we need to lend capital as well which is a facility to equity. The capital should be more than we are lending” (Participant 5).

There will always be a demand for credit and although the markets are under pressure they tend to get increased business. With credit being as expensive as it is, it is something that all businesses need and have to factor into their expenditure. They have been able to do that. The banks’ profits are governed by the difference between the borrowing rate and lending rate which is a fixed rate. The difference between the two is how banks make their money. Higher interest rates or lower interest rate does not deter most clients as they in need of credit facilities (Participant 6).

“Interest rates have been impacted on credit negatively because banks are at the point where clients are paying to have a facility, for e.g.; Banks are charging 1% for initiation fee on an overdraft facility, clients are not very pleased with that. It also places us in a situation because we are offering the client a facility but we are asking them to pay for it so in that sense it is quite negative to the bank” (Participant 9).

The abovementioned findings are supported by [34] who maintain “The cost of credit and the National Credit Act, the total cost of credit (TCOC) depends on the ruling repurchase rate of the SA Reserve Bank (i.e. 2.2 times this rate, plus 20%) as well as the maximum initial and service fees. The total cost of credit is determined by the repo rate, initial fees as well as a percentage that was set in line with the National Credit Act. Initiation fees are capped at 15% of the loan amount. The service fees for these loans are capped at a fixed amount of R50.00 per a month for the full loan period.

Participant 2 explained that the cost of credit is expensive. Participant 4 stated that banks are becoming less profitable with credit and are looking for other avenues to generate revenue whilst Participant 5 explained that banks have increased interest rates to increase profits. Participant 7 and 8 explained that banks are governed by legislation and government has tightened on reckless lending, hence, interest rates are affected by legislation.

Participants 1, 7 and 8 have said that clients lack affordability due to increased cost of credit. The cost of credit is on the increase due to the constant regulatory change and requirements [3]. Participant 1, 2 and 4 stated that clients are reluctant to borrow due to increased interest rates. The findings from literature indicates that household debt has been on the increase where consumers were unable to pay existing debt with their current disposable income, consumers cannot afford to take up further credit [17].

The banks do make more revenue when interest rates are higher. Participant 6 states that interest rates have not deterred the client from borrowing as they need credit, however, Participant 5 and 7 and 9 said it is difficult to get clients to borrow as interest rates have increased, which also affects their disposable income for new and existing credit as well as service fees. Contributing factors which have caused a decline in personal credit is due to household constraints like finances, increased unemployment and slow income growth. Due to this, many consumers have become credit adverse, hence, were reluctant to take on new debt.

Participant 1 and 8 maintained that banks have become stricter with lending requirements and banks have targets to meet, however, lending has become tighter. Participant 1 and 2 explained that the Basel III Accord ensures that banks lend funds correctly and that the amount of risk taken by the bank in terms of credit lending requests that they keep aside more liquid funds in line with the regulation. Liquidity, operational and lending risk has become stricter. Participant 4 also affirmed that for the amount of funds lent out to a client, an amount has to be reserved by the bank as the capital requirement, whilst Participant 5 said that the retained amount needs to be higher. The Basel III Accord was designed and implemented to improve the capital

and liquidity requirements in event of banks facing financial crisis [22]. Capital conversion buffers were introduced in the Basel III Accord, the required percentage benchmark for the capital conversion buffer was 2.5 per cent which had been an additional reserve to facilitate banks in stressful situations [22].

External Factors Affecting Banks Interest Rates

Banks need to make money in order to make a profit. For example, Wesbank, “When we try to get a better interest rate for the customer the bank prefers to back out the deal as the bank would incur a loss (Participant 2).” It is obviously affected by supply and demand in the market and who the key players are when it comes to certain commodities so something like fuel that is volatile affects the fuel industry. All the companies that transport food would affect the increase in the prices of food as the cost of transportation has increased resulting in a snowball effect.

Theme Three: Bad Debt

Bad debt is when credit is granted to a consumer by the bank but when the consumer is unable to repay their debt it is considered as “bad debt” to the bank because they cannot recoup these funds from the client which becomes a loss and has to be written off their books.

Provision for Bad Debt

This bank in particular, about eight years ago the scored model was introduced for both consumer and business. The system was still in its infancy and also up for abuse in that staff and consumers knew how to manipulate the system. As a result, banks have made more provision for bad debt; they have set aside funds in an event a client defaults on payment. This has impacted on profitability. (If the bank does not lend more funds, there is no interest in return). Being an institution that lends money (key function) apart from investments, the banks’ loan book is not good and this will affect profitability (Participant 1).

“Bad debt affects the balance sheet of the region then it affects the balance sheet of the entire country as it has a ripple effect, if one region performs badly it affects other regions adversely as its profitability is counted for holistically” (Participant 2). In this particular case, bad debt has been written off but banks have also become harder on debt. They have decreased the room for the writing off of bad debts by taking precautions to mitigate risk. If there is not enough turnover shown on a client’s account it goes straight to the credit department in Johannesburg.

