Is the National Credit Act accidentally a step towards curtailing financial system fragility as described by Minsky's Financial Instability Hypothesis?

Usanda Gqwaru
School of economic and Business Sciences, University of the Witwatersrand

Paper presented at the biennial conference of the Economic Society of South Africa
31 August 2017 – 1 September 2017
Grahamstown, Eastern Cape

Abstract
This paper argues that the South African National Credit Act (NCA) accidentally provides a method to curtail fragility in the financial system caused by reckless lending to individual consumers. This paper makes use of Minsky's Financial Instability Hypothesis (FIH) to describe how a financial system moves stability to instability and possible end up in a financial crisis. Minsky's FIH focused on credit extended by creditors to non-financial firms, however this paper extends the application of Minsky's FIH to credit extended to consumers. According to the hypothesis, Minsky argued that the financial systems of free market or capitalist economies are inherently unstable. He argued that during a period of economic prosperity, creditors become optimistic and take greater lending risks in search for higher returns anticipating that the trend will last. This optimism leads to high leverage by the financial or banking system, such that an external shock for example a rise in bad debts can lead to a financial crisis. Minsky advocated for government intervention aimed at preventing a financial crisis this includes regulation and central bank action. Minsky's proposals to address the FIH are similar in purpose and desired outcome to South Africa's NCA. The NCA 34 of 2005 came into effect in South Africa on 1st June 2006. One of the purposes of the Act is to prevent reckless lending by creditors to consumers, thus consumer over-indebtedness. The motivation to curtail consumer over-indebtedness was not the prevention of fragility in the financial system, but was a result of concerns about its social implications. The Act prohibits lenders from providing loans to consumers without determining whether a consumer will be able to repay a loan and if reckless lending is proven, Courts can set aside the debtor's obligation to repay a loan. By making it costly for banks to engage in reckless lending, the NCA provides a disincentive for South African creditors to engage in reckless lending and this suggests that if a regulation similar to the NCA was in place in the USA before the 2008 Subprime crisis this might have aided in averting the 2008 Subprime crisis since it is attributed to reckless lending to consumers with poor credit scores.

1. Introduction
The 2008 financial crisis triggered by 2008 Subprime crisis in the United States of America (USA) has been regarded as one of the biggest financial crisis since the Great Depression by Alan Greenspan and other economists (Ryan, 2008; Kregel 2010). The 2008 Subprime crisis is widely attributed to reckless lending by banks to consumers. Due to the globalisation, the crisis had a negative impact in the global economy and the banking system in the USA and other countries that held USA subprime backed securities. It contributed to the collapse of banks for example Lehman brothers in the US which had $639 billion in assets and $619 billion in debt, making it the largest victim of the crisis and the nationalisation of Northern Rock bank in the United Kingdom (UK). The crisis led to a recession round about 2008-2009 in North America and Europe and a slowdown in economic growth in China and other countries. Amongst others the financial crisis was also characterised by loss of jobs, a decline in the value of listed shares and pension funds. This crisis brought to the fore the severe impact that a

financial crisis can have on the global economy and economies of different countries and it raised questions on the effectiveness of financial regulations in place.

This crisis had been dubbed the Minsky Moment because it reflects the process that leads to a financial crisis as described in Minsky's Financial Instability Hypothesis. Minsky argued that the financial system of free market or capitalist economies is inherently unstable. He argued that during periods of economic prosperity, creditors become optimistic and adopt riskier lending practices in search for higher returns assuming that the good times will last, consequently creating fragility in the financial system, that can cause a financial crisis in case of an economic shock for example a shock that leads to an increase in loan repayment default rate. In his analysis of the financial system, Minsky divided the private sector into borrowers, who were generally non-financial firms and creditors for example banks, where borrowers made investments in fixed capital from operating profits or loans and creditors provided the loans (Minsky, 1986, 1992). This paper extends the application of Minsky's FIH to credit extended by creditors to individual consumers. This paper argues that the South African National Credit Act (NCA) unintentionally provides a method to curtail fragility in the financial system caused by reckless lending to individual consumers. The paper refers to this as unintentional, because this is not what the Act was intended for.

