

**The Cost of Credit  
in the Micro-finance Industry  
in South Africa**

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## **Abstract**

This thesis analyses the cost of credit in the micro-finance industry in South Africa. The study situates micro-lending agreements within the law of contract, beginning with an examination of contractual fairness in terms of the common law: the fundamental principle of freedom of contract that underpins the common law of contract; the principle that agreements contrary to public policy should not be enforced; and the impetus given by constitutional values that inform public policy. In regard to moneylending transactions, common law usury law will be explained.

The study then goes on to trace the origins and rapid growth of the micro-finance industry which was made possible by its exemption in 1992 from the Usury Act 73 of 1968. The upshot of this development was that registered micro-lenders have for nearly 14 years charged excessive interest rates, and continue to do so. The dire socio-economic impact of these high interest rates on individual consumers and low-income communities is then demonstrated: how borrowers of small loans soon become over-indebted; the loss of billions of rands every year to low-income communities in the form of interest on micro-loans.

The study then shifts to the legislative response to the need for consumer protection in regard to consumer credit. The extensive credit law review process is explained, resulting ultimately in the National Credit Act 34 of 2005, which allows the Minister to prescribe limits on interest rates and fees in all sectors of the consumer credit market.

The prescribed limits on the cost of credit in the micro-finance sector are thoroughly explained and analysed, with particular reference to the implications of each element

of the credit costing structure, and the combined impact of the total cost of credit on different types and sizes of loans. The envisaged maximum interest and fees will markedly alter the positions of micro-lenders and consumers, and receive careful analysis.

The study closes with a summary of findings in the thesis, which includes suggested amendments to the National Credit Regulations and a review of possible legal challenges to the high cost of credit on smaller loans.

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# Chapter One

## Introduction

### 1.1 The general purpose of this study

The principal object of this research is to examine the law relating to the cost of credit in the micro-finance industry in South Africa. The reasons for this study will become apparent from the narrative below, which illustrates the legal problem that this thesis seeks to address and provides a context for the research.

Agnes is a 52 year old domestic worker earning R1 000 per month. She is a single mother of two teenage children, and is the sole breadwinner in the household which includes her sister, who is ill with tuberculosis, and her sister's young son. She realises the value of education, having herself managed to complete only grade 9, and is determined that her children should complete their schooling.

In January 2007 she has to buy school uniforms for the new school year, for which she needs R1 000. She has a cheque account with a bank but she does not qualify for an overdraft facility and her bank is not willing to give her a loan. She has been warned not to borrow from the *mashonisas*<sup>1</sup> in her neighbourhood, who have a reputation for being harsh, charging exorbitant interest rates and taking borrowers' identity documents or bank cards. There are a number of micro-lending enterprises in the town in which she lives, and she diligently shops around to find the cheapest available credit. All the businesses that she visits charge interest of at least 30% per month. In desperation she approaches a local community advice office, where a paralegal advises her that there will be a new law in place on 1 June 2007 which will force micro-lenders to charge much lower interest rates – 5% per month on smaller loans – and that she should try to wait until June before borrowing money. There are certain items like shoes that her children cannot do without, so she decides to borrow R500 from Cash Loans CC, and to wait until July before borrowing a further R500, when she will buy the remaining clothing. She is told that if she takes out a one month loan of R500, she will have to repay R650 at the end of the month, and calculates that she will not be able to afford to do that. She decides instead to repay

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<sup>1</sup> Xhosa translation for moneylender. *Mashonisas* are township lenders who operate outside of the formal sector (Ebony Consulting International "DTI Interest Rate Study" 28 <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006).

the loan over six months in order to ensure that the loan is repaid before she takes out the next loan. The loan repayments will be R189 per month.

In a period of only six months, Agnes will have to repay R1134, being well over double the amount that she borrows, and will use 19% of her monthly income to do so. This will have a terrible impact on the household, leaving only R811 per month for her to pay for necessities such as food, rental, municipal services, clothing, medicine and transport. Of the total of R1134 that she will repay to the micro-lender, R634 will be paid to service the debt, representing over 10% of her total income for six months. If Agnes had had no basic arithmetic skills, she may have ill-advisedly agreed to repay R650 at the end of one month, which would have left her family with only R350 to live on. This may have forced her to take out a further loan of R650 at the end of the month, and she would have very quickly ended up in a permanent debt trap.

Agnes' predicament represents the hard reality faced by millions of South Africans – the vast majority of the economically active population – on an ongoing basis. Low incomes relative to the cost of living ensure that these people have to borrow money in order to provide for the basic necessities of life. The lack of security for their debt ensures in turn that they will pay much more for credit. The typical interest rate of 30% per month (360% per year) that is common today<sup>2</sup> is 18 times the current maximum interest rate prescribed by the Usury Act.<sup>3</sup> The cost of debt for lower income consumers is therefore proportionately higher, indeed at least 18 times higher, than that of wealthier consumers who will qualify for a bank loan or other credit. People with low incomes become over-indebted because of their poverty (being forced through need to turn to micro-lenders), and their poverty is exacerbated as a result. Many people become permanently indebted because of basic economic needs, making loan repayments on an indefinite basis.

When Agnes returns to the micro-lender for her next loan of R500 in July 2007, she expects to pay interest at 5% per month as the paralegal had advised her. She has already calculated that she will be able to afford to repay this loan within a month, and the amount that she will have to repay will be R525 (the R500 loan plus 5% interest, amounting to R25). To her horror, however, she discovers that the second

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<sup>2</sup> See 4.2.3 below.

<sup>3</sup> The current maximum for loans less than R10 000 is 20% *per annum* (GN 1100, *Government Gazette* 26809, 17 September 2004), which will remain in force until 31 May 2007.

loan will cost as much to repay over one month as the first loan. As a result, she has no choice once again but to repay the loan over six months.

The maximum interest rate on short-term loans in terms of the National Credit Regulations<sup>4</sup> will be 5% per month, but the new initiation and service fees introduced by the National Credit Act<sup>5</sup> and Regulations will ensure that the total cost of credit on a loan of R500 could be as much as 31% per month.<sup>6</sup> Borrowers of small loans such as Agnes are likely to pay more or less the same as they do in the current regime of no interest rate limits.<sup>7</sup>

## 1.2 The specific goals of the research

The overriding question that the research will aim to answer is: do current and envisaged regulated limits on the cost of credit in South Africa afford appropriate protection to recipients of micro-loans?

The specific goals of the research are to achieve the following:

- (a) To present all relevant law that impacts on the current and envisaged cost of credit in the micro-finance industry, including the common law, legislation and constitutional considerations, and to examine the extent to which this law can protect borrowers of high-cost loans.
- (b) To demonstrate the socio-economic impact of high credit costs on lower-income individuals and communities as effectively as possible.
- (c) To enhance understanding and appreciation of the gravity of the problem of the high cost of credit.<sup>8</sup>

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<sup>4</sup> National Credit Act (34/2005): Regulations, R489 *Government Gazette* 28864, 31 May 2006, which will come into effect on 1 June 2007 in terms of Proclamation No. 22, Commencement of the National Credit Act 34 of 2005, *Government Gazette* 28824, 11 May 2006.

<sup>5</sup> Act 34 of 2005.

<sup>6</sup> See Table P in Chapter Six below.

<sup>7</sup> See 6.4 below for a thorough analysis of the cost of credit in terms of the National Credit Act and Regulations.

<sup>8</sup> The negative impact of the high cost of credit on consumers is usually not appreciated nor understood even by those who qualify for bank loans, who are often well educated. There is an extremely high level of ignorance of the gravity of the problem amongst lawyers, academics, economists and politicians alike. This lack of interest and concern appears to stem largely from the fact that the negative impact of these high costs is not felt personally by such people.

- (d) To conduct a thorough analysis of the cost of credit provisions in the National Credit Act and Regulations and their impact, including a comprehensive assessment of the full implications of each element of the cost of credit.
- (e) To develop a persuasive argument for keeping the cost of credit in the micro-finance industry as low as possible.
- (f) To propose a suitable approach for establishing appropriate levels for interest rates and fees, and to make suggested amendments to the National Credit Regulations.
- (g) To consider potential legal challenges to the high cost of credit in terms of the current and envisaged law that could form the basis of strategic litigation to combat high credit costs.
- (h) To make a constructive contribution to a just and equitable outcome for the regulation of limits on the cost of credit in the micro-finance sector.

### **1.3 Structure of the thesis**

Micro-finance agreements form part of consumer credit law, which in turn is situated firmly within the milieu of the law of contract. The thesis therefore commences in Chapter Two with an examination of the common law in regard to contractual fairness in general, the impact of constitutional values and their indirect application to contract law, and certain legislative reforms in the realm of consumer law.

The focus will then narrow down in Chapter Three to the common law in regard to usury, with an emphasis on moneylending transactions. Usury legislation and the *in duplum* rule (common law and legislation) will then be reviewed.

The law in regard to contractual fairness (Chapter Two) and usury law (Chapter Three) provide the context for the specific focus of the thesis, being the cost of credit in the micro-finance industry. Further, a consideration of the law in regard to contractual fairness and usury will make it possible to establish the extent to which such law could assist in achieving equitable levels for the cost of credit in the micro-finance industry.

In Chapter Four the enquiry will focus squarely on the birth and growth of the micro-finance industry in South Africa, including the position prior to regulation in 1992, the various exemptions to the Usury Act and the *Lurama* case.

In Chapter Five, the consequences of the failure to cap interest rates in the micro-lending industry for a period of nearly 14 years will be discussed, with an emphasis on the socio-economic hardships suffered by lower-income individuals and communities, and the negative impact on poverty alleviation in general. It will be shown that these consequences could render contractual clauses providing for exorbitant interest rates unenforceable in terms of the common law discussed in Chapters Two and Three.

Finally, the cost of credit provisions in the National Credit Act and Regulations will be thoroughly explained and analysed in Chapter Six. The full implications of the envisaged maximum interest and fees on the total cost of credit will be closely scrutinised, and the socio-economic impact of these costs will be considered. Specific amendments to the National Credit Regulations will be proposed, as well as potential litigation to combat high credit costs in terms of the Regulations. The chapter will also include a brief overview of certain consumer protection measures in the Act that do not relate to the cost of credit, but which are of some relevance to this study.

The thesis will conclude in Chapter Seven with a summary of the specific findings made in the study.

The overarching research methodology has been desktop research of relevant legal texts, journal articles, legislation, cases, policy documents, survey and research material and other materials, all available in hard copy or on the internet. Some *ad hoc* case studies will be referred to, but the research will not be based upon empirical survey material.

The thesis reflects the law as stated in the sources available to me as at 1 December 2006.

## Chapter Two

# Fairness in the South African Law of Contract

### Outline

In this chapter, the question of fairness in the South African law of contract in general will be examined, in order ultimately to address the extent to which the law relating to contractual fairness might have a role to play in achieving equitable levels for the cost of credit in the micro-lending industry. The focus will be on the common law in regard to contractual fairness, with constant reference to constitutional values and their indirect application to contract law. The main purpose of the chapter will be to establish what the current law is in regard to contractual fairness and equity, with some analysis thereof. The traditional approach of freedom of contract, the philosophical underpinnings of our contract law, public policy and good faith will be separately considered, all with reference to constitutional considerations. The chapter will conclude with a brief review of current legislative intervention in regard to contractual fairness and consumer protection. In Chapters Three and Four the enquiry will narrow down to usury laws and the cost of credit in the micro-lending industry, respectively.

### 2.1 The traditional approach: freedom of contract

The South African law of contract has its foundation firmly in *laissez-faire* economic liberalism, which stresses a non-interventionist, individualistic approach to contract.<sup>1</sup> Parties to every contract are perceived to have absolute individual autonomy,<sup>2</sup> being free to decide whether, with whom and on what terms they contract,<sup>3</sup> summarised in the time-honoured term “freedom of contract”.<sup>4</sup> Such autonomy is given expression through the legal concept of consensus to a contract.<sup>5</sup> The principle of sanctity of

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<sup>1</sup> Bhana and Pieterse “Towards a Reconciliation of Contract Law and Constitutional Values: *Brisley and Afrox Revisited*” (2006) 122 SALJ 865 at 867.

<sup>2</sup> *Wynn’s Car Hire Products (Pty) Ltd v First National Industrial Bank Ltd* 1991 (2) SA 754 (A).

<sup>3</sup> According to Hawthorne in “The Principle of Equality in the Law of Contract” (1995) *THRHR* 157 at 163, the doctrine of freedom of contract appears to be used in four distinct senses: freedom to negotiate terms without interference; freedom to agree terms that will be given full effect without interference; freedom to contract with whom one chooses; and freedom to choose not to contract.

<sup>4</sup> See, for example, Atiyah *The Rise and Fall of the Freedom of Contract* (1979) 388–405.

<sup>5</sup> Visser “The Principle *pacta servanda sunt* in Roman and Roman-Dutch Law, with Specific Reference to Contracts in Restraint of Trade” (1984) 101 SALJ 641; Bhana and Pieterse 2006 SALJ 867.

contract is the corollary of this freedom, best described in the famous statement of Sir George Jessel MR in *Printing and Numerical Registering Co v Sampson*.<sup>6</sup>

“If there is one thing that more than another public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice.”<sup>7</sup>

This dictum encapsulates a further linked principle which is fundamental to our law of contract, namely that the courts will enforce contracts, captured in the Latin expression *pacta sunt servanda*. Thus Christie<sup>8</sup> finds “the starting point of the common law” in *Burger v Central South African Railways*,<sup>9</sup> in which Innes CJ stated that:

“[O]ur law does not recognise the right of a court to release a contracting party from the consequence of an agreement duly entered into by him merely because that agreement appears to be unreasonable.”<sup>10</sup>

Thus, since parties are understood to have negotiated and contracted on equal terms, the courts have traditionally preferred to adopt a hands-off approach, assuming the role of neutral umpires whose duty it is merely to ensure that the terms of the contract are strictly enforced.<sup>11</sup> If a term of a contract is unreasonable, unconscionable or oppressive, should it be open to attack? The default position is against interference,<sup>12</sup> because intervention by the courts when parties have contracted freely and voluntarily would amount to a form of paternalism which is inconsistent with the parties’ freedom of contract.<sup>13</sup> Further, judicial intervention is seen as a threat to the much-vaunted and worthy policy objective of legal certainty<sup>14</sup> and could open the floodgates to potential litigants, with the result that “vast numbers

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<sup>6</sup> (1875) LR 19 Eq 462 at 465.

<sup>7</sup> This statement has been widely cited with approval in South Africa in: *Wells v South African Alumenite Company* 1927 AD 69 at 73; *Marlin v Durban Turf Club & Others* 1942 AD 112 at 131; Corbett “Aspects of the Role of Policy in the Evolution of Our Common Law” (1987) 104 SALJ 52 at 64.

<sup>8</sup> Christie *The Law of Contract in South Africa* 5 ed (2006) 14.

<sup>9</sup> 1903 TS 571.

<sup>10</sup> 576.

<sup>11</sup> See Atiyah *The Rise and Fall of Freedom of Contract* (1979) 292-358.

<sup>12</sup> Lewis “Fairness in South African Contract Law” (2003) 120 SALJ 330 at 332.

<sup>13</sup> Christie *Contract* 14. Christie goes on to note that this general principle of non-intervention has been “whittled away” by the common law, which will not enforce a contract that is in contravention of an unreasonable restraint of trade clause, or an unreasonable term in a contract that is signed without having been read, or in an unsigned document such as a ticket.

<sup>14</sup> Bhana and Pieterse 2006 SALJ 868.

of default judgment, summary judgment and provisional sentence claims dealt with in this Division and in the Transvaal Provincial Division would be rendered bad in law”.<sup>15</sup>

This traditional approach to contract law in its crudest form is expressed most effectively by the oft-quoted words of Professor Hahlo:<sup>16</sup>

“Provided a man is not a minor or a lunatic, and his consent is not vitiated ... his contractual undertakings will be enforced to the letter. If, through inexperience, carelessness or weakness of character, he has allowed himself to be overreached, it is just too bad for him, and it can only be hoped that he will learn from his experience. The courts will not release him from the contract or make a better bargain for him. Darwinian survival of the fittest, the law of nature, is also the law of the market-place.”

The Supreme Court of Appeal has confirmed its support for the classical, liberal understanding of freedom of contract, and has situated its support within two fundamental constitutional values – freedom and dignity.<sup>17</sup>

“[C]ontractual autonomy is part of freedom. Shorn of its obscene excesses, contractual autonomy informs also the constitutional value of dignity.”

And again:<sup>18</sup>

“[T]he Constitution prizes dignity and autonomy, and in appropriate circumstances these standards find expression in the liberty to regulate one's life by freely engaged contractual arrangements.”

Contractual autonomy is part of freedom because “freedom of contract is typically believed to enhance and affirm individual autonomy, and resonates in many respects with understandings of individual liberty in classical liberal theory.”<sup>19</sup> Furthermore, it is arguable that several other constitutional rights such as freedom of association<sup>20</sup>

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<sup>15</sup> Kriegler J in *Donnelly v Barclays National Bank Ltd* 1990 (1) SA 375 (W) 384A.

<sup>16</sup> Hahlo “Unfair Contract Terms in Civil Law Systems” (1981) 88 SALJ 70. It is submitted that this approach is now outdated, out of touch with the modern South African reality, and in conflict with the spirit, purport and objects of the Bill of Rights in an unequal society (s 39(2) of the Constitution of the Republic of South Africa, 1996).

<sup>17</sup> Cameron JA in his concurring judgment in *Brisley v Drotosky* 2002 (4) SA 1 (SCA) para 94. See also the pronouncement of Davis J in *Mort NO v Henry Shields-Chiat* 2001 (1) SA 464 (C): “Contractual autonomy is part of freedom”.

<sup>18</sup> *Napier v Barkhuizen* 2006 (4) SA 1 (SCA) 8D.

<sup>19</sup> Bhana and Pieterse 2006 SALJ 877.

<sup>20</sup> Section 18 of the Constitution of the Republic of South Africa, 1996.

and freedom of trade, occupation and profession<sup>21</sup> serve to confirm the principle of freedom of contract.<sup>22</sup> The Supreme Court of Appeal appears to have distanced itself from an alternative interpretation of the values of freedom and dignity that would support the promotion of contractual fairness.

Finally, linked to the notion that consensus is the basis of contract is the idea that consensus necessarily implies that all contracts are entered into in good faith, which position was consistently adopted in Roman-Dutch law.<sup>23</sup> Conversely, the value of good faith requires parties to honour their agreements, and it is asserted that the presence of consensus, together with the value of good faith, “renders our law of contract inherently equitable – the concept of good faith is said to have infused the law of contract with an equitable spirit”.<sup>24</sup> This interpretation of good faith seems to contradict the possibility of the absence of good faith being used as a defence to render an unfair contract unenforceable, which will be discussed in 2.4 below.

## **2.2 Philosophical underpinnings of the law of contract**

Concepts of freedom of contract, individual autonomy and the question of fairness and related issues in the common law of contract are concerned more with policy and values than with hard law. In order to better understand the approaches of commentators and judges to these issues and the resultant development of the common law, it is enlightening and indeed essential to examine briefly the philosophical underpinnings or “political morality”<sup>25</sup> that inform this law.

### **2.2.1 A rules-based approach**

Writing in 1992, Cockrell argued persuasively that the traditional manner in which standard South African textbooks presented contract law was in the form of rules, as opposed to standards: “[A] seamless web of rules which possesses a determinative rationality of its own, such that answers to any disputes will be thrown up by the inexorable logic that is internal to the system itself”.<sup>26</sup> This rules-based form “depicts contract law as a set of determinative rules that can be applied by judges to facts in a

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<sup>21</sup> S 22 of the Constitution of the Republic of South Africa, 1996.

<sup>22</sup> Van Aswegen “The Implications of a Bill of Rights for the Law of Contract and Delict” (1995) 11 *SAJHR* 50 at 69; Bhana and Pieterse 2006 *SALJ* 871.

<sup>23</sup> Christie *Contract* 7.

<sup>24</sup> Bhana and Pieterse 2006 *SALJ* 867–868.

<sup>25</sup> Cockrell “Substance and Form in the South African Law of Contract” 109 (1992) *SALJ* 40 at 41.

<sup>26</sup> Cockrell 1992 *SALJ* 40.

mechanical way”.<sup>27</sup> The role of the courts is limited to the “application of rules to proven facts in a non-creative manner”.<sup>28</sup>

Whilst this rules-based interpretation is perhaps a deliberate over-statement of the actual position, there is a clear ring of truth to it. This classical model and its underlying assumptions of individual autonomy and liberty to consent are presented in traditional South African contract law as axiomatic universal truths, expressed as unwavering rules of the common law of contract.<sup>29</sup> The courts are thus free to concern themselves primarily with the enforcement of contracts rather than with their substantive fairness, and judicial discretion is limited. The result is that parties can contract within a framework of predictability and efficiency, and a high degree of certainty in contract law is achieved.<sup>30</sup>

### 2.2.2 A standards-based approach

Cockrell argues that this widely-accepted classical model produces a distorted picture of modern South African law of contract, which is in fact “shot through with normative commitments”.<sup>31</sup> Counter to this rules-based form is a preference for expressing contract law doctrines in the form of open-ended standards that “state normative propositions at a high level of abstraction” not easily reduced to specific rules, and that “allow for purposive adjudication by the courts”.<sup>32</sup> Just legal outcomes are promoted at the expense of certainty, accommodating competing social and normative considerations like fairness, dignity and social equality.<sup>33</sup>

This standards-based approach embraces a healthy measure of legal paternalism.<sup>34</sup> “The law attempts to establish ‘patterns of acceptable relationships’ informed by ‘a moral idea of the proper kinds of contractual relations in modern society, one based on trust’.”<sup>35</sup> Contracts form part of the greater fabric of society, and so society should “exercise some control over contract, so as to ensure social justice and equality”.<sup>36</sup>

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<sup>27</sup> Cockrell 1992 *SALJ* 43.

<sup>28</sup> *Ibid.*

<sup>29</sup> Bhana and Pieterse 2006 *SALJ* 868.

<sup>30</sup> *Ibid.*

<sup>31</sup> Cockrell 1992 *SALJ* 40.

<sup>32</sup> Cockrell 1992 *SALJ* 43. Cockrell’s discussion draws heavily on an article by Kennedy “Form and Substance in Private Law Adjudication” (1976) 89 *Harvard Law Review* 1685.

<sup>33</sup> Du Plessis and Davis “Restraint of Trade and Public Policy” (1984) 101 *SALJ* 86 at 88; Bhana and Pieterse 2006 *SALJ* 868.

<sup>34</sup> Bhana and Pieterse 2006 *SALJ* 868.

<sup>35</sup> Lubbe and Murray *Farlam & Hathaway Contract: Cases, Materials, Commentary* 3 ed (1988) 242.

<sup>36</sup> Bhana and Pieterse 2006 *SALJ* 868.

In South African contract law, these open-ended standards are public policy, the public interest, the general *boni mores*, good faith and reasonableness, which will be discussed later in this chapter.

### 2.2.3 Examples of the rules-based approach and implications for contractual fairness

An excellent example of the individualistic rules-based approach was the case of *Tjollo Ateljees (Eins) Bpk v Small*<sup>37</sup> which led to the demise of the doctrine of *laesio enormis*. In short, this Roman Dutch (formerly Roman) doctrine provided that the buyer was entitled to rescind a contract where the price paid was more than double the market value of the goods, unless the seller was willing to repay the difference.<sup>38</sup> Likewise, the seller of movable or immovable goods was entitled to rescind a contract where the price paid was less than half the market value of the goods, unless the buyer was willing to make up the difference.<sup>39</sup> In either event, therefore, a party that suffered an enormous loss as a result of the operation of an unfair contract was entitled to recourse. The judgment of Van den Heever JA explicitly rejects the doctrine, on the basis that it was in conflict with the doctrine of freedom of contract: “The theory of *laesio enormis* implies that parties may not contract freely, that the law steps in and turns their contracts into something which neither intended.”<sup>40</sup> Van den Heever JA objects strongly to the fact that the doctrine could not be formulated as a rule:

“I am satisfied that despite all the learning relating to the rescission of contracts on the ground of *laesio enormis* nothing has evolved out of it which could be *dignified by the name of a rule of positive law*.”<sup>41</sup>

And again:

“Since the alleged rule encourages a party to divest himself of obligations which he has freely and solemnly undertaken, I do not consider it in harmony either with immanent reason or public policy.”<sup>42</sup>

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<sup>37</sup> 1949 (1) SA 856 (A).

<sup>38</sup> Tladi “Breathing Constitutional Values into the Law of Contract: Freedom of Contract and the Constitution” 35 (2002) *De Jure* 306 at 310.

<sup>39</sup> *Ibid.*

<sup>40</sup> 875.

<sup>41</sup> 875 (my emphasis).

<sup>42</sup> 873.

The court suggested that the doctrine should be repealed by way of legislation,<sup>43</sup> which in fact occurred three years later, signalling the end of a key tool for securing contractual fairness.<sup>44</sup>

A more recent example of the rules-based approach was the case of *Bank of Lisbon and South Africa Ltd v De Ornelas*,<sup>45</sup> which was a landmark decision because it was a further major setback for the principle of equity in contract. Prior to this decision, the *exceptio doli generalis* had generally been assumed to be a substantive equitable remedy against the enforcement of an unfair contract, or the enforcement of a contract in unfair circumstances.<sup>46</sup> After a comprehensive review of the old and modern authorities, the majority (per Joubert JA) concluded that the *exceptio* is not part of our law, since it had never been received into Roman-Dutch law, nor into South African law.<sup>47</sup> With a stroke of the judicial pen, Joubert JA rejected the *exceptio* “as a superfluous, defunct anachronism”,<sup>48</sup> going on to state that all forms of equity remained subject to the “principle of law” and could not override a “clear rule of law”.<sup>49</sup> For Joubert JA, the *exceptio* could have no validity unless it appears in modern law in the same form it took in Roman law, because “for a hard positivist, a proposition can only count as being legally valid if it has the right pedigree, if it can be identified by a rule of recognition”.<sup>50</sup>

The strongly-contrasting dissenting judgment of Jansen JA, in which he argues for the retention of the *exceptio*, is of great interest. He questions that both the substantive principle of individualism and the formal principle of certainty are absolute in the law:<sup>51</sup>

“It is said that the recognition of the *exceptio doli* in this sense would be an infraction of the freedom of contract and the principle that *pacta servanda sunt* – that it would lead to legal uncertainty. Freedom of contract, the principles of *pacta servanda sunt* and certainty are not however absolute values.”

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<sup>43</sup> Per Schreiner JA at 860.

<sup>44</sup> Tladi 2002 *De Jure* 311.

<sup>45</sup> 1988 (3) SA 580 (A).

<sup>46</sup> Christie *Contract* 12; see Kerr *The Principles of the Law of Contract* 6 ed (2002) 638–666 for a thorough exposition of the *exceptio doli generalis*.

<sup>47</sup> 596–597 and 601–605.

<sup>48</sup> 607B.

<sup>49</sup> 606A.

<sup>50</sup> Lewis “Fairness in South African Contract Law” (2003) 120 *SALJ* 330 at 332.

<sup>51</sup> 613B.

He goes on to recognise that the equity principle must be considered in this case.<sup>52</sup>

“Moreover, the twin concepts of freedom of contract and *pacta servanda sunt* have, during this century, increasingly come under assault as a result of *inter alia* rampant inflation, monopolistic practices giving rise to unequal bargaining power and the large-scale use of standard-form contracts (often couched in small print).”

Jansen JA’s words expose Joubert JA’s judgment as being “fixated on the doctrine itself rather than the principle underpinning it”.<sup>53</sup>

The demise of the *exceptio* is a sideshow to the issue of achieving fairness in contract. Christie concludes that it would not be desirable to bring the *exceptio* back to life again, “because the half-life of the *exceptio* from 1925 to 1988 showed it to be so entangled in its history that it was not a satisfactory instrument for modern courts to use”.<sup>54</sup> The result was the loss of another mechanism to alleviate the harshness of unfair contracts or contract terms and to attain more equitable results in appropriate circumstances, and the law had to look to other mechanisms in order to do so.<sup>55</sup>

Importantly, for the purposes of this discussion, although the *exceptio* was a defence to an action for specific performance, it was a good example of a legal standard that cannot be reduced to the form of a determinative rule, and Joubert JA clearly disliked the resultant open-ended discretion with which courts were vested.<sup>56</sup> The decision was “predicated upon an extreme individualism which seeks to deny that the law may legitimately superimpose an overriding duty to act in good faith upon the voluntary arrangements of consenting adults”.<sup>57</sup> The judgment was widely criticised in a similar vein for its “positivist-historical approach”<sup>58</sup> and “absence of an in-depth discussion of general policy considerations or the responsibility of a court to ensure justice”.<sup>59</sup> Glover sums up the position succinctly:<sup>60</sup>

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<sup>52</sup> 613D.

<sup>53</sup> Lewis 2003 SALJ 333.

<sup>54</sup> Christie *Contract* 13.

<sup>55</sup> See the discussion regarding public policy and good faith in 2.3 and 2.4 below.

<sup>56</sup> Cockrell 1992 SALJ 44.

<sup>57</sup> *Ibid.*

<sup>58</sup> Van der Merwe, Lubbe and Van Huyssteen “The *Exceptio Doli Generalis: Requiescat in Pace – Vivat Aequitas*” (1989) 106 SALJ 235 at 238.

<sup>59</sup> Christie *Contract* 12.

<sup>60</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* (PhD thesis, Rhodes University, 2003) 129.

“The chorus of disapproval was indicative of a key trend: the classical *laissez-faire* theory of contract, fortified by the majority in the *Bank of Lisbon* case, was increasingly being exposed as a failure.”

The *Bank of Lisbon* case prompted commentators and the courts to seek alternative ways to attempt to find a balance between law and equity in the law of contract.<sup>61</sup>

#### **2.2.4 Conclusion**

Thus, concludes Cockrell, the assumption that South African contract law is “steeped in an axiomatic commitment to pure individualism framed in the form of clear rules” is “seriously at odds with large tracts of the contemporary law”, which “embody a very different style of normative commitment and which are characteristically expressed in a standards-based form”; they “exist alongside individualism in the law as a competing vision of communal life”.<sup>62</sup>

“[A]ll that we can ask of contract law is that it mediate between self-interest and sociality in a self-conscious manner that does not blindly value legal doctrine as an end unto itself.”<sup>63</sup>

It is noteworthy that Cockrell was writing prior to the constitutional era. Without question, the introduction of the Bill of Rights further legitimates the use of general principles as a guide to the judiciary.<sup>64</sup> These principles take the form of values and rights, and resemble very closely the standards-based form discussed above. The impact of the Constitution on contractual fairness will be discussed in greater depth in 2.3.4 below. As far as the common law is concerned, the mechanism that the courts turned to in order to try to find a balance between rules and standards was the concept of public policy.

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<sup>61</sup> See 2.3 and 2.4 below.

<sup>62</sup> Cockrell 1992 *SALJ* 63.

<sup>63</sup> *Ibid.*

<sup>64</sup> Lewis 2003 *SALJ* 331.

## 2.3 Public policy in the law of contract

### 2.3.1 Some background history

The doctrine of “public policy” provides, in short, that contracts should occur in the public interest, and (its corollary) that agreements contrary to public policy are illegal and should not be enforced.<sup>65</sup> This fundamental tenet of our law of contract<sup>66</sup> is most forcibly stated in the well-known words of Innes CJ in *Eastwood v Shepstone*:<sup>67</sup>

“Now this Court has the power to treat as void and to refuse in any way to recognise contracts and transactions which are against public policy or contrary to good morals. It is a power not to be hastily or rashly exercised; but once it is clear that any arrangement is against public policy, the Court would be wanting in its duty if it hesitated to declare such an arrangement void. What we have to look for is the tendency of the proposed transaction, not its actually proved result.”

Over the years, the courts, like Innes CJ, have counselled a measure of caution in the exercise of the power to refuse to enforce a contract on the grounds of policy,<sup>68</sup> which has the potential to be “a very unruly horse, and when once you get astride it you never know where it will carry you”.<sup>69</sup> Lord Atkin in *Fender v St John-Mildmay*<sup>70</sup> said of public policy:

“The doctrine should only be invoked in clear cases in which the harm to the public is substantially incontestable, and does not depend upon the idiosyncratic inferences of a few judicial minds...”

Likewise, in *Roffey v Catterall, Edwards & Goudre (Pty) Ltd*,<sup>71</sup> Didcott J provided a carefully-reasoned and cautious appraisal as to why public policy should not be given too much sway. In upholding a covenant in restraint of trade in the face of a defence

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<sup>65</sup> Wessels *The Law of Contract in South Africa* Vol 1, 2 ed (1951) paragraph 480 states that “[an] act which is contrary to the interests of the community is said to be an act contrary to public policy”. *Wille’s Principles of South African Law* by Hutchison, van Heerden, Visser and van der Merwe 8 ed (1991) 324 states that an agreement is contrary to public policy “if it is opposed to the interests of the State, or of justice, or of the public”.

<sup>66</sup> *Ibid.*

<sup>67</sup> 1902 TS 294 at 302.

<sup>68</sup> Corbett 1987 SALJ 64.

<sup>69</sup> Burrough J in *Richardson v Mellish* (1824) 2 Bing 229 at 252.

<sup>70</sup> 1938 AC 1 (HL) at 12, quoted by Smalberger JA in *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A).

<sup>71</sup> 1977 (4) SA 494 (N).

of public policy, he was not prepared to allow a principle of fairness in contract to diminish the force of the sanctity of contract principle to any extent.<sup>72</sup>

“I am satisfied that the South African law prefers the sanctity of contracts... The principle has a moral dimension too, which gives it a durability and universality beyond the norms of the marketplace. This consists of its simple requirement that people should keep their promises.”

### **2.3.2 *Sasfin (Pty) Ltd v Beukes***

*Sasfin (Pty) Ltd v Beukes*<sup>73</sup> is the leading authority on the modern law of illegality or unenforceability of contracts by common law,<sup>74</sup> and represented a shift in the philosophical approach to public policy. Delivering the majority judgment, Smalberger JA concedes at the outset that public policy is an expression of “vague import and what the requirements of public policy are must needs often be a difficult and contentious matter”.<sup>75</sup> Yet he tackles the principles concerned in a carefully-considered judgment, in order to give some substance to the meaning of the term:<sup>76</sup>

“The interests of the community or the public are therefore of paramount importance in relation to the concept of public policy. Agreements which are clearly inimical to the interests of the community, whether they are contrary to law or morality, or run counter to social and economic expedience, will accordingly, on the grounds of public policy, not be enforced.”

In adopting the approach of “cautious boldness”<sup>77</sup> enjoined on the courts by Innes CJ,<sup>78</sup> Smalberger JA “struck the balance between boldness and caution”,<sup>79</sup> in carefully weighing fairness against legal certainty. He added:

“No court should therefore shrink from the duty of declaring a contract contrary to public policy when the occasion so demands. The power to declare contracts contrary to public policy should, however, be exercised sparingly and only in the clearest of cases, lest uncertainty as to the validity of contracts result from an arbitrary and indiscriminate use of the power. One must be careful not to conclude

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<sup>72</sup> 505F-G.

<sup>73</sup> 1989 (1) SA 1 (A).

<sup>74</sup> *Christie Contract* 343.

<sup>75</sup> 7I-J.

<sup>76</sup> 8C-D.

<sup>77</sup> *Christie Contract* 344.

<sup>78</sup> *Eastwood v Shepstone* 1902 TS 294 at 302.