Profitability of Data

In terms of profitability and making the business profitable it has obviously seen a decrease. In some divisions in the bank it has cost staff members or staffs their jobs. So, it has also come down to tightening the expenses to try to generate additional income that has been lost (Participant 8). Profitability on the side of the bank when they lend funds the objective is to make profit, so by charging more there is higher profit made. In most cases because of the repo-rate being on an upward trend even if the bank charges more they also pay more.

“Our lending system is quite good. Our bad debt book is on an increase but we would like to think the systems that are in place has decreased the bad debt” Participant 8. “Not really that much, we do have a good credit/recoveries department. We sign letters of surety ship so we do try and get as much as we can from clients that fall into our bad debt book but it has been maintained. FNB is very conservative when it comes to lending so when we do lend, we have all our ducks in a row. So when it comes to bad debt we obviously pricing for debt and we know how to recover” Participant 9. Participant 1 maintained that banks are making more provision for bad debt when clients default. Participant 2 stated that bad debt has been written off but banks have made it harder to attain credit and more procedures have been put in place to recover bad debt and Participant 9 has explained that bad debt recoveries has been on the increase, banks have also become more conservative with their lending. Participant 4, 5, 6 and 8 all agreed that bad debt has been on the increase in the past five years whereas Participant 3 and 7 said that bad debt has decreased and Participant 9 said that banks are managing their books well and are more conscious and conservative when lending credit. Bad debt recoveries have been on the increase as well.

Conclusions

Challenges with Credit Facility

The findings reveal that there is strict credit criterion that is applied in evaluating an application for a credit facility. Banks have become very conservative with their lending to align with the Basel III requirements.

Stricter credit criteria mitigate the risk of the bank becoming insolvent due to the writing off of bad debts. The higher capital requirement serves as a buffer for instances when the client is unable to repay the debt owed to the bank. Overall, the capital retained needs to be higher than the capital lending. The law protects and safeguards both the financial institution and the consumer from risks. Credit has also become expensive as it is priced to risk. Bank apply higher interest rates for clients with impaired credit ratings and the bank is then able to recoup funds sooner.

The difficulties have been discussed and outlined in the above paragraph. Due to the Basel III Accord, banks have become stricter with credit lending. If a client does not qualify for a credit facility, he/she will not be granted the facility. The Basel

III Accord however safeguards the client and the financial institution because if the client lacks affordability then they would not be granted the facility. The banks are safeguarded in the sense that the loss of repayment is mitigated due to the stringent measures of the Accord.

Basel III Affected Loan Growth

Although there is a need for credit facilities by businesses and consumers the findings reveal that the loan growth rate has decreased in the past five years. The Basel III regulation has caused an increase in interest rates due to more stringent credit measures and the consequence is a decrease in the loan growth. Banks have to hold higher funds in alignment with the Basel III requirements.

In assessing credit applications and credit worthiness and this is risk to payback the bank may require that a 50% collateral is provided to align with the Basel III liquidity ratio.

The National Credit Act provided safeguards for consumers not to be overexposed and indebted. There is a decrease in risk for banks falling over reckless lending.

Hence the Basel III Accord capital requirements provides banks with higher capital buffers. Due to this, interest rates have increased substantially. Collateral is also required when granting of credit facilities so if a client does not have funds, he/she will not be able to attain a credit facility.

Increased Cost of Credit

The Basel III regulation affects the cost of credit because there are less loans approved because of the stringent credit criteria. Interest rates on credit facilities are influenced by stringent legislation and lower loan growth. Client and businesses seeking credit are forced to pay higher interest rates increasing the cost of credit (interest rates and facility charges).

The South African Reserve Bank (SARB) plays a significant role in interest rates. Interest rates are controlled by the South African Reserve Bank (SARB). When consumers overspend then the South African Reserve Bank (SARB) increases interest rates to reduce consumer spending and debt and reduce interest rates to stimulate and encourage consumer spending.

Interest rates have increased the cost of credit and this ultimately affects banks negatively Interest rate is linked to prime and fluctuates. South African banks are priced to risk because of the bad debt. Priced to risk to gain earlier recovery in event of a client being unable to pay their debt. This safeguards the bank as their bad debt book would be on the decrease. Clients can always shop around for better interest rates at other banks and banks are constantly negotiating

Recommendations to the Banking Sector

The Basel III Accord is a framework set by the government and cannot be altered. It is there to safeguard the banks and its capital as the National Credit Act is there to protect consumers. Banks need to comply with the conservative nature of credit lending to avoid jeopardising the financial system that may lead to another global economic crisis. Banks need to adhere to all risk weighted ratios and constantly keep within those parameters in order to maintain a financially sound business.

The banking scoring models to score a client for a credit facility across the banking system must be updated and aligned across the Basel III regulation. In addition, banks must ensure that all employees responsible for credit assessment must have updated knowledge on Basel III Accord Regulations.

Conclusion

Basel III Accord has placed high demands on financial institutions. The key consideration is to find a solution that allows these banks to comply Basel III and streamline their systems and processes to reduce capital requirements and improve operational effectiveness. This study indicated that among the signatories of the Basel Accords are some of the BRICS countries. South Africa being a member country, and as a leading partner on the banking sector performance could influence positively the other countries in complying with and implementing the BASEL III rules and regulations. This will help a great deal in effective and efficient banking operations in the studied organisation going forward.

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