This paper is structured as follows:

- Section 2 provides an overview of the NCA
- Section 3 provides an overview of Minsky's FIH and argues that the NCA provides insights to curtail financial fragility as described in Minsky's FIH. In this section this paper also argues that the NCA could have aided in preventing financial fragility that led to the 2008 subprime crisis.
- Section 4 concludes

2. An overview of the NCA

The South African National Credit Act 34 of 2005 (NCA) came into effect on 1st June 2006. The NCA governs the South African credit industry and it replaced two Acts that is the Usury Act 73 of 1968 and the Credit Agreements Act 75 of 1980. Amongst others the NCA was designed to promote fair credit practices, to establish national norms and standards relating to consumer credit, to address over-indebtedness, to ensure transparency and to prevent predatory and reckless lending.

This paper will focus on one of the purposes of the NCA that is the prevention of reckless lending to consumers, therefore consumer over-indebtedness. Initially when the NCA came into effect in 2006 it provided guidelines that were unenforceable aimed at preventing consumer over-indebtedness. A consumer is said to be over-indebted according to the Act if the consumer is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which he or she is a party. As expected, this Act came into effect as South Africa was experienced a fast growing middle class. Observing that consumer debt to disposable income continued to increase rapidly coupled with the an increasing number of consumers with impaired credit (which implied that consumer over-indebtedness was increasing), the South African government changed the guidelines into regulations through the National Credit Amendment Act of 2014 which came into effect on 13 March 2015. In its current form the NCA prohibits reckless lending to consumers with the aim of preventing consumer over-indebtedness. It is interesting to note that the NCA has placed great value on the prevention of consumer over-indebtedness, given that the matter is not seen as a major problem in the economic discourse. During an interview with government, the author learnt that the motivation to prevent consumer over-indebtedness was due to concerns regarding its social implications for example residential property repossessions and this was not based on Minsky's FIH. This could be because the government was avoiding providing social housing to people who lost their homes due to over-indebtedness. This being the case, this paper demonstrates that accidentally the NCA provides a mechanism to curtail fragility in the financial system due to reckless lending to consumers. This is accidental, because the fundamental principle of the Act is consumer protection, not to the prevent fragility in the financial system.

Section 81 of the NCA requires a credit provider to do an assessment on the consumer before entering into a credit agreement. The assessment is in three parts:

a. The credit provider is required to take reasonable steps to ensure that the consumer has an understanding and appreciation of the costs and the risks of the proposed credit and the consumer's rights and obligations under a credit agreement.
b. The credit provider is required to assess the repayment history of the consumer under credit agreements.
c. The credit provider is required to assess the existing financial status of the consumer in terms of the consumer's financial means, prospects and obligations.

The NCA requires that the assessment be done to ensure that the consumer is able to repay the proposed debt under a credit agreement and to prevent reckless lending. The NCA defines three forms of reckless lending by the credit providers that is:

i. Failure to conduct the three part assessment in section 81 of the NCA irrespective of what the outcome would have been.
ii. Reckless lending occurs when the credit provider enters into a credit agreement with the consumer whereas the consumer did not understand or appreciate the risks, costs or obligations under the proposed credit agreement.
iii. Lastly reckless lending occurs when the assessment indicated that entering into a credit agreement with consumer would render the consumer over-indebted, however the credit provider still went ahead and entered into a credit agreement with the consumer.

For individuals the ability to repay a loan according to the NCA is based on the current income, for example a salary not potential income. The NCA applies to some business loans, however deliberating on this aspect is beyond the scope of this paper, since this paper is confined to credit extended to individual consumers.

3. An overview of Minsky's FIH and insights from the NCA towards addressing financial fragility stemming from reckless lending to consumers.

This section provides an overview of Minsky's FIH and argues that the NCA provides a method to prevent financial fragility stemming from reckless lending to consumers. Minsky's FIH describes the process that leads to fragility in the financial system of free market economies. In this section this paper also argues that the NCA could have helped in preventing the 2008 subprime crisis.