<sup>79</sup> *Christie Contract* 344.

that a contract is contrary to public policy merely because its terms (or some of them) offend one's individual sense of propriety and fairness."<sup>80</sup>

Again, whilst Smalberger JA recognised that "public policy generally favours the utmost freedom of contract, and requires that commercial transactions should not be unduly trammelled by restrictions on that freedom",<sup>81</sup> he states in the next paragraph that "public policy should properly take into account the doing of simple justice between man and man".<sup>82</sup> As Lubbe explains:<sup>83</sup>

"This necessitates the weighing up of competing considerations of a normative nature, the question to be answered being whether the general public interest in the enforcement of seriously intended agreements is in a particular case trumped by competing considerations germane to public policy in a manner requiring that it be denied legal operation."

Smalberger JA thus deliberately distances his judgment from the absolute sanctity of contract advocated by many commentators and courts over the years, and requires that there be limitations on the freedom of contract. Realising that this approach might seem "counter-intuitive to many positivist judges",<sup>84</sup> Smalberger JA urges that "no court should therefore shrink from the duty of declaring a contract contrary to public policy when the occasion so demands".<sup>85</sup> Thus, whilst the power to declare a contract unenforceable should be "exercised sparingly and only in the clearest of cases",<sup>86</sup> Corbett, writing before the *Sasfin* judgment, reminded his readers that "the courts are constantly called upon to take fundamental policy decisions, and in doing so to weigh conflicting interests and strike a balance".<sup>87</sup>

A few months later, the Appellate Division reinforced the *Sasfin* majority judgment with a unanimous judgment in the case of *Botha (now Griessel) v Finanscredit (Pty)*

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<sup>80</sup> 9A-B.

<sup>81</sup> 9E. See also *Magna Alloys & Research (SA) Ltd v Ellis* 1984 (4) SA 874 (A) at 893I–894A; *SA Sentrale Ko-op Graanmaatskappy Beperk v Shifren en Andere* 1964 (4) SA 760 (A) at 767A; *Roffey v Catterall, Edwards & Goudre (Pty) Ltd* 1977 (4) SA 494 (N); Lubbe "Bona fides, Billikheid en die Openbare Belang in die Suid-Afrikaanse Kontrakereg" (1990) 1 *Stell LR* 7 at 13; *Afrox Health Care Bpk v Strydom* 2002 (6) SA 21 (SCA) para 23 at 38D.

<sup>82</sup> 9G. Smalberger JA was in fact quoting from a judgment of Stratford CJ in *Jajhbay v Cassim* 1939 AD 537 at 544.

<sup>83</sup> Lubbe "Taking Fundamental Rights Seriously: the Bill of Rights and its Implications for the Development of Contract Law" (2004) 121 *SALJ* 400.

<sup>84</sup> Lewis 2003 *SALJ* 334.

<sup>85</sup> 9A-B.

<sup>86</sup> *Ibid.*

<sup>87</sup> Corbett 1987 *SALJ* 65.

*Ltd*<sup>88</sup> which, in the opinion of Christie, opened up the possibility of replacing the defunct *exceptio doli generalis* with an alternative method of “controlling contractual terms that are ‘plainly improper and unconscionable’ or ‘unduly harsh and oppressive’”<sup>89</sup>. Christie then sums up the effect of *Sasfin* and *Botha (now Griessel)* in a number of propositions, which are helpful for a more systematic approach to the “often difficult problem”<sup>90</sup> of public policy.<sup>91</sup>

- “1. Public policy generally favours the utmost freedom of contract.
2. Public policy properly takes into account the necessity of doing simple justice between man and man.
3. The power to declare a contract or a term in a contract contrary to public policy and therefore unenforceable should be exercised sparingly and only in the clearest of cases.
4. Nevertheless a contract or a term in a contract may be declared contrary to public policy if it is clearly inimical to the interests of the community, or is contrary to law or morality, or runs counter to social or economic expedience, or is plainly improper and unconscionable, or unduly harsh or oppressive.”

In *Juglal v Shoprite Checkers (Pty) Ltd*,<sup>92</sup> Heher JA added more flesh to these propositions:<sup>93</sup>

“Because the courts will conclude that contractual provisions are contrary to public policy only when that is their clear effect ... it follows that the tendency of a proposed transaction towards such a conflict ... can only be found to exist if there is a probability that unconscionable, immoral or illegal conduct will result from the implementation of the provisions according to the tenor. (It may be that the cumulative effect of implementation of provisions not individually objectionable may disclose such a tendency).”

Consideration should also be given to the helpful words of Cameron JA in *Brisley v Drotzky*:<sup>94</sup>

“The ‘legal convictions of the community’ – a concept open to misinterpretation and misapplication – is better replaced, as the Constitutional Court has itself suggested,

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<sup>88</sup> 1989 (3) SA 773 (A) 782I–783C.

<sup>89</sup> Christie *Contract* 344, quoting Hoexter JA in *Botha (now Griessel) v Finanscredit (Pty) Ltd* 783B–C.

<sup>90</sup> Smalberger JA in *Sasfin* at 9E.

<sup>91</sup> Christie *Contract* 344–345.

<sup>92</sup> 2004 (5) SA 248 (SCA).

<sup>93</sup> 258.

<sup>94</sup> 2002 (4) SA 1 (SCA) 35D.

by the 'appropriate norms of the objective value system embodied in the Constitution'.<sup>95</sup>

Not very long after *Sasfin*, in the case of *Donnelly v Barclays National Bank Ltd*,<sup>96</sup> Kriegler J pointed out that the effect of *Sasfin* is not to provide "a free pardon for recalcitrant and otherwise defenceless debtors".<sup>97</sup>

"[T]he maxim *pacta sunt servanda* is still a cornerstone of our law of contract. Nothing said or implied in the *Sasfin* case in any way serves to derogate from that important principle."<sup>98</sup>

Without question, though, *Sasfin* remains a leading case that will continue to guide the courts in deciding whether contracts at issue are contrary to public policy.<sup>99</sup> The Supreme Court of Appeal has continued to endorse the *Sasfin* approach to public policy. In *Afrox Healthcare Ltd v Strydom*,<sup>100</sup> the court confirmed that a contractual clause that is so unreasonable that it conflicts with public policy is unenforceable, and public policy was shown to be an overarching corrective doctrinal control mechanism.<sup>101</sup> Further, it will be seen in 2.4.4 below that since the Supreme Court of Appeal's preference for public policy over good faith,<sup>102</sup> *Sasfin* "has become the leading case for testing the enforceability of contracts which in other jurisdictions would raise questions of good faith".<sup>103</sup>

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<sup>95</sup> Cameron JA was referring to *Carmichele v Minister of Safety and Security* 2001 (4) SA 938 (CC) para 56. In regard to public policy and constitutional values, see 2.3.4 below.

<sup>96</sup> 1990 (1) SA 375 (W).

<sup>97</sup> 381E.

<sup>98</sup> 381H.

<sup>99</sup> Christie *Contract* 346–347, lists a number of examples of contracts whose clauses have attracted scrutiny by the courts in this regard, namely: antenuptial contracts (*Barnard v Barnard* 2000 (3) SA 741 (C) 753C–754F); contracts of cession (*Interland Durban (Pty) Ltd v Walters* 1993 (1) SA 223 (C)); suretyship (*First National Bank of SA Ltd v Sphinx Fashions CC* 1993 (2) SA 721 (W)); maintenance (*Baart v Malan* 1990 (2) SA 862 (E)); reinstatement of sequestration proceedings (*Standard Bank of SA Ltd v Essop* 1997 (4) SA 569 (D) 575E–577E and *Traco Marketing (Pty) Ltd v Commissioner for the South African Revenue Service* 1998 (4) SA 1002 (SE) 1011F–1013B); settlement of property rights on divorce (*Stembridge v Stembridge* 1998 (2) All SA 5 (D) 13g–15b); tender bidding (*Warrenton Munisipaliteit v Coetzee* 1998 (3) SA 1103 (NC) 1111J–1113A); restraint of trade (*Mossgas (Pty) Ltd v Sasol Technology (Pty) Ltd* 1999 (3) All SA 321 (W) 334e–336a).

<sup>100</sup> 2002 (6) SA 21 (SCA) 33H.

<sup>101</sup> Lubbe 2004 SALJ 398.

<sup>102</sup> See *Brisley v Drotzky* 2002 (4) SA 1 (SCA) and *Afrox Healthcare Bpk v Strydom* 2002 (6) SA 21 (SCA).

<sup>103</sup> Christie *Contract* 347.

### 2.3.3 Towards a clearer understanding of public policy

But what is this public interest in accordance with which contracts should be concluded? Or, how can the criteria for public policy be more clearly defined?

First, it serves no useful purpose to draw a distinction between contracts contrary to the common law, those against public policy and those *contra bonos mores*, since the three expressions are interchangeable.<sup>104</sup> Van der Merwe *et al*<sup>105</sup> accept that the terms “public policy” and “public interest” can be used interchangeably,<sup>106</sup> but seek to draw a distinction between public policy and public interest on the one hand and the *boni mores* of the community on the other hand.<sup>107</sup> In my view, nothing much turns on this possible distinction.

Second, the grounds upon which a contract may be unenforceable have over time crystallised out into specific categories,<sup>108</sup> and most writers deal with unenforceable contracts under separate headings.<sup>109</sup> Smalberger JA in *Sasfin* confirmed, however, that this is purely a matter of convenience,<sup>110</sup> and these categories do not represent a *numerus clausus*,<sup>111</sup> because, as Christie puts it, “human devilment and foolishness know no limits and the courts cannot set themselves limits which disable them from combating such things”.<sup>112</sup>

Third, public policy is a question of fact, not law,<sup>113</sup> and changes with “the general sense of justice of the community, the *boni mores*, manifested in public opinion”.<sup>114</sup> Conceptions of public policy are variable over space and time, and it has to be left to the courts to determine whether a contract is enforceable or not.<sup>115</sup> It is “a flexible

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<sup>104</sup> *Sasfin (Pty) Ltd v Beukes* 71–9A; Christie *Contract* 343–344; Kerr *General Principles of the Law of Contract* 6 ed (2002) 185, Footnote 42. As Aquilius “Immorality and Illegality in Contract” Part 1 (1941) 58 *SALJ* 337 at 344 puts it: “[I]n a sense... all illegalities may be said to be immoral and all immorality and illegality contrary to public policy.”

<sup>105</sup> Van der Merwe, van Huyssteen, Reinecke, Lubbe & Lotz *Contract General Principles* 2 ed (2003).

<sup>106</sup> Van der Merwe *et al Contract* 177.

<sup>107</sup> *Ibid.* With reference to the norms governing sexual morals and honest and proper conduct as examples of everyday *boni mores* or standards of conduct set by society, they state at 177: “[T]hat which is in accordance with public policy and in the public interest would include that which is in accordance with good morals, although an agreement which is not immoral as such may for reasons of economic or other expediency nevertheless be against public policy and the public interest.”

<sup>108</sup> Corbett 1987 *SALJ* 64.

<sup>109</sup> See, for example, Christie *Contract* 335ff.

<sup>110</sup> 8G.

<sup>111</sup> See *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 891H–I; Corbett (1987) 104 *SALJ* 64.

<sup>112</sup> Christie *Contract* 347.

<sup>113</sup> Christie *Contract* 345; Aquilius “Immorality and Illegality in Contract” (1941) *SALJ* 346; *Ryland v Edros* 1997 (2) SA 690 (C); *Amod v Multilateral Motor Vehicle Accident Fund* 1999 (4) SA 1319 (A).

<sup>114</sup> *Lorimar Productions Inc v Sterling Clothing Manufacturers (Pty) Ltd* 1981 (3) SA 1129 (T).

<sup>115</sup> *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 890–893; Lubbe 2004 *SALJ* 400.

measure of variable content of the social adequacy of agreements”,<sup>116</sup> for “it is only natural that perceptions as to what is or is not contrary to public policy may vary from era to era”.<sup>117</sup> With the passage of time, courts may introduce new categories of public policy, or abandon or limit old ones.<sup>118</sup> Thus, in *Ryland v Edros*<sup>119</sup> Farlam J, a single judge in a provincial division, was able to make a different finding to that in *Ismail v Ismail*,<sup>120</sup> an Appellate Division decision made 14 years earlier, in which potentially polygamous Muslim marriages were held to be contrary to public policy.<sup>121</sup>

Fourth, writers have distinguished between superficial public opinion, “which can swing like the weathercock”<sup>122</sup> and “seriously considered public opinion”<sup>123</sup> as to the broader sense of justice and morality of society. Adherence to the latter interpretation will ensure that contracts are not at the mercy of fickle public opinion.<sup>124</sup> Rather, only contracts “clearly inimical to the interests of the community”<sup>125</sup> should not be enforced.

Fifth, in a useful effort to give substantive content to the term “public interest”,<sup>126</sup> van der Merwe *et al*<sup>127</sup> suggest that this term should not be limited to the wider interests of society in general. Rather, it should include the individual interests of the parties to the contract at issue, which may be at variance with the interests of the broader community, in which case it is possible that the public interest may be determined by individual interests. Likewise, the sectional interests of the group to which the contracting parties belong, within the broader society, must be considered:

“The guiding principle should be that sectional interests must be evaluated within the context of the wider interests of society as a whole: sections of a society have an interest in upholding the general interests of the society, whilst the society itself has an interest in maintaining sectional interests.”<sup>128</sup>

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<sup>116</sup> Lubbe 2004 SALJ 400.

<sup>117</sup> Corbett 1987 SALJ 64.

<sup>118</sup> *Ibid.*

<sup>119</sup> 1997 (2) SA 690 (C).

<sup>120</sup> 1983 (1) SA 1006 (A).

<sup>121</sup> There were also important constitutional considerations applicable in this case, which will be discussed in 2.3.4 below.

<sup>122</sup> Christie *Contract* 345.

<sup>123</sup> *Ibid.*; Corbett 1987 SALJ 67–68.

<sup>124</sup> Christie *Contract* 345.

<sup>125</sup> *Sasfin (Pty) Ltd v Beukes* 8C.

<sup>126</sup> Van der Merwe *et al Contract* suggest at 178 that the term “social interest” would be preferable.

<sup>127</sup> Van der Merwe *et al Contract* 178.

<sup>128</sup> *Ibid.* See also *Ryland v Edros* 708–709.

It may therefore be in the public interest to protect sectional interests and customs above the interests and customs of the wider community.<sup>129</sup>

Finally, in utilising the instrument of public policy, the courts are not required to conduct a comparative study, because it is internationally accepted that each country should develop and apply its own understanding of this principle.<sup>130</sup>

## 2.3.4 Public policy and constitutional values

### 2.3.4.1 Introduction

The discussion above sets out the common law position in regard to public policy as it was prior to the constitutional dispensation,<sup>131</sup> which is still the foundation for our law today. Until constitutional considerations have been applied, however, the picture is not complete, because our understanding of common law public policy, as with all law, is overlaid by constitutional principles. Constitutional rights and values are all-pervasive in our law,<sup>132</sup> and demand to be considered at every juncture,<sup>133</sup> and not simply tagged on at the end of a discussion. In *Brisley v Drotzky*,<sup>134</sup> Cameron JA had this to say in regard to the Constitution:<sup>135</sup>

“All law now enforced in South Africa and applied by the courts *derives its force from the Constitution*. All law is therefore subject to constitutional control, and all law inconsistent with the Constitution is invalid. That includes the common law of contract, which is subject to the supreme law of the Constitution. The Bill of Rights applies to all law, and binds the Judiciary no less than the Legislature, the Executive and all organs of State. In addition, the Constitution requires the courts, when developing the common law of contract, *to promote the spirit, purport and objects of the Bill of Rights*. These propositions, if they ever were controversial, are no longer so. They derive from the provisions of the Constitution itself, as the Constitutional Court has interpreted and applied them.”<sup>136</sup>

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<sup>129</sup> See, for example, *Mohamed v Jassiem* 1996 (1) SA 673 (A), in which the test for defamation was applied with reference to the Muslim community of the Western Cape.

<sup>130</sup> *Christie Contract* 17.

<sup>131</sup> This is so mainly because *Sasfin* was decided in 1989.

<sup>132</sup> Section 8(1) of the Constitution of the Republic of South Africa, 1996 provides: “The Bill of Rights applies to all law, and binds the legislature, the executive, the judiciary and all organs of state.”

<sup>133</sup> See s39(2) of the Constitution.

<sup>134</sup> 2002 (4) SA 1 (SCA).

<sup>135</sup> Constitution of the Republic of South Africa, 1996.

<sup>136</sup> *Brisley v Drotzky* 33F–G. My emphasis.

### 2.3.4.2 The impact of constitutional values on public policy

The indirect impact or radiating effect of the Constitution is clearly relevant to contractual fairness and public policy. Christie states correctly that the Constitution “provides an exceptionally reliable statement of seriously considered public opinion”.<sup>137</sup> That this is so is without question when one considers the widespread consultation and negotiation during its drafting, and the broad approval it has received.<sup>138</sup> Once again, Cameron JA puts this most forcibly in a clear and unequivocal statement of the impact of the Constitution on the law of contract, and one can do no better than to quote him extensively:<sup>139</sup>

“In its modern guise, ‘public policy’ is now *rooted in our Constitution and the fundamental values it enshrines*. These include human dignity, the achievement of equality and the advancement of human rights and freedoms, non-racialism and non-sexism.

It is not difficult to envisage situations in which contracts that offend these fundamentals of our new social compact will be *struck down as offensive to public policy*. They will be struck down *because the Constitution requires it*, and the values it enshrines will guide the courts in doing so. The decisions of this Court that proclaim that the limits of contractual sanctity lie at the borders of public policy will therefore receive *enhanced force and clarity in the light of the Constitution* and the values embodied in the Bill of Rights.”

### 2.3.4.3 The role of public policy in developing the common law

Public policy is likely to be the main instrument for applying or developing the common law of contract in terms of s8(3)(a) of the Constitution, in order to give effect to a provision of the Bill of Rights, and for developing the common law in terms of s8(3)(b) to limit such a right.<sup>140</sup> Thus, de Vos<sup>141</sup> suggests that the existing common

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<sup>137</sup> Christie “The Law of Contract and the Bill of Rights” in Mokoro and Tlakula (eds) *Bill of Rights Compendium* (2006) para 3H8. He goes on to qualify this statement, however, by making it clear that it would be a mistake to treat the Constitution as the last word on public policy. Rather, the Bill of Rights should inform the common law by developing it in terms of s8(3)(a) of the Constitution.

<sup>138</sup> *Ibid.*

<sup>139</sup> *Brisley v Drotsky* 34H–35B. My emphasis. These views were reiterated again in *Napier v Barkhuizen* 2006 (4) SA 1 (SCA) 7A–B.

<sup>140</sup> Christie “The Law of Contract and the Bill of Rights” *Bill of Rights Compendium* para 3H8. Section 8(3) provides: “When applying a provision of the Bill of Rights to a natural or juristic person in terms of sub-section (2), a court –

- (a) in order to give effect to a right in the Bill, must apply, or if necessary develop, the common law to the extent that legislation does not give effect to that right; and
- (b) may develop rules of the common law to limit the right, provided that the limitation is in accordance with s36(1).

law rule that contractual provisions that are *contra bonos mores* are unenforceable could be developed by treating as *contra bonos mores* any provision which is clearly at odds with the basic principles of the Bill of Rights. Whilst constitutional values are of fundamental importance to our society, however, they do not contain an exclusive embodiment of the values that are in accordance with public policy in the law of contract.<sup>142</sup>

Cameron JA points out that the courts have “a ‘general obligation’, which is not purely discretionary, to develop the law in the light of fundamental constitutional values”.<sup>143</sup> Thus, whilst previously there was strong academic and judicial opinion that the courts should, in interpreting the law, have regard to the values and needs of society at the time (traditional public policy), they must now do so for there is a legal mandate to do so.<sup>144</sup> Christie believes that the reliability of the Constitution as a statement of public policy “can and should” be used by the courts in applying the provisions of s8(2) and s8(3)(a).<sup>145</sup> The constitutional imperative in s8(3)(a) – “a court ... must apply, or if necessary develop, the common law...”<sup>146</sup> – of which Cameron JA reminds us confirms that the courts are rather duty-bound to do so, and cannot choose not to do so. As Cameron JA re-asserts more recently in *Napier v Barkhuizen*:<sup>147</sup>

“[T]he common law of contract is subject to the Constitution. This means that courts are obliged to take fundamental constitutional values into account while performing their duty to develop the law of contract in accordance with the Constitution.”

This approach to developing the common law in terms of the interim Constitution<sup>148</sup> was adopted effectively by Farlam J in the case of *Ryland v Edros*<sup>149</sup> in which he found, by virtue of the radiating effect of numerous provisions of the interim Constitution, that potentially polygamous Muslim marriages could no longer be regarded as contrary to public policy.<sup>150</sup>

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<sup>141</sup> De Vos “Pious wishes or directly enforceable human rights?: Social Justice and Economic Rights in South Africa’s 1996 Constitution” 1997 SAJHR 67 at 101.

<sup>142</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 146–147 refers, for example, to the fundamentally important principle *pacta sunt servanda*, which is not articulated in the Bill of Rights.

<sup>143</sup> *Brisley v Drotsky* 34C–D.

<sup>144</sup> Lewis 2003 SALJ 337.

<sup>145</sup> Christie “The Law of Contract and the Bill of Rights” *Bill of Rights Compendium* para 3H8.

<sup>146</sup> Section 8(3)(a).

<sup>147</sup> 2006 (4) SA 1 (SCA) 6E–F.

<sup>148</sup> Constitution of the Republic of South Africa Act 200 of 1993.

<sup>149</sup> 1997 (2) SA 690 (C), discussed in 2.3.3 above.

<sup>150</sup> Christie “The Law of Contract and the Bill of Rights” *Bill of Rights Compendium* para 3H8.

#### 2.3.4.4 Limitations on the impact of constitutional values on public policy

Further, the Constitution does not give the courts judicial licence to release litigants from contracts based upon subjective views of what is or is not just, nor to ignore judicial precedent.<sup>151</sup> Rather, clear legal and factual justification will be required to declare contract terms unenforceable. In *Napier v Barkhuizen*,<sup>152</sup> Cameron JA warns against what amounts to pre-suppositions regarding the perceived meanings of constitutional values:<sup>153</sup>

“[T]he constitutional values of dignity, equality and the advancement of human rights and freedoms ... provide no general all-embracing touchstone for invalidating a contractual term.

Nor does the fact that a term is unfair or may operate harshly by itself lead to the conclusion that it offends against constitutional principle ...

This is not to envisage an implausible contractual nirvana. It is to respect the complexity of the value system the Constitution creates ...

It is relatively easy to see how the Constitution's foundational values of non-racialism and non-sexism could lead to the invalidation of a contractual term. Less immediately obvious is how the values of human dignity, the achievement of equality and the advancement of human rights and freedoms may affect particular contractual outcomes. But *Brisley* and *Afrox* and *Stoff* opened the door to precisely such determinations.”

Smalberger JA's statement that “the power to declare contracts contrary to public policy should be exercised sparingly and only in the clearest of cases”<sup>154</sup> is still relevant in the constitutional era. Again, Cameron JA expresses this best:<sup>155</sup>

“What is evident is that neither the Constitution nor the value system it embodies gives the courts a general jurisdiction to invalidate contracts on the basis of judicially perceived notions of unjustness or to determine their enforceability on the basis of imprecise notions of good faith. On the contrary, the Constitution's values of dignity and equality and freedom require that the courts approach their task of striking down contracts or declining to enforce them with perceptive restraint. One of the reasons,

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<sup>151</sup> Lewis 2003 SALJ 338.

<sup>152</sup> 2004 (4) SA 1 (SCA).

<sup>153</sup> 8C–H.

<sup>154</sup> *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A) 9B.

<sup>155</sup> *Brisley v Drotzky* 35D–E.

as Davis J has pointed out,<sup>156</sup> is that contractual autonomy is part of freedom. Shorn of its obscene excesses, contractual autonomy informs also the constitutional value of dignity.”

Thus, Cameron JA reminds us that contractual autonomy remains a foundationally important policy factor in our law of contract, and that nothing can detract from this.<sup>157</sup> “Freedom” is a foundational value of the Bill of Rights too,<sup>158</sup> and both Davis J and Cameron JA have declared that “contractual autonomy is part of freedom”.<sup>159</sup> Cameron JA confirms, however, that contractual autonomy (including the values of freedom of contract and *pacta sunt servanda*) is not absolute, and can be defeated by other policy factors, including countervailing constitutional values.

#### **2.3.4.5 Conclusion**

It is clear therefore that the Constitution gives the courts more power legitimately to find contractual terms to be contrary to public policy, which is a significant development for the common law of contract. In exercising this power, however, the courts must strive:

“...to achieve a careful balance between the unacceptable excesses of contractual ‘freedom’, and securing a framework within which the ability to contract enhances rather than diminishes our self-respect and dignity.”<sup>160</sup>

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<sup>156</sup> *Mort NO v Henry Shields-Chiat* 2001 (1) SA 464 (C) 474–475.

<sup>157</sup> See also the words of Cameron JA in *Napier v Barkhuizen* 2006 (4) SA 1 (SCA) 8E–F.

<sup>158</sup> See s7(1) and s39(1) of the Constitution.

<sup>159</sup> See the discussion in 2.1 above.

<sup>160</sup> Cameron JA’s concluding remarks in *Brisley v Drotsky* 36A.

## 2.4 Good faith in the law of contract

### 2.4.1 All contracts are *bonae fidei*

According to Roman-Dutch law, which has been received into South African law, all contracts are considered to be *bonae fidei*,<sup>161</sup> are entered into in good faith,<sup>162</sup> or are grounded in the principle of good faith, which underpins our law of contract.<sup>163</sup> There appears to be a close link between this notion and individual autonomy, the traditionally dominant contractual philosophy in South Africa.<sup>164</sup> The principle of good faith has not had a prominent role in South African contract law, because a less individualistic approach would have been necessary in order for fairness and the interests of others to be given higher priority.<sup>165</sup>

It is extremely difficult, however, to understand and articulate what is actually meant by the statement that all contracts are *bonae fidei*. It appears that in South Africa:

“The principle of good faith provides a moral, or principle-based, jurisprudential justification for the existence of the many so-called black-letter rules and doctrines that exist in contract law, and which are designed to promote fair dealing and ensure the legitimate expectations of contracting parties are met.”<sup>166</sup>

The principle is understood to be inherent in various technical rules and doctrines, providing justification or legitimacy for them. This understanding suggests that such rules and doctrines, together making up our law of contract, are assumed to be inherently good or equitable or fair, an understanding with which most South African lawyers who are for the most part loyal to the Roman-Dutch origins of our law would probably be comfortable.

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<sup>161</sup> Cockrell 1992 SALJ 55; *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) 433B; *Meskin NO v Anglo-American Corporation of SA Ltd* 1968 (4) SA 793 (W) 802A.

<sup>162</sup> Christie *Contract* 7. Bhana and Pieterse 2006 SALJ 867.

<sup>163</sup> Kerr *The Principles of the Law of Contract* 301ff; Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 133. Cockrell 1992 SALJ 55 describes good faith as “the epitome of a legal standard that embodies communitarian values of altruism, care and concern”.

<sup>164</sup> See the discussion in 2.1 above. Bhana and Pieterse 2006 SALJ 867–868 suggest that the presence of consensus, together with the value of good faith, “renders our law of contract inherently equitable – the concept of good faith is said to have infused the law of contract with an equitable spirit”.

<sup>165</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 134.

<sup>166</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 142; cf Cockrell 1992 SALJ 40.

Does this understanding of the principle of good faith have any practical application? The principle appears to refer not just to contract law, but to actual contracts themselves, all of which are assumed to be “grounded in the principle of good faith”. Is it intended to imply by this that all contracts concluded in practice are good or equitable or fair? Likewise, the notion that all contracts are entered into in good faith<sup>167</sup> implies that parties to contracts always conduct themselves in good faith. This of course has no foundation in practice, as a brief perusal of our law reports will soon confirm. If these are correct implications of the principle, then this somewhat quaint and antiquated principle appears to serve no useful practical purpose. It seems to exist only to prop up and justify contract law and the process of contracting, and to remind us of the need for fair dealing, while providing little assistance for redress in the event that dealing is not fair. It amounts to the importation into our law of a principle in the form of a theoretical legal maxim or construction that has only a legitimating or explanatory function,<sup>168</sup> aimed primarily at self-justification. With reference to the classical model of contract law, Bhana and Pieterse argue that:<sup>169</sup>

“[I]t fails to ensure substantive consensus between the parties by simply accepting that compliance with the rules of contract law (regardless of the context within which they operate) *will in itself adequately guarantee legitimate consensus and therefore good faith.*”

This interpretation of good faith, adopted by South African law, seems to operate to the exclusion of any approach to good faith that would aim to promote fairness and equity in a more pro-active manner, for example through the absence of good faith being used as a defence to render an unfair contract unenforceable. The exclusion of such an alternative approach is illustrated in *Bank of Lisbon and South Africa Ltd v De Ornelas*,<sup>170</sup> in which the majority declared that the *exceptio doli generalis* is unnecessary, as all contracts are in any event based on good faith,<sup>171</sup> yet declined to apply *bona fides* in the adjudication of the matter.<sup>172</sup>

“[I] cannot find any support in Roman-Dutch law for the proposition that in the law of contract an equitable exception or defence, similar in effect to the *exceptio doli generalis*, was utilised under the aegis of *bona fides*.”

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<sup>167</sup> This notion appears to be an alternative articulation of the same principle that all contracts are *bonae fidei*.

<sup>168</sup> Brownsword, Hird & Howells (eds) *Good Faith in Contract: Concept and Context* (1999) 230.

<sup>169</sup> Bhana and Pieterse 2006 *SALJ* 894. My emphasis.

<sup>170</sup> 1988 (3) SA 580 (A).

<sup>171</sup> Tladi 2002 *De Jure* 312.

<sup>172</sup> 606D.

## 2.4.2 Theories of good faith

Before proceeding to discuss the further development of South African law in regard to good faith, it will be helpful briefly to consider three models for the operation of the principle of good faith that have been suggested.<sup>173</sup> The approach adopted in South Africa that all contracts are *bonae fidei* accords most closely with the model that Brownsword calls “a good faith requirement”.<sup>174</sup> In terms of this interpretation good faith acts as a controlling principle that requires parties to comply with the standards of fair dealing that are already recognised and accepted in a particular contracting context (e.g. a sale of land or an employment contract). These standards accord with the reasonable, legitimate expectations of the contracting community in the particular market.<sup>175</sup>

The second model, “a good faith regime”,<sup>176</sup> acts on the standards of fair dealing that are dictated or prescribed by co-operative ground rules established by law. Its content is derived not from the common standards of the parties in a particular contracting community (as with the first model) but from a moral form of contractual justice imposed by the legal system which would seemingly allow widely-recognised market practices to be overridden.<sup>177</sup> The courts, as arbiters of public morality, are required to decide whether or not a contract or the process of contracting is in good faith.<sup>178</sup>

The third model, which Bridge calls “visceral justice”,<sup>179</sup> gives to judges judicial license to make decisions based entirely on their subjective notions of fairness in each case before them, all in the name of good faith.<sup>180</sup> Clearly, this approach is untenable in a legal system which by its very nature depends on rules, principles and precedent for the proper administration of justice.

The merits of the first two models will be briefly discussed in relation to South African contract law in 2.4.5 below.

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<sup>173</sup> See, for example, Brownsword *Contract Law: Themes for the Twenty-first Century* (2000) 115–120.

<sup>174</sup> Brownsword *Contract Law* 116.

<sup>175</sup> *Ibid.*

<sup>176</sup> *Ibid.*

<sup>177</sup> *Ibid.*

<sup>178</sup> *Ibid.*

<sup>179</sup> Bridge “Good Faith in Commercial Contracts” in Brownsword, Hird & Howells (eds) *Good Faith in Contract: Concept and Context* (1999) 139 at 140.

<sup>180</sup> Brownsword *Contract Law* 116.

### 2.4.3 “A brief turn towards fairness”

In the aftermath of the *Bank of Lisbon* and *Sasfin* cases, however, there was renewed interest in academic writing and court decisions in the principle of good faith.<sup>181</sup> The most significant decision was the minority judgment of Olivier JA in *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman*,<sup>182</sup> in which he conducted a thorough analysis of the good faith principle in South African law, and showed that good faith forms one of the cornerstones of the law of contract in many European civil jurisdictions.<sup>183</sup> He held that if good faith so required, a court could refuse to enforce an otherwise valid contract.<sup>184</sup> He submitted that the *bona fides* principle forms an element of the umbrella concept of public policy,<sup>185</sup> concluding his judgment thus:<sup>186</sup>

“I am convinced that the principles of good faith, grounded in public opinion, continue to play an important role in our law of contract, and must do so, like in any system of law that is sensitive to the convictions of the community, which is the ultimate creator and beneficiary of moral and ethical values of reasonableness, fairness and decency.”

Olivier JA’s judgment went against the tide of judicial opinion in regard to the principle of good faith,<sup>187</sup> and has been described as “a brief turn towards fairness”.<sup>188</sup> This approach was, however, effectively ended by the Supreme Court of Appeal in the case of *Brisley v Drotsky*.<sup>189</sup>

### 2.4.4 *Brisley v Drotsky* and *Afrox Healthcare Ltd v Strydom*

The case of *Brisley v Drotsky* is of critical importance, because it reflects the current judicial attitude towards fairness in contract law, and provides current authority in this

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<sup>181</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 135.

<sup>182</sup> 1997 (4) SA 302 (SCA).

<sup>183</sup> 326J–327I.

<sup>184</sup> 319A.

<sup>185</sup> 322E.

<sup>186</sup> 326G. This is a translation of the original Afrikaans: “*Ek hou dit as my oortuiging na dat die beginsels van die goeie trou, gegrond op openbare beleid, steeds in ons kontraktereg ’n belangrike rol speel en moet speel, soos in enige regstelsel wat gevoelig is vir die opvattinge van die gemeenskap, wat die uiteindelijke skepper en gebruiker is, met betrekking tot die morele en sedelike waardes van regverdigheid, billikheid en behoorlikheid.*”

<sup>187</sup> The judgment was, however, followed in the case of *Miller and another NNO v Dannecker* 2001 (1) SA 928 (C).

<sup>188</sup> Lewis 2003 SALJ 336.

<sup>189</sup> 2002 (4) SA 1 (SCA).

regard.<sup>190</sup> The Supreme Court of Appeal was prepared to make what was intended to be a definitive pronouncement on the nature and role of good faith in South African contract law,<sup>191</sup> which was something akin to Brownsword's good faith requirement.

In short, the majority dismissed the views of Olivier JA in *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman* as those of a single judge, and held that good faith cannot be accepted as an independent basis for setting aside contractual provisions. It was alleged in the case that a non-variation clause in a lease agreement could not be enforced because it was unreasonable, unfair and in conflict with the principles of good faith.<sup>192</sup> The court rejected this argument on the basis that there was no general equitable discretion enabling a court to refuse to enforce any contractual provision merely on the grounds of it being unreasonable, unconscionable or against good faith.<sup>193</sup> The court held that good faith is a foundational principle that underlies contract law and finds expression in the specific rules and principles of such law.<sup>194</sup> Good faith does not constitute "an independent, or 'free-floating', basis for the setting aside or non-enforcement of contractual provisions".<sup>195</sup>

In *Afrox Healthcare Ltd v Strydom*,<sup>196</sup> it was contended that an exemption clause was unenforceable for the reason that it was, *inter alia*, unreasonable, unfair and in conflict with the principles of *bona fides* or good faith. Brand JA (on behalf of all the members of the court) endorsed the decision in *Brisley v Drotzky*, stating that abstract ideas such as good faith, reasonableness, fairness and justice provide "the foundation and justification for the existence of legal rules", although they are not legal rules in themselves, and therefore have indirect application only.<sup>197</sup> As Lubbe expresses it: "Good faith does not, on the view adopted by the court, operate on the black-letter or doctrinal level as an open norm" and "entails no more than that the courts in the enunciation of legal doctrine should have regard to undefined and undifferentiated equitable considerations".<sup>198</sup>

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<sup>190</sup> Lewis 2003 SALJ 330.