3.1. An overview of Minsky's FIH

Hyman Minsky (1919-1996) developed the Financial Instability Hypothesis (FIH). Minsky spent much his academic career studying and explaining financial crises. This hypothesis became a lot more pertinent as a result of the 2008 US Subprime crisis. According to the Hypothesis, Minsky argued that the financial systems of free market or capitalist economies are inherently unstable. He argued that during a period of economic prosperity, creditors become optimistic and take greater lending risks in anticipation that the trend will last. As creditors take greater lending risks in order to increase profits, this endogenously creates financial fragility in the financial system that may lead to a financial crisis especially if there is an economic shock for example a sudden increase in interest rates. Minsky (1957) showed that, when faced with insufficient reserves, creditors satisfy the demand for loans to finance investments by firms through financial innovations. These financial innovations helps creditors to increase their loan book and as such their profits, however they come at a great risk. Minsky's FIH, attempts to explain how free market economies endogenously generate a financial structure which is susceptible to a financial crisis (Beshenov et al 2015) and how the normal functioning of the financial system in a recovery period will lead to a boom and a financial crisis (Minsky, 1983; Mullineux, 1990). Minsky generalised the FIH as follows. “The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an instable financial system” (Minsky, 1992). The FIH demonstrates that “stability – or tranquillity – in a world with a cyclical past and capitalist financial institutions is destabilising” (Minsky, 1985; Beshenov et al 2015). Minsky (1974) conceded that a fundamental characteristic of free market economies is that the financial system swings between robustness and fragility and that these swings are an integral part of the process that generates business cycles. To curtail a financial crisis, Minsky advocated for government intervention this included regulation and central bank action.

As noted above Minsky’s analysis of the financial system was based on the interaction between financial firms and non-financial firms, where financial firms were lenders to non-financial firms. This paper extends this analysis to an interaction between creditors and individual consumers, where creditors lend to consumers for example in the form of mortgage loans or loans to acquire a vehicle (vehicle finance).

Minsky explained the process from stability to instability using three phases of debt that is the Hedge phase, Speculative phase and Ponzi phase.

a. The Hedge phase: In this phase lenders are cautious within a growing economy and tend to have a strict lending criteria. In this phase lenders lend to consumers who are able to repay the entire their loan that is both the interest and capital portion based on the creditor’s lending criteria.

b. The Speculative phase: In this phase as result of economic prosperity, creditors become more optimistic and relax their lending criteria. In the case of mortgage loans, creditors begin to extend credit to consumers who are only able to repay a portion of the loan in anticipation that the borrower will sell the asset and pay off the remaining portion of the loan on maturity.

c. The Ponzi phase: This is the phase that precedes the financial crisis or the end of the bubble. In this phase creditors extend credit for purchasing assets to borrowers who are unable to pay both the interest and principal portions of their loan in anticipation that at maturity the borrower will sell the asset at a higher price and pay both the interest and principal portion of the loan.

The next section provides a detailed exploration of the phases that are step further on the risk side which are the Speculative and Ponzi phase and provides insights from the NCA to curtail financial fragility as described by Minsky's FIH stemming from reckless lending to consumers.

3.2. The Speculative and Ponzi phases and insights from the NCA in minimising financial fragility

A. The Speculative phase: In this phase as a result of the economic boom, creditors become optimistic and take greater lending risk, this could be through innovating more risky financial products or lending to more risky borrowers. This allows creditors to earn better returns. They begin to extend credit to consumers who are only able to repay a portion of their loan for example this could be consumers who are only able to pay the interest portion of their loan and not the capital portion. For example in the case of mortgage loans or vehicle finance, banks begin to provide credit with a balloon or residual instalments to clients who are able to pay a portion of their loan. In the case of the property market, an economic boom tends to be accompanied by increasing property prices which in itself fuels credit expansion, this is because an increase in property prices implies that consumers are able to get more debt based on the higher prices. During a period of increasing property prices, consumers also tend to demand more credit by increasing their mortgage loans based on the higher property prices.

A balloon or residual instalment allows a borrower not pay a portion of the loan until the end of the loan period and then pay it off in one huge instalment. This helps to reduce the monthly instalments for the borrower. In vehicle finance the balloon payment could be the market value of the vehicle when the balloon payment is due, under the assumption that the vehicle depreciates over time. There are two types of residual instalments in vehicle finance that is the ownership and non-ownership residual. Under the ownership type, the buyer is responsible for payment of the balloon payment. The non-ownership type is associated with rental agreements. Under this type, at the end of the loan period the creditor still owns the vehicle and is responsible for reselling the vehicle to settle the balloon payment. Creditors typically would therefore place certain restrictions under this type like a mileage ceiling in order to ensure it resale value. Balloon payments are generally offered under the assumption that at maturity, the asset will be sold to settle the balloon payment.

South Africa is not active on mortgage loans with balloon payments, but is active on vehicle finance with balloon payments. Vehicle finance with balloon payments have increased in South Africa and they are always favourable to consumers as they are able to acquire vehicles with low instalments and banks have an option to resell the vehicle at the end of the period as a settlement for the balloon payment or consumers simply take loans to settle the balloon payment when it's due or opt to refinance it. This financial innovation helps the banking system to extend credit to consumers who wouldn't have been able to repay both the interest and capital payments of the vehicle finance and it fuels credit as consumers are able to acquire vehicles they wouldn't have been able to do so, had there been no balloon payment. Loans with balloon payments are more risky than those granted to borrowers who can repay both the interest and principal portion of the loan.

Given that the NCA prohibits creditors from lending to borrowers who are unable to repay a loan, balloon payments may viewed as a financial innovation that enables creditors to expand credit to consumers who are able to repay a portion of their loan.

Mortgage loans with balloon payments are more risky than vehicle finance with balloon payments because:

i. The value of a mortgage loan per individual tends to be far bigger than the value of a vehicle finance loan,
ii. The market for people who qualify for mortgage loans tends to be less than the market for those who qualify for vehicle finance loans and this makes it a challenge to sell a property at a fair value especially when property prices start to fall as compared to disposing a second hand vehicle.
iii. It’s a risk to offer mortgage finance with balloon payments based on increasing property prices, because it is hard to predict when the prices will cool off, whereas in vehicle finance the balloon payment tends to be the market value of the vehicle, under the assumption that the vehicle depreciates over time.

Currently balloon payments are not regulated under the NCA, however the government is looking at tightening the NCA. If government were to regulate balloon payments, one would argue that they would restrict balloon payments to the non-ownership type, since the NCA is based on consumer protection. Let’s assume they do this, this means that creditors will be cautious when they offer loans with balloon payments and whenever creditors are cautious you are tilting towards the hedge phase and this translates to reduce financial system fragility. Theoretically, noting that mortgage loans with balloon payments are more risky than vehicle finance with balloon payments, it might be desirable to restrict balloon payments for mortgage loans to the non-ownership type and not to regulate balloon payments in vehicle finance. In vehicle finance the regulation of balloon payments is not desirable because:

i. Residual payments whether it’s the ownership type or non-ownership type, on maturity they are secured by the resale of a second hand vehicle which is easier to sell for a fair price.
ii. You don’t want to discourage financial innovation since innovation is important for economic development, however you want to prevent reckless lending and balloon payments in vehicle finance are less risky.

In conclusion credit extended during the speculative phase is more risky when compared to credit extended during the hedge phase. This risk is higher in the market for mortgage loans as compared to vehicle finance.

B. Ponzi phase: As a result of the economic boom, at this juncture in the property market, creditors are still optimistic that the increase in property prices is sustainable and they begin to offer even more risky loans as compared to the speculative phase. Creditors lend to borrowers who are unable to pay both the interest and principal portions of their loan in anticipation that at maturity the borrower will sell the asset at a higher price and pay both the interest and principal portion of the loan. This phase depends on rising asset prices. The borrower is also optimistic that the property price will continue to increase, with the hope of selling at a higher price in order to repay both the interest and the principal and subsequently make a profit. However, it can be expected that the increases in property prices will ultimately slow down demand, and this will be followed by a decline in prices. The decline in prices will lead to a high default rate by borrowers in this phase and will also negatively affect the borrowers in the speculative phase whose balloon payments were based on higher prices. Vercelli’s (2009) research highlighted that the 2008 financial crisis reflects Minsky’s debt cycles that is when the United States economy was booming it endogenously generated fragility in the US financial system.

In the case of South Africa the Ponzi phase wouldn't take off, because the NCA prohibits reckless lending or lending to those who are not able to repay the loan. South African banks do not play in the Ponzi phase as described by Minsky and this in turn reduces financial system fragility due to reckless lending to consumers.

In conclusion moving from a hedge phase to a speculative phase introduces financial system fragility and moving to a Ponzi phase greatly increases the fragility and in the case of an economic shock, this may lead to a financial crisis.