<sup>191</sup> Lubbe 2004 SALJ 397.

<sup>192</sup> 12G.

<sup>193</sup> 12I.

<sup>194</sup> 15E.

<sup>195</sup> *Ibid.* This is a translation of the original Afrikaans: " 'n onafhanklike, oftewel 'n 'free-floating', basis vir die tersydestelling of die nie-toepassing van kontraktuele bepalings."

<sup>196</sup> 2002 (6) SA 21 (SCA).

<sup>197</sup> 40I. This is a translation of the original Afrikaans: "die vorming en die verandering van regsreels". This approach provides a further excellent example of the "rules-based approach" discussed in 2.2.1 and 2.2.3 above.

<sup>198</sup> Lubbe 2004 SALJ 397.

In both cases, however, the Supreme Court of Appeal recognised public policy as a legitimate basis for the setting aside of unfair contract provisions,<sup>199</sup> although on the facts of the cases before the respective courts decided not to do so.

#### 2.4.5 Conclusion

The traditional approach to good faith, that all contracts are *bonae fidei*, is the foundation for our law of contract, although it has limited practical significance. *Brisley v Drotsky* and *Afrox Healthcare Ltd v Strydom* have endorsed this approach and enunciated what it means mainly with reference to what it is not, namely that it may not be used as an independent basis for refusing to enforce an unfair contract or an unfair term of a contract. This interpretation of good faith appears to resemble most closely Brownsword's "good faith requirement", and without doubt represents the current law.

The possibility that our courts could develop the principle of good faith as a mechanism for pro-actively promoting contractual fairness in the determination of whether or not a contract or contract term should be enforced, however, should not be totally discounted. In the preface to the fifth edition of his book, Christie postulates:<sup>200</sup>

"[It] will be a mistake to regard the door as forever closed, and to isolate ourselves from the many other legal systems in which good faith plays a prominent part."

The seeds for such an approach were sown by Olivier JA in the *Saayman* case, which could see the incorporation into our law of aspects of Brownsword's "good faith regime" model for good faith. It is not difficult, for example, to envisage the development of standards of fair dealing required by the law, with power given to the courts to decide when a contract has or has not been entered into in good faith, which could result, for example, in the declaration of a contractual clause as unenforceable. This would be something akin to the courts' current approach in respect of public policy. It is also worth noting that the Supreme Court of Appeal's rejection of the notion of judges being permitted to exercise "independent, free-floating" discretion in regard to good faith in cases before them amounts to a rejection only of Brownsword's third model (Bridge's "visceral justice"). The "good

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<sup>199</sup> *Brisley v Drotsky* 34F and *Afrox Healthcare Ltd v Strydom* 37C–D.

<sup>200</sup> Christie *Contract* (v).

faith regime” model is an entirely different proposition which is still worthy of serious consideration.

Further, this approach could easily be given greater impetus by relevant constitutional values such as equality and dignity. Constitutional values have to be considered in the on-going development of the principle of good faith, because the Constitution demands this. As Davis J stated in *Mort NO v Henry Shields-Chiat*.<sup>201</sup>

“Like the concept of *boni mores* in our law of delict, the concept of good faith is shaped by the legal convictions of the community... In short, the constitutional State which was introduced in 1994 mandates that all law should be congruent with the fundamental values of the Constitution.”

In the final analysis, however, it is clear that public policy, fortified by constitutional values, has been and will continue to be a far more effective mechanism for developing the common law in regard to contractual fairness by means of s8(3)(a) of the Constitution.<sup>202</sup>

“In the result, the Supreme Court of Appeal has rejected the concept of good faith and reaffirmed the concept of public policy as an instrument for handling cases of contractual unfairness that cannot satisfactorily be handled by existing rules.”<sup>203</sup>

## 2.5 Legislative responses to contractual unfairness

Since there has been little progress towards contractual fairness in the common law, Parliament has deemed it necessary to intervene on a piecemeal basis to promote fairness in consumer-related contexts. Business relationships between suppliers of goods and services and consumers (who are purchasers of goods and services) were classically regulated by the common law of contract. The principles of a free market and of active competition are fundamental ideals that have been repeatedly emphasised by our courts.<sup>204</sup> Increasing recognition of socio-economic differences, however, manifest most significantly in imbalances in economic power between suppliers on the one hand and consumers on the other hand, has seen the rise of

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<sup>201</sup> 2001 (1) SA 464 (C) 474J and 475B.

<sup>202</sup> Christie *Contract* 16 is of the view that “public policy is likely to prove the more satisfactory instrument”. See 2.3 above for further discussion in this regard.

<sup>203</sup> Christie *Contract* 16.

<sup>204</sup> In *Taylor and Horne (Pty) Ltd v Dentall (Pty) Ltd* 1991 (1) SA 412 (A) 421, the court stated that competition is “the lifeblood of commerce”.

consumer law, primarily through legislation, as a branch of the law of contract worthy of special attention. Thus, the principle of “freedom of contract” has to some extent been modified by legislation in a number of areas of law, in order to give greater protection to consumers.<sup>205</sup> Furthermore, progress towards increased consumer protection through legislation has been given greater impetus by the Constitution.<sup>206</sup> The constitutional values of equality and dignity are likely to impact increasingly on the traditional common law.<sup>207</sup>

### **2.5.1 South African Law Commission<sup>208</sup> Project 47: Unreasonable Stipulations in Contracts and the Rectification of Contracts**

Since there is no general equity jurisdiction in the South African law of contract,<sup>209</sup> in 1983 the South African Law Commission initiated a project to consider whether legislation should be passed which would allow courts to remedy contracts or contract terms that are unjust or unconscionable. After a lengthy process of discussion and comment from the South African public, in April 1998 the Law Commission submitted its Final Report<sup>210</sup> to the Minister of Justice, in which it comprehensively reviewed comparative law<sup>211</sup> as well as respondents’ contributions to its previous discussion paper.<sup>212</sup> Although there was both significant opposition<sup>213</sup> as well as support for proposed legislation, the final report strongly recommended legislation to achieve this objective, to be called the Control of Unreasonableness, Unconscionableness or Oppressiveness in Contracts or Terms Act. There have been no further developments in regard to this proposed legislation to date, other than the incorporation of some of the proposals into a draft Consumer Protection Bill

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<sup>205</sup> See, for example, The Trade Practices Act 76 of 1976, the Maintenance and Promotion of Competition Act 96 of 1979, and the Consumer Affairs (Unfair Business Practices) Act 7 of 1996. In terms of the latter Act, nine Provincial Consumer Courts were established, with the purpose of providing protection to consumers against unfair business practices (which could take the form of unfair contracts) and obviating lengthy and expensive litigation in the ordinary courts.

<sup>206</sup> The Constitution of the Republic of South Africa, 1996.

<sup>207</sup> See Sections 9 and 10 of the Constitution of the Republic of South Africa, 1996.

<sup>208</sup> Now the South African Law Reform Commission, but referred to throughout this study as the South African Law Commission, as it then was.

<sup>209</sup> See, for example, *Bank of Lisbon and South Africa Ltd v De Ornelas* and *Brisley v Drotzky* 16C and 35C–E.

<sup>210</sup> South African Law Commission Report on Unreasonable Stipulations in Contracts and the Rectification of Contracts (Final Report; Project 47) (1998).

<sup>211</sup> A review of legislation in regard to contractual fairness in other jurisdictions is most enlightening, but beyond the scope of this study.

<sup>212</sup> South African Law Commission Report on Unreasonable Stipulations in Contracts and the Rectification of Contracts (Discussion Paper 65; Project 47) (1996).

<sup>213</sup> The main bases for opposition to legislation were that unconscionability should be a matter for the common law, that uncertainty would result from legislation, and that existing legislation was sufficient (pages 33–47 of the Final Report). The Commission expressed the view that fears provoked by the Bill regarding resultant excessive litigation are exaggerated, and that in any event legal uncertainty resulting from the proposed Bill is the price that must be paid if greater contractual justice is to be achieved.

of 2006<sup>214</sup> which will be discussed in 2.5.2 below, and the fate of the Law Commission's proposed legislation is therefore uncertain.<sup>215</sup> It is, however, still a worthwhile exercise to consider the proposed legislation and some of the comment thereon, as read with the Consumer Protection Bill, since it is indicative of the direction in which our contract law may be heading. Further, most of the comment on the Law Commission's proposed legislation is also relevant to the Consumer Protection Bill. What follows therefore is merely a brief overview of the main points in the Law Commission's final report and proposed legislation, with little analysis thereof.<sup>216</sup>

The Law Commission was of the view that it was necessary to give the courts a more general power to curb unfairness in contracts, via legislation, in order to fill the gaps that exist in the common law, most notably inequality of bargaining power.<sup>217</sup> It therefore recommended legislation against contractual unfairness, unreasonableness, unconscionability or oppressiveness in all contractual phases.<sup>218</sup> Section 1(1) of the proposed draft Bill establishes the fairness criterion, the circumstances in which it can be invoked, and the findings that a court can make, which altogether conferred upon courts wide-sweeping powers, best illustrated by quoting the proposed sub-section:<sup>219</sup>

**“Court may determine whether contractual terms are unreasonable, unconscionable and oppressive, and issue appropriate orders**

- 1(1) If a court is of the opinion that
- (a) the way in which a contract between the parties or a term thereof came into being; or
  - (b) the form or the content of a contract; or

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<sup>214</sup> Department of Trade and Industry “Draft Consumer Protection Bill” <http://www.thedti.gov.za/> (accessed 14 March 2006)

<sup>215</sup> It appears that the Law Commission's proposed legislation may not be implemented, in view of the progress of the Consumer Protection Bill, which seems to go some way towards fulfilling the original purpose of the Law Commission's recommendations.

<sup>216</sup> Other less important elements of the proposed legislation, which are not discussed below, include the following (section numbers of the proposed Bill are indicated in brackets): the exclusion from the Bill of certain contractual acts arising from the Labour Relations Act 66 of 1995; the Bills of Exchange Act 34 of 1964; the Companies Act 61 of 1973; and the Close Corporations Act 69 of 1984 (s3); the taking into account of the effect of changed circumstances after the conclusion of a contract (s4); the admissibility of evidence of what passed between the parties during and after the execution of the contract – seemingly an effective proposed abolition of the parole evidence rule (s5).

<sup>217</sup> Christie *Contract* 13–14. Christie points out that the common law has developed many principles and rules to curb unfairness in the making of contracts, including: quasi-mutual assent, written terms, misrepresentation and fraud, duress, undue influence, mistake, illegality and unenforceability (which includes public policy and good faith).

<sup>218</sup> SALC Final Report 58.

<sup>219</sup> SALC Final Report 213–214.

- (c) the execution of a contract; or
  - (d) the enforcement of a contract,
- is unreasonable, unconscionable or oppressive, the court may declare that the alleged contract –
- (aa) did not come into existence; or
  - (bb) came into existence, existed for a period, and then, before action was brought, came to an end; or
  - (cc) is in existence at the time the action is brought, and it may then –
    - (i) limit the sphere of operation and/or the period of operation of the contract; and/or
    - (ii) suspend the operation of the contract for a specified period or until specified circumstances are present; or
    - (iii) make such order as may in the opinion of the court be necessary to prevent the effect of the contract being unreasonable, unconscionable or oppressive to any of the parties.”

The inclusion of “unreasonableness” has attracted considerable criticism, as has the term “oppressiveness”, which probably adds nothing further of significance to the definition of unconscionability, and both terms should therefore be excluded.<sup>220</sup> It has also been persuasively argued that the term “good faith” would be preferable to “unconscionability”, since good faith is “one of the oldest and most venerable principles that exists in our contract law”,<sup>221</sup> although the Law Commission believed that “the two approaches lead to the same result”.<sup>222</sup> The preferred theoretical basis for the proposed legislation was unconscionability, a relatively new concept in South African law which, if adopted, would have to be defined with reference to other mainly Anglo-American jurisdictions in which it is prominent.<sup>223</sup>

The proposed legislation was further criticised for the wide-sweeping powers it conferred upon the courts,<sup>224</sup> but the Law Commission was firmly of the view that

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<sup>220</sup> See, for example, the respondents’ proposals which are summarised in the Law Commission Final Report at 138–145, in particular those of the two groups of Supreme Court of Appeal judges and of Professors Hutchison and van Heerden at 139–140. Christie *Contract* 14, for example, argues that the starting point of the common law is that the courts will not interfere with a contract on the grounds that it is unreasonable, and that accepting unreasonableness “would lead, not to a mere continuation of this process of whittling away the general principle [of freedom of contract], but to its complete abandonment”, resulting in “a form of paternalism inconsistent with the parties’ freedom of contract”.

<sup>221</sup> Glover *The Doctrine of Duress in the Law of Contract and Unjustified Enrichment in South Africa* 377.

<sup>222</sup> SALC Final Report 22.

<sup>223</sup> For further discussion in this regard, see Graham Glover “The South African Law Commission’s Report on Unreasonable Stipulations in Contract and its Potential Effect on Procedural Unfairness in the Common Law” (2004) 18 *Speculum Juris* 79.

<sup>224</sup> These powers are mostly encapsulated within s1.

wide powers were necessary in order to ensure contractual justice, especially when considering the wide powers conferred on courts by legislation in other jurisdictions.<sup>225</sup> The proposed legislation also sought to give courts powers in respect of procedural unfairness: “[T]he way in which a contract between the parties or a term thereof came into being”.<sup>226</sup>

Section 2 of the Bill provided for 25 guidelines to assist the courts to determine whether or not the criterion of unreasonableness, unconscionableness or oppressiveness has been met,<sup>227</sup> many of which are relevant to the pre-contractual stage. Furthermore, the courts could have regard to “any other factor which in the opinion of the court should be taken into account”,<sup>228</sup> thus conferring on the courts extremely wide powers. Again, there was much opposition to the proposed guidelines,<sup>229</sup> but the Law Commission was of the view that guidelines would provide some definition to the fairness criterion, that legal certainty and predictability would be enhanced without unduly limiting judicial discretion, and that the guidelines would encourage preventative action.<sup>230</sup>

In response to many respondents’ arguments regarding the inaccessibility of the courts to ordinary people, resulting from their being effectively out of financial reach of most people,<sup>231</sup> the draft Bill provided for the establishment of the office of an ombudsperson with wide powers, which are set out in the Bill.<sup>232</sup> These included powers to prevent the continued use of contract terms that do not meet the Bill’s fairness criterion,<sup>233</sup> and the power to prepare draft codes of conduct in particular fields of trade or commerce.<sup>234</sup> Importantly, however, these powers would be limited to pre-formulated standard-form contracts only.<sup>235</sup> Further, the courts are not able to develop the common law in terms of s8(3)(a) of the Constitution until suitable cases are brought before them, which in the ordinary course of litigation could take many

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<sup>225</sup> SALC Final Report 115–122.

<sup>226</sup> Section 1(1)(a).

<sup>227</sup> SALC Final Report 215–218.

<sup>228</sup> Section 2(z).

<sup>229</sup> Christie *Contract* 13, for example, is of the view that the proposed guidelines “would open almost every contract to attack”.

<sup>230</sup> SALC Final Report 170–171. The Law Commission was of the view that guidelines resulting in increased predictability would encourage preventative action via informed self-control by drafters of standard-form contracts, action by representative bodies, and negotiations with a view to settling disputes.

<sup>231</sup> Christie *Contract* 13, for example, has consistently argued that “it is the machinery rather than the law” in regard to contractual fairness that needs attention, because of prohibitive court costs.

<sup>232</sup> Section 6(2).

<sup>233</sup> Section 6(2)(d).

<sup>234</sup> Section 6(2)(e).

<sup>235</sup> Christie *Contract* 13 argues that “the proposed limitation of the ombudsperson’s powers to standard-form contracts would solve only part of the problem”.

years. The ombudsperson, however, “has the potential to put the ordinary person and the common law in touch with each other”,<sup>236</sup> thereby strengthening the hand of the law in practice.

In contemplating briefly the need for legislation to curb contractual unfairness, Christie’s views in 2001 are insightful.<sup>237</sup> Commenting on the proposed legislation in regard to the unfair enforcement of a contract,<sup>238</sup> he proposed that any gaps that exist in the common law could be filled by developing the common law, for example via the approach to good faith suggested by Olivier JA in *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman*.<sup>239</sup> He argued that legislation should not be necessary, “unless, of course, the Supreme Court of Appeal fails the test”, for the courts “are practised in developing the law seamlessly”,<sup>240</sup> and “[t]here is every reason to hope that when the opportunity arises the Supreme Court of Appeal will apply Olivier JA’s reasoning”.<sup>241</sup> One would have thought there was reason for hope, but the Supreme Court of Appeal appears to have failed Christie’s test insofar as good faith is concerned,<sup>242</sup> which strengthens the case for legislation to curb contractual unfairness.

## 2.5.2 The Consumer Protection Bill

The Department of Trade and Industry made a policy decision to legislate in regard to consumer protection in general, and initiated a review of the consumer legislative framework that culminated in the publication of a second discussion draft of the Consumer Protection Bill, 2005<sup>243</sup> on 15 March 2006. Much of the Bill is devoted to an articulation of eight distinct “Fundamental Consumer Rights”,<sup>244</sup> one of which is the “Right to Honest Dealing and Fair Agreements”,<sup>245</sup> which is of relevance to this chapter. Sections 52 to 54 introduce the notions of unreasonable, unfair, unjust and unconscionable transactions, familiar terms from the Law Commission proposals

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<sup>236</sup> Christie *Contract* 15.

<sup>237</sup> Christie *The Law of Contract in South Africa* 4 ed (2001) 19–20.

<sup>238</sup> Section 1(1)(d).

<sup>239</sup> 1997 (4) SA 302 (SCA).

<sup>240</sup> Christie *The Law of Contract in South Africa* 4 ed (2001) 20.

<sup>241</sup> Christie *The Law of Contract in South Africa* 4 ed (2001) 19.

<sup>242</sup> *Brisley v Drotzky* 2002 (4) SA 1 (SCA); *Afrox Healthcare Ltd v Strydom* 2002 (6) SA 21 (SCA). It is, however, arguable that the Supreme Court of Appeal has been constrained in its ability to develop the common law in regard to good faith, in view of the fact that it has not had the opportunity of adjudicating suitable test cases. It should be noted that in these cases the Supreme Court of Appeal confirmed that public policy still has a role to play in regard to contractual fairness.

<sup>243</sup> Consumer Protection Bill, second discussion draft, GN R418, *Government Gazette* 28629, 15 March 2006 <http://www.thedti.gov.za/> (accessed 14 March 2006).

<sup>244</sup> Sections 7 to 76 of the Bill.

<sup>245</sup> Part F, ss 45 to 60 of the Bill.

discussed in 2.5.1 above. These terms are not properly defined anywhere in the Bill, but are merely articulated in these sections with reference to what is prohibited.<sup>246</sup> What follows is a brief summary of the provisions relevant to this chapter, since an attempted analysis would appear to be premature.<sup>247</sup>

“Unreasonable transactions”<sup>248</sup> are described with reference to a prohibition on the supply of goods or services when the supplier has knowledge that they are “materially unsuitable” (irrespective of whether or not the goods are of good quality), and when the consumer is unlikely to be able to make the necessary determination of material unsuitability.

“Unfair or unjust transactions”<sup>249</sup> are described with reference to a prohibition on the supply of goods or services at a price or on terms that are unfair or unjust, and with reference to the marketing, negotiation, conclusion or administration of an agreement to supply goods or services in a manner that is unfair or unjust. A transaction is unfair or unjust if it is “excessively one-sided”, or the terms are “so adverse ... as to be inequitable”, or “the consumer relied upon a false, misleading or deceptive representation, or statement of opinion”.<sup>250</sup>

“Unconscionable conduct”<sup>251</sup> is articulated with reference to a prohibition on “physical force, coercion, undue influence, pressure or harassment, unfair tactics or any other conduct” at any stage before, during or after the conclusion of an agreement.<sup>252</sup> The Bill goes on to provide that it is unconscionable for a supplier to take advantage of a consumer’s “disability, illiteracy, ignorance, inability to understand the language of an agreement, or any other similar factor”.<sup>253</sup>

Section 55 of the Bill gives to the courts and the National Consumer Tribunal<sup>254</sup> wide-sweeping powers to declare any transaction or agreement, or any aspect or provision

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<sup>246</sup> An exception is s53(2), in which an attempt is made at giving the term “unfair or unjust” greater definition.

<sup>247</sup> The discussion is limited to ss 52–58, since the remainder of Part F of the Bill (“Right to Honest Dealing and Fair Agreements”) concerns matters that are not strictly relevant to this chapter, namely contractual fairness in general.

<sup>248</sup> Section 52.

<sup>249</sup> Section 53.

<sup>250</sup> Section 53(2).

<sup>251</sup> Section 54.

<sup>252</sup> Section 54(1) includes the stages of marketing, supply, negotiation, conclusion, execution or enforcement of an agreement, and demand for, collection of or payment for any goods or services, or recovery of goods.

<sup>253</sup> Section 54(2).

<sup>254</sup> The National Consumer Tribunal was established by the National Credit Act 34 of 2005.

of it, to be unreasonable, unfair, unjust or unconscionable,<sup>255</sup> and to make a number of other possible orders.<sup>256</sup> In making any order, the court or Tribunal must have regard to, *inter alia*, “the relative strengths of the bargaining positions of the supplier and the consumer”, their conduct, opportunities for and extent of negotiation, and any conditions in the agreement that are not reasonably necessary.<sup>257</sup>

Section 56 provides that a consumer agreement is unlawful if, *inter alia*, a court concludes that it is unreasonable, unfair, unjust or unconscionable, in which case the agreement is unlawful only to the extent ordered by the court.<sup>258</sup> An agreement that is unlawful is void from date of conclusion, “despite any provision of common law, any other legislation, or any provision of an agreement to the contrary”.<sup>259</sup>

Section 57 prohibits unlawful provisions or conditions in consumer agreements for the supply of goods or services, and lists numerous provisions and conditions that are unlawful.<sup>260</sup> An unlawful provision is void from the date on which it takes effect, and a court must sever or alter it, or declare the entire agreement unlawful, and make any other appropriate order.<sup>261</sup>

Section 58 then goes on to provide a separate set of requirements in respect of “unfair contract terms”, and lists the factors to which a court must have regard in determining whether a term of a contract is unfair or unreasonable.<sup>262</sup> If a court finds a contract term to be unfair or unreasonable, it may rescind or amend the contract or a term of the contract, or make any other appropriate order, “notwithstanding the principle that effect must be given to the contractual terms agreed upon by the parties”.<sup>263</sup> The difference between “unlawful provisions of consumer agreements” (s57) and “unfair contract terms” (s58) is not clear, as are also the circumstances in which each section is applicable.

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<sup>255</sup> Section 55(1)(a).

<sup>256</sup> Section 55(1)(b).

<sup>257</sup> Section 55(2)(a).

<sup>258</sup> Section 56(1)(c).

<sup>259</sup> Section 56(3).

<sup>260</sup> Section 57(2)(a)–(j).

<sup>261</sup> Section 57(4).

<sup>262</sup> Section 58(1). These factors are: the relative bargaining strengths of the parties; any inducement to agree to the term; whether the consumer knew or ought to have known of the existence and extent of the term; and whether the goods were manufactured, processed or adapted to the special order of the buyer.

<sup>263</sup> Section 58(2).

It can therefore be seen that the fairness criterion in the proposed Bill is very broadly articulated, and so its precise definition could prove to be problematic. Further, the courts or the National Consumer Tribunal are given wide-ranging powers to invoke the fairness criterion and make findings that they deem appropriate. A notable change from the Law Commission's proposed legislation is that the Consumer Protection Bill dispenses with an ombudsperson, choosing to rely rather on the National Consumer Tribunal.

## 2.6 Conclusion

It is clear that public policy, fortified by constitutional values, is now the best common law method for promoting contractual fairness. Public policy is a doctrine which is more acceptable to the courts (in particular the Supreme Court of Appeal), as opposed to the much more vague, somewhat controversial and less-developed principle of good faith.<sup>264</sup> The Supreme Court of Appeal has given unequivocal recognition to the acceptance in *Sasfin* and other decisions that in cases of extreme unfairness, an agreement may be contrary to public policy and therefore unenforceable, and that public policy is founded upon constitutional values.<sup>265</sup>

“[T]he courts will invalidate agreements offensive to public policy, and will refuse to enforce agreements that seek to achieve objects offensive to public policy. Crucially, in this calculus 'public policy' now derives from the founding constitutional values of human dignity, the achievement of equality and the advancement of human rights and freedoms, non-racialism and non-sexism.”

In a case which is of interest in regard to the micro-lending industry, the Supreme Court of Appeal held in *Bafana Finance Mabopane v Makwakwa and another*<sup>266</sup> that a clause in a micro-lending agreement in which the borrower undertakes not to apply to a magistrate's court to be placed under administration is contrary to public policy and therefore invalid. Cachalia AJA stated:<sup>267</sup>

“That a court may not enforce an agreement because the objective it seeks to achieve is contrary to public policy is firmly part of our law. And in this determination 'public policy' is anchored in the founding constitutional values which include human

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<sup>264</sup> Good faith is at most an aspect of the public policy enquiry.

<sup>265</sup> Cameron JA in *Napier v Barkhuizen* 7A–B. See also *Afrox Healthcare Ltd v Strydom* 33H–J and 34G–I, and the discussion in 2.3.2 above.

<sup>266</sup> 2006 (4) SA 581 (SCA).

<sup>267</sup> Para 11.

dignity, the achievement of equality and the advancement of human rights and freedoms.”

It therefore seems that our common law of contract is well placed, through the systematic and incremental development of these principles and values, to achieve an appropriate balance between the values of contractual freedom and equity.

“[I]t can be said with some confidence that public policy is a sufficiently flexible and tested concept in South Africa to achieve all the results that could be achieved by the concept of good faith and to achieve them in a more predictable way.”<sup>268</sup>

That being the case, is legislation still necessary? In my view, appropriate legislation is for a number of reasons essential in order for the law to be able to make a serious contribution towards equity in contract. First, as has already been pointed out,<sup>269</sup> the courts are not able to develop the common law in terms of Section 8(3)(a) of the Constitution until suitable cases are placed before them. This could take many years, partly because only a very small percentage of South Africa’s population can afford such litigation, and also because suitable test cases requiring courts to decide matters exclusively on the pertinent points at issue are necessary in order for the courts to pronounce on those issues and thereby develop the common law.<sup>270</sup>

Second, although public policy infused by constitutional values appears to be well set to be an effective tool to be used by the courts to develop the law in regard to contractual fairness, there is no certainty that the courts will in fact do so with the necessary vigour. The courts are notoriously conservative and slow to develop the law, preferring to do so carefully and incrementally in accordance with the traditional, proven “time-honoured method of developing the common law one step at a time”,<sup>271</sup> and there is much merit in this approach. However, the development of our contract law would seem to be too much at the mercy of our rather conservative judiciary, and the constitutional imperative and the South African reality<sup>272</sup> provide a serious challenge to the adequacy of this traditional approach. Further, the Supreme Court

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<sup>268</sup> Christie *Contract* 17.

<sup>269</sup> See 2.5.1 above.

<sup>270</sup> See, for example, *Napier v Barkhuizen* 7C, discussed below, in which Cameron JA stated that the court may have been able to invalidate a time-bar term in an insurance contract, and thereby develop the common law, if evidence had been placed before the court of inequality of bargaining power which had the effect of infringing the insured’s constitutional rights to dignity and equality. See also *Afrox Healthcare Ltd v Strydom* 35C–D.

<sup>271</sup> Christie “The Law of Contract and the Bill of Rights” *Bill of Rights Compendium* para 3H2.

<sup>272</sup> For example, low levels of education, literacy and numeracy, and widespread ignorance of legal rights, to be discussed later in this study.

of Appeal is not renowned for judicial activism and may prove to be resistant to proactively developing the law in regard to contractual fairness,<sup>273</sup> evidenced by its rejection of good faith as an instrument for handling cases of contractual fairness.<sup>274</sup> In these cases, the Supreme Court of Appeal appears to have failed Christie's "test"<sup>275</sup> in regard to good faith, going against the tide of academic and judicial thinking in relation to contractual fairness, "to the dismay of many commentators".<sup>276</sup> Although it is highly improbable that public policy will suffer the same fate at the hands of the Supreme Court of Appeal, this court may prove to be far too reticent and slow to develop the law in this regard. Having expressed "confidence"<sup>277</sup> in the prospects of public policy, Christie could be disappointed again. Given these constraints on the judiciary, legislation is necessary.

Third, and most important of all, the courts are not accessible to the vast majority of the South African population, primarily because they are simply financially out of reach.<sup>278</sup> This creates an extremely serious problem that cannot be brushed aside, because everyone "has the right to equal protection and benefit of the law".<sup>279</sup> Of course, there is little that the courts can do about this, and it is a challenge that only the legislature can address. The Law Commission's proposed ombudsperson would go a long way towards improving access to contractual justice for most people. Whether or not the National Consumer Tribunal<sup>280</sup> is likely to be as effective in this regard remains to be seen. All things considered, however, it is highly desirable that an alternative, cheaper mechanism be found for the resolution of consumer disputes in order to enhance access to contractual justice, and legislation is necessary in order to achieve this. In the absence of legislation to maintain equity in the law of contract, widespread exploitation in the contractual sphere will continue, and South African law will not be able to live up to its constitutional ideals.<sup>281</sup> The precise form

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<sup>273</sup> It is noteworthy that nearly all the Supreme Court of Appeal's progressive pronouncements regarding the role of public policy and constitutional values have been made by Cameron JA.

<sup>274</sup> See Brand JA's summary of *Brisley v Drotzky* and *Afrox Healthcare v Strydom*, in the matter of *South African Forestry Co Ltd v York Timbers Ltd* 2005 (3) SA 323 (SCA) 338H–339C. Bhana and Pieterse 2006 SALJ 893 have the following insight in this regard: "Much of the court's ostensible opposition to the constitutional development of the common law appears to arise from fears that such development would disturb the equilibrium of interests that common law seeks to achieve and would sacrifice the legal certainty associated with the unfettered operation of well-oiled common law rules in favour of ad hoc, unprincipled, subjective, abstract and value-based decision-making."

<sup>275</sup> Christie *The Law of Contract in South Africa* 4 ed (2001) 20 and 22.

<sup>276</sup> Cameron JA in *Napier v Barkhuizen* 7B.

<sup>277</sup> Christie *Contract* 17.

<sup>278</sup> Christie *Contract* 13.

<sup>279</sup> Section 9(1) of the Constitution of the Republic of South Africa, 1996.

<sup>280</sup> Proposed by the Consumer Protection Bill, 2006.

<sup>281</sup> Lewis 2003 SALJ 351.

that such legislation should take, however, is another matter altogether, and beyond the scope of this study.

In conclusion, it is worth noting that the Supreme Court of Appeal has heavily emphasised inequality of bargaining power as an important factor in striking down a contract on public policy and constitutional grounds.<sup>282</sup> In both *Afrox Healthcare Ltd v Strydom*<sup>283</sup> and *Napier v Barkhuizen*,<sup>284</sup> there was no evidence to prove inequality of bargaining power, and the court in both cases pointed out that its finding may well have been different had such evidence been forthcoming, “for it is here that the constitutional values of equality and dignity may prove decisive”.<sup>285</sup> It is of interest to note that perceived inequality of bargaining power, more than anything else, seemed to motivate the Law Commission’s Project 47 report proposing legislation to give courts wider powers to control contractual unfairness. The Consumer Protection Bill clearly also considers this to be a critical factor: a transaction is unfair or unjust if it is excessively one-sided,<sup>286</sup> and in applying the fairness criterion, courts or the National Consumer Tribunal may have regard to “the relative strengths of the bargaining positions of the supplier and the consumer”.<sup>287</sup> There is also no doubt that inequality of bargaining power bears directly on the fundamental constitutional right to equality.<sup>288</sup> Inequality of bargaining power is an important thread in South African contract law that is likely to play an increasingly prominent role in the development of both the common law and legislation relating to contractual fairness.

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<sup>282</sup> *Napier v Barkhuizen* 7C.

<sup>283</sup> 35C–D.

<sup>284</sup> 7B–D.

<sup>285</sup> *Napier v Barkhuizen* 8H. Cameron JA was referring to inequality of bargaining power.

<sup>286</sup> Section 53(2)(a).

<sup>287</sup> Section 55(2)(a)(i).

<sup>288</sup> Section 7(1), s9 and s39(1) of the Constitution of the Republic of South Africa, 1996. See also Christie *Contract* 19; Lubbe 2004 *SALJ* 398; Bhana and Pieterse 2006 *SALJ* 879–880; *Napier v Barkhuizen* 7C.

## Chapter Three

# Usury Laws in regard to Consumer Credit

### Outline

The previous chapter examined the extent to which the South African common law of contract (with reference to constitutional values) might provide protection to contracting parties in general, in the context of contractual fairness. In this chapter, the enquiry will narrow down to focus on usury laws in relation to consumer credit in general, with an emphasis on moneylending transactions. The common law in regard to usury will be reviewed first, followed by usury legislation and the *in duplum* rule (common law and legislation). The next chapter (Chapter 4) will focus specifically on the cost of credit in the micro-finance industry in South Africa, via regulation since 1992.

### 3.1 The common law in regard to usury

#### 3.1.1 General historical background

For millennia, lawmakers have had to make rules to regulate relations between contracting parties in order to combat exploitation and malpractice.<sup>1</sup> The matter of the charging of interest has attracted a vast amount of comment from theologians, economists and jurists alike, in relation to numerous types of contracts, but primarily moneylending.<sup>2</sup> The issue of the cost of credit is not new to our age, but is the same issue that lawmakers have been wrestling with for centuries. Usury law has a strong social, economic and moral basis,<sup>3</sup> and it is necessary to take note of the historical developments in this regard, because they provide the social, economic and juridical background to current legislation.<sup>4</sup>

Legislation that limits interest rates has existed for nearly 4000 years,<sup>5</sup> the first known enactments being in the Code of Hammurabi of 1750 BC.<sup>6</sup> Interest was prohibited in

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<sup>1</sup> *South African Law Commission Working Paper 46 – Project 67: the Usury Act and Related Matters: New Credit Legislation for South Africa* (proposed to the South African Law Commission by JM Otto and NJ Grové) (1991) 18.

<sup>2</sup> SALC Working Paper 46 at 18.

<sup>3</sup> Otto “Consumer Credit” in Joubert (ed) *LAWSA Vol 5(1) 2 ed* (2004) para 2.

<sup>4</sup> SALC Working Paper 46 at 18.

<sup>5</sup> Otto *LAWSA Vol 5(1)* para 2.

the Old Testament of the Bible, save for certain exceptions.<sup>7</sup> The teaching of the New Testament is less clear, and the old church fathers disagreed as to the interpretation of biblical texts.<sup>8</sup> For a long time, therefore, the debate was about whether or not interest could be charged at all.<sup>9</sup> In terms of traditional canon law, interest was forbidden, although from the time of Calvin it has been accepted that interest is permissible within certain limits.<sup>10</sup>

### 3.1.2 The common law

In order to limit the length of this discussion, the historical development of South African common law will be confined largely to the interpretation thereof by our courts. The South African cases that discuss the common law position in relation to usury all date back more than 95 years. The case of *Dyason v Ruthven*<sup>11</sup> provides a full description of the Roman and Roman-Dutch authorities' writings in relation to usury. Under Roman Law, there were always maximum rates of interest, which changed from time to time.<sup>12</sup> The Twelve Tables provided for an interest rate of one twelfth of the loan per month (i.e. 100% per annum).<sup>13</sup> Later, Justinian laid down that business loans would be at 8% per annum, ordinary loans at 6%, loans to illustrious persons at 4%, and that in the case of goods bought beyond the sea 12% was permitted.<sup>14</sup> Compounding of interest was forbidden.<sup>15</sup> Whilst the Roman Law position is enlightening, it provides limited assistance, since the fixing of interest rates was not received into our law.

Roman-Dutch authorities had to contend with the conflict between commercial realities and the canon law proscription on the charging of interest, and wrote at length about the various rates applicable to loans at different stages and under different circumstances.<sup>16</sup> The rates referred to are of limited value today, but serve to remind us that rules regarding interest rate limits are certainly not the preserve of the modern era.

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<sup>6</sup> Grové *Gemeenregtelike en Statutere Beheer oor Woekerrente* (LLD thesis, RAU, 1989) 10.

<sup>7</sup> Otto *LAWSA* Vol 5(1) para 2.

<sup>8</sup> *Ibid.*

<sup>9</sup> SALC Working Paper 46 at 18.

<sup>10</sup> Grové *Gemeenregtelike en Statutere Beheer oor Woekerrente* 73ff.

<sup>11</sup> 1860 Searle 282.

<sup>12</sup> Thomas *Textbook of Roman Law* (1976) 273.

<sup>13</sup> *Ibid.*

<sup>14</sup> C 4.32.26.

<sup>15</sup> D 12.6.26.1.

<sup>16</sup> Otto "Consumer credit" in Joubert (ed) *LAWSA* Vol 5(1) (2004) para 2, who refers in turn to van Leeuwen *CF* 1 4 4 5 and 1 4 4 9, van Leeuwen *RHR* 4 6 6; van der Keessel *Praelectiones op Gr* 3 10 9 10; Huber *HR* 3 16 3, 11, 14 and 15; 3 36; 3 37.

It is well established that the common law explicitly and directly provides protection against usury, although there is no *certum modum usurarum*.<sup>17</sup> The writer Loenius stated: "From the relation of others I have understood, and also from Fiscal De Groot, that in our country here we have no certain rate of interest, but that the same is regulated according to circumstances of times, places, and persons."<sup>18</sup> Arising from this background, our common law decides whether a particular loan is usurious by examining the particular circumstances of the loan. In *Dyason v Ruthven*, Bell J stated that

"... if the circumstances of any case should show that advantage had been taken by a creditor of the position of his debtor to extort from him an excessive or exorbitant amount of interest, even by previous stipulation, this Court would give relief in such a case by modifying the interest to a reasonable rate".<sup>19</sup>

The question is, judged from the risks and the current value of money, is the stipulation so enormous as to amount to fraud?<sup>20</sup> Or,

"... if any stipulation of interest be attacked as liable to reduction, on the ground of usury or extortion, this can only be done by offering proof of the usury and extortion in the particular case".<sup>21</sup>

This statement of the common law, as received into the Cape, was approved and fully adopted by Innes CJ in *Reuter v Yates*.<sup>22</sup>

"But our law does not in my opinion define any particular rate of interest as being necessarily usurious; it does not fix a limit up to which interest is legitimate and proper, and beyond which it becomes illegal and excessive. That must depend upon the circumstances of each case. Usury is a good defence; the difficulty arises in deciding when a contract is usurious and when it is not. And that difficulty is not to be solved by a mere reference to the rate of interest agreed upon; it requires a careful inquiry into all the circumstances surrounding the transaction which is challenged.

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<sup>17</sup> SALC Working Paper 46 at 19.

<sup>18</sup> Loenius *Decesien and Observatien* (Casus 21), as quoted by Hodges CJ in *Dyason v Ruthven* 290.

<sup>19</sup> 304.

<sup>20</sup> *Per* Watermeyer J at 311.

<sup>21</sup> *Per* Watermeyer J at 312.

<sup>22</sup> 1904 TS 855.

And the onus in my opinion is upon the person who sets up the defence, to satisfy the court upon the facts that it is applicable and sufficient.”<sup>23</sup>

The court confirmed that in deciding whether a rate of interest is usurious, “the rate of interest agreed upon would of course be a most important circumstance to consider”.<sup>24</sup> Furthermore, the court recognised that “[i]t may possibly be that such an exorbitant rate of interest was charged as in itself to afford evidence of such inequitable dealing as to afford ground for relief”.<sup>25</sup>

The courts, however, also recognise that other circumstances besides the interest charged are relevant. The law espoused in *Reuter v Yates* was applied in the case of *SA Securities Ltd v Greyling*,<sup>26</sup> in which a rate of 120% per annum was held, in the circumstances, not to be usurious. Wessels J said:

“Therefore, the mere fact that the amount of interest seems high is not sufficient to make the transaction usurious. What then is there in a transaction which makes it usurious? If it is not the mere amount of interest, what other circumstances are there? ... I think the most you can say is that the transaction must show that there has been either extortion or oppression, or something which is akin to fraud.”<sup>27</sup>

Innes CJ in *Reuter v Yates* went further in articulating the relevant circumstances to be taken into account in deciding whether a particular transaction is usurious:

“It comes then to this – in deciding whether the defence of usury has been sustained, and whether the lender has taken such an undue advantage of the borrower, has so practised extortion and oppression, that his conduct, being akin to fraud, disentitles him to relief, the Court will examine all the circumstances of the case. It will not only look at the scale at which interest has been stipulated for, but will have regard to the ordinary rate prevalent in similar transactions, to the security offered and the risk run, to the length of time for which the loan was given, the amount lent, and the relative positions and circumstances of the parties.”<sup>28</sup>

Finally, if a court concludes that a rate is too high and is therefore usurious, the contract is not void, but the court may reduce the rate to one which is reasonable in

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<sup>23</sup> 856.

<sup>24</sup> 857.

<sup>25</sup> *Per* Smith J at 859.

<sup>26</sup> 1911 TPD 352

<sup>27</sup> 356.

<sup>28</sup> 858.

the circumstances.<sup>29</sup> In *Taylor v Hollard*,<sup>30</sup> Kotze J concluded that where parties agree on an excessive rate of interest, such rate may lawfully be reduced, since it is not in the public interest to enforce rates of this nature, because "... to countenance such proceedings would be contrary to good morals, the interests of our citizens, and the policy of our law".<sup>31</sup>

From the above case law, our common law in regard to usury can be summarised as follows:

- (i) There is no such thing as a "common law rate of interest".<sup>32</sup>
- (ii) Interest which is proved to be extortionate or usurious may not be claimed by a creditor<sup>33</sup> (although a court will not lightly interfere with an interest rate upon which the parties have agreed).<sup>34</sup>
- (iii) The Defendant bears the onus of proving its defence of usury.<sup>35</sup>
- (iv) In order to satisfy that onus, it has to lead evidence to establish extortion and oppression akin to fraud.<sup>36</sup>
- (v) To achieve this, evidence as to the ordinary rate prevalent in similar transactions, the size of the loan, the period of the loan, the purpose of the loan, the relative positions of the parties, the security and the risk, will all be relevant.<sup>37</sup>
- (vi) A contract declared to be usurious will not be void, but a court has the power to declare such a contract partially enforceable to the extent that the interest is not usurious.<sup>38</sup>

The circumstances listed in (v) above are not a *numerus clausus* of possible relevant circumstances to be taken into account in deciding whether or not a transaction is usurious. The relative positions and circumstances of the parties, for example, will surely allow for consideration as to whether the loan is for business or private consumption. Grové<sup>39</sup> lists the following additional factors or circumstances that may

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<sup>29</sup> *Dyason v Ruthven* 304; *Taylor v Hollard* 1885–1888 (2) SAR 78 at 84.

<sup>30</sup> 1885–1888 (2) SAR 78 at 84.

<sup>31</sup> 85.

<sup>32</sup> *Dyason v Ruthven* 291, 304, 305, 312; *Reuter v Yates* 856, 859.

<sup>33</sup> *Taylor v Hollard* 84, 85; *Reuter v Yates* 856; *Dyason v Ruthven* 291.

<sup>34</sup> *Dyason v Ruthven* 310; *Reuter v Yates* 856, 859.

<sup>35</sup> See, for example, *Reuter v Yates* 856.

<sup>36</sup> *Dyason v Ruthven* 311–312; *Reuter v Yates* 858; *SA Securities Ltd v Greyling* 356.

<sup>37</sup> *Reuter v Yates* 858.

<sup>38</sup> *Grové Gemeenregtelike en Statutere Beheer oor Woekerrente* 138; *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 1984 (4) SA 874 (A).

<sup>39</sup> *Grové Gemeenregtelike en Statutere Beheer oor Woekerrente* 140ff.

be relevant: how quickly the borrower wants the funds; whether a deposit or security is required; whether the debt is repayable in instalments; hidden finance costs; the possibility of early repayment; remedies on breach; whether financing is available in general for similar cases.

Finally, it should be noted that the above common law is still relevant, notwithstanding the existence of the Usury Act and exemption notices,<sup>40</sup> in view of the presumption that a statute alters the common law as little as possible.<sup>41</sup>

## **3.2 Usury legislation: an historical overview**

It is not surprising that legislatures have regarded the common law as providing insufficient protection to consumers. Otto and Grové<sup>42</sup> usefully divide usury legislation<sup>43</sup> into first-, second- and third-generation consumer credit laws.<sup>44</sup>

### **3.2.1 First-generation consumer credit legislation**

First-generation consumer legislation pre-dated the Union of South Africa. It was designed to remove uncertainty as to whether interest could be charged at all, at a time in South African legal history when no statutory or common law control over maximum finance charge rates existed.<sup>45</sup> For instance, the Orange Free State Lawbook:<sup>46</sup> “The trade in money shall be free, and everyone shall have the right to demand as much interest for his money as he may think fit.”<sup>47</sup> A distinguishing feature was that the different colonies dealt with the matter in different ways, and there was no question of uniformity.<sup>48</sup>

Likewise, section 1 of Act 6 of 1858 (Natal) provided that companies or individuals may “lend ..., at any rate of interest, or premium or discount, that may be arranged or agreed between the borrower and lender of capital”. The Natal Act was amended in 1908<sup>49</sup> to provide protection for “natives”, who were entitled to be charged a

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<sup>40</sup> And subsequently, the National Credit Act and Regulations.

<sup>41</sup> Du Plessis *Re-Interpretation of Statutes* (2002) 177–178.

<sup>42</sup> SALC Working Paper 46.

<sup>43</sup> Until 1991, at the time that they wrote.

<sup>44</sup> SALC Working Paper 46 at 22–29.

<sup>45</sup> SALC Working Paper 46 at 22.

<sup>46</sup> OVS Wetboek, 1854–1891.

<sup>47</sup> Ch 98, as translated in the SALC Working Paper 46 at 22.

<sup>48</sup> SALC Working Paper 46 at 24.

<sup>49</sup> Act 41 of 1908.

maximum of 15% interest per annum. Other maximum interest rates were prescribed (not only for moneylending contracts), and contracts that exceeded prescribed rates were void.<sup>50</sup> If a moneylender made a fraudulent misrepresentation, he was guilty of an offence.<sup>51</sup>

The Cape Colony passed a Cape Usury Act in 1908,<sup>52</sup> which applied primarily to moneylending transactions. In an interesting early recognition of the broader scope of the cost of credit, the term “interest” was widely defined to include “valuable consideration for a loan of money, whether such consideration be in cash, in goods, in kind or in any other form whatsoever”.<sup>53</sup> For the first time, different rates for different amounts lent were prescribed, and any person exacting more than the maximum prescribed rate was guilty of an offence.<sup>54</sup> If a creditor recovered too much interest, a court could order him/her to pay back the excessive interest.<sup>55</sup>

### **3.2.2 Second-generation consumer credit legislation**

Otto and Grové’s second-generation consumer credit legislation was so called because it applied for the first time on a national scale,<sup>56</sup> with different legislation provided for different types of transactions, as will be seen below. The first Act passed by the Parliament of the Union of South Africa was the Usury Act of 1926,<sup>57</sup> which applied only to moneylending transactions.<sup>58</sup> This act provided a sliding scale of interest rates which depended upon the size of the loan.<sup>59</sup> Loans of less than 10 pounds attracted a maximum of 30% interest per year; at the top of the scale, loans exceeding 50 pounds attracted a maximum of 12% interest per year. Any person contravening these provisions was guilty of an offence and liable to a fine not exceeding 100 pounds.<sup>60</sup> All moneylending transactions had to be in writing and

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<sup>50</sup> Section 3.

<sup>51</sup> Sections 5 and 8.

<sup>52</sup> Act 23 of 1908.

<sup>53</sup> Section 2.

<sup>54</sup> Section 5.

<sup>55</sup> Section 9.

<sup>56</sup> SALC Working Paper 46 at 24.

<sup>57</sup> Act 37 of 1926. This Act did not in fact provide complete uniformity throughout the Union. The Cape Usury Act and Chapter 98 of the Orange Free State Law Book were repealed by Section 15(10), but Section 1 of Act 6 of 1858 (Natal) was only partially amended by Section 15(2). The Natal Act was subsequently repealed by the Pre-Union Statute Law Revision Act 78 of 1967.

<sup>58</sup> In effect, instalment transactions relating to movables were not statutorily regulated until the passing of the Hire-Purchase Act 36 of 1942, from which date the Usury Act and the Hire-Purchase Act co-existed without impacting on each other at all, because they applied to different types of contracts.

<sup>59</sup> Section 1(1).

<sup>60</sup> Section 1(2).

contain certain prescribed information.<sup>61</sup> Provision was made for certain permissible expenses other than interest.<sup>62</sup>

In March 1967, the Minister of Finance appointed a committee under the chairmanship of Dr DG Franzsen to investigate and improve the 1926 Usury Act. Within a few months of the Franzsen Committee completing its report, the Limitation and Disclosure of Finance Charges Act<sup>63</sup> was passed, which repealed the 1926 Usury Act, and later became the Usury Act 73 of 1968.<sup>64</sup> The long title of the Act described its purpose:

“To provide for the limitation and disclosure of finance charges levied in respect of moneylending transactions, credit transactions and leasing transactions and for matters incidental thereto; and to repeal the Usury Act, 1926.”

The Usury Act of 1968 did not set fixed rates for transactions falling within its ambit, but provided for maximum interest rates in moneylending, leasing and credit transactions. It was characterised by repeated references to notices promulgated by the Minister of Trade and Industry.<sup>65</sup> Thus, maximum rates for different sizes of transactions were not set out in the Act itself, but were all changed fairly frequently from time to time by promulgation by the Minister.<sup>66</sup> Failure to comply with the Act was a criminal offence.<sup>67</sup> A moneylender commits the statutory offence of “usury” where he “stipulates or demands or receives” finance charges<sup>68</sup> at a rate in excess of that prescribed by the Act.<sup>69</sup>

As in the case of most consumer credit laws, the Usury Act restricted many of the traditional rights and powers of creditors and increased the remedies available to

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<sup>61</sup> Section 5(1)

<sup>62</sup> Section 2(1). These included stamp costs, mortgage costs, rates and taxes, licence fees, insurance premiums (in certain cases) and “any costs which have actually been incurred by the lender in the recovery of his debt.”

<sup>63</sup> Act 73 of 1968.

<sup>64</sup> The Act was renamed in terms of s9 of the Limitation and Disclosure of Finance Charges Act 42 of 1986.

<sup>65</sup> Prior to 1993, the relevant Minister was the Minister of Finance; see the Usury Amendment Act 30 of 1993, section 1.

<sup>66</sup> The most recent promulgation of interest rates in terms of the Usury Act, for example, provided for a maximum interest rate of 20% per annum for loans less than R10 000, and 17% per annum for loans greater than R10 000 (GN 1100, *Government Gazette* 26809, 17 September 2004). These rates will be valid until 1 June 2007, when the relevant provisions of the National Credit Act come into operation.

<sup>67</sup> Section 17.

<sup>68</sup> The concept of “finance charges” – as contained in the Usury Act – does not convey the same meaning as that of “interest rate”, but entails more. According to Grové and Otto *Basic Principles of Consumer Credit Law* (2002) 66, the term “finance charges” theoretically encompasses all charges charged by a moneylender where a loan is extended.

<sup>69</sup> Grové and Otto *Basic Principles of Consumer Credit Law* 2 ed (2002) 97 fn 177.

debtors.<sup>70</sup> In spite of its consumer protection orientation, however, the Act was unfortunately an example of highly complex and verbose legislative drafting.

Otto and Grové point out<sup>71</sup> that with the passing of the Sale of Land on Instalments Act in 1971,<sup>72</sup> a pattern of “second-generation legislation” was established, namely:

- an act for the financial aspects of moneylending transactions and instalment transactions relating to movables;<sup>73</sup>
- an act for the contractual aspects of instalment transactions relating to movables;<sup>74</sup> and
- an act for the purchase of land on instalments.<sup>75</sup>

This pattern was to continue to apply to consumer credit law in South Africa until 2006.<sup>76</sup>

This legislation was, however, of an ad hoc nature, and there was no evidence of the legislature attempting to harmonise these laws with one another.<sup>77</sup> Whilst the history of the development of consumer credit legislation in South Africa is similar to that of other countries, in many respects South African legislation was more fragmented than other modern jurisdictions.<sup>78</sup>

### 3.2.3 Third-generation consumer credit legislation

Otto and Grové’s third-generation consumer credit legislation represents a modernisation of the second-generation legislation referred to above. It was of less relevance to moneylending transactions: the Credit Agreements Act<sup>79</sup> repealed the Hire-Purchase Act, and regulated the contractual aspects of instalment sale transactions; the Limitation and Disclosure of Finance Charges Act<sup>80</sup> was extensively revised, in an attempt to bring it into line with the Credit Agreements Act, and to

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<sup>70</sup> Kern *The Regulation of the Micro-lending Industry in Terms of South African Law and Related Aspects* (LLM thesis, RAU, 2003) 10.

<sup>71</sup> SALC Working Paper 46 at 28.

<sup>72</sup> Act 72 of 1971.

<sup>73</sup> Usury Act 73 of 1968.

<sup>74</sup> The Hire-Purchase Act 36 of 1942, subsequently replaced by the Credit Agreements Act 75 of 1980.

<sup>75</sup> The Sale of Land on Instalments Act 72 of 1971, subsequently replaced by the Alienation of Land Act 68 of 1981.

<sup>76</sup> Until the National Credit Act came into force on 1 June 2006.

<sup>77</sup> SALC Working Paper 46 at 28.

<sup>78</sup> SALC Working Paper 46 at 45.

<sup>79</sup> Act 75 of 1980.

<sup>80</sup> This later became the Usury Act 73 of 1968.

make it applicable to instalment sale transactions relating to land;<sup>81</sup> the Sale of Land on Instalments Act was repealed and replaced by the Alienation of Land Act.<sup>82</sup>

Otto and Grové contend, however, that "...despite the adoption of the new legislation, the tripartite distinction between legislation relating to land, that relating to movables and that relating to finance remained largely intact".<sup>83</sup>

"Right from the promulgation of these Acts, reconciling their ambits proved problematic. In time, these problems became worse. Amendments to the legislation resulted in the ambits of the various provisions drifting further apart, which greatly complicated the practical application of the Acts."<sup>84</sup>

### 3.2.4 The National Credit Act

All consumer credit legislation came under review again, and in 1991 a new "Credit Act" was proposed by the South African Law Commission,<sup>85</sup> which sought to repeal the Usury Act and the Credit Agreements Act, and bring all credit legislation under a single Act. There were no further significant developments until May 2002, however, when the Department of Trade and Industry launched a credit law review process, specifically in regard to consumer credit law, and in tandem with the review of the broader consumer legislative framework referred to in Chapter Two above.<sup>86</sup> A technical committee was appointed to conduct an extensive review of the consumer credit market, and produced a report handed to the Department in October 2003.<sup>87</sup> The research suggested numerous issues for policy and regulatory reform, resulting in the Department drafting a consumer credit policy framework<sup>88</sup> in August 2004.

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<sup>81</sup> Also of relevance here was the Prescribed Rate of Interest Act 55 of 1975, which provided for the calculation of interest on a debt at a prescribed rate and for payment of interest on certain judgment debts. This Act, as subsequently amended, still has important application today.

<sup>82</sup> Act 68 of 1981.

<sup>83</sup> SALC Working Paper 46 at 29.

<sup>84</sup> *Ibid.*

<sup>85</sup> *South African Law Commission Working Paper 46 – Project 67: the Usury Act and Related Matters: New Credit Legislation for South Africa* (proposed to the South African Law Commission by JM Otto and NJ Grové) (1991), which has been extensively quoted and referred to in this chapter already.

<sup>86</sup> The review of the broader legislative framework resulted in the Consumer Protection Bill, 2006, referred to in Chapter Two above.

<sup>87</sup> The Technical Committee, Department of Trade and Industry "Credit Law Review, August 2003: Summary of Findings" <http://www.thedti.gov.za/ccrdlawreview/forward.htm> (accessed 14 March 2006)

<sup>88</sup> Department of Trade and Industry "Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)" <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006).

This consumer credit policy framework recognised that the regulatory framework was between 20 and 30 years old and had become outdated, and in the meantime the credit market had evolved significantly.<sup>89</sup>

“There is thus a need to modernise the current consumer credit laws and to harmonise them with best practice international jurisdictions.”

The policy framework proposed a more regulated consumer credit market through “a single law that treats transactions equivalently”,<sup>90</sup> in order to “ensure a consistent approach to interest rate regulation, minimising arbitrage and circumvention”.<sup>91</sup>

The credit law review process culminated in the National Credit Act,<sup>92</sup> which was signed into law by the President on 15 March 2006, and most of which became effective on 1 June and 1 September 2006.<sup>93</sup> There are many extremely important provisions of the Act that will come into force only on 1 June 2007, for example the whole of Chapter 5 of the Act (“Consumer credit agreements”), which includes all interest provisions in Part C thereof and which is critical to this study.

The National Credit Act repealed the Usury Act<sup>94</sup> and the Credit Agreements Act,<sup>95</sup> seeking to harmonise all credit legislation within a single Act.<sup>96</sup> The Act applies to all credit transactions and to all credit providers, and provides for a number of consumer protection measures in relation to credit law. Whilst it seeks to adopt a consistent approach to all transactions through a common regulatory scheme, it recognises the inherent differences between each sub-sector of the consumer credit market.<sup>97</sup> Thus, for example, it attempts to provide for differential treatment to accommodate differences in products and in costs associated with smaller transactions.<sup>98</sup>

In regard to the regulation of the cost of credit, there are lengthy provisions in Part C of Chapter 5 of the Act. In short, section 105 of the Act allows the Minister to

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<sup>89</sup> Department of Trade and Industry “Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)” paragraph 2.10.

<sup>90</sup> Paragraph 4.7.

<sup>91</sup> *Ibid.*

<sup>92</sup> 34 of 2005.

<sup>93</sup> Proclamation No. 22, Commencement of the National Credit Act 34 of 2005, *Government Gazette* 28824, 11 May 2006.

<sup>94</sup> 73 of 1968.

<sup>95</sup> 75 of 1980.

<sup>96</sup> Section 172(4).

<sup>97</sup> There are great differences, for example, between a pawn transaction, a mortgage bond, and a credit card or overdraft facility, which relate primarily to disclosure, the treatment of accounts and contracts.

<sup>98</sup> See, for example, s105(1), which will be thoroughly analysed in Chapter 6 below.

prescribe limits on interest rates and fees in all sectors of the consumer credit market. These provisions and resultant regulations promulgated by the Minister in regard to small loans will be discussed in detail in 3.3, Chapter Four and Chapter Six below.

Thus, for the first time in South Africa's legislative history, all credit legislation has been encapsulated in a single Act, as proposed by the South African Law Commission 15 years prior to its enactment.

### 3.3 The *in duplum* rule

The so-called "*in duplum* rule" is a rule that is entrenched in the common law of South Africa, and is extremely important in regard to the imposition of limits on the cost of credit, and consumer protection. It is a rule that was developed in response to the common law's inability to provide a workable mechanism for setting limits on the interest that can accrue on a debt. In short, the common law *in duplum* rule provides that interest stops running on a debt when the unpaid interest equals the outstanding capital.<sup>99</sup> This law has been applied in a long line of reported cases.<sup>100</sup> As clearly stated by Gillespie J in *Commercial Bank of Zimbabwe Ltd v MM Builders & Suppliers (Pty) Ltd and Others and Three Similar Cases*:<sup>101</sup>

"[I]t is a principle firmly entrenched in our law that interest, whether it accrues as simple or as compound interest, ceases to accumulate upon any amount of capital owing, whether the debt arises as a result of a financial loan or out of any contract whereby a capital sum is payable together with interest thereon at a determined rate, once the accrued interest attains the amount of capital outstanding."<sup>102</sup>

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<sup>99</sup> See, for example, *Standard Bank of South Africa v Oneanate Investments (in liquidation)* 1998 (1) SA 811 (SCA) 827H.

<sup>100</sup> See, most recently: *Stroebele v Stroebele* 1973 (2) SA 137 (T); *Commercial Bank of Zimbabwe Ltd v MM Builders & Suppliers (Pty) Ltd and Others and Three Similar Cases*; *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in Liquidation)*; *F & I Advisors (Edms) Bpk en 'n Ander v Eerste Nasionale Bank van Suidelike Afrika Bpk* 1999 (1) SA 515 (SCA); *Georgias and Another v Standard Chartered Finance Zimbabwe Ltd* 2000 (1) SA 126 (ZS); *Sanlam Life Insurance Ltd v South African Breweries Ltd* 2000 (2) SA 647 (W); *Commissioner, South African Revenue Service v Wouldidge* 2002 (1) SA 68 (SCA); *Meyer v Catwalk Investments 354 (Pty) Ltd en Andere* 2004 (6) SA 107 (T); *Verulam Medicentre (Pty) Ltd v Ethekweni Municipality* 2005 (2) SA 451 (D).

<sup>101</sup> 1997 (2) SA 285 (ZH).

<sup>102</sup> 303C–E.

When, due to payment, unpaid interest drops below the outstanding capital, interest again begins to run until it once again equals the amount of the outstanding capital.<sup>103</sup>

Thus, for example, a consumer who borrows R1000 per month at interest of 120% per year will have to repay R230 per month over six months. If as a result of retrenchment the borrower is able to repay only R30 per month for six months, she will after five months be in arrears with interest payments in the total amount of R1000.<sup>104</sup> This amount is equal to the outstanding capital of R1000,<sup>105</sup> and interest will therefore stop running at the end of five months. When unpaid interest is less than the capital outstanding, interest will start to accrue again.

The *in duplum* rule has its origins in public policy designed to protect borrowers from exploitation by lenders.<sup>106</sup> In the Appellate Division case of *LTA Construction Bpk v Administrateur, Transvaal*,<sup>107</sup> Joubert JA conducted a thorough analysis of the origin and purpose of the *in duplum* rule, reviewing in the process the Roman law, the Roman-Dutch law and the South African authorities. The *in duplum* rule emerged in Roman Law as one of the methods to limit the interest which could be claimed because of the greed of moneylenders, providing a measure of protection or relief to credit receivers,<sup>108</sup> and the rule still exists for similar reasons today.

The National Credit Act,<sup>109</sup> which sought, *inter alia*, to enhance consumer protection, effectively codified the *in duplum* rule for the first time in South Africa's legislative history, and extended the rule further:

“Despite any provision of the common law or a credit agreement to the contrary, the amounts contemplated in section 101(1)(b) to (g) that accrue during the time that a consumer is in default under the credit agreement may not, in aggregate, exceed the

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<sup>103</sup> *Ibid*; *LTA Construction Bpk v Administrateur, Transvaal* 482C.

<sup>104</sup> The monthly shortfall of R200 (R230 instalment less R30 paid) x 5 months = R1000.

<sup>105</sup> The outstanding capital is the same as the initial loan amount, since monthly payments accrue first to interest and then only to capital, and the monthly interest due is always greater than R30 in the first five months.

<sup>106</sup> *LTA Construction Bpk v Administrateur, Transvaal* 482F-G; *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 828D-E.

<sup>107</sup> 1992 (1) SA 473 (A).

<sup>108</sup> 477C. Other methods for limiting of interest referred to in the judgment were: imposing a limit on the rate of interest that could be charged, and prohibiting the charging of interest on interest.

<sup>109</sup> Act 34 of 2005.

unpaid balance of the principal debt under that credit agreement as at the time that the default occurs.”<sup>110</sup>

Section 103(5) is a succinct articulation of the meaning of the common law *in duplum* rule, which it clearly intends to codify.<sup>111</sup> The Act does more than this, however, since the common law rule was limited to interest only. Section 103(5) extends the ambit of the *in duplum* rule to include all types of consideration that a credit agreement may require a consumer to pay<sup>112</sup> in terms of section 101(1)(b) to (g) of the Act, namely: an initiation fee, a service fee, interest, the cost of any credit insurance, default administration charges and collection costs.<sup>113</sup> The aggregate, or total, of all such amounts that accrue “during the time that a consumer is in default under the credit agreement”<sup>114</sup> may not exceed the unpaid balance of the principal debt. The codification of the rule in terms of section 103(5) will come into force only on 1 June 2007.<sup>115</sup>

In analysing its meaning, and for a fuller exposition of the rule, however, reference must be made to the interpretation of the common law *in duplum* rule as handed down by the courts. Of relevance here is the presumption in South African law of interpretation of statutes that statute law does not alter the existing law more than is necessary.<sup>116</sup> Legislation must be interpreted in the light of the common law, and must as far as possible be reconciled with related precepts of the common law.<sup>117</sup> Statutory provisions have sometimes been construed as mere extensions or supplements to the common law.<sup>118</sup> In regard to the *in duplum* rule, therefore, the common law can be seen to amplify the rule set out in section 103(5), where the common law is not in conflict with the Act.

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<sup>110</sup> Section 103(5), which will come into effect on 1 June 2007 in terms of Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006.

<sup>111</sup> See paragraph 6.17 of the Department of Trade and Industry’s “Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)” <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006).

<sup>112</sup> Excluding, of course, the principal debt, referred to in s101(1)(a).

<sup>113</sup> Section 101(1)(b) to (g) respectively.

<sup>114</sup> Section 103(5).

<sup>115</sup> Proclamation No. 22, Commencement of the National Credit Act 34 of 2005, *Government Gazette* 28824, 11 May 2006. The whole of Chapter 3 of the National Credit Act, headed “Consumer credit agreements” (which includes all interest provisions in Part C thereof), will come into force only on 1 June 2007.

<sup>116</sup> Du Plessis *Re-Interpretation of Statutes* (2002) 177–181.

<sup>117</sup> 178.

<sup>118</sup> *Ibid.*

It is essential to note that all listed fees, costs and interest incurred in the ordinary course whilst the consumer is not in default of the credit agreement are not subject to the codified rule. In terms of the common law, the *in duplum* rule was similarly applicable to arrear interest only, and not to accumulated interest.<sup>119</sup> Furthermore, it was held in the case of *Verulam Medicentre (Pty) Ltd v Ethekweni Municipality*<sup>120</sup> that where interest is intended to fulfill a function other than the usual purpose for which interest is intended, it is not subject to the *in duplum* rule. The Supreme Court of Appeal dismissed the subsequent appeal in this matter, for the reason that the interest agreed upon by the parties was not interest in the ordinary sense, but was a means of formulating fair and proper restitution for what had been paid.<sup>121</sup>

The common law provides that payments are appropriated first to interest, and then to capital,<sup>122</sup> and it follows that the same should apply also to the fees and costs now subject to the rule. Further, the practice of capitalisation of interest by bankers does not result in the interest losing its character as such for the purposes of the *in duplum* rule, since “[i]f interest were to become capital, the capital amount of the debt would always be increasing and the bank would run no risk of a lesser capital amount being the subject-matter of the rule”.<sup>123</sup> As pointed out by Selikowitz J in *Standard Bank of South Africa Ltd v Oeanate Investments (Pty) Ltd*:<sup>124</sup>

“Words like ‘capitalisation’ are used to describe the method of accounting used in banking practice. However, neither the description nor the practice itself affects the nature of the debit. Interest remains interest and no methods of accounting can change that.”<sup>125</sup>

It is clear from the National Credit Act that a debtor cannot waive his/her right to the protection of the *in duplum* rule by prior agreement.<sup>126</sup> Indeed, this principle has

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<sup>119</sup> See, for example, *Sanlam Life Insurance Ltd v South African Breweries Ltd*, in which Blieden J stated at 655D–E: “[T]he *in duplum* rule is confined to arrear interest and to arrear interest alone”.

<sup>120</sup> 2005 (2) SA 451 (D).

<sup>121</sup> *Ethekweni Municipality v Verulam Medicentre (Pty) Ltd* (unreported SCA judgment dated 29 September 2005).

<sup>122</sup> Wessels *The Law of Contract in South Africa* 2 ed vol 2 para 2308 (xi) states: “Where a debt produces interest, the money paid must be applied in the first instance to the payment of the interest and then to the capital. Even if the payment is made on account of principal and interest, it will by law be appropriated first to the interest and then to the capital.”

<sup>123</sup> *Standard Bank of South Africa v Oeanate Investments (in liquidation)* 828J.

<sup>124</sup> 1995 (4) SA 510 (C).

<sup>125</sup> 572C–D.

<sup>126</sup> See the opening words of s103(5): “Despite any provision of ... a credit agreement to the contrary...”

always been firmly entrenched in the common law in regard to the rule.<sup>127</sup> It has been held, however, that it may be possible for a debtor, when interest has accumulated to an amount equalling the capital, to agree with the creditor, to avoid litigation, that he (the debtor) would not rely on the *in duplum* rule.<sup>128</sup> In this regard, it should be noted that section 103(5) prohibits the waiver of the *in duplum* rule in the initial “credit agreement” only, implying that a subsequent agreement to waive the *in duplum* rule might well be possible.<sup>129</sup>

The Court has a duty *mero motu* to raise the illegality of interest claimed in contravention of the *in duplum* rule, if this is clear from the facts, even if the *in duplum* rule was not pleaded.<sup>130</sup> This approach has been given added impetus by the proscriptive nature of section 103(5). The Court is, however, not required to speculate or piece together a defence on behalf of the defendant from mere fragments of evidence.<sup>131</sup>

It has been held that the *in duplum* rule can be applied in the real world of commerce and economic activity only where it serves considerations of public policy in the protection of borrowers against exploitation by lenders.<sup>132</sup> Thus, for example, when unpaid interest reaches the equal of the unpaid capital during the course of litigation, the *in duplum* rule is not applicable, and a debtor is not protected “*pendente lite* against interest in excess of the double”.<sup>133</sup> The rationale for this finding is that a debtor is not being exploited when a creditor is being kept out of pocket with the assistance of delays inherent in legal proceedings.<sup>134</sup> Upon judgment being given, interest on the full amount of the judgment debt (including any interest for which judgment has been granted) commences to run afresh.<sup>135</sup>

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<sup>127</sup> *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 828C; *Commercial Bank of Zimbabwe Ltd v MM Builders & Suppliers (Pty) Ltd and Others and Three Similar Cases* 321D–322D.

<sup>128</sup> *F & I Advisors (Edms) Bpk en 'n Ander v Eerste Nasionale Bank van Suidelike Afrika Bpk* 525I–J.

<sup>129</sup> On the other hand, the words “may not” in section 103(5) suggest strongly that the *in duplum* rule is peremptory and a waiver will not be permitted.

<sup>130</sup> *F & I Advisors (Edms) Bpk en 'n Ander v Eerste Nasionale Bank van Suidelike Afrika Bpk* 525H–526A.

<sup>131</sup> *Ibid.*

<sup>132</sup> *Commissioner, South African Revenue Service v Woulidge* 75B–C; *LTA Construction Bpk v Administrateur, Transvaal* 482F–G; *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 828D.

<sup>133</sup> *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 834C.

<sup>134</sup> 834B–C.

<sup>135</sup> *Commercial Bank of Zimbabwe Ltd v MM Builders & Suppliers (Pty) Ltd and Others and Three Similar Cases* 303D.

“This would then mean that (i) the *in duplum* rule is suspended *pendente lite*, where the *lis* is said to begin upon service of the initiating process, and (ii) once judgment has been granted, interest may run until it reaches the double of the capital amount outstanding in terms of the judgment.”<sup>136</sup>

Again, this common law interpretation of the rule can be extended to include the fees and costs referred to in section 103(5).

The development of the common law *in duplum* rule was a response to the inability of the common law and legislation in regard to usury to provide sufficient protection to consumers from the effects of the accumulation of further debt from high interest rates. Whilst it is clear that the *in duplum* rule is deeply entrenched in the common law, the rule has been significantly fortified through clarification and extension via the National Credit Act, and it is likely that increased use will be made of the rule as a defence when appropriate.

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<sup>136</sup> *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 834H. Thus, if judgment is granted for capital (X) and interest (Y), and the total judgment debt is Z, then interest on the judgment debt (Z) will stop running when it reaches the amount of the judgment debt (Z).

## Chapter Four

# The Regulation of the Cost of Credit in the Micro-finance Industry in South Africa

### Outline

In the previous two chapters, the common law of contract was examined with reference to constitutional values, followed by usury laws in relation to consumer credit in general, with a focus on moneylending transactions. In this chapter, the enquiry will narrow down further to focus squarely on the subject of this study, namely the cost of credit in the micro-finance industry in South Africa. The chapter will begin with a discussion of the situation prior to regulation in 1992, followed by a review of the regulation of the industry via exemption of micro-loans from the Usury Act and the *Lurama* case.<sup>1</sup> The chapter will end with a brief overview of the cost of credit in the National Credit Act and Regulations.

### 4.1 The position until 1992

Until 1992, all money lending transactions were subject to the limits on interest rates imposed by the Usury Act.<sup>2</sup> At the end of 1992 (when micro-loans were first exempt from the Usury Act), the maximum permissible interest rate in terms of the Usury Act for loans not exceeding R6 000 was set at 30% per annum, and for loans greater than R6 000 was set at 27% per annum.<sup>3</sup> The formal banking sector was not in a position to provide necessary credit to South Africa's lower-income groups.<sup>4</sup> The reasons for this are many, but revolve primarily around the fact that low-income earners were not in a position to provide the collateral security necessary to reduce risk to credit providers.<sup>5</sup> This meant that the vast majority of the population were excluded from the formal credit market, and lower income groups were desperate for

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<sup>1</sup> *Lurama Vyftien (Pty) Ltd and 49 Others v The Minister of Trade and Industry and Another* (case no. 22125 of 1999) and *The Association of Micro Lenders v The Minister of Trade and Industry and Another* (case no. 23453 of 1999) (unreported TPD).

<sup>2</sup> Act 73 of 1968.

<sup>3</sup> Usury Act, 1968, R3273 *Government Gazette* 14438, 4 December 1992.

<sup>4</sup> *Lurama* 10.

<sup>5</sup> For further discussion in this regard, see Department of Trade and Industry "Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)" 12–15. <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006).

credit, primarily for housing, small business enterprises and for consumption purposes.<sup>6</sup> The Usury Act limitations effectively denied credit to this sector of the population which it was intended to protect.

These circumstances gave rise to the emergence of the so-called “cash loans industry”, which operated largely unlawfully, charging interest rates way in excess of the Usury Act limitations.<sup>7</sup> Lawful micro-lending practice was not an economically viable business at this time, since lenders did not consider it profitable to lend small amounts of money to consumers offering little or no security at Usury Act-compliant interest rates.<sup>8</sup> Otto and Grové provided two reasons for the net return on lenders’ capital being small:<sup>9</sup>

- (a) Micro-lenders were not deposit-taking institutions, and therefore had to borrow capital from financial institutions at relatively high rates of interest.
- (b) The overheads of the micro-lender were more or less the same for small loans as they were for larger loans, which adversely affected profit margins if interest rates for all loans were the same.

Millions of low-income consumers were forced to turn to the illegal cash loans industry, where they found themselves at the mercy of an unregulated market in which they enjoyed no legal protection whatsoever, in spite of the existence of the Usury Act.<sup>10</sup> For these reasons, it was believed that exemption of micro-lenders from the limitations of the Usury Act was essential to enable a large sector of South Africa’s population to gain access to credit from lenders who were not operating illegally.

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<sup>6</sup> *Lurama* 10.

<sup>7</sup> SALC Working Paper 46 at 220.

<sup>8</sup> Kern *The Regulation of the Micro-lending Industry in Terms of South African Law and Related Aspects* 13–14.

<sup>9</sup> SALC Working Paper 46 at 220.

<sup>10</sup> Kern *The Regulation of the Micro-lending Industry in Terms of South African Law and Related Aspects* 13–14.

## 4.2 The exemption of micro-loans from the Usury Act

The exemption of micro-loans from the Usury Act was made possible in 1988 by the insertion of section 15A into the Act via section 8 of the Usury Amendment Act,<sup>11</sup> which marked the high point of the control of the Usury Act by the Minister of Finance. The text reads:

“The Minister may from time to time by notice in the Gazette exempt the categories of moneylending transactions, credit transactions or leasing transactions which he may deem fit, from any of or all the provisions of the Act on such conditions and to such extent as he may deem fit, and may at any time in like manner revoke or amend any such exemption.”

Thus, it became possible for an exemption from the Act to be made on certain conditions. The extent of the discretion of the Minister to make an exemption and to impose conditions was limited by the usual rules of administrative action, which action would have to take into account the overriding purpose of the Usury Act, as set out in its long title, namely to limit finance charges.<sup>12</sup>

Prior to the exemption of micro-loans from the Act, a number of other exemptions in terms of section 15A were effected by the Minister, which are not strictly relevant to this study.<sup>13</sup>

### 4.2.1 The 1992 Exemption Notice

On 31 December 1992, all loans of up to R6 000 to borrowers who were natural persons were exempted by Notice (“the 1992 Exemption Notice”)<sup>14</sup> from the provisions of the Usury Act. The loan plus all finance charges had to be paid back over a period not exceeding 36 months from the date of payment of the loan amount

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<sup>11</sup> Act 100 of 1988; the section was later substituted by s6 of the Usury Amendment Act 91 of 1989.

<sup>12</sup> The long title of the Usury Act reads as follows: “To provide for the limitation and disclosure of finance charges...”

<sup>13</sup> The following transactions were exempted from the Act between 1988 and 1992: lease transactions exceeding R100 000 and involving the sale of a business as a going concern, with no capping of interest (GN 2262 of 4 November 1988, as amended by GN 1697 of 1 August 1989); certain categories of loans secured by a mortgage bond and for which the state stood as guarantor were exempt from the limitation on additional finance charges in terms of Section 4 of the Act (GN 1418 of 27 June 1989, as amended by GN 1711 of 4 August 1989); loans relating to the acquisition of housing and loans from pension monies for this purpose, with the interest rate limited to an amount set out by notice by the Minister (GN R3162 and 3163 of 20 November 1992).

<sup>14</sup> Notice in terms of Section 15A of the Usury Act 73 of 1968, GN R3451, *Government Gazette* 14498, 31 December 1992.

to the borrower. A few other conditions were provided,<sup>15</sup> but such micro-lenders were exempt from all other constraints of the Usury Act, and no maximum interest rate was imposed. The effect of the exemption was, *inter alia*, that microlenders were no longer bound by the maximum rates of interest prescribed in terms of section 2 of the Usury Act, and therefore there was no limit on the interest rates that they could charge.

The 1992 Exemption Notice led to the booming of the micro-lending industry, now free from the shackles of the Usury Act. In reviewing this period of history of the industry, Yacoob J in *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Department of Trade and Industry*<sup>16</sup> described the position thus:<sup>17</sup>

“The micro-finance industry had been legitimated. It grew exponentially. Many relatively poor people were now able to secure loans from willing lenders; lenders could now make limitless profit, who were subject to very little (if any) control. This brought negative consequences. Unsurprisingly, complaints of abuse arising from micro-finance loans were directed by borrowers against lenders with rapidly increasing frequency.”

An independent study conducted in 2000<sup>18</sup> described the micro-lending industry as having “exploded” during the eight years since the 1992 Exemption Notice.

As was to be expected, abuses followed, best described by Mynhardt J in the *Lurama* case as follows:<sup>19</sup>

“Consumers were exploited. The high, sometimes exorbitant, rates at which interest on short-term loans were charged, created so-called debt traps. Consumers had to enter into fresh loan agreements in order to repay existing loans. This resulted in them becoming more and more indebted to their creditors.”

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<sup>15</sup> The loan amount could not be paid back by the borrower “in terms of a credit card scheme” or from a cheque account where it would result in the cheque account becoming overdrawn; a so-called cooling-off period of three days after the date of conclusion of the transaction was prescribed, during which period the lender could not pay the money over to the borrower; before the conclusion of the transaction, the lender had to furnish to the borrower in writing “the amounts in rand and cents of the loan amount and the sum of the finance charges and the other costs payable in terms of such a transaction”.

<sup>16</sup> 2006 (11) BCLR 1255 (CC) paras 9-10.

<sup>17</sup> Para 10.

<sup>18</sup> Ebony Consulting International “DTI Interest Rate Study” page (iv) to (v) <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006).

<sup>19</sup> *Lurama* 12.

In 1993, the Department of Trade and Industry embarked upon a process of consultation with all the so-called role-players in the industry, which lasted for approximately five years.<sup>20</sup> The Department wanted to afford better protection to consumers whilst at the same time not disregarding the interests of the micro-lenders. The result of this consultation was that it was decided that micro-lenders and other role-players should have some say alongside government in the manner in which the industry was regulated.<sup>21</sup>

In 1994, when the African National Congress came to power, it almost immediately expressed its dissatisfaction with the state of affairs in the micro-lending industry, and took steps to rectify matters.<sup>22</sup> There was particular concern about the high interest rates on loans for consumption purposes.<sup>23</sup> On 30 June 1994, the then Minister of Trade and Industry, Mr Trevor Manuel, announced by way of a notice<sup>24</sup> that he intended to repeal GN R3451 of 31 December 1992, which exempted micro-lenders from the Usury Act, and interested parties were invited to submit written representations regarding the intended repeal within 30 days.

The Department of Trade and Industry received inputs from numerous interested parties, and draft notices were prepared and made available from time to time for discussion at certain workshops,<sup>25</sup> where the regulation of the industry and the capping of interest rates were amongst the topics that were discussed.<sup>26</sup>

By June 1999, the mushrooming micro-lending industry had been operating without interest rate limits and with minimal regulation and control for six-and-a-half years. In his 1999 Budget Speech, Minister of Finance Trevor Manuel had the following to say in this regard:

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<sup>20</sup> *Lurama* 24.

<sup>21</sup> *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Department of Trade and Industry* para 11.

<sup>22</sup> *Lurama* 13.

<sup>23</sup> *Lurama* 23. Loans for consumption purposes would include, for example, loans to purchase food and clothing and to pay household expenses such as electricity.

<sup>24</sup> Notice of intention to repeal the Notice whereby moneylending transactions not exceeding R6 000 are exempted from the Act, GN 1183, *Government Gazette* 15836, 30 June 1994.

<sup>25</sup> Two such workshops were held on 20 February 1997 and 8 July 1998.

<sup>26</sup> *Lurama* 25.

“Too many people have become hostage to unscrupulous moneylenders. There is a place for the micro-lending industry. But we will not tolerate the blatant exploitation that appears to be taking place at the moment.”<sup>27</sup>

By the end of 1999 there were more than 850 registered institutions comprising more than 3 500 branches, including firms with a wide range of different legal statuses, from natural persons to publicly-traded commercial banks.<sup>28</sup> There was tremendous variation in size and outreach (from lenders with 100 clients and R50 000 in their portfolio to lenders with over a million clients and more than three billion rand in their outstanding portfolio), as well as important differences in targeted term of loan (from five days to three years).<sup>29</sup> Interest rates varied greatly, from effective rates of 60% per year for long-term loans of up to three years to rates that surpassed 1 000% per year for very short-term loans of less than a week.<sup>30</sup>

#### 4.2.2 The 1999 Exemption Notice

Finally, Government took a positive step towards regulated control. The succeeding Minister of Trade and Industry, Mr Alexander Erwin, decided to issue a revised exemption, in addition to repealing the 1992 exemption. His decision was motivated mainly by a desire to sustain the micro-enterprise lending industry,<sup>31</sup> as opposed to all microlenders.<sup>32</sup> On 13 November 1998, the Minister gave notice of his intention to publish an exemption, and called for written comment and representations.<sup>33</sup> This notice, for the first time, referred to an intention to establish a regulatory institution, which would set maximum rates for the total charge of credit<sup>34</sup> in respect of categories of loans.

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<sup>27</sup> COSATU “Submission to the Parliamentary Hearing on Bank Charges, Micro-lending and the Usury Act” (presented to the Portfolio Committee on Trade and Industry) COSATU <http://www.cosatu.org.za/docs/1999/bankrate.htm> (accessed on 14 March 2006).

<sup>28</sup> Ebony Consulting International “DTI Interest Rate Study” page (v) <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006).

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.*

<sup>31</sup> “Micro-enterprise lending” is described by Mynhardt J with reference to papers before the court in *Lurama 7* to be “lending of money by ‘micro enterprise lenders’ to consumers ‘to set up or grow small businesses’, which both generates a future income and creates employment”.

<sup>32</sup> *Lurama 7*. Mynhardt J stated further: “The micro-enterprise lenders face the highest business risks, says the Minister, because their clients generally have no formal employment, no bank account and often no fixed address. Their clients also contribute to growth in the country’s economy and to job creation.”

<sup>33</sup> Department of Trade and Industry Exemption in terms of Section 15A of the Usury Act, 1968, GN 2726, *Government Gazette* 19457, 13 November 1998.

<sup>34</sup> The “total charge of credit” was defined extremely broadly to mean “all charges levied on the loan, including interest charges and other charges including administration fees, ledger fees, commissions, but excluding insurance premiums”.

The result was Government Notice 713 of 1 June 1999 (“the 1999 Exemption Notice”),<sup>35</sup> which repealed the December 1992 Notice and substituted a new exemption. Registered lenders loaning amounts of R10 000 or less, repayable over a period not exceeding 36 months, and who complied with a number of conditions, were exempt from the Usury Act. Most importantly for the purposes of this study, paragraph 3.3 of Annexure A to the Schedule to the Notice provided that a registered moneylender “shall ensure that the annual rate of the total charge of credit stipulated, demanded or received by the lender shall not exceed ten times the average prime overdraft lending rate from time to time of the four banks, registered under the Banks Act, 1990 (Act No. 94 of 1990), from time to time with the largest asset base providing cheque services”.<sup>36</sup>

Further, a number of rules for the purpose of the exemption were published with respect to confidentiality, disclosure, a cooling-off period and collection methods,<sup>37</sup> which considerably shifted regulatory control towards consumer protection. Importantly, lenders were prohibited from retaining identity documents and bank cards as security of debt.<sup>38</sup> On 16 July 1999, the Micro-finance Regulatory Council (“the MFRC”) was approved as a regulatory institution in terms of the 1999 Exemption Notice.<sup>39</sup> Lenders were required to register with this institution by 15 September 1999, and a number of consumer safeguards existed within the membership requirements of the MFRC.<sup>40</sup> The MFRC rules went further, to set out procedures for such matters as inspections of lenders’ premises, records, disciplinary rules, appeals and lending practices, including methods for calculation of interest.<sup>41</sup>

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<sup>35</sup> Notice in terms of Section 15A of the Usury Act 73 of 1968, GN R713, *Government Gazette* 20145, 1 June 1999.

<sup>36</sup> Paragraph 3.3 of Annexure A to the Schedule to GN R713 of 1 June 1999.

<sup>37</sup> Annexure A to the Schedule to GN 713 of 1 June 1999.

<sup>38</sup> Paragraph 6 of Annexure A to the Schedule to the Notice in terms of Section 15A of the Usury Act 73 of 1968, GN R713, *Government Gazette* 20145, 1 June 1999

<sup>39</sup> Notice in terms of Government Notice (No 713 of 1 June 1999), GN 911, *Government Gazette* 20307, 16 July 1999.

<sup>40</sup> In order to satisfy application procedures, micro-lenders had to comply with all accreditation criteria set down by Annexure B to the Schedule to GN 713 of 1 June 1999, including: commitment to full compliance with the MFRC’s rules; registration with the South African Revenue Services; auditing procedures; executive staff of lender not to have criminal records for certain offences.

<sup>41</sup> MFRC “Rules of the MFRC” <http://www.mfrc.co.za> (accessed 24 March 2006).

### 4.2.3 The *Lurama* case<sup>42</sup>

Concerns in the micro-lending industry regarding the provisions of the 1999 Exemption Notice prompted two court applications<sup>43</sup> against the Minister of Trade and Industry and the MFRC, one by the Association of Micro-lenders, representing 1830 micro-lenders, and the other by a group of 50 lenders. The two matters were heard together. The applications sought to have reviewed and set aside the 1999 Exemption Notice, alternatively the approval of the MFRC as a regulatory institution for purposes of the Notice and certain provisions of the Notice.

The applications were unsuccessful in all but one extremely important respect: the court reviewed and set aside the decision of the Minister to publish paragraph 3.3 of Annexure A to the Schedule to the 1999 Exemption Notice, which related to the cap on interest rates. The court made its decision on the basis of a finding that the applicants had a legitimate expectation to be consulted regarding the proposed interest rate caps, but were not consulted.<sup>44</sup> The effect of the *Lurama* decision was that paragraph 3.3 was struck from the Notice, and that all micro-lenders who were registered with the MFRC and who complied with all conditions of the Notice could lend at any rate, with effect from 11 November 1999, the date of the judgment.

It is noteworthy that both applicants in the *Lurama* case (representing a total of 1 880 micro-lenders) charged interest on loans at 30% per month (360% per year), at the time.<sup>45</sup> Paragraph 3.3 sought to restrict interest to what amounted to approximately 13,75% per month at that time, and an investigation by an auditor of the financial statements of 47 of the members of the Association of Micro-lenders found that at this rate of interest, 81% of those investigated would not be able to continue to do business profitably.<sup>46</sup>

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<sup>42</sup> *Lurama Vyftien (Pty) Ltd and 49 Others v The Minister of Trade and Industry and Another* (Case No. 22125 of 1999) and *The Association of Micro Lenders v The Minister of Trade and Industry and Another* (Case No. 23453 of 1999) (unreported TPD).

<sup>43</sup> *Ibid.*

<sup>44</sup> *Lurama* 39.

<sup>45</sup> *Lurama* 7.

<sup>46</sup> *Lurama* 34.

#### 4.2.4 The 2005 Exemption Notice

On 8 August 2005, the 1999 Exemption Notice was repealed,<sup>47</sup> and a new Notice (“the 2005 Exemption Notice”) was promulgated.<sup>48</sup> In short, the Notice provided for enhanced consumer protection in a number of respects via stricter rules relating to lending activities,<sup>49</sup> expanded obligations of lenders (particularly in regard to “reckless lending”)<sup>50</sup> and the establishment of a National Loans Register.<sup>51</sup> Most important for the purpose of this study, however, is that no interest rate cap was promulgated.

### 4.3 The National Credit Act and Regulations

As explained in 3.2.4 above, a credit law review process was set in motion in May 2002, resulting in the drafting by the Department of Trade and Industry of a consumer credit policy framework<sup>52</sup> in August 2004. This process culminated in the National Credit Act,<sup>53</sup> most of which became effective on 1 June and 1 September 2006.<sup>54</sup> As mentioned in Chapter Three above, there are many extremely important provisions of the Act that will come into force only on 1 June 2007 (the whole of Chapter 5 of the Act, for example, which includes all interest provisions in Part C thereof and which is critical to this study). The National Credit Act replaced the Usury Act, the 2005 Exemption Notice and the Credit Agreements Act.<sup>55</sup>

Section 105 of the Act allows the Minister to prescribe limits on interest rates and fees in all sectors of the consumer credit market. On 20 February 2006, Draft National Credit Regulations<sup>56</sup> were published for comment, and National Credit Regulations were promulgated on 31 May 2006.<sup>57</sup> All regulations in which the Minister prescribes limits on the cost of credit will come into effect on 1 June 2007,

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<sup>47</sup> Notice to repeal Notice 713 of 1 June 1999, GN 1406, *Government Gazette* 27889, 8 August 2005.

<sup>48</sup> Notice in terms of Section 15A of the Usury Act, 1968, GN 1407, *Government Gazette* 27889, 8 August 2005.

<sup>49</sup> Part 2 of Annexure A to the Schedule to GN 1407.

<sup>50</sup> Part 3 of Annexure A to the Schedule to GN 1407.

<sup>51</sup> Part 5 of Annexure A to the Schedule to GN 1407.

<sup>52</sup> Department of Trade and Industry “Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)” <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006).

<sup>53</sup> 34 of 2005.

<sup>54</sup> Proclamation No. 22, Commencement of the National Credit Act, 34 of 2005, *Government Gazette* 28824, 11 May 2006.

<sup>55</sup> 75 of 1980.

<sup>56</sup> Draft National Credit Regulations, GN R307, *Government Gazette* 28531, 20 February 2006.

<sup>57</sup> National Credit Act (34/2005): Regulations, R489 *Government Gazette* 28864, 31 May 2006.

because that is when the enabling provisions in Chapter 5 of the Act become operative.<sup>58</sup> Section 5 of Schedule 3 to the Act, which concerns transitional provisions, provides that until such time as the Minister prescribes a maximum rate of interest in terms of section 105 of the Act,<sup>59</sup> the Usury Act maximum annual finance charge rate applicable immediately prior to the coming into force of the Act<sup>60</sup> will continue to remain in force.<sup>61</sup> This means that until 1 June 2007, when section 105 comes into force, the Usury Act maximum rates as at 31 May 2006 will remain in force. Likewise, the 2005 Exemption Notice will remain in force until 31 May 2007,<sup>62</sup> with the effect that until 1 June 2007 there will continue to be no limit on the interest rates that registered micro-lenders may charge.

Regulation 42(1) provides for a maximum interest rate on “short-term credit transactions”<sup>63</sup> of 5% per month,<sup>64</sup> and a maximum interest rate on “unsecured credit transactions”<sup>65</sup> that is linked to the South African Reserve Bank Repurchase Rate.<sup>66</sup> The maximum interest rate on unsecured credit transactions currently amounts to 38,7% per annum, based on the current Repurchase Rate of 8,5% *per annum*.<sup>67</sup>

In addition, Regulation 42(2) provides for a maximum initiation fee on every loan of R150 plus 10% of the amount of the agreement in excess of R1 000, but never to exceed R1 000. Further, Regulation 44 provides for a maximum monthly service fee of R50. Although micro-loans will be cheaper for most consumers, the cost of credit of smaller loans will be as expensive and in some cases more expensive than the

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<sup>58</sup> Proclamation No. 22, Commencement of the National Credit Act, 34 of 2005, *Government Gazette* 28824, 11 May 2006.

<sup>59</sup> That is, until 1 June 2007.

<sup>60</sup> On 1 June 2006.

<sup>61</sup> The Usury Act maximum on 31 May 2006, which will therefore remain in force until 31 May 2007, is 20% per annum for loans greater than R10000, and 17% per annum for loans less than R10000 (Usury Act 73 of 1968 Annual Finance Charge Rate, GN 1100, *Government Gazette* 26809, 17 September 2004). This provision accords with s11 of the Interpretation Act 33 of 1957, which provides that “[w]hen a law repeals wholly or partially any former law and substitutes provisions for the law so repealed, the repealed law shall remain in force until the substituted provisions come into operation”.

<sup>62</sup> Reg 73.

<sup>63</sup> A “short-term credit transaction” is defined in Regulation 39(2) as “a credit transaction in respect of a deferred amount at inception of the agreement not exceeding R8 000; and in terms of which the whole amount is repayable within a period not exceeding 6 months”.

<sup>64</sup> That is, 60% per annum.

<sup>65</sup> An “unsecured credit transaction” is defined in Regulation 39(3) as a “credit transaction in respect of which the debt is not supported by any pledge or other right in property or suretyship or any other form of personal security”. This interest rate limit will therefore cover all loans, large and small, that are repaid over a period exceeding four months and are not secured.

<sup>66</sup> Regulation 42 provides that the maximum interest rate is established by applying the formula: (Repurchase Rate x 2.2) + 20% per year.

<sup>67</sup> South African Reserve Bank home page <http://www.reservebank.co.za/> (accessed 1 December 2006).

current typical 30% per month. The full implications of the new cost of credit will be comprehensively analysed in Chapter Six below.

Whereas in the past the cost of credit in the micro-lending industry was lawfully determined only by the interest rate applied to loans, the National Credit Act and Regulations now provide for interest, an initiation fee and a service fee,<sup>68</sup> and imposes very specific limits on these costs. The cost of credit in the micro-lending industry for the purposes of this study therefore includes all financial costs<sup>69</sup> to the borrower of loaning amounts of money without providing security.<sup>70</sup>

#### **4.4 Conclusion**

Thus, since the *Lurama* decision, there has been no regulated limit on the interest rates that registered micro-lenders may lawfully charge. Until 1 June 2007, when section 105 of the National Credit Act and the National Credit Regulations come into effect, there will continue to be no such limit. In effect, there has been and will continue to be no such limit for a total of nearly 14 years, between 31 December 1992<sup>71</sup> and 1 June 2007 (excluding the period of less than six months between 1 June 1999<sup>72</sup> and 11 November 1999<sup>73</sup>), during which period micro-lenders have lawfully charged exorbitant interest rates.

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<sup>68</sup> Regulations 42 and 44.

<sup>69</sup> In the case of micro-loans: interest, the initiation fee and the service fee.

<sup>70</sup> Usually loans of R8 000 or less, being the maximum amount for a short-term credit transaction, as defined in Regulation 39(2).

<sup>71</sup> The 1992 Exemption Notice.

<sup>72</sup> The 1999 Exemption Notice.

<sup>73</sup> The *Lurama* decision.

## Chapter Five

# The Socio-economic Impact of No Limits on the Cost of Credit

*“The rich rule over the poor, and the borrower is the lender’s slave.”<sup>1</sup>*

### Outline

The failure to cap interest rates in the micro-lending industry for a period of nearly 14 years since 1992, demonstrated in the previous chapter, has had (and continues to have) far-reaching consequences for recipients of micro-loans. This chapter will illustrate the devastating socio-economic impact of the absence of limits on the cost of credit in this sector for individuals and poor communities. The common law illegality of exorbitant interest rates will then be reviewed, with reference to Chapters Two and Three. Although regulated limits on the cost of credit are imminent,<sup>2</sup> it will be shown that it is likely that extremely high rates of interest in excess of the regulated limits will continue to be charged by micro-lenders, albeit unlawfully, as a result of the legacy of the last 14 years. In the next chapter, the consequences of the National Credit Act limits on the cost of credit will be examined.

### 5.1 Two credit markets and the perpetuation of poverty

Although there is some variation in interest rates, registered micro-lenders exempt from the Usury Act have, for the most part, charged interest on short-term loans at 30% per month, or 360% per year.<sup>3</sup> In terms of the Usury Act, the maximum permissible interest rate for credit transactions of less than R10 000 has been 20% *per annum* since 17 September 2004.<sup>4</sup> Therefore, the cost of credit in the registered

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<sup>1</sup> Proverbs 22:7, New International Version of the Holy Bible.

<sup>2</sup> The National Credit Regulations, which provide for limits on the cost of credit, will come into force on 1 June 2007.

<sup>3</sup> Both applicants in the *Lurama* case, one of which was the Association of Micro-Lenders (representing a total of 1 830 micro-lenders) charged interest on short-term loans at 30% per month (*Lurama* 7). Ebony Consulting International “DTI Interest Rate Study” <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006) 48 reports that 30% per month is the interest charge agreed upon by the Association of Micro-lenders. See also “Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)” <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006) at para 2.4, and Dr Penelope Hawkins “The cost, volume and allocation of consumer credit in South Africa” <http://www.thedti.gov.za/ccrdlawreview/forward.htm> (accessed 14 March 2006) at para 8.

<sup>4</sup> GN 1100, *Government Gazette* 26809, 17 September 2004. This rate will be valid until 1 June 2007, when the relevant provisions of the National Credit Act come into operation. The Usury Act maximum interest rate has since 1988 fluctuated between its highest level of 36% *per annum* in 1998 and the current 20% *per annum*, which is its lowest level during this period.

micro-lending industry has for over two years been and still remains some 18 times higher than the cost of credit in the formal banking sector.<sup>5</sup>

Who is paying these higher prices for credit? The Department of Trade and Industry's August 2004 consumer credit policy framework,<sup>6</sup> referred to in Chapters Three and Four above, was the result of a lengthy and thorough credit law review process, which began in 2002 and involving extensive research by private consultants into numerous aspects of consumer credit in South Africa. In this policy framework,<sup>7</sup> the Department described "two economies" or "two credit markets" in South Africa: firstly, a market for middle- and high-income consumers (about 15% of the population), with easy access to credit (some 72% of total credit extension) from a range of mainstream credit providers, including banks, at preferential cost limited by the Usury Act; secondly, a market for low-income consumers (about 67% of the population) with limited access to credit (6% of total credit extension) in the form of micro-loans and other credit<sup>8</sup> at high cost.<sup>9</sup> This disparity is demonstrated in Table A below.

**Table A: Comparison of the cost of credit for the two credit markets – middle- / high-income vs low-income consumers<sup>10</sup>**

	Proportion of total population	Percentage (%) of total credit extension (rand amount per year)	Common source of loans	Interest rate on any loan up to R10 000	Amount of interest generated per month on a loan of R1 000
Middle-/ high-income consumers	15%	72% (approximately R261 billion)	Banking sector	Maximum 20% <i>per annum</i>	R16,67
Low-income consumers	67%	6% (approximately R21 billion)	Registered micro-lenders	Unlimited (usually 360% <i>per annum</i> )	R300

It is therefore the poorest 67% of the population who are paying the much higher prices for credit. The cost of credit for poor people, who are denied credit by the

<sup>5</sup> With the Usury Act limit at its highest level of 36% *per annum* in 1998, it can be said that the cost of credit in the registered micro-lending sector has for the past 14 years remained between 10 and 18 times higher than the cost of credit in the formal banking sector.

<sup>6</sup> Department of Trade and Industry "Consumer Credit Law Reform: Policy Framework for Consumer Credit (August 2004)" <http://www.thedti.gov.za/ccrdlawreview/policyjune2005.pdf> (accessed 14 March 2006).

<sup>7</sup> DTI "Policy framework" paras 2.1–2.6.

<sup>8</sup> Other credit includes store cards, credit agreements and loans backed by provident or pension fund guarantees.

<sup>9</sup> Typically 30% per month, in the case of short-term loans from micro-lenders.

<sup>10</sup> All figures are obtained from Chapters 2 and 3 of the DTI "Policy Framework".

banks and forced to borrow money from micro-lenders, is proportionately higher – some eighteen times higher – than that of the wealthiest 15% of the population.

It is easily evident from this analysis that while higher-income groups can generate capital wealth through relatively cheap credit, lower-income groups will most certainly become poorer as a result of having to pay such high interest rates for cash loans, and that poverty will be perpetuated as a result. The problem, unfortunately, does not stop there. Low-income consumers and small and micro-enterprises have historically been denied access to bank savings facilities, and South Africa traditionally has low savings levels.<sup>11</sup> An inability to save increases dependence on short-term credit, especially in the case of emergencies.<sup>12</sup> Further, the savings account is not an attractive proposition for low-income persons, because an extremely poor or non-existent return on savings is offered by banks, especially in the case of small amounts and entry-level saving.<sup>13</sup>

Finally, it was found that the most important distinguishing feature between these so-called “banked” and “unbanked” sectors of the population was the availability or otherwise of collateral security, in particular immovable property, which substantially reduces the risk to credit providers and increases the availability of reasonably priced credit.<sup>14</sup> This fact serves to deepen the divide that exists between the wealthy and the poor, and reinforced the Department’s concern about the historical relationship between poverty and poor access to resources,<sup>15</sup> be those immovable property or reasonably-priced credit, and the Department sought to address this concern.

## **5.2 Impact on individual consumers**

What impact does this high cost of credit have on individual consumers? One way to demonstrate this impact is by way of examples of various loan sizes, repayment periods and consumer incomes. The assumed figures upon which this analysis is based are explained in the footnotes to Table B below.

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<sup>11</sup> DTI “Policy Framework” para 3.18. Approximately 40% of South African adults do not have access to any formal financial services (including savings, transmission, credit and insurance facilities), while in excess of 50% are excluded from savings accounts (para 3.21).

<sup>12</sup> DTI “Policy Framework” para 3.19.

<sup>13</sup> DTI “Policy Framework” para 3.21. According to a Department of Trade and Industry survey of five major banks as well as Post Bank, when fees are taken into account, entry-level savings accounts offer negative returns to low-income consumers, some being of a significant magnitude (–20%).

<sup>14</sup> DTI “Policy Framework” paras 3.4–3.11.

<sup>15</sup> DTI “Policy Framework” para 2.2.

**Table B: Sample survey of variable loan sizes and repayment periods viewed against monthly income (an interest rate of 30% per month or 360% per year – the most common rate<sup>16</sup> – is assumed in each case)<sup>17</sup>**

	A	B	C	D	E	F	G	H
	Amount of loan <sup>18</sup>	Period of repayment <sup>19</sup>	Instalment per month <sup>20</sup>	Monthly wage/pension of borrower <sup>21</sup>	Percentage (%) of income available for all other expenses (after loan repayment)	Total interest paid during loan period <sup>22</sup>	Percentage (%) of total income utilised to pay interest charges during loan period	Percentage (%) of total amount repaid which is utilised to pay interest charges
1	R200	1 month	R260	R820 <sup>23</sup>	68%	R60	7%	23%
2	R500	1 month	R650	R820	26%	R150	18%	23%
3	R1000	1 month	R1300	R2000	35%	R300	15%	23%
4	R1000	6 months	R378,39	R2000	81%	R1270,37	11%	56%
5	R1000	12 months	R313,45	R2500	87%	R2761,45	9%	73%
6	R1638	12 months	R513,44	R2500	79%	R4523,25	15%	73%
7	R1638	24 months	R492,31	R3000	84%	R10177,37	14%	86%
8	R1638	36 months	R491,44	R3500	86%	R16053,80	13%	91%
9	R2500	24 months	R751,38	R3000	75%	R15533,22	22%	86%
10	R3000	36 months	R900,07	R4000	77%	R29402,56	20%	91%
11	R5000 <sup>24</sup>	6 months	R1891,97	R4000	53%	R6351,83	26%	56%
12	R5000	12 months	R1567,27	R4000	61%	R13807,24	29%	73%
13	R5000	24 months	R1502,77	R4000	62%	R31066,45	32%	86%

<sup>16</sup> The basis for the assumption of interest at 30% per month is explained in 5.1 above.

<sup>17</sup> Simple interest is assumed: that is interest on the capital only, not compound interest, which includes interest on interest. It is possible that compound interest is charged on arrears, but this is not clear.

<sup>18</sup> R1 638 was the average size loan for the year ended May 2006 (Micro-finance Regulatory Council "Micro-lending industry overview May 2006 quarter" <http://www.mfrc.co.za/detail.php?s=91> (accessed 13 October 2006). For this reason the various assumed loan amounts used in the examples average out in the vicinity of R1 638.

<sup>19</sup> A spread of repayment periods is assumed in the examples, from the common one month loan,, through various "term loans" to the maximum 36-month loan permitted by the Usury Act exemption.

<sup>20</sup> The monthly instalment is calculated by adopting the following formula:  $FV = PV(1+it)$

(FV = future value; PV = present value; i = interest rate; t = time).

<sup>21</sup> According to the MFRC Submission to the Portfolio Committee on Indebtedness dated 17 June 2003, Appendix para 5.1 (unpublished) the income profile of micro-lenders' clients is as follows:

- 12% of borrowers have an income of between R1 000 and R2 000 per month;
- 28% of borrowers have an income of between R2 000 and R3 000 per month;
- 22% of borrowers have an income of between R3 000 and R4 000 per month.

The bulk of the client base earns between R2 000 and R4 000 per month, and it is for this reason that figures in this vicinity have been assumed for the incomes of borrowers in Column D of Table B.

<sup>22</sup> This amount is the sum total of interest payable for each of the months of the repayment period. Interest for each month is calculated by multiplying the balance outstanding at the end of the previous month by 30%. For an example of a loan amortisation table (Example 7 in Table B), see Appendix A. Interest can also be calculated as follows: instalment per month x number of months, less loan amount.

<sup>23</sup> R820 is the current monthly old-age state pension.

<sup>24</sup> A similar table to my Table B appears on the Department of Trade and Industry website in which consumers are warned of the total instalments and total interest payable for a loan of R5 000 re-payable over 6, 12 or 24 months. Hence, these figures are repeated in Items 10, 11 and 12, respectively, of Table B, with particular reference to columns C and F (Department of Trade and Industry "Consumer Alert" <http://www.dti.gov.za/ccrd/YouhavetheRighttoCreditOptions.htm>) (accessed 17 October 2006).

The following deductions can be made from Table B:

- (a) Very low-income earners (e.g. pensioners) borrowing even relatively small amounts are particularly vulnerable: the borrowers in Examples 2 and 3 will have available only 26% and 35%, respectively, of their income to pay for all their other expenses (Column E). Being already poor, they will as a result of having taken out this loan have only a small percentage of their original meagre income to live on.
- (b) Between 7% and 32% of consumers' personal income in the thirteen examples has to be used merely to service this debt – that is to say, to pay the interest on the debt (Column G). This is a disproportionately high amount, having the direct result that less money will be available to pay for all other necessary living expenses. These figures relate to a single loan only; additional debt owed by the consumer will raise this amount further.
- (c) In the case of loans repaid over a period of 12 months or more, over 73% of the total repayments made are paid towards interest on the debt, as opposed to the original loan amount (Column H).
- (d) Attached as Appendix A is a micro-lending loan amortisation schedule in respect of Example 7 in Table B, which is probably the most representative example available (including average loan size, average loan repayment period and average wage of borrower, based upon the data referred to in the footnotes to Table B). In the early months of repayment, nearly the entire monthly instalment is utilised towards servicing the debt, whilst there is hardly any reduction in the capital amount of the loan. For example:
- In the first three months, a total of R1 473,30 is paid towards interest, and only R3,82 is paid towards the capital debt of R1 638.
  - In the first 12 months, a total of R5 840,31 is paid towards interest, and only R67,41 is paid towards the capital debt.
- It is only in the final six to 12 months that the borrower will begin to reduce the outstanding capital by any significant amount. The borrower will end up paying a total amount of R10 177,37 for interest alone, more than six times the initial loan of only R1 638.
- (e) Again, in Example 9 of Table B, the borrower will end up paying a total of over seven times the original capital debt (capital and interest repaid). In Example 10, the borrower will pay nearly 11 times the original capital debt.

## 5.3 Different types of loans and their impact

### 5.3.1 30-day loans and the debt spiral

“Cash loans” in micro-lending industry parlance mean very short-term loans, usually 30-day loans,<sup>25</sup> but they sometimes have repayment periods of up to four months, for which an “industry standard” interest rate of 30% per month is widespread.<sup>26</sup> Frequently, loan repayment periods are less than 30 days, when repayment is required “at the end of the month” (sometimes as little as seven days), but the interest of 30% remains the same,<sup>27</sup> which results in effective interest rates in excess of 100% per month being charged in some instances.

In her March 2003 report, prepared at the request of the Department of Trade and Industry as part of its credit law review process,<sup>28</sup> Dr Penelope Hawkins shows how 30-day loans are expected to work in order to ensure that a consumer can be free of debt within six months:<sup>29</sup>

“If an individual with an income of R1 000 borrows R300 in month one, he must repay R390 by month end. If the following month he borrows R250, he needs to repay R351. If this trend continues, the client is likely to move out of debt within six months. This appears to be the rule of thumb – out of debt within six months makes a wise (and not over-indebted) borrower.”

To get out of debt within six months, a series of six 30-day loans is necessary in this example, and each loan will invariably be utilised to pay back part of the previous loan.

The example above assumes that the borrower is able to fund the repayment in part from another source every month (e.g. in Month 2 in the example, the shortfall of R140, being the difference between R390 and R250, will have to be funded from elsewhere). It is difficult to foresee, however, what this source would be, given that the individual had to borrow R300 just one month before for another purpose, and this repayment model therefore appears to be unsustainable. The more common scenario, explained by Dr Hawkins, is that repeated loans have to be taken out to fund in full the repayment of previous loans, demonstrated in the examples below.

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<sup>25</sup> See Example 1 of Table B for an example of such a loan.

<sup>26</sup> Dr Penelope Hawkins “The cost, volume and allocation of consumer credit in South Africa” <http://www.thedti.gov.za/ccrdlawreview/forward.htm> (accessed 14 March 2006) para 4.7.2.

<sup>27</sup> Hawkins “The cost, volume and allocation of consumer credit in South Africa” para 4.7.1.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*

**Table C: Illustration of the 30-day loan and resultant debt spiral**

	Month	Loan amount	Interest at 30% per month	Repayment amount	Income
Example A	1	R300	R90	R390	R820 (old-age pension)
	2	R390	R117	R507	
	3	R507	R152	R659	
	4	R659	R197	R856	
Example B	1	R500	R150	R650	R1 000 (wage)
	2	R650	R195	R845	
	3	R845	R253	R1 098	

In Example A, by Month 3, the pensioner's loan repayment (R659) amounts to 80% of her monthly pension of R820. By Month 4, the loan repayment (R856) exceeds her pension, being already more than double the loan repayment at the end of Month 1 (R390). In Example B, by Month 3, the loan repayment (R1 098) has already exceeded the worker's wage of R1 000. This is obviously not workable or sustainable, and such a borrower is quickly caught in a debt spiral and ends up in a debt trap from which there can be no escape. In effect, the debtor will remain permanently indebted. S/he will have to continue to pay monthly instalments, which are usually determined by whatever s/he can afford, on an indefinite basis, paying only a part of the interest due, and never being able to pay off the capital debt.

The unfortunate reality is that the practice of borrowing money to repay other debt is occurring on a wide scale in South Africa. Dr Hawkins reports that 30-day lenders acknowledge that some 80% of their clientele are repeat borrowers.<sup>30</sup> In a 2000 interest rate study commissioned by the Department of Trade and Industry,<sup>31</sup> Ebony Consulting International concluded that one half of employees on the government payroll system were repaying loans, and that 15% of these are trapped in a debt spiral, which occurs "when a borrower is forced to borrow to help pay back his loans, hence driving him deeper into debt".<sup>32</sup> Further, a rural survey carried out in the Northern Province showed that 25% of borrowers from micro-lenders borrowed to make payments on another loan.<sup>33</sup> In its report on the impact of credit and

<sup>30</sup> *Ibid.*

<sup>31</sup> Ebony Consulting International "DTI Interest Rate Study" <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006).

<sup>32</sup> Ebony "DTI Interest Rate Study" (v).

<sup>33</sup> *Ibid.*

indebtedness of clients,<sup>34</sup> the Micro-finance Regulatory Council concluded that the high cost of servicing micro-loans “implies that poorer individuals will remain in a debt trap under the best of circumstances, and further deepen that debt trap under the worst of circumstances”.<sup>35</sup>

### 5.3.2 Term loans and over-indebtedness

The dangers of over-indebtedness are not limited to 30-day loans. Problems with “term loans” of six to 36 months have already been highlighted, with reference to Table B above, from which it is noteworthy that the longer the term of the loan, the higher the percentage of the total amount re-paid utilised to pay interest charges.<sup>36</sup> Ebony Consulting International describes the interplay between term and 30-day loans:<sup>37</sup>

“[T]he major debt problem appears to be stemming from the term lenders, who are taking salary deductions at the source, before the employee even sees his/her paycheck. Some term lenders often write irresponsible loans to salaried employees, leaving them with unacceptable net take-home portions of the salaries that are then forcing the clients to take short-term debt at even higher interest rates. This is a greater cause of long-term indebtedness than short-term loans from the 30-day cash lenders.”

**Table D: Outstanding loan book<sup>38</sup> and annual turnover by loan term<sup>39</sup>**

Term of loan	Percentage of outstanding loan book	Percentage of annual turnover
1 month	8%	53%
1–6 months	7%	11%
6–12 months	16%	18%
12–36 months	64%	17%
> 36 months	5%	1%

Sixty-four percent of the total rand amount of loans outstanding in 2000 (R3,4 billion of a total of R5,3 billion) was in respect of term loans of 12 to 36 months, and surprisingly only 8% was in respect of one-month loans. However, in the case of

<sup>34</sup> MFRC “Report on Impact of Credit and Indebtedness of Clients” (unpublished).

<sup>35</sup> MFRC “Report on Impact of Credit and Indebtedness of Clients” 60.

<sup>36</sup> Between 56% and 91% in the case of loan terms of six to 36 months (Column H of Table B above).

<sup>37</sup> Ebony “DTI Interest Rate Study” (v).

<sup>38</sup> “Outstanding loan book” means the total rand value of loans outstanding.

<sup>39</sup> Ebony “DTI Interest Rate Study” 30–31.

annual turnover, 53% of total turnover was attributable to one-month loans, and 17% to term loans of 12 to 36 months, probably largely because of the higher (or quicker) turnover of one-month loans, by their very nature.<sup>40</sup> Total turnover in the industry was R9,7 billion – nearly double the amount for loans outstanding.<sup>41</sup> These figures serve to confirm that both cash loans and term loans contribute considerably to the micro-lending market.

## 5.4 Consumption finance

The full impact of the high cost of credit cannot be fully understood until one has considered what the proceeds of micro-loans are spent on. Before addressing this question directly, however, it is enlightening to consider the nature of expenditure by South Africans in different income categories in general – that is, from all sources of income, disregarding for the moment any borrowing of funds.

**Table E: Expenditure in South Africa from all sources of income<sup>42</sup>**

	<R6481 (annual income)	R6481– R11090	R11091– R19440	R19441– R41484	>R41484
Food and beverages	51%	49%	43%	31%	14%
Clothing	3%	5%	6%	5%	3%
Housing	8%	7%	8%	11%	19%
Furniture	1%	2%	3%	3%	2%
Fuel and power	7%	7%	9%	11%	18%
Transport	3%	3%	4%	5%	11%
Health and medicine	2%	2%	1%	2%	4%
Education	2%	2%	2%	3%	3%
Personal care	6%	5%	4%	4%	3%
Other	17%	18%	20%	25%	23%
Total	100%	100%	100%	100%	100%

The most striking feature of these figures is that South Africans with total annual incomes of less than R19 440 spent at least 43% of their income on food and

<sup>40</sup> Ebony “DTI Interest Rate Study” 31.

<sup>41</sup> *Ibid.*

<sup>42</sup> Ebony Consulting International “Analysis on the Application of Borrowed Funds” Final Report to the Micro-finance Regulatory Council, dated April 2003 (unpublished) 14, based upon Statistics South Africa’s Income and Expenditure Survey of 2000.

beverages (51% in the case of the lowest-income group).<sup>43</sup> According to Ebony Consulting International, who provided these statistics in their report, it is generally accepted that households that spend more than 60% of their income on food, beverages, clothing and housing are considered vulnerable.<sup>44</sup> All those earning less than R11 090 in the lowest two income groups are therefore considered vulnerable as they contribute 62% and 61% of their expenditure, respectively, to these items.

“This means that consumption expenditure for the most basic household goods is an extremely significant constraint on the poorer households in South Africa. Furthermore, this implies that the demand for debt at the lower end of income distribution is highly inelastic, and will consequently remain pervasive in the medium term.”<sup>45</sup>

Turning then to micro-loans, it is therefore no surprise to find that the vast majority of loans disbursed were for consumption purposes, as is evident from Table F below.

**Table F: Loan usage**<sup>46</sup>

	Consumption	Housing	Furniture	Education	Business <sup>47</sup>	Other
Based on number of loans	43%	13%	8%	12%	3%	21%
Based on rand value disbursement	44%	13%	8%	12%	3%	20%

The fact that most of the proceeds of micro-loans are being used to sustain daily needs rather than to pay for assets or durable commodities makes these already vulnerable people even more vulnerable.<sup>48</sup> People who borrow to pay for necessities can be regarded as involuntary borrowers, being forced to pay extremely high interest rates to fund the most basic necessities of life, let alone other fundamental expenses such as education and housing. Effectively, such people are borrowing to supplement their income, on a month-to-month basis, and micro-loans are regarded

<sup>43</sup> Those with annual incomes of between R19 441 – R41 484 spent 31% of their income on food and beverages. This category most closely resembles the incomes of most borrowers of small loans, who earn between R2 000 and R4 000 per month (see the footnote to Column D, Table B above).

<sup>44</sup> Ebony “Analysis on the Application of Borrowed Funds” 14.

<sup>45</sup> *Ibid.*

<sup>46</sup> Ebony “Analysis on the Application of Borrowed Funds” 36 (statistics supplied by the Micro-finance Regulatory Council).

<sup>47</sup> It is interesting to note that only 3% of micro-loans were used for business purposes, given that the promotion of small business was a driving force behind the exemption of micro-loans from the Usury Act.

<sup>48</sup> MFRC “Report on Impact of Credit and Indebtedness of Clients” 60.

by many poor people as a ready source of disposable income<sup>49</sup> or income substitution,<sup>50</sup> which is necessary in order to survive.

The terrible plight of such consumers is most graphically depicted in a Black Sash submission to the Department of Trade and Industry:<sup>51</sup>

“Our advice offices continually hear stories which demonstrate the multi-faceted nature of poverty. Our client profile displays a range of persons with poverty-specific constraints which are directly linked with hunger, unemployment, homelessness, and a lack of access to basic services. One of the risks of this fragile profile is their vulnerability to crisis (such as involvement in a road accident, or the injury to or loss of a breadwinner). These types of crises place vulnerable sectors into situations of financial strain from which they are often never able to recover. This often results in large debt to moneylenders etc.

[T]he reason for the increasing indebtedness – in the case of consumptive borrowers – is because they have no choice. Their financial decisions are controlled by the cost of providing for themselves and their families.”

Black Sash clients who exhibit a continual struggle to survive caused this organisation to conduct extensive research into the practice of moneylending to the poor. This research confirmed that the majority who took out loans used the money to purchase basic necessities such as food, rent, education, transport, funerals and electricity.<sup>52</sup>

“[S]uch use of micro-loans causes millions of South African consumers to find themselves trapped in an ever-worsening debt spiral... [T]he micro-lending industry, while it should be alleviating poverty, in fact worsens the decline of borrowers’ living standards.”<sup>53</sup>

The Department of Trade and Industry’s policy framework<sup>54</sup> describes credit as “a double-edged sword”:

“Whilst credit allows access to products or services that cannot be acquired out of a single month’s income, it can also be a dangerous instrument that can lead to high levels of debt and indebtedness.

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<sup>49</sup> Kern *The Regulation of the Micro-lending Industry in terms of South African Law and Related Aspects* (LLM thesis, RAU, 2003) 57.

<sup>50</sup> Black Sash “Submission on Interest Rate Study to the Department of Trade and Industry”, dated July 2000 (unpublished) 5.

<sup>51</sup> Black Sash “Submission on Interest Rate Study” 1, 5.

<sup>52</sup> *Ibid.*

<sup>53</sup> Kern *The Regulation of the Micro-lending Industry in terms of South African Law and Related Aspects* 56–57.

<sup>54</sup> DTI “Policy Framework” paras 1.8, 1.10.

It is quite easy for credit to lead to financial hardship and destroy a household's wealth. Taking on extra loans in order to pay back existing loans can lead people into a debt spiral out of which it may be difficult to escape. Over-indebtedness has a negative impact on families and has in some extreme cases even led to family suicides. Over-indebtedness further has an impact upon the workplace, can lead to de-motivation, absenteeism and even a propensity to commit theft.”

This is indeed a troubling state of affairs in a country with a Constitution<sup>55</sup> which places a high value on such rights as education and basic socio-economic rights.<sup>56</sup>

## 5.5 Consumer ignorance and illiteracy

In paying such high rates of interest, so much of consumers' income is lost to interest that one would think that it would make little logical sense to borrow money upon this basis. Consumers benefit from being able to make a desired purchase with the initial proceeds of loans, but in the longer term they are able to purchase much less because they are spending so much of their income on interest to service these loans. However, a poor person in a crisis, be it to buy school clothing or to pay for medicine or food, will frequently see no alternative but to turn to a micro-lender, ignorant of the terrible consequences of doing so. Interestingly, research has repeatedly shown<sup>57</sup> that interest rates are not the main concern to the borrower, especially in the case of very short-term loans. Rather, the borrower's main concern is getting access to credit and the usefulness of the money for the period that the borrower has it. Put simply, many consumers are not able to see beyond the benefits of immediate cash in hand, or do not want to see beyond these benefits. A Credit Law Review research report puts it simply, without attempting to give reasons: “The reality is that consumers cannot assess the real cost of credit.”<sup>58</sup>

Why should this be so? The Black Sash report referred to in 5.4 above suggests that the reason is that, faced with hunger, homelessness or ill health, a desperate consumer will have no choice but to take out a high-interest loan, the high cost being a small price to pay for the satisfaction of basic needs.

But what of those who are borrowing money for less pressing or less desperate reasons? Ebony Consulting International<sup>59</sup> concludes that the base cause of over-

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<sup>55</sup> The Constitution of the Republic of South Africa, 1996.

<sup>56</sup> Sections 27 and 29 of the Constitution.

<sup>57</sup> Ebony “DTI Interest Rate Study” (iv).

<sup>58</sup> Hofmeyer, Herbstein and Gihwala Inc. “Report for the Credit Law Review” para 6.12 <http://www.thedti.gov.za/ccrdlawreview/forward.htm> (accessed 14 March 2006).

<sup>59</sup> Ebony “DTI Interest Rate Study” (vi).

indebtedness is (i) aggressive lending and (ii) uninformed or naïve clients. The latter cause appears to be an understatement of a much bigger and more drastic problem: ignorance born of extremely high levels of illiteracy and innumeracy in South Africa.

**Table G: Literacy and basic education levels of South Africans aged 15 and over<sup>60</sup>**

Level of education	1996 general population census	2001 general population census
Full general education (Grade 9 and above)	13,1 million (50%)	15,8 million (52%)
Less than full general education (less than Grade 9)	13,2 million (50%)	14,6 million (48%)
Less than Grade 7	8,5 million (32%)	9,6 million (32%)
No schooling	4,2 million (16%)	4,7 million (16%)

Thus, in 2001, some 16% of the adult population had no schooling at all, and 32% of the adult population had less than a Grade 7 level of education and were therefore functionally illiterate.<sup>61</sup> During the five-year period to 2001, the percentage of both categories of adults remained the same, although the raw numbers increased.

Of particular interest to the Eastern Cape Province is that 22,8% of the population of the province aged 20 years and older had no schooling at all in 2001 – fewer only than the Limpopo and Mpumalanga Provinces (the national average was 17,9%).<sup>62</sup> The Eastern Cape Province was also the only province whose unschooled population showed a percentage increase in the five-year period from 1996 (from 20,9% in 1996 to 22,8% in 2001).<sup>63</sup> In 2001, the Eastern Cape Province was also the province with the third-largest number of people aged 20 years or older with no schooling (743 700 people) and with less than Grade 7-level education (643 921 people).<sup>64</sup> Aitchison and Harley conclude their survey of the literacy and basic education statistics for adults by emphasising the urgent need for literacy and adult basic education

<sup>60</sup> John Aitchison and Anne Harley “South African Illiteracy Statistics and the Case of the Magically-growing Number of Literacy and ABET Learners” (September 2004) 3 <http://www.ukzn.ac.za/cae/caepubs.htm> (accessed 18 September 2006). More recent statistics are not available.

<sup>61</sup> People with less than Grade 7 are generally regarded as being functionally illiterate (Aitchison and Harley “South African Illiteracy Statistics” 3). There are no statistics available for innumeracy or functional innumeracy, but it follows that one can deduce innumeracy and functional innumeracy levels from basic education levels, as is done in the case of illiteracy, since arithmetic (numeracy) skills form part of basic education, just as literacy skills do.

<sup>62</sup> Aitchison and Harley “South African Illiteracy Statistics” 6.

<sup>63</sup> *Ibid.*

<sup>64</sup> Aitchison and Harley “South African Illiteracy Statistics” 7.

intervention, and single out the Eastern Cape Province above all other provinces for special attention in this regard.<sup>65</sup>

The dire consequences for borrowers of micro-loans resulting from these low levels of literacy and basic education cannot be underestimated. Illiteracy will have the direct result of potential borrowers not being able to read contracts presented to them (assuming that they are written in a language that the borrower can understand). Should the terms of the contract be read or explained to the borrower, little or no basic education will still result in a low level of understanding of the nature of such terms. Most importantly, such borrowers will have little or no arithmetic ability, and will not be able to understand the concept of interest: what interest means, how it is calculated, and how quickly a debt attracting a large amount of interest will grow.

All of this (poor education, literacy and numeracy levels) invariably adds up to a high level of ignorance of the consequences of entering into micro-lending agreements, and is very likely to be an important reason why so many consumers ill-advisedly borrow money at such high rates of interest. Until the promulgation of the National Credit Regulations in 2006, the Minister of Trade and Industry failed to limit interest rates in order to control the negative impact of high rates, and to protect consumers who are unable, due to ignorance, to protect themselves.

## **5.6 Impact on poor communities**

### **5.6.1 The size of the micro-lending industry**

For the 12 months ending May 2006, the total rand value of loans disbursed in the registered micro-finance sector was R28,7 billion – a R6,7 billion or 30% increase on the R22 billion reported for the year ended May 2005.<sup>66</sup> Micro-finance Regulatory Council research<sup>67</sup> shows that micro-loans contribute 36% to micro-loan borrowers' total financial commitments, second only to retail debt, which contributes 38%. Micro-lenders are clearly therefore major players in the credit market.

In addition, there is a large unregistered micro-lending sector, the size of which is difficult to quantify.<sup>68</sup> In their April 2000 research, Ebony Consulting International

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<sup>65</sup> Aitchison and Harley "South African Illiteracy Statistics" 10.

<sup>66</sup> Micro-finance Regulatory Council "Micro-lending industry overview May 2006 quarter" <http://www.mfrc.co.za/detail.php?s=91> (accessed 13 October 2006).

<sup>67</sup> MFRC "Submission to the Portfolio Committee on Indebtedness" (Appendix para 5.2).

<sup>68</sup> These lenders include semi-formal moneylenders lending money as their main livelihood, pawnbrokers, and informal moneylenders such as *mashonisas* (township moneylenders), *stokvels* and burial societies.

estimated the total value of loans written per year (registered and unregistered sectors) at R23,35 billion, with the registered sector at R15,45 billion and the unregistered sector at R7,9 billion.<sup>69</sup> Assuming the same estimated proportions (66% registered and 34% unregistered), and given the most recent figure for total disbursements in the registered sector (R28,7 billion),<sup>70</sup> then current disbursements in the unregistered sector could well be in the region of R14,8 billion, and total annual disbursements in the industry (registered and unregistered) some R43,5 billion.

## 5.6.2 Growth of the industry

It is not merely the size of the micro-lending industry that is significant, but its growth rate. From its inception in 1992, the industry has shown growth which has been steady and at times rapid. Growth figures in recent years bear this out.

**Table H1: Growth of the micro-finance industry<sup>71</sup>**

Quarter/year	Number of loans disbursed	Total value of loans disbursed in the micro-lending industry (R billion)
Jun–Aug 2002	2 710 569	2,98
Sep–Nov 2002	2 941 914	3,39
Dec 2002–Feb 2003	2 902 390	3,38
Mar–May 2003	2 914 687	3,26
<b>The year June 2002 – May 2003</b>	<b>11 469 560</b>	<b>R13 billion</b>
Jun–Aug 2003	2 896 419	3,61
Sep–Nov 2003	3 108 297	4,35
Dec 2003–Feb 2004	3 076 596	4,40
Mar–May 2004	3 264 961	4,41
<b>The year June 2003 – May 2004</b>	<b>12 346 273</b>	<b>R16,7 billion</b>
Jun–Aug 2004	3 533 402	4,91
Sep–Nov 2004	3 600 293	5,47
Dec 2004–Feb 2005	3 589 927	5,81
Mar–May 2005	3 647 664	5,76
<b>The year June 2004 – May 2005</b>	<b>14 371 286</b>	<b>R21,9 billion</b>
Jun–Aug 2005	3 794 851	6,29
Sep–Nov 2005	4 450 720	7,53
Dec 2005–Feb 2006	4 432 737	7,63
Mar–May 2006	4 418 186	7,25
<b>The year June 2005 – May 2006</b>	<b>17 096 494</b>	<b>R28,7 billion</b>

**Table H2: Annual growth rate of the micro-finance industry<sup>72</sup>**

	Rand increase in disbursements on the	Percentage increase in disbursements on the
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<sup>69</sup> Ebony “DTI Interest Rate Study” 35. Note that the total value of loans written per year for any period reflects a much higher figure than total disbursements for that period.

<sup>70</sup> Micro-finance Regulatory Council “Micro-lending industry overview May 2006 quarter”.

<sup>71</sup> *Ibid.*

<sup>72</sup> *Ibid.*

	previous year (R billion)	previous year (%)
The year June 2003 – May 2004	R3,7 billion	28,46%
The year June 2004 – May 2005	R5,2 billion	31,13%
The year June 2005 – May 2006	R6,75 billion	30,8%

In the three years between June 2003 and May 2006, industry disbursements more than doubled in amount (from R13 billion to R28,7 billion), and the industry grew by an average of over 30% per year. In the six years since 2000 when disbursements were R5,3 billion,<sup>73</sup> total disbursements increased more than five-fold. Nearly every quarter since 2002 has shown an increase in both the number of loans disbursed and the total value of loans disbursed.

**Table J: Size of industry by type of lending entity<sup>74</sup>**

	Number of registered lenders	Number of branches	Percentage of total disbursements in the industry	Percentage of total number of loans disbursed in the industry
Banks	8	3 439	41%	26,07%
Public companies	5	16	0,3%	0,83%
Private companies	290	3 763	40%	33,56%
Close corporations	1 927	2 865	16%	35,74%
Trusts	17	138	1%	2,68%
Co-operatives	27	47	1%	0,48%
S21 companies	19	51	1%	0,64%
<b>Industry totals</b>	<b>2 346</b>	<b>10 319</b>	<b>100%</b>	<b>100%</b>

There are now 2 346 lenders operating from 10 319 branch offices. The vast majority of lenders are close corporations, although it is the banks and private companies that together account for 81% of the total disbursements in the industry.

The spectacular growth of the industry is directly attributable to its exemption from the Usury Act, fuelled by the fact that “lenders could now make limitless profit”, because the industry was “free from almost all of the constraints of the Usury Act and unbounded by any finance charge limit at all!”<sup>75</sup>

<sup>73</sup> Ebony “DTI Interest Rate Study” 25.

<sup>74</sup> Micro-finance Regulatory Council “Micro-lending industry overview May 2006 quarter”.

<sup>75</sup> Yacoob J in *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Department of Trade and Industry* para 9 and 10.

### 5.6.3 Borrowers' income profiles and levels of indebtedness

According to Micro-finance Regulatory Council research, the majority of borrowers of micro-loans are from lower-income groups, with 63% of borrowers earning less than R4 000 per month.<sup>76</sup> This finding is confirmed in the Department of Trade and Industry's description of "two credit markets" in South Africa:<sup>77</sup> one market for low-income consumers (about 67% of the population) with limited access to credit at high cost, and the other market for middle- and high-income consumers (about 15% of the population) with easy access to credit at low cost. There is therefore no doubt that the vast majority of borrowers of micro-loans are from poorer communities.

A further disturbing trend is that levels of indebtedness are increasing, and the greatest increases occurred in the poorest households, in particular in the R5 000 to R25 000 annual income range, with record increases in excess of 200% in most cases (see the right-hand column of Table K below).<sup>78</sup>

**Table K: Change in numbers of indebted households by income group**<sup>79</sup>

Annual income category (R1K = R1000)	No. of indebted households in 1995	Percentage of indebted households in 1995	No. of indebted households in 2000	Percentage of indebted households in 2000	Percentage change in percentage of indebted households (1995 to 2000)
<R5K	56 344	7	271 151	12	62%
R5K–R10K	105 555	6	449 949	18	216%
R10K–R15K	99 289	8	355 520	26	236%
R15K–R20K	90 706	10	261 743	31	198%
R20K–R25K	75 398	12	226 563	37	208%
R25K–R30K	71 268	16	157 106	37	134%
R30K–R40K	122 912	18	242 899	41	128%

Between 1995 and 2000, total debt (especially consumption debt) increased markedly in the lowest-income categories, whilst total debt actually decreased in most other income categories, as demonstrated in Table L below.<sup>80</sup>

<sup>76</sup> MFRC "Submission to the Portfolio Committee on Indebtedness" (Appendix para 5.1).

<sup>77</sup> DTI "Policy framework" paras 2.1–2.6. See 5.1 above for more discussion in this regard.

<sup>78</sup> Statistics South Africa's Income and Expenditure Surveys for 1995 and 2000, recorded in a report by the Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000", prepared for the Micro-finance Regulatory Council, dated June 2003 (unreported). More recent statistics are not available.

<sup>79</sup> Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000" 6.

<sup>80</sup> Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000" 5–9.

**Table L: Total debt and consumption debt by income category**

Annual income (R1K = R1 000)	Total debt in 1995	Total debt in 2000	Consumption debt in 1995	Consumption debt in 2000
<R5K	8%	38%	4%	14%
R5K–R10K	9%	15%	5%	10%
R10K–R15K	13%	17%	8%	11%
R15K–R20K	26%	16%	9%	10%
R20K–R25K	43%	20%	12%	9%
R25K–R30K	38%	39%	11%	10%
R30K–R40K	31%	37%	12%	9%

In the lowest-income category (households earning less than R5 000 per year), total debt increased nearly five-fold in the five years between 1995 and 2000 (from 8% to 38%), while consumption debt more than trebled (from 4% to 14%). There were increases in the next two income categories (R5 000 to R15 000 per year), but these were less pronounced. Perhaps the most alarming available statistic in regard to indebtedness is that the poorest households carry the heaviest debt servicing burden: 60,2% of regular disposable income of households in the poorest income category (less than R5 000 per year) was used to service debt in 2000.<sup>81</sup>

Furthermore, given that a large percentage of consumers of micro-loans service these loans from the proceeds of social grants,<sup>82</sup> it follows that large amounts of such proceeds per year are paid to micro-lenders in the form of interest on micro-loans, and are thereby lost to the social security system. Many other vulnerable groups besides those receiving old-age pensions and disability grants are particularly susceptible to the negative impact of high interest rates. In particular, HIV/AIDS is expected to increase household indebtedness in South Africa with increased borrowing through the AIDS cycle, since people living with HIV/AIDS have greater economic needs in the form of access to medicine, doctors, nutritional food and safe places to live.<sup>83</sup> The Micro-finance Regulatory Council believed this to be an area of

<sup>81</sup> Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000" 7–8.

<sup>82</sup> In particular: old-age pensions and disability grants, currently both at R820 per month. According to Hawkins "The cost, volume and allocation of consumer credit in South Africa" para 7.2, debtors with fixed incomes (e.g. salaries or social grants) provide a more viable and lower-risk market for lenders, who are able to recover monthly repayments through direct deductions from salaries or bank debit orders.

<sup>83</sup> ECI Africa "Industry strategy to address HIV/AIDS – a strategy document submitted to the MFRC (June 2005)" [http://www.mfrc.co.za/files/mfrc\\_hiv\\_aids\\_report\\_final.pdf](http://www.mfrc.co.za/files/mfrc_hiv_aids_report_final.pdf) (accessed 18 March 2006).

particular concern, and commissioned research specific to micro-lending and HIV/AIDS.<sup>84</sup> The financial burden resulting from the illness, unemployment, and deaths of those infected with HIV/AIDS will lead to an increased likelihood that they will borrow money and an increased risk that they will become over-indebted.<sup>85</sup> HIV/AIDS-affected households will have to contend not only with the disease, but with the economic and financial impact of the illness.<sup>86</sup> People living with HIV/AIDS are thus extremely vulnerable to the negative impact of high interest rates charged by micro lenders, and this group of vulnerable people is likely to grow significantly as a result of the HIV/AIDS crisis.

#### **5.6.4 Summary of findings**

The negative impact of high interest rates on poor communities is best illustrated by analysing the figures in 5.6.1 above. As indicated, the total rand value of loans disbursed in the registered micro-finance sector was R28,7 billion for the 12 months ended May 2006, and total annual disbursements in the registered and unregistered sectors are likely to be well in excess of R40 billion. These figures of course represent only the capital amount of the loans disbursed, and not the interest that accrues on these loans. Such interest will become due every month for between one and 36 months after each loan is disbursed (depending on the duration of the loan) and will be paid when due, or will be paid months or sometimes even years later if the borrower falls into arrears with payments. The cost of the initial loan is therefore often borne (and the impact felt) for years after the initial transaction.

There are no available statistics in regard to interest that accrues on loans in the industry, but there can be no doubt that such interest is considerable. Interest will usually far exceed the amount of the initial loan, except in the case of 30-day and other very short-term loans.<sup>87</sup> According to the figures in Table B above, in the case of term loans, with interest at 30% per month, the total amount of interest due on loans repayable over 12 months will be nearly three times the initial loan amount.<sup>88</sup> The total amount of interest due on loans repayable over 36 months will be nearly 10 times the initial loan amount.<sup>89</sup>

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<sup>84</sup> ECI Africa "Industry strategy to address HIV/AIDS – a strategy document submitted to the MFRC (June 2005)".

<sup>85</sup> ECI Africa "Industry strategy to address HIV/AIDS – a strategy document submitted to the MFRC (June 2005)" 5–7, especially Figure 2.

<sup>86</sup> *Ibid.*

<sup>87</sup> See Examples 1 and 2 of Table B, columns A and F.

<sup>88</sup> See Examples 4, 5 and 11 of Table B, columns A and F.

<sup>89</sup> See Examples 7 and 9 of Table B, columns A and F.

It therefore follows that every year tens of billions of rands in the form of interest on micro-loans is being drained out of the hands of poor communities into the hands of micro-lending enterprises, whose wealth is being enhanced directly at the expense of these communities. This money is not being recycled back into poor communities, but rather is lost to them. High interest rates on micro-loans have therefore resulted directly in the exacerbation of poverty in South Africa, and the money lost to poorer communities is increasing as levels of indebtedness of the lowest-income groups increase.<sup>90</sup> It is highly unlikely that this could have been understood or intended by Government when micro-loans were first exempted from interest rate limits, since Government repeatedly claims that poverty alleviation is a high priority.

## 5.7 Common law illegality of high interest-bearing loans

Although the exemption of micro-loans from the Usury Act provides no limit on the rates of interest that may be charged by registered micro-lenders that comply in every respect with the conditions of the exemption and therefore trade lawfully,<sup>91</sup> excessive interest levels permitted by the exemption that are charged by such micro-lenders may still be challenged on the basis of the common law.<sup>92</sup> The residual common law is still applicable, in view of the presumption that a statute alters the common law as little as possible, and the courts will interpret an act as ousting the common law only if this appears clearly from the intention of the legislature.<sup>93</sup> There is nothing in the statutory history in regard to usury that indicates such an intention; rather, the converse is the case.<sup>94</sup> Such court action would be possible only on a case-by-case basis; it could not attack the regulatory framework, and it could therefore not provide the basis for a class action.

Three such grounds for challenging high interest rates exist, namely: the application of the *in duplum* rule; a finding that interest rate provisions are contrary to public policy; and a contravention of common law usury law. These three potential bases for a court challenge have already been discussed at length in Chapters Two and Three above, and will therefore be outlined very briefly here in relation to micro-lending.

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<sup>90</sup> See the percentage increases in Tables K and L above.

<sup>91</sup> The 1999 Exemption Notice referred to in 4.2.2 above did provide for a maximum interest rate, which was subsequently reviewed and set aside in the *Lurama* decision.

<sup>92</sup> These arguments are most relevant to current unlimited interest rates, but may still be relevant in respect of the new limits on the cost of credit in the National Credit Regulations, which will come into force on 1 June 2007 and which will be discussed in detail in Chapter Six.

<sup>93</sup> Du Plessis *Re-interpretation of Statutes* (2002) 177–178.

<sup>94</sup> See the Usury Act 37 of 1926 and the Usury Act 73 of 1968, discussed in 3.2.2 above.

### 5.7.1 The *in duplum* rule<sup>95</sup>

The common law *in duplum* rule provides that interest stops running on a debt when the unpaid interest equals the outstanding capital.<sup>96</sup> Section 103(5) of the National Credit Act,<sup>97</sup> which will come into force on 1 June 2007,<sup>98</sup> has effectively codified the *in duplum* rule. Table B (read with Appendix A) above best illustrates the potential relevance of the *in duplum* rule. In Item 7 of Table B,<sup>99</sup> for example, if the borrower, as a result of unforeseen circumstances, is able from commencement of repayments to pay instalments of only R350 per month rather than the required R492,31 per month, s/he will after 12 months be in arrears with interest payments in the total amount of R1 707,72.<sup>100</sup> This amount exceeds the outstanding capital<sup>101</sup> of R1 638,<sup>102</sup> and interest will stop running after less than 12 months has passed, when outstanding interest amounts to R1 638. When unpaid interest is less than the capital outstanding, interest will commence to run again. Given the speed with which unpaid interest can accumulate (resulting from high interest rates), and subsequent likely default by borrowers, the *in duplum* rule is therefore a highly relevant mechanism for limiting the cost of credit.

### 5.7.2 Interest provisions contrary to public policy

The *in duplum* rule is cold comfort for a borrower who is charged 30% interest per month and who diligently pays each instalment due, or whose arrears interest never reaches the amount of the initial loan. Agreements which are “clearly inimical to the interests of the community, whether they are contrary to law or morality, or run counter to social and economic expedience, will ..., on the grounds of public policy, not be enforced.”<sup>103</sup> Public policy is now informed by constitutional values:<sup>104</sup>

“It is not difficult to envisage situations in which contracts that offend these fundamentals of our new social compact will be struck down as offensive to public

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<sup>95</sup> For a thorough explanation of the *in duplum* rule, see 3.3 above.

<sup>96</sup> See, for example, *Standard Bank of South Africa v Oneanate Investments (in liquidation)* 1998 (1) SA 811 (SCA) 827H.

<sup>97</sup> Act 34 of 2005.

<sup>98</sup> Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006.

<sup>99</sup> A loan of R1 638, repayable over 24 months in equal instalments of R492,31 each.

<sup>100</sup> Monthly shortfall of R142,31 x 12 months = R1 707,72.

<sup>101</sup> Or “unpaid balance of the principal debt”, *per* s103(5) of the National Credit Act.

<sup>102</sup> The outstanding capital is the same as the initial loan amount, since monthly payments accrue first to interest and then only to capital, and the monthly interest due is always greater than R350 in the first 12 months.

<sup>103</sup> Smalberger JA in *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A) 8C–D. For a fuller discussion of the principle of public policy, see 2.3 above.

<sup>104</sup> Cameron JA in *Brisley v Drotzky* 2002 (4) SA 1 (SCA) 34H–35B. See also *Napier v Barkhuizen* 2006 (4) SA 1 (SCA) 7A–B.

policy. They will be struck down because the Constitution requires it, and the values it enshrines will guide the courts in doing so.”

The development of a thorough argument in support of the contention that micro-lending contracts that attract interest rates of 360% *per annum* are contrary to public policy is beyond the ambit of this study, and in any event the specific circumstances of the particular case before the court would of course have to be carefully considered. Such an argument would have to be considered within the context of small loans, small incomes and the purpose of the industry made possible by the Usury Act exemption, namely to provide credit for lower-income groups who do not qualify for credit from the banking sector. It would also most certainly draw on much of the evidence of the negative socio-economic impact of high interest loans that is set out in this chapter.

The court would have to consider questions such as the following: can public policy countenance the fact that the majority of South Africa’s population who find themselves in the lowest-income groups must pay 18 times as much as higher-income groups for credit, even within the context of the difficulties that lenders experience with recovery of payments due on micro-loans?<sup>105</sup> Or that after payment of a monthly instalment, a pensioner will have only 26% of her pension left to cover all other necessary living expenses?<sup>106</sup> Or that a borrower may end up paying nearly 11 times the initial loan amount?<sup>107</sup> Or that the loan repayments after three months and three consecutive 30-day loans exceed the initial loan amount?<sup>108</sup>

It would seem not, especially if the loan was disbursed for consumption purposes (as are 43% of all micro-loans)<sup>109</sup> and the borrower is already considered vulnerable prior to taking out the loan, because she spends more than 60% of her income on food, beverages, clothing and housing.<sup>110</sup> The view that an interest rate of 360% *per annum* offends against public policy and the public interest is strengthened by the scale of the industry<sup>111</sup> and the fact that so many people are affected by such exorbitant interest rates.<sup>112</sup> Circumstances particular to the borrower and the lender will also likely be relevant, such as illiteracy and any other significant disadvantage or disability, for example if the borrower is HIV-positive and has to pay large medical

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<sup>105</sup> See 5.1 above.

<sup>106</sup> See Note (a) to Table B above.

<sup>107</sup> See Note (e) to Table B above.

<sup>108</sup> See example 2 in Table C above.

<sup>109</sup> See Table F above.

<sup>110</sup> Ebony “Analysis on the Application of Borrowed Funds” 14.

<sup>111</sup> See 5.6.1 and 5.6.2 above.

<sup>112</sup> According to paragraphs 2.1–2.6 of DTI “Policy Framework”, 67% of South Africa’s population are paying very high interest rates.

expenses on an ongoing basis. The court will have to carefully weigh up and assess all these and other factors and circumstances peculiar to the case before it.

### 5.7.3 Common law usury law<sup>113</sup>

In terms of common law usury law, the onus is on the debtor seeking to have an interest rate declared usurious to prove that the interest rate amounts to “extortion and oppression akin to fraud”.<sup>114</sup> To achieve this, evidence as to the ordinary rate prevalent in similar transactions, the size of the loan, the period of the loan, the purpose of the loan, the relative positions of the parties, the security and the risk, will all be relevant.<sup>115</sup> Many of these factors are also relevant to a possible contravention of public policy, referred to above. Equally, many other factors not listed by the courts in regard to usurious loans that are relevant to a possible contravention of public policy may also be relevant to the question of whether or not the interest rate is usurious.<sup>116</sup> A contract declared to be usurious will not be set aside, but a court may declare such a contract partially enforceable, to the extent that the interest is not usurious.<sup>117</sup>

A debtor seeking to have an interest provision declared invalid could plead that the rate of interest is contrary to public policy and therefore unenforceable, and go on to plead in the alternative that such rate is usurious, in that it amounts to “extortion and oppression akin to fraud”. It is also possible that the extortionate and oppressive (and therefore usurious) rate of interest could be pleaded as one of many other factors which render an interest provision contrary to public policy and therefore unenforceable.

## 5.8 The unregistered sector and the legacy of no interest rate limits

Prior to the exemption of micro-lenders from the Usury Act in 1992, there was already a significant “cash loans industry” which operated unlawfully and with no

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<sup>113</sup> For a fuller discussion of common law usury law, see 3.1 above.

<sup>114</sup> *Dyason v Ruthven* 311–312; *Reuter v Yates* 858; *SA Securities Ltd v Greyling* 356.

<sup>115</sup> *Reuter v Yates* 858. Grové (*Gemeenregtelike en Statutere Beheer oor Woekerreente* 140ff) lists the following additional factors or circumstances that may be relevant: how quickly the borrower wants the funds; whether a deposit or security is required; whether the debt is repayable in instalments; hidden finance costs; the possibility of early repayment; remedies on breach; whether financing is available in general for similar cases.

<sup>116</sup> There is no *numerus clausus* of possible relevant circumstances to be taken into account in deciding whether or not a transaction is usurious (Grové *Gemeenregtelike en Statutere Beheer oor Woekerreente* 140ff).

<sup>117</sup> Grové *Gemeenregtelike en Statutere Beheer oor Woekerreente* 138; *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 1984 (4) SA 874 (A); LAWSA para 52.

regulation, and which charged high interest rates in contravention of the Usury Act, and to which millions of borrowers turned for credit.<sup>118</sup> The emergence of this informal industry was one of the main reasons for the exemption of micro-loans and the birth of a legitimate micro-finance industry. After 1992, this informal sector continued to flourish, and many micro-lenders in this sector chose not to register with the Micro-finance Regulatory Council after its establishment in 1999.<sup>119</sup> These unregistered micro-lenders continued to operate informally and unlawfully,<sup>120</sup> charging interest rates comparable with or in excess of those charged by the registered sector, and still do so today. Since they did not register with the Micro-finance Regulatory Council (or latterly with the National Credit Regulator),<sup>121</sup> they are not exempt from the Usury Act, which provides that any contravention of the Act is an offence.<sup>122</sup> However, they do not fall within the jurisdiction of the Micro-finance Regulatory Council, which in any event has its work cut out controlling the registered micro-lending sector. They are therefore able to trade unlawfully in an uncontrolled environment, with little policing of their actions. The size of this unregistered sector, although difficult to quantify, is significant, estimated by Ebony Consulting International in 2000 to be more than one half the size of the registered sector.<sup>123</sup>

With the capping of interest rates by the National Credit Regulations, with effect from 1 June 2007,<sup>124</sup> it will be even less attractive for lenders in this informal sector to register with the National Credit Regulator,<sup>125</sup> and there seems to be little doubt that these informal lenders will continue to trade unlawfully. However, the problem of the unregistered sector could become much bigger. It seems to be very likely that many lenders that have been registered with the Micro-finance Regulatory Council will choose not to register with the National Credit Regulator, but rather to join the informal sector and continue to lend at the rates to which they have been accustomed for the past 14 years or more, which will in future be unlawful. Any lender not thus registered will be contravening the National Credit Act,<sup>126</sup> and a court will be able to declare a loan from an unregistered micro-lender to be unlawful and therefore void, order the micro-lender to refund all instalments paid, and cancel the lender's rights to claim back the amount loaned, or declare such amount forfeited to

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<sup>118</sup> Kern *The Regulation of the Micro-lending Industry in Terms of South African Law and Related Aspects* 13–14.

<sup>119</sup> Government Notice 713 of 1 June 1999.

<sup>120</sup> A common practice of many unregistered micro-lenders, amongst others, is to retain the borrower's identity document or bank card as security for the loan (Ebony "DTI Interest Rate Study" 28).

<sup>121</sup> Established by s12 of the National Credit Act.

<sup>122</sup> Section 17. Failure to comply with interest rate limits prescribed by the Act will constitute an offence.

<sup>123</sup> Ebony "DTI Interest Rate Study" 35.

<sup>124</sup> Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006.

<sup>125</sup> In the current situation of no capping of interest rates, it would seem that informal lenders choose not to register with the Micro-finance Regulatory Council so as not to be constrained by their administrative requirements.

<sup>126</sup> Section 89 of the National Credit Act.

the State.<sup>127</sup> The latter remedy is new and likely to weaken the position of unregistered lenders, but it remains to be seen whether or not this will effectively deter micro-lenders from lending without being registered. Very importantly, a micro-lender who practices as such without registering will not commit an offence in terms of the National Credit Act, whereas the Usury Act provided that any person who contravenes any provision of the Act commits an offence.<sup>128</sup>

Why should such a lender choose not to register? In terms of the new credit limits in the National Credit Regulations, all loans larger than R500 will be cheaper than the current typical 30% per month.<sup>129</sup> Most micro-lenders will therefore be able to earn much less than they are currently able to earn with interest rates at 30% per month.

In the *Lurama* case,<sup>130</sup> it was contended by the applicants that most micro-lenders would not be able to continue to do business profitably should they be restricted to charging interest at approximately 13,75% per month.<sup>131</sup> The financial statements of 47 members of the Association of Micro-lenders (one of the Applicants in the matter) were investigated by an auditor, who concluded that at 13,75% per month, only 19% of these micro-lenders were likely to survive in business, and the remaining 81% would have to shut down.<sup>132</sup>

When one considers the rate of growth of the industry in the last three years, being over 30% per year,<sup>133</sup> the success of which has been founded upon the high profit margin made possible by high interest rates, it appears to be unlikely that the new Regulations will be successful in enforcing the new interest rate limits and thereby stemming this tide of growth. Further, since levels of indebtedness in lower-income groups are steadily increasing,<sup>134</sup> it seems clear that the high demand for credit from poor communities will prevail, ensuring the continued growth of the industry.

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<sup>127</sup> Section 89(5). For a fuller discussion in this regard, see 6.2.6 below.

<sup>128</sup> Section 17.

<sup>129</sup> The cost of credit on all loans will decrease the larger the loan: a loan of R500 will cost a maximum of 31% per month (Chapter Six, Table P, Example 2 below), and a loan of R10 000 will cost about 4% per month (Chapter Six, Table Q, Example 6 below). Most loans of less than R500 will be more expensive than the current typical 30% per month.

<sup>130</sup> *Lurama Vyftien (Pty) Ltd and 49 Others v The Minister of Trade and Industry and Another* (Case No. 22125 of 1999) and *The Association of Micro-lenders v The Minister of Trade and Industry and Another* (Case No. 23453 of 1999) (unreported TPD).

<sup>131</sup> 13,75% per month was the maximum permissible rate in terms of paragraph 3.3 of Annexure A to the Schedule to the 1999 Exemption Notice at that time, since it was linked to the banks' prime overdraft lending rate. Paragraph 3.3 was subsequently reviewed and set aside in this case for the reason that the Applicants had a right to be heard before the 1999 Exemption Notice was published, and the Applicants were not properly heard.

<sup>132</sup> *Lurama* 34.

<sup>133</sup> Based upon annual growth of 28,46%, 31,13% and 30,8% in the last three years (see Table H above).

<sup>134</sup> See Tables K and L above.

Should this segment of the currently registered sector be “driven underground” by failing to register with the National Credit Regulator and continuing to trade unlawfully and in contravention of the new interest rate caps, this development will be attributable at least in part<sup>135</sup> to the legacy of the last 14 years: namely, the failure of the relevant Minister to limit interest rates when micro-loans were first exempted from the Usury Act in 1992.<sup>136</sup> The financial success of the industry has been built upon the firm foundation of the income to be earned from high interest rates, the benefits of which currently registered lenders are unlikely to be willing to forego. The temptation to join the ranks of the unregistered sector, which has by all accounts been trading profitably alongside the registered sector for so long, will be very strong indeed. The net result might well be that the unregistered sector, lending at customary exorbitant rates, will grow significantly at the expense of the registered sector, and borrowers will suffer the consequences.

In short: the failure to cap interest rates since 1992<sup>137</sup> is likely to have the direct result in the era of the National Credit Regulations of a much bigger unregistered sector, charging customary exorbitant interest rates, relative to the registered sector. This would not have been the case had interest rates been limited effectively from the outset in 1992, or even later. Registered micro-lenders would at that stage have had to adjust their expectations of profits to realistic levels dictated by the interest rate limits, without the free reign given to them by the failure to limit interest rates.

For these reasons, the legacy of the 14 years of no interest limits is likely to live on, and borrowers from mostly poorer communities will have to carry the cost. The negative socio-economic impact of legitimate, excessive interest rates charged during the 14 years from 1992 until 31 May 2007, the subject of this chapter, will likely still be felt to a significant degree after the National Credit Regulations become law on 1 June 2007, which result will be due in part to the failure to limit interest rates since 1992.

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<sup>135</sup> Such a development will, of course, also be attributable to the advent of limits on the cost of credit in the National Credit Regulations. This negative consequence of the capping of interest rates will be discussed in Chapter Six below.

<sup>136</sup> Besides, of course, the attempt of the 1999 Exemption Notice to limit the interest rate, which survived less than six months before such limit was set aside in the *Lurama* case.

<sup>137</sup> Notwithstanding the attempt to do so in 1999.

## Chapter Six

# An Analysis of the National Credit Act and Regulations

*“To promote a fair and non-discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit...”*

*“[T]o prohibit certain unfair credit and credit marketing practices...”<sup>1</sup>*

### Outline

The National Credit Act<sup>2</sup> has introduced a new era of consumer credit regulation and practice, bringing about wholesale changes to the consumer credit industry. This chapter will commence with a brief overview of the provisions of the Act that do not relate to the cost of credit, with particular reference to certain consumer protection measures that are of greater relevance to this study.

The bulk of the chapter will focus squarely on the cost of credit provisions: the legislative framework for the cost of credit, the prescribed limits on the cost of credit, and a thorough analysis of the new cost of credit. The full implications of the maximum prescribed interest rates, initiation fee and service fee will be separately considered. The combined impact of these credit costs will then be demonstrated and comprehensively analysed, and their socio-economic impact reviewed. Suggested amendments to the National Credit Regulations<sup>3</sup> will then be proposed, together with a suggested approach to setting appropriate levels for interest rates relative to other fees, viewed within the context of the total cost of credit as a whole, with reference to an example. Finally, the likely growth of the unregistered sector resulting from the credit cost limits and administrative burdens of the Act will be briefly explained.

The chapter will conclude with a discussion of potential legal challenges to the high cost of credit on smaller loans, including the possible review of certain provisions of the Regulations.

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<sup>1</sup> Extract from the preamble to the National Credit Act.

<sup>2</sup> Act 34 of 2005.

<sup>3</sup> National Credit Act (34/2005): Regulations, R489 *Government Gazette* 28864, 31 May 2006.

## 6.1 A brief overview of the National Credit Act

The National Credit Act is an extremely complex and lengthy piece of legislation which seeks to include within its ambit and to regulate in a concise manner all conceivable sectors of the consumer credit market. A review of the entire Act is of course way beyond the scope of this study. Rather, a brief overview of the Act is given in order to situate the cost of credit provisions within the context of the Act as a whole, with particular reference to certain consumer protection provisions which are of relevance to this study.

### 6.1.1 Background to the Act

The August 2004 policy framework of the Department of Trade and Industry<sup>4</sup> was the culmination of extensive research conducted since 2002 as part of the credit law review process, and was the policy document that directly informed the substance of the National Credit Act. The document re-iterated the critical role of credit in the economy:<sup>5</sup>

“Credit enables people to have use of a product or service, at a cost represented by an interest rate, prior to their having paid for that product or service or, where an item cannot be afforded from a single month’s salary, to spread payments over a number of months.”

In succinctly describing credit as a “double-edged sword”,<sup>6</sup> however, this document highlights the “considerable imbalance of power between consumers and credit providers”,<sup>7</sup> attributing this to poor consumer education levels and knowledge of consumer rights and inability to enforce such rights through negotiation or legal action.<sup>8</sup> Because of its complex nature:

“[C]redit cannot therefore be seen as a universal basic service to which access should be extended in the same way as access to water, healthcare and electricity. There is a greater need to balance access to credit with protection for consumers, especially the vulnerable.”<sup>9</sup>

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<sup>4</sup> DTI “Policy Framework”.

<sup>5</sup> Para 1.6.

<sup>6</sup> Para 1.8. See also 5.4 above.

<sup>7</sup> Para 1.9.

<sup>8</sup> *Ibid.*

<sup>9</sup> Para 1.12.

At the inauguration of the National Credit Regulator on 30 August 2006, the Minister of Trade and Industry, Mr Mandisi Mphahlele, said:<sup>10</sup>

“[T]he National Credit Act regulatory framework is designed to unlock the economic potential of all South African consumers by increasing access to credit, while recognising the dangers associated with over-indebtedness and the injudicious use of credit. The new framework therefore aims to support the development of a consumer credit market that would be of benefit to all consumers, whilst simultaneously providing protection against over-indebtedness and assisting consumers who over-extend themselves.”

Credit policy must also balance consumer protection measures with the regulatory burden it imposes on credit providers.<sup>11</sup> For these reasons, the policy framework concludes, there is a need for a more detailed and sometimes highly prescriptive legislative and regulatory approach to consumer credit than is necessary in the regulation of other sections of the financial market.<sup>12</sup>

The result of these objectives is succinctly summarised by Professor Otto:<sup>13</sup>

“It is a well-known fact that many poor South Africans have been enticed in recent years to enter into credit agreements that they could ill afford. The Act goes a long way to curb this. This is not done without creating administrative burdens for creditors. Consumer protection comes at a price, and the National Credit Act is no exception. One can expect it to be a rather expensive exercise for credit providers and the State’s coffers alike. Only time will tell: ‘*was die kool die sous werd?*’”<sup>14</sup>

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<sup>10</sup> “New era for South African credit consumers” [http://www.ncr.org.za/press\\_release/New%20era.pdf](http://www.ncr.org.za/press_release/New%20era.pdf) (accessed 9 November 2006).

<sup>11</sup> Para 1.15. The document acknowledges that excessively onerous and costly compliance requirements will increase the cost and risk for credit providers, and ultimately lead to higher cost of credit for consumers and lower returns for providers.

<sup>12</sup> Para 1.11.

<sup>13</sup> Otto *The National Credit Act Explained* (2006) 6.

<sup>14</sup> Jooste “That NNCA – who is going to pay for it?” (2006) 6 *Without Prejudice* 21 demonstrates the excessive cost of the implementation of the Act to be borne by both Government and credit providers. Sishuba “Consumer Credit Bill” (2006) *Leadership* 33 at 35 points out that the effects of the cost burden levied on credit providers could be passed on to the consumer.

## 6.1.2 Purpose of the Act

The purpose of the National Credit Act is contained in section 3, the full text of which is quoted below. Some brief discussion regarding certain aspects of the Act which are related but not directly relevant to this study is contained in the footnotes to section 3.

### “Purpose of Act

3. The purposes of this Act are to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers, by –

- (a) promoting the development of a credit market that is accessible to all South Africans and in particular to those who have historically been unable to access credit under sustainable market conditions;
- (b) ensuring consistent treatment of different credit products and different credit providers;<sup>15</sup>
- (c) promoting responsibility in the credit market by –
  - (i) encouraging responsible borrowing, avoidance of over-indebtedness and fulfillment of financial obligations by consumers; and
  - (ii) discouraging reckless credit granting by credit providers and contractual default by consumers;<sup>16</sup>
- (d) promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers;<sup>17</sup>
- (e) addressing and correcting imbalances in negotiating power between consumers and credit providers by –
  - (i) providing consumers with education about credit and consumer rights;<sup>18</sup>

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<sup>15</sup> One of the overriding objectives of the Act is to provide a single law that treats all credit transactions and credit providers “equivalently” (DTI “Policy Framework” para 4.7–4.8). The Act, when fully operative, will repeal the Usury Act 73 of 1968 and the Credit Agreements Act 75 of 1980, and will have a far wider field of application than its predecessors. It will apply to all credit, with no limit on the amount of credit involved, unlike its predecessors.

<sup>16</sup> Over-indebtedness and reckless credit are discussed in 6.1.4 below.

<sup>17</sup> Numerous rights of consumers are emphasised in the Act (with corresponding duties on the part of credit providers according to law), but very few rights of credit providers appear in the Act. The Act has been criticised for its pre-occupation with consumer rights at the expense of the rights of credit providers. Consumer rights include: the right to apply for credit (s60); protection against discrimination in respect of credit (s61); the right to reasons for credit being refused (s62); the right to information in official language (s63); the right to information in plain and understandable language (s64); the right to receive documents (s65); protection of consumer credit rights (s66). Other rights include: rights regarding information held by credit bureaux (ss70–72); protection against certain marketing practices (ss74–76); the right to confidentiality and privacy (s68); the right to early settlement (s125) and pre-payments (s126).

<sup>18</sup> The National Credit Regulator is responsible for implementing education and information measures to develop public awareness of the provisions of the Act [s16(1)(a)].

- (ii) providing consumers with adequate disclosure<sup>19</sup> of standardised information<sup>20</sup> in order to make informed choices;<sup>21</sup> and
- (iii) providing consumers with protection from deception, and from unfair or fraudulent conduct by credit providers<sup>22</sup> and credit bureaux;
- (f) improving consumer credit information and reporting and regulation of credit bureaux;<sup>23</sup>
- (g) addressing and preventing over-indebtedness of consumers, and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations;<sup>24</sup>
- (h) providing for a consistent and accessible system of consensual resolution of disputes arising from credit agreements; and
- (i) providing for a consistent and harmonised system of debt restructuring, enforcement and judgment which places priority on the eventual satisfaction of all responsible consumer obligations under credit agreements.”

The Act therefore has the ambitious and extremely difficult objective of promoting a competitive, efficient and effective credit industry and market which is at the same time fair, transparent, responsible and accessible. The overriding theme of the Act is consumer protection, evident in many of the nine objectives making up the remainder of section 3. There is no direct reference in section 3 to the intention to place limits on the cost of credit, although this is one of the most important practical results of the Act in regard to consumer protection. Indirect references to this objective can be found in paragraphs (a), (b), (d) and (g) of section 3, but the specific measures regarding the cost of credit are introduced elsewhere in the Act and the Regulations.

<sup>19</sup> Section 92(1) provides that a credit provider must give to a consumer a pre-agreement statement and quotation in the prescribed form prior to entering into a “small” credit agreement, namely a credit agreement of no more than R15 000 [s9 as read with National Credit Act (34/2005): Determination of Thresholds, GN713, 2006, *Government Gazette* 28893, 1 June 2006]. The quotation is binding upon the credit grantor for five business days, being in the nature of an option created by statute with the prospective consumer as the option holder. (Otto *The National Credit Act Explained* 40).

<sup>20</sup> Section 93(1) provides that a credit provider must deliver to a consumer, without charge, a copy of a document that records their credit agreement which, in the case of a small credit agreement, must be in the prescribed form. Notably, the Act does not provide that a credit agreement not reduced to writing will be void, neither is this an offence – this appears to be an omission in the Act.

<sup>21</sup> The DTI “Policy Framework”, Chapter 5, identified the need to help consumers to make informed choices: “Due to weak disclosure of the full cost of credit and the financial complexities of some products, it is difficult for consumers to understand the risks and make informed choices. Standard information in a simple, comparable form is essential if consumers are to make informed choices.”

<sup>22</sup> Section 90(2)(a) provides that a provision of a credit agreement is unlawful if its general purpose or effect is to, *inter alia*, deceive the consumer or subject the consumer to fraudulent conduct.

<sup>23</sup> Part B of Chapter 4 of the Act contains detailed provisions in regard to the management of consumer credit information via a national register of credit agreements and the regulation of credit bureaux. Importantly, s73 empowers the Minister to prescribe requirements for the verification, review and removal of consumer credit information by registered credit bureaux. The Minister did so by way of Draft National Credit Regulations, GN1388, 2006 *Government Gazette* 29246, 21 September 2006, for public comment by 27 October 2006, and the final prescribed requirements are currently awaited. The detailed and exacting management and control of consumer credit information is an example of the exhaustive regulation of the industry in the name of consumer protection.

<sup>24</sup> Over-indebtedness is discussed in 6.1.4 below.

### 6.1.3 New consumer credit institutions

Much of the responsibility for implementing the purposes of the Act lies with the National Credit Regulator, established by section 12 of the Act on 1 June 2006 to oversee the entire consumer credit industry, including all the functions and responsibilities of the former Micro-finance Regulatory Council in the micro-lending context. The National Credit Regulator is an independent juristic person<sup>25</sup> governed by a Board,<sup>26</sup> with a Chief Executive Officer<sup>27</sup> who may appoint inspectors and investigators.<sup>28</sup> The Regulator has an enormous number of responsibilities set out in great detail in sections 13 to 18 of the Act, and it remains to be seen whether or not it will have the necessary capacity to perform all these functions.<sup>29</sup>

The National Consumer Tribunal was established by the Act on 1 September 2006.<sup>30</sup> It is a juristic person with jurisdiction throughout South Africa, comprising a chairperson and at least 10 other members.<sup>31</sup> It is a tribunal of record<sup>32</sup> which conducts its proceedings in public in an informal, inquisitorial manner, applying principles of natural justice,<sup>33</sup> with the function of adjudicating on any matter brought before it in terms of the Act.<sup>34</sup> The Act provides rules of practice, procedure, evidence and a list of possible orders in relation to the Tribunal.<sup>35</sup>

Consumer debt is enforced by the courts, but only after the consumer has been notified of his default, advised to seek advice and a certain period has elapsed.<sup>36</sup> Other disputes may be settled by initiating a complaint to the National Credit

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<sup>25</sup> Section 12(1)(b).

<sup>26</sup> Section 19.

<sup>27</sup> Section 23.

<sup>28</sup> Section 25.

<sup>29</sup> These responsibilities include: the promotion and development of an accessible credit market [s13(a)]; monitoring and reporting annually certain market trends to the Minister [s13(c)]; conducting research and proposing policies to the Minister regarding the consumer credit industry [s13(d)]; regulating the industry by registering credit providers, credit bureaux and debt counsellors, and suspending or cancelling registration (s14); enforcing the Act in numerous ways listed in s15(a)–(j); promoting public awareness of consumer credit matters in various ways listed in s16(1)(a)–(g); engaging with provincial regulatory authorities (s17); advising the Minister, and recommending and reporting to the Minister on various aspects of consumer credit practice, policy and legislation (s18).

<sup>30</sup> Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006.

<sup>31</sup> Section 26(2).

<sup>32</sup> Section 26(1).

<sup>33</sup> Section 142(1).

<sup>34</sup> Section 27. The powers of the Tribunal are mentioned throughout the Act and are too many to list here.

<sup>35</sup> Sections 142–152.

<sup>36</sup> Sections 129–133. These lengthy pre-litigation requirements have been criticised by Visagie “Collecting your debt against the odds?” (June 2006) *De Rebus* 20 at 21.

Regulator,<sup>37</sup> initiating an application to the National Consumer Tribunal in various circumstances,<sup>38</sup> or referring a matter to an appropriate “ombud”, consumer court, or alternative dispute resolution agent.<sup>39</sup> Sections 134 to 138 provide procedures and guidelines in this regard, including provision for a consent order that can be made an order of a court or of the National Consumer Tribunal upon consent of the parties.<sup>40</sup> Complaints can furthermore be informally investigated and resolved by the National Credit Regulator,<sup>41</sup> or referred to the National Consumer Tribunal.<sup>42</sup>

In a synopsis of the Act, Professor Otto concludes:<sup>43</sup>

“All in all, the muscle of the National Credit Regulator, the far-reaching powers of the National Consumer Tribunal and the courts, the almost paternalistic protective inclination of the legislature, and the extensive network of dispute-solving account for consumer legislation that is going to have a huge impact on the enormous credit industry in South Africa.”

#### **6.1.4 Over-indebtedness and reckless credit**

It is clear from Chapter Five of this study that over-indebtedness is frequently a disastrous consequence of the high cost of credit, and is therefore a critical aspect of this study that is worthy of specific attention. Levenstein summarises succinctly this state of affairs:<sup>44</sup>

“Unfortunately, in South Africa, too many people with too little money have been given too much credit. This ultimately leads to over-indebtedness which results in a never-ending circle of frustration for the consumer who can never repay his debts.”

One of the most important objectives of the Act is to combat over-indebtedness and reckless credit granting,<sup>45</sup> and the Act contains lengthy, detailed, far-reaching and extremely important provisions in this regard.<sup>46</sup> A very brief overview is given below.

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<sup>37</sup> Section 136.

<sup>38</sup> Section 137.

<sup>39</sup> Section 134.

<sup>40</sup> Section 135 read with s 138.

<sup>41</sup> Sections 139–140.

<sup>42</sup> Section 141.

<sup>43</sup> Otto *The National Credit Act Explained* 12.

<sup>44</sup> Levenstein “Setting new parameters for reckless lending” (2006) 6 *Without Prejudice* 50.

<sup>45</sup> Section 3(c), (g) and (i).

<sup>46</sup> Sections 78–88, all of which will come into effect on 1 June 2007.

A consumer is over-indebted if the preponderance of available information indicates that the consumer is unable to satisfy all obligations under a credit agreement in a timely manner, having regard to the consumer's financial means, prospects and obligations, and history of debt repayment.<sup>47</sup> In any court proceedings, a court may declare a consumer to be over-indebted<sup>48</sup> or refer a consumer to a debt counsellor for a recommendation in this regard.<sup>49</sup> A consumer may also apply in person to a debt counsellor to be declared over-indebted.<sup>50</sup> In either event if, after an evaluation the debt counsellor finds that the consumer is over-indebted, the counsellor can recommend to the Magistrate's Court that one or more credit agreements be declared reckless,<sup>51</sup> or that the consumer's debts be re-arranged.<sup>52</sup> If the counsellor finds that the consumer is not over-indebted but is experiencing problems in paying debts punctually, then the counsellor can facilitate a voluntary agreement between credit provider and consumer on a "plan of debt re-arrangement", which can be filed as a consent order with the Tribunal or a court.<sup>53</sup>

A credit provider must not enter into a reckless credit agreement with a consumer.<sup>54</sup> Before entering into a credit agreement, a credit provider must first take reasonable steps to assess the consumer's general understanding of the risks and costs of the proposed credit, the consumer's debt repayment history and existing financial means, prospects and obligations.<sup>55</sup> The consumer must fully and truthfully provide the requested information.<sup>56</sup> A credit agreement is reckless if:

- at the time it was concluded the credit provider failed to conduct the necessary assessment, irrespective of what the outcome of such assessment might have been,<sup>57</sup> or
- the credit provider entered into the agreement despite the fact that information available to the credit provider showed that the consumer did not generally understand the consumer's risk and the costs or obligations under

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<sup>47</sup> Section 79(1).

<sup>48</sup> Section 85(b).

<sup>49</sup> Section 85(a).

<sup>50</sup> Section 86(1).

<sup>51</sup> Section 86(7)(c)(i) read with s80.

<sup>52</sup> Section 86(7)(c)(ii).

<sup>53</sup> Section 86(7)(b).

<sup>54</sup> Section 81(3).

<sup>55</sup> Section 81(2). In general, a credit provider may adopt its own assessment mechanisms to this end, provided they are fair and objective [s82(1)]. It has been suggested that in due course "best practice standards" will be established in each industry for conducting necessary assessments (Levenstein 2006 *Without Prejudice* 50).

<sup>56</sup> Section 81(1). Failure by the consumer to do so could serve as a complete defence against an allegation of reckless credit [s81(4)].

<sup>57</sup> Section 80(1)(a). Otto *The National Credit Act Explained* 66 concludes that this section is penal in nature, designed "to prevent credit providers from taking shortcuts by simply accepting an apparently creditworthy debtor on face value".

the proposed credit agreement, or the conclusion of the agreement would cause the consumer to become over-indebted.<sup>58</sup>

In any proceedings that concern credit agreements, a court may declare that a credit agreement is reckless.<sup>59</sup> In this event, it may make an order setting aside all or part of the consumer's rights and obligations under the agreement, or suspending the force and effect of the agreement for a determined period.<sup>60</sup> Such a court is further required to find whether or not the consumer was over-indebted at the time of conclusion of the agreement.<sup>61</sup> If such finding is affirmative, it may order the suspension of the force and effect of the agreement and restructuring of the consumer's obligations under any other credit agreements.<sup>62</sup> During the period of suspension, the consumer is not required to pay anything in terms of the credit agreement, no interest or fee may be debited to the consumer, and the credit provider's rights in terms of the agreement are unenforceable.<sup>63</sup> After such suspension ends, all the parties' rights and obligations are revived and become enforceable again, save that interest or fees that accrued during the period of suspension may not be charged to the consumer,<sup>64</sup> which is a drastic remedy indeed.

The negative consequences for credit providers of contracting with over-indebted consumers or concluding reckless credit agreements, some of which are penal in nature, are substantial enough to ensure that credit providers will be careful to reduce the risk of bad debt.<sup>65</sup> The above provisions are therefore likely to reduce over-indebtedness and reckless credit granting, at least in the formal sector.<sup>66</sup> A negative consequence for consumers, however, could be that credit grantors are likely to be significantly more reticent about granting credit in the future, and fewer people will be able to access credit.<sup>67</sup>

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<sup>58</sup> Section 80(1)(b). This definition of "reckless credit" has been criticised for applying to the credit provider only, and not to the consumer [Heath Executive Consultants *Submissions on the National Credit Bill* (undated) 9 (unpublished)].

<sup>59</sup> Section 83(1).

<sup>60</sup> Section 83(2).

<sup>61</sup> Section 83(3)(a).

<sup>62</sup> Section 83(3)(b).

<sup>63</sup> Section 84(1).

<sup>64</sup> Section 84(2).

<sup>65</sup> Law Review Project *Comment on the National Credit Bill* (July 2005) 27 (unpublished).

<sup>66</sup> The positive results of these consumer protection measures will to a great extent unfortunately be negated by the excessive cost of credit on smaller loans in terms of the Act, which will be demonstrated in detail later in this chapter.

<sup>67</sup> Law Review Project *Comment on the National Credit Bill* 28 described this as an apparent contradiction in the Bill: "The Portfolio Committee and the government must decide whether a substantial reduction to the access to credit for the consumers it wants to benefit is justified by a corresponding reduction in over-indebtedness and reckless credit."

## 6.2 The legislative framework for the prescribed limits on the cost of credit

### 6.2.1 The enabling provisions

The cost of credit is dealt with in sections 100 to 106 of the National Credit Act, which together comprise Part C<sup>68</sup> of Chapter 5<sup>69</sup> of the Act. The whole of Part C of the Act will come into effect on 1 June 2007.<sup>70</sup> Section 105(1) provides that the Minister<sup>71</sup> may prescribe “a method for calculating” a maximum rate of interest and the maximum fees contemplated in the Act,<sup>72</sup> and that different levels of interest and fees be applicable to each sub-sector of the consumer credit market.<sup>73</sup> The different sub-sectors of the consumer credit market as well as the different maximums for credit agreements within each sub-sector are to be determined by the Minister.<sup>74</sup>

Importantly, the Minister is not obliged to cap interest rates and, until this was effected in the Draft National Credit Regulations in February 2006, there was concern that the Minister would continue to fail to do so in regard to micro-loans, just as the responsible Ministers had failed to do since 1992 (besides the short-lived limits of the 1999 Exemption Notice).

The Minister is required to consider, amongst others, the following factors when prescribing maximum rates of interest and fees:

- (a) The need to make credit available to historically disadvantaged persons, low-income persons and communities, and remote, isolated or low-density populations and communities.<sup>75</sup>
- (b) Conditions prevailing in the credit market, including the cost of credit and the optimal functioning of the consumer credit market.<sup>76</sup>
- (c) The social impact on low income consumers.<sup>77</sup>

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<sup>68</sup> Headed “Consumer’s liability, interest, charges and fees”.

<sup>69</sup> Headed “Consumer Credit Agreements”.

<sup>70</sup> Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006. Part C includes all relevant cost of credit provisions in terms of which the Minister may prescribe limits. All the law discussed in 6.2 to 6.4 hereof will therefore come into effect on 1 June 2007.

<sup>71</sup> Section 1 of the Act defines the Minister as the member of Cabinet responsible for consumer credit. This Minister is currently the Minister of Trade and Industry.

<sup>72</sup> The most important fees in regard to money loans are the initiation fee and the service fee.

<sup>73</sup> Section 105(1).

<sup>74</sup> Section 105(3)(a).

<sup>75</sup> Section 105(2)(a) as read with s13(a).

<sup>76</sup> Section 105(2)(b).

The first and third of these factors are concerned with accessibility and fairness of credit extension, respectively (primarily the interests of consumers), while the second factor is concerned with competitiveness and efficiency of the credit market (primarily the interest of credit providers).<sup>78</sup> These three factors will therefore always be of utmost importance when establishing appropriate levels for the cost of credit and when analysing such cost, and will therefore be referred to in 6.4.6 and 6.5 below.

By 2004, the Department of Trade and Industry had already proposed the “standardisation of charges across all service providers into three categories, being loan origination fees, monthly service fees and interest”.<sup>79</sup> Section 101(1) provides a closed list of the type of payments that a consumer may be required to make, namely: the principal debt,<sup>80</sup> an initiation fee, a service fee, interest, cost of credit insurance, default administration charges and collection costs. No money or other consideration other than the types of payments listed may be required by a credit provider. Conspicuously absent from this list is bond registration costs, which were included in the definition of “principal debt” in s1 of the Usury Act. The nature of these costs will first be discussed in general terms before the limits prescribed by the National Credit Regulations are explained and analysed in 6.3 and 6.4 below.

## 6.2.2 Interest

Interest may not exceed the applicable maximum prescribed rate, must be calculated in the prescribed manner, and must be expressed in percentage terms at an annual rate.<sup>81</sup> In general, interest may be calculated daily and may be added to the deferred amount (the principal debt) monthly.<sup>82</sup> Interest is calculated as follows:<sup>83</sup>

$$\text{Rand amount of interest for a day} = \frac{\text{Deferred amount for the day} \times \text{interest rate}}{\text{Number of days in the year}}$$

<sup>77</sup> Section 105(2)(c). This factor requires the Minister to consider, amongst others, all the issues raised in Chapter Five of this study above.

<sup>78</sup> cf s3.

<sup>79</sup> DTI “Policy Framework” para 4.9.

<sup>80</sup> Section 101(1)(a). The principle debt in the case of a money loan is the amount deferred in terms of the agreement; that is, the initial loan amount.

<sup>81</sup> Section 101(1)(d).

<sup>82</sup> Reg 40(1), which provides for other dates that interest may be added to the deferred amount, in certain circumstances. Precise methods for the calculation of interest on different categories of credit transactions are given in the remainder of reg 40.

<sup>83</sup> Reg 40(2)(a).

Central to this calculation is the deferred amount, which includes the initiation fee, the service fee, unpaid interest, credit insurance, default administration charges and collection costs.<sup>84</sup> In effect, the deferred amount is increased with monthly capitalisation of any unpaid interest or fees, and interest is paid on unpaid interest and fees. A variable interest rate is permissible during the term of a credit agreement only if the variation is by fixed relationship to a reference rate stipulated in such agreement,<sup>85</sup> and a credit provider must not unilaterally increase interest rates or service fees.<sup>86</sup>

The common law *in duplum* rule is codified in s103(5), and goes further to clarify and extend the common law.<sup>87</sup> Although this provision has been discussed in detail in Chapter Five above, it is so important that it is worthy of further emphasis here. The common law *in duplum* rule should have played a more prominent role in the era of no interest caps on small loans, but its precise meaning has often been regarded as rather obscure, understood only on the reading of selected case law, and its application has therefore been limited.<sup>88</sup> It is likely that the legislated *in duplum* rule will become an increasingly important mechanism for limiting the cost of credit. Any uncertainty about its meaning has been removed by its clear articulation in the Act. Its profile has been raised by its codification, which is likely to ensure that it will be more widely used than in the past. This is somewhat ironic, given that this increased use will occur in the new era in which the cost of credit for small loans will be limited.

### 6.2.3 The initiation fee

An initiation fee,<sup>89</sup> not to exceed the amount prescribed by the Minister and relative to the principal debt,<sup>90</sup> may be charged if the application for credit results in a credit agreement.<sup>91</sup> The initiation fee is defined as a fee in respect of the costs of initiating a credit agreement,<sup>92</sup> “intended to allow for the recovery of reasonable costs of

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<sup>84</sup> Reg 39(1).

<sup>85</sup> Section 103(4).

<sup>86</sup> Section 104(1). The remainder of s104 sets out the circumstances in which interest rates and fees may be changed during the term of a credit agreement.

<sup>87</sup> Section 103(5). Not just interest, but all elements of the cost of credit will now be relevant to the enquiry. See 3.3 above for detailed discussion of s103(5).

<sup>88</sup> Hofmeyer, Herbststein and Gihwala Inc “Report for the Credit Law Review”

<http://www.thedti.gov.za/ccrdlawreview/forward.htm> (accessed 14 March 2006) para 6.13.

<sup>89</sup> Section 101(1)(b). The initiation fee will be introduced into South African consumer credit law for the first time.

<sup>90</sup> Section 101(1)(b)(i).

<sup>91</sup> Section 101(1)(b)(ii).

<sup>92</sup> Section 1, definition of “initiation fee”.

originating a transaction”.<sup>93</sup> It is unclear exactly what costs the fee is intended to cover, but examples that have been given by the Department of Trade and Industry include the cost of undertaking credit checks, photocopying costs, mortgage bond registration costs and evaluation costs in respect of the purchase of immovable property.<sup>94</sup>

The initiation fee is a one-off payment, paid by the consumer on conclusion of the credit agreement or charged to the consumer.<sup>95</sup> It appears to be likely that an initiation fee so charged could be regarded as a short-term credit transaction, attracting interest at 60% *per annum*.<sup>96</sup> The fee is levied on the date of approval of the credit application, or later by agreement.<sup>97</sup> No initiation fee may be charged if a new credit agreement is entered into between the same two parties that replaces an earlier agreement in whole or in part.<sup>98</sup>

#### 6.2.4 The service fee

A service fee may be charged,<sup>99</sup> not to exceed the amount prescribed by the Minister relative to the principal debt.<sup>100</sup> The service fee is defined as a fee that may be charged periodically by a credit provider in connection with the routine administration cost of maintaining a credit agreement.<sup>101</sup> It will usually be payable monthly, but could be payable annually or on a transaction basis.<sup>102</sup>

#### 6.2.5 Other fees, costs and charges

A credit provider may require a consumer to maintain during the term of the credit agreement credit life insurance in an amount not exceeding the total outstanding amount of the agreement.<sup>103</sup> Credit life insurance “includes cover payable in the

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<sup>93</sup> Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing” <http://www.pmg.org.za/viewminute.php?id=7375> (accessed 25 October 2006).

<sup>94</sup> *Ibid.* The mortgage bond and evaluation costs would of course not be relevant to a money loan.

<sup>95</sup> Section 1, definition of “initiation fee”.

<sup>96</sup> Reg 39(2) read with reg 42(1). See further the discussion regarding short-term credit transactions below, as well as comments made at “Trade and Industry Portfolio Committee meeting 16 August 2006 on National Credit Regulations and National Credit Regulator: briefing” <http://www.pmg.org.za/viewminute.php?id=8080> (accessed 24 October 2006).

<sup>97</sup> Reg 42(1).

<sup>98</sup> Reg 43(2) read with s101(2).

<sup>99</sup> Section 101(1)(c). The service fee will be introduced into South African consumer credit law for the first time.

<sup>100</sup> Section 101(1)(c)(iii).

<sup>101</sup> Section 1, definition of “service fee”.

<sup>102</sup> Section 101(1)(c)(i) and (ii), read with reg 41(2), 41(3) and 41(4).

<sup>103</sup> Section 106(1)(a), read with s101(1)(e).

event of a consumer's death, disability, terminal illness, unemployment or other insurable risk that is likely to impair a consumer's ability to earn an income or meet the obligations under a credit agreement".<sup>104</sup>

If the consumer defaults on payment, default administration charges may be imposed only in respect of each letter necessarily written.<sup>105</sup> Likewise, collection costs may be imposed, such costs not to exceed the costs permissible in terms of the relevant Act,<sup>106</sup> for example the Magistrates' Courts Act.<sup>107</sup> Subject to the codified *in duplum* rule,<sup>108</sup> the interest rate applied to an amount in default may not exceed the rate charged on the principal debt.<sup>109</sup>

## 6.2.6 Contraventions of the Act

No money or consideration other than the interest, charges and fees referred to in 6.2.2 to 6.2.5 above<sup>110</sup> may be charged to a consumer in terms of a credit agreement.<sup>111</sup> Further, a credit provider may not charge interest, fees or other charges in excess of the amount permitted by the Act.<sup>112</sup> Notably, a contravention of these provisions does not constitute an offence. The Act provides only a relatively short list of offences that attract criminal penalties.<sup>113</sup> By contrast, the Usury Act provided that any person who contravenes any provision of the Act commits an offence.<sup>114</sup> Thus, it was a criminal offence to charge interest higher than the Usury Act maximum.

When a credit agreement provides for charges that are not permitted, or when the amount of interest, fees or other charges exceeds the maximum amount permissible, the necessary relief will be provided by section 90 of the Act, read with section 89. It is most helpful to begin with section 89, which informs section 90. Section 89 lists a number of credit agreements that are unlawful. Amongst others, any credit

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<sup>104</sup> Section 1, definition of credit life insurance.

<sup>105</sup> Section 101(1)(f) read with reg 46 and Part C of Chapter 6 of the Act. This payment may not exceed the amount payable in respect of a registered letter of demand in an undefended action in terms of the Magistrate's Court Act, 1944 as well as reasonable delivery costs of such letter.

<sup>106</sup> Section 101(1)(g) read with reg 47 and Part C of Chapter 6 of the Act.

<sup>107</sup> Act 32 of 1944.

<sup>108</sup> Section 103(5).

<sup>109</sup> Section 103(1).

<sup>110</sup> Which are listed in s101(a)–(g)

<sup>111</sup> Section 101(1) read with 100(1)(a).

<sup>112</sup> Section 100(1)(b) and (c).

<sup>113</sup> Sections 156–160. These include breaches of confidence, hindering the administration of the Act, failure to attend when summoned to a hearing, failure to answer truthfully or fully at a hearing, and offences relating to the National Credit Regulator and Tribunal.

<sup>114</sup> Section 17.

agreement is unlawful if at the time of the agreement the credit grantor was not registered with the National Credit Regulator and the Act requires that such credit grantor be registered,<sup>115</sup> or was subject to a notice from the National Credit Regulator to stop trading.<sup>116</sup> A credit agreement entered into while the credit grantor was not registered will, however, not be unlawful if application for registration is made within 30 days after the credit agreement was concluded.<sup>117</sup> Section 89(5) provides that if a credit agreement is found to be unlawful, a court must order that:

- (a) the credit agreement is void from date of its conclusion;<sup>118</sup>
- (b) the credit provider must refund to the consumer any monies paid by the consumer, with interest;<sup>119</sup>
- (c) the credit provider's rights to recover monies paid or goods delivered to the consumer are cancelled unless the court is of the view that this would unjustly enrich the consumer, in which event such rights will be forfeited to the state.<sup>120</sup>

Thus, a court will be able to declare a loan from an unregistered micro-lender to be void, and order the micro-lender to refund all instalments paid. Furthermore, the court must order that the loan amount advanced to the consumer be retained by the borrower or forfeited to the State, and it is thereby lost to the unregistered micro-lender altogether. Whichever order the court makes, the credit provider will lose his/her performance, while performance is restored to the consumer.<sup>121</sup> The latter provision is a drastic remedy and a departure from the common law. It is not currently available in the case of unregistered micro-lenders, and is a significant new consumer protection measure.

Section 90 lists numerous provisions of credit agreements that are unlawful and not permitted.<sup>122</sup> This list is broadly framed and far-reaching, and many of the provisions will probably be open to a wide range of interpretations, which is likely to lead to uncertainty. For example, the first unlawful provision listed is one whose general

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<sup>115</sup> Section 89(1)(d). Section 40(1) provides that a person must apply to the National Credit Regulator to be registered as a credit provider if that person provides credit in at least 100 credit agreements or the total principal debt on all outstanding debts exceeds the amount of R500 000, an amount prescribed by the Minister [National Credit Act (34/2005): Determination of Thresholds, GN713, 2006, *Government Gazette* 28893, 1 June 2006].

<sup>116</sup> Section 89(1)(e).

<sup>117</sup> Section 89(4)(a). This provision will make it fairly easy for a credit provider to validate a credit agreement that could otherwise be declared to be void.

<sup>118</sup> Section 89(5)(a).

<sup>119</sup> Section 89(5)(b).

<sup>120</sup> Section 89(5)(c).

<sup>121</sup> Otto *The National Credit Act Explained* 43.

<sup>122</sup> Section 90(2)(a)–(o). There are too many such provisions to list them all here. Section 90 deals with unlawful provisions of credit agreements as opposed to unlawful credit agreements (s89).

purpose or effect is to defeat the purposes or policies of the Act, or to “deceive” the consumer.<sup>123</sup> Further, a provision is unlawful if it directly or indirectly purports to avoid a credit provider’s obligation or duty in terms of the Act,<sup>124</sup> to set aside or override the effect of any provision of the Act,<sup>125</sup> or to authorise the credit provider to do anything that is unlawful in terms of the Act or to fail to do anything that is required in terms of the Act.<sup>126</sup> Thus, if a money loan agreement provides for charges that are not permitted, or if the amount of interest, fees or other charges exceeds the maximum amounts permissible, the offending provisions will be unlawful. A provision is also unlawful that allows for the deposit with the credit provider of an identity document, credit or debit card or other similar device, or for access by the credit provider to a borrower’s personal information code on his/her bank account.<sup>127</sup>

An unlawful provision is void from the date of conclusion of the agreement.<sup>128</sup> Whenever a court has a matter before it which concerns a credit agreement that contains an unlawful provision, the court must sever the unlawful provision from the credit agreement, or alter the provision to the extent required in order to render it lawful, or may even declare the whole credit agreement unlawful.<sup>129</sup> In addition, the court may “make any order that is just and reasonable in the circumstances to give effect to the principles of s89(5) with respect to that unlawful provision, or entire agreement, as the case may be”.<sup>130</sup> The precise meaning of the words “... give effect to the principles of s89(5) ...” is not clear. It would seem, however, that section 90(4) will entitle a court to make orders in respect of the offending provision (or agreement) similar to those contemplated in paragraphs (a), (b) and (c) on page 15 above.<sup>131</sup>

Thus, for example, if a loan agreement provides for interest or fees in excess of the maximum amounts permissible, a court will be able to declare the offending provisions to be void, and order the micro-lender to refund all unlawful interest or fees paid. Again, the court may order that the funds advanced to the consumer be retained by the borrower or forfeited to the State, a new remedy that will considerably strengthen the hand of the consumer.

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<sup>123</sup> Section 90(2)(a).

<sup>124</sup> Section 90(2)(b)(ii).

<sup>125</sup> Section 90(2)(b)(iii).

<sup>126</sup> Section 90(2)(b)(iv).

<sup>127</sup> Section 90(2)(l).

<sup>128</sup> Section 90(3).

<sup>129</sup> Section 90(4). The latter drastic remedy represents a total departure from the common law, described by Otto as a “phenomenal discretion resting with a court” (Otto *The National Credit Act Explained* 46).

<sup>130</sup> *Ibid.*

<sup>131</sup> Section 89(5).

### 6.3 The prescribed limits on the cost of credit

The prescribed limits on the cost of credit in terms of the National Credit Regulations, published on 31 May 2006,<sup>132</sup> will come into effect on 1 June 2007.<sup>133</sup> The Regulations introduce and distinguish two categories of credit agreements that are fundamental to this study: short-term credit transactions and unsecured credit transactions.<sup>134</sup> These two categories include within their ambit money loans which are comparable with micro-loans currently exempt from the Usury Act, clearly in an attempt to consider “[c]onditions prevailing in the credit market, including the cost of credit and the optimal functioning of the consumer credit market”.<sup>135</sup> The effective cost of credit is the result of an attempt to balance fairness with the need for a competitive market,<sup>136</sup> “to make credit as cheap as possible and at the same time allow lenders to make a living”.<sup>137</sup>

The Act introduces three major categories of credit agreements, and provides that every credit agreement will fall under one of these three categories, namely: credit facilities,<sup>138</sup> credit transactions,<sup>139</sup> and credit guarantees.<sup>140</sup> Other sub-categories of credit agreements include mortgage agreements,<sup>141</sup> developmental credit agreements,<sup>142</sup> incidental credit agreements,<sup>143</sup> and short-term and secured credit transactions referred to above. Credit agreements are further categorised into small, intermediate and large credit agreements.<sup>144</sup> These categories are distinguished by threshold amounts prescribed by the Minister. The lower threshold amount distinguishing small from intermediate credit agreements is R15 000, meaning that all loans of no more than R15 000 (which are relevant to this study) are categorised as small credit agreements for purposes of the Act.<sup>145</sup>

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<sup>132</sup> National Credit Act (34/2005): Regulations, R489 *Government Gazette* 28864, 31 May 2006.

<sup>133</sup> The whole of Chapter 5 of the Act, which concerns Consumer Credit Agreements (including all relevant cost of credit provisions in terms of which the Minister may prescribe limits, contained in Part C thereof), will come into effect on 1 June 2007 in terms of Commencement of the National Credit Act, 2005 (Act No. 34 of 2005) Proclamation R22, 2006, *Government Gazette* 28824, 11 May 2006.

<sup>134</sup> Reg 39.

<sup>135</sup> Section 105(2)(b).

<sup>136</sup> DTI “Policy framework” ch 4.

<sup>137</sup> See the remarks of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>138</sup> Section 8(3). Credit facilities include credit card accounts and cheque accounts.

<sup>139</sup> Section 8(4). Short-term and secured credit transactions fall under this category of credit agreements.

<sup>140</sup> Section 8(5).

<sup>141</sup> Section 1. Definition of “mortgage agreement”.

<sup>142</sup> Section 10.

<sup>143</sup> Section 1. Definition of “incidental credit agreement”.

<sup>144</sup> Section 9.

<sup>145</sup> National Credit Act (34/2005): Determination of Thresholds, GN713, 2006, *Government Gazette* 28893, 1 June 2006.

### 6.3.1 Different categories of loans and their interest rate limits

A short-term credit transaction is defined as “a credit transaction in respect of a deferred amount at inception of the agreement not exceeding R8 000, and in terms of which the whole amount is repayable within a period not exceeding 6 months”.<sup>146</sup> This category is clearly intended to provide mainly for the 30-day loans common under the Usury Act exemption, which sometimes have repayment periods of up to 4 months.<sup>147</sup> There is no requirement that short-term credit transactions be unsecured.<sup>148</sup> The maximum interest rate on short-term credit transactions is 5% per month,<sup>149</sup> or 60% *per annum*.<sup>150</sup>

An unsecured credit transaction is defined as “a credit transaction in respect of which the debt is not supported by any pledge or other right in property or suretyship or any other form of personal security”.<sup>151</sup> There is no limit as to the amount loaned or the repayment period, and it appears that this category of loan is intended to provide for loans in excess of R8 000, repayable over a period of more than 6 months. The hallmark of this category of loan is that there is no security for the debt whatsoever. Thus any unsecured loan, large or small, which is more than R8 000 and / or which is repayable over a period of more than 6 months will fall into this category.<sup>152</sup> The maximum interest rate on unsecured credit transactions is linked to the South African Reserve Bank Repurchase Rate, and is calculated by applying the following formula: (Repurchase Rate x 2.2) + 20% per year.<sup>153</sup> The maximum interest rate on unsecured credit transactions would therefore currently be 38,7% *per annum*, based

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<sup>146</sup> Reg 39(2), which goes on to describe a short term credit transaction as:

- involving the disbursement of an amount of money to the consumer, to be used at the sole discretion of the consumer;
- including pawn transactions;
- not including credit transactions conditional upon the deferred amount being paid by the credit provider to a relative of the credit provider, or to a person other than the consumer (unless this condition is introduced by the consumer).

The limits on this category of loans are reminiscent of the limits on loans exempt from the Usury Act, namely loans less than R10 000 repayable over a period of less than 36 months (which encompass both so-called “30-day loans” and “term loans”).

<sup>147</sup> See ph 5.3.1 above. It is interesting to note that Reg 36 of the Draft National Credit Regulations, published on 20 February 2006, provided for much lower limits on “short-term loans”, namely a principal amount not exceeding R5 000, the whole amount of which is repayable within 4 months.

<sup>148</sup> It is of course a requirement that an “unsecured credit transaction” be unsecured.

<sup>149</sup> Reg 42(1), Table A.

<sup>150</sup> Again, it is interesting to note that reg 42 of the Draft National Credit Regulations, published on 20 February 2006, provided for a lower maximum interest rate on “short-term loans” of 4% per month, or 48% *per annum*.

<sup>151</sup> Reg 39(3).

<sup>152</sup> Any unsecured loan not exceeding R8 000 which is repayable within 4 months will qualify as both an unsecured credit transaction and a short term credit transaction.

<sup>153</sup> Reg 42(1), Table A.

on the current Repurchase Rate of 8,5% *per annum*.<sup>154</sup> This is considerably less than the maximum interest rate on short term credit transactions.

By contrast, a secured bank loan falls under the category of credit agreement termed a “credit transaction”,<sup>155</sup> whilst a credit card or cheque account falls under the category “credit facility”.<sup>156</sup> The maximum interest rates on both secured loans and credit facilities (including credit card and cheque accounts) is also linked to the South African Reserve Bank Repurchase Rate, and is currently 28,7% *per annum*.<sup>157</sup> In comparing interest rates only, the maximum interest rate on a secured bank loan will therefore be 10% lower than that of an unsecured loan, and less than one half of that of a short term credit transaction.<sup>158</sup> Further, the maximum secured bank loan will be much higher than the current Usury Act maximum of 20% *per annum* for loans up to R10 000, and 17% *per annum* for loans greater than R10 000.<sup>159</sup>

### 6.3.2 The cost of the initiation fee

In terms of regulation 42(2), Table B, the maximum initiation fee for both short term and unsecured credit transactions is R150 per credit agreement, plus 10% of the amount of the agreement in excess of R1 000, but never to exceed R1 000.<sup>160</sup> However, regulation 43(3) provides that the initiation fee may never exceed 15% of the principal debt. This provision would at first blush appear to contradict regulation 42(2) in respect of loans of less than R1 000.<sup>161</sup> This apparent contradiction would have been cured had regulation 42(2) stated that the maximum initiation fees set out

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<sup>154</sup> South African Reserve Bank home page <http://www.reservebank.co.za/> (accessed 1 December 2006). The repurchase rate increased on three occasions since June 2006 from a low of 7% *per annum*. Thus, when the Regulations were promulgated on 31 May 2006, the maximum interest rate on unsecured credit transactions would have been 35,4% per year: (Repurchase Rate of 7% x 2.2) + 20% = 35,4%. In the current economic climate of increasing interest rates, the maximum interest rate on unsecured credit transactions is likely to increase further in the near future.

<sup>155</sup> Section 8(4)(d). For purposes of maximum interest rates and fees in regs 42(1) and 43(1), a secured loan falls under the category “other credit agreements”.

<sup>156</sup> Section 8(3).

<sup>157</sup> Reg 42(1), Table A. This rate is calculated by applying the following formula: [Repurchase rate (currently 8,5% *per annum*) x 2.2] + 10% per year.

<sup>158</sup> The comparison of only the interest rates of the three categories of loans discussed does not provide a true reflection of the relative cost of credit of these three categories of loans. A proper comparison is achieved only once the initiation and service fees have been added.

<sup>159</sup> GN 1100, *Government Gazette* 26809, 17 September 2004.

<sup>160</sup> Reg 42(2). The same maximum initiation fee is provided for credit facilities and other credit agreements, which include credit card and cheque accounts and secured bank loans. It is interesting to note, as in the case of maximum interest rates, that reg 42 of the Draft National Credit Regulations, published on 20 February 2006, provided lower limits for initiation fees of R150 per credit agreement, plus 5% (as opposed to the final regulated 10%) of the amount of the credit agreement in excess of R1000, but never to exceed R500 (in the case of unsecured credit transactions) and R350 (in the case of “short-term loans”) – as opposed to the final regulated R1 000.

<sup>161</sup> This apparent contradiction would have been cured had regulation 42(2) stated that the maximum initiation fees set out therein are subject to the limit imposed by regulation 43(3). The Regulations should therefore be amended accordingly.

therein are subject to the limit imposed by regulation 43(3). The Regulations should therefore be amended accordingly. The Act, however, states that the initiation fee “may not exceed the prescribed amount relative to the principal debt”.<sup>162</sup> It therefore seems to be clear that regulation 43(3) must limit the maximum initiation fees permitted by regulation 42(2) on loans less than R1 000. Examples of the calculation of initiation fees for different size loans are given in Table M below in order to demonstrate the effect of the regulation 42(2) and regulation 43(3) limits.

**Table M: Initiation fees for different size loans**

Loan amount	Initiation fee	Initiation fee as a percentage of loan amount	Method of calculation
R200	R30	15%	15% of R200 [reg 43(3)]
R500	R75	15%	15% of R500
R1 000	R150	15%	15% of R1000, or R150 maximum [reg 42(2)]
R2 000	R250	12,5%	R150 + R100 (10% of R1000, which is the amount in excess of R1000) [reg 42(2)]
R5 000	R550	11%	R150 + R400 (10% of R4000, which is the amount in excess of R1000)
R8 000	R850	10,6%	R150 + R700 (10% of R7000, which is the amount in excess of R1000)
R9 500	R1 000	10,5%	R150 + R850 (10% of R8500, which is the amount in excess of R1000)
Loans greater than R9 500	R1 000	Less than 10,5%	The maximum limit [reg 42(2)]

The cost of the initiation fee will therefore be a maximum of 15% of the loan amount on loans up to R1 000, and between 15% and 10,5% of the loan amount on loans between R1 000 and R9 500.

### 6.3.3 The cost of the service fee

Regulation 44 provides that “[t]he maximum monthly service fee, prescribed in terms of section 105(1) of the Act, is R50”.<sup>163</sup> If the service fee is paid annually, the maximum permissible fee is R600.<sup>164</sup> Where a once-off fee is paid on a transaction basis or for a loan period which is not exactly one month or one year, the total service fee may not exceed a *pro rata* share of the monthly or annual limit.<sup>165</sup>

<sup>162</sup> Section 101(1)(b)(i). My underlining.

<sup>163</sup> Reg 44.

<sup>164</sup> Reg 44(1).

<sup>165</sup> Reg 44(1) and (2).

The same maximum service fee is applicable “across the board” to all categories of credit agreements,<sup>166</sup> including both short term and unsecured credit transactions, irrespective of their size. The “flat rate” of R50 is not varied according to the size of a loan as occurs in the case of the initiation fee, and the same monthly service fee of R50, for example, may therefore be charged on a loan of R500, R5 000 or R50 000. The effect of the application of the service fee on different size loans is far-reaching, and will be demonstrated when analysing the cost of credit according to the Regulations in 6.4.3 below.

It appears that the service fee was standardised in order to simplify the application of the Act, justifiable on the basis that every loan, no matter what the size, needs to be administered.<sup>167</sup> There is, however, evidence that shows that administration costs in fact do increase with bigger loans, which would call into question the correctness of having the same size service fee for all loans.<sup>168</sup>

The standardised fee is also a result of the Department of Trade and Industry’s overriding pre-occupation with the need for a single piece of legislation that treats all consumer credit transactions and all credit providers “equivalently”.<sup>169</sup> This concern is expressed in one of the purposes of the Act that is necessary to promote consumer protection, namely to ensure “consistent treatment of different credit products and different credit providers”.<sup>170</sup> Once the full impact of the standardised service fee is appreciated,<sup>171</sup> it will be seen that this section 3(b) objective has been achieved at the expense of the “consistent treatment” of consumers. Not only will consumers be treated inconsistently, but such treatment will be so unfair as to discriminate against borrowers of very small loans who are almost invariably from the poorest communities. The purpose of the standardisation of fees in the name of consumer protection is therefore strange, for it is clearly pre-occupied with the equal treatment of credit providers as opposed to consumers.

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<sup>166</sup> The service fee of R50 per month is thus also applicable to credit facilities and other credit agreements, including credit card and cheque accounts and secured bank loans.

<sup>167</sup> See the comments of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>168</sup> See, for example, Hawkins “The cost, volume and allocation of consumer credit in South Africa” para 7.5.

<sup>169</sup> DTI “Policy Framework” para 4.7.

<sup>170</sup> Section 3(b). Conspicuous by its absence from being mentioned in s3(b) is the consumer.

<sup>171</sup> See 6.4.3 and 6.4.4 below.

### 6.3.4 Maximum limits and probable market costs

The prescribed interest rates, initiation fees and service fees are maximum amounts only, and the wish of the Department of Trade and Industry is that competitive market forces should determine the amount of fees that are charged in the money lending market.<sup>172</sup> The Department “hoped that the industry would not jump to the maximum rates”, but “admitted that there was a risk of the industry charging the maximum rates permissible”.<sup>173</sup> Moneylenders are currently accustomed to charging much more for credit, and many will be hard pressed to remain in business once constrained by the new limits which will come into force on 1 June 2007.<sup>174</sup> There therefore seems to be very little reason for most lenders to settle for any amount less than the maximum interest and fees permitted, except perhaps for bigger lenders such as banks which are able to afford to be competitive.<sup>175</sup> However, the Department intends to “monitor the market extremely carefully, and will not hesitate to change the Regulations should the market go for the maximum rates”.<sup>176</sup> It remains to be seen whether or not the Department will in fact do so.

Another danger foreseen by the Department is that credit providers will re-price existing products, resulting in consumers paying higher prices for existing products.<sup>177</sup>

“We’ll be monitoring prices in the market very closely. It is within our powers to adjust the maximum rates permissible quickly, if the need arises. Strictly applied and monitored standardised disclosure of credit terms will allow consumers to compare, whereas right now they can’t.”<sup>178</sup>

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<sup>172</sup> Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>173</sup> See the comments of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>174</sup> In the *Lurama* case it was contended by the applicants that most micro-lenders would not be able to continue to do business profitably should they be restricted to charging interest at approximately 13,75% per month.

<sup>175</sup> For this reason, it is assumed in all the calculations in this chapter that the maximum interest rates and fees will be charged.

<sup>176</sup> See the comments of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>177</sup> Business Report 23 February 2006 “State proposes cap on microlenders’ loan rates” <http://www.businessday.co.za/home.aspx?Page=BD4P1236&MenuItem=BD4P1236> (accessed 23 February 2006).

<sup>178</sup> Ms Astrid Ludin, Deputy Director-General for Consumer and Corporate Regulation at the Department of Trade and Industry, quoted in Business Report 23 February 2006 “State proposes cap on microlenders’ loan rates”.

### 6.3.5 Periodic review of the cost of credit

Regulation 45 provides that the National Credit Regulator must review interest rates and costs at intervals of no more than three years, and advise the Minister of proposed changes. When making such recommendations, the Regulator must consider:

- (a) Ruling interest rates and fees.
- (b) The cost of providing credit.
- (c) The choice available to consumers in particular categories of credit agreements between different products and different credit providers.
- (d) The impact upon access to finance for historically disadvantaged persons, low income persons and communities, and remote, isolated or low density populations and communities.<sup>179</sup>

It is interesting to compare these required considerations on periodic review of interest rates and costs by the Regulator with the factors that the Minister is required to consider when prescribing maximum rates of interest and fees.<sup>180</sup> The majority of the issues to be considered by the Regulator when making recommendations to the Minister<sup>181</sup> are concerned with “[c]onditions prevailing in the credit market, including the cost of credit and the optimal functioning of the consumer credit market”.<sup>182</sup> The majority of factors to be considered by the Minister when making regulations, on the other hand, are concerned with accessibility and fairness of credit extension to low income<sup>183</sup> and otherwise vulnerable<sup>184</sup> consumers. It appears therefore that the onus is primarily on the Minister to ensure fairness and accessibility of credit to poor communities when acting on the recommendations of the Regulator, and it is hoped that the Minister will in future consistently do so.

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<sup>179</sup> Reg 45 read with s13(a) of the Act.

<sup>180</sup> Section