Based on the discussion above one can deduce that the NCA provides a method towards addressing financial system fragility originating from reckless lending to consumers. It does this by averting an economy from moving into the Ponzi phase that is it prevents Minsky's debt phases from unfolding completely. Since it's a government regulation it supports Minsky's proposal for government intervention. The NCA provides a disincentive for South African creditors to engage in reckless lending, because if that is proven in court, they risk losing the credit extended. This suggests that if a regulation similar to the NCA was in place in the USA before the 2008 Subprime crisis this might have aided in preventing 2008 Subprime crisis since it is attributed to reckless lending to consumers with poor credit scores. Regulations similar in purpose and intended outcome to the NCA can aid in reducing financial fragility in capitalist economies. The role of the central bank as lender of last resort is important in bailing out banks in distress, however the advantage of a legislation similar to the NCA is that it prevents an economy from moving into the Ponzi phase and as it is said 'prevention is better than cure'.

4. Conclusion

This paper demonstrates that accidentally the NCA provides a method to curtail fragility in the financial system due to reckless lending to consumers. This shows that regulations similar to the NCA have a role to play in reducing financial fragility by preventing an economy moving from a Speculative phase to a Ponzi phase. This is because it prevents creditors from lending to consumers who are unable to repay their loans. Preventing an economy from moving into a Ponzi phase is crucial in preventing a financial crisis as this is the phase that precedes a financial crisis in an event of an economic shock. The advantage with the NCA is that it prevents an economy from advancing into the Ponzi phase, instead of alleviating the impact of a financial crisis when it has taken place. This paper shows that regulation similar to the NCA is one of the measures government can use to avert financial fragility in line Minsky's proposal that government intervention is important in preventing financial fragility.

This paper argues that if the US had regulations similar to the NCA in place before the 2008 Subprime crisis, this might have prevented the US subprime crisis. The NCA is a disincentive for banks and other creditors in South Africa to engage in reckless lending.

References:

Beshenov, S. & Rozmainsky, I. (2015). Hyman Minsky's financial instability hypothesis and the Greek debt crisis. *Russian Journal of Economics. 1* (4). 419-438.

Kregel, J. (2010) Minsky moments and Minsky´s proposals for regulations of an unstable financial system. Draft of Opening Remarks for the 19th Annual Hyman P. Minsky Conference. Available at: http://www.levyinstitute.org/pubs/conf_april10/19th_Minsky_Kregel_drt.pdf

Minsky, H. P. (1957). Central banking and money market changes. *Quarterly Journal of Economics*, *71* (2), 171–187.

Minsky, H. P. (1974). "Our Financial System is Fragile". *Ocala Star Banner*. Available at: http://digitalcommons.bard.edu/cgi/viewcontent.cgi?article=1274&context=hm_archive .

Minsky, H. P. (1983). The financial instability hypothesis: An interpretation of Keynes and an alternative to "standard" theory (pp. 282–292). In J. C. Wood (Ed.), *John Maynard Keynes. Critical assessments*. London: Macmillan.

Minsky, H. P. (1985). The financial instability hypothesis: A restatement (pp. 24–55). In P. Arestis, & T. Skouras (Eds.). *Post-Keynesian economic theory: A challenge to neoclassical economics*. Brighton: Wheatsheaf.

Minsky, H. P. (1986). *Stabilizing an unstable economy*. New Haven, CT: Yale University Pre-ss.

Minsky, H. P. (1992). The Financial instability hypothesis. *Jerome Levy Economics Institute Working Papers, 74*.

Mullineux, A. W. (1990). Business cycles and financial crises. *Hemel Hempstead: Harvester Wheatsheaf.*

Renke, S. (2011). Measures in South African Consumer Credit Legislation Aimed at the Prevention of Reckless Lending and Over-Indebtedness: An Overview Against the Background of Recent Developments in the European Union. Available at: https://www.researchgate.net

Ryan, S. G. (2008). Accounting in and for the Subprime Crisis. *The Accounting Review, 83 (6), 1605-1638*

Vercelli, A. (2009), 'A perspective on Minsky Moments: The core of the financial instability hypothesis in light of the subprime crisis', *Levy Economics Institute of Bard College - Working Paper No. 579,* http:/ /ssrn.com /abstract=1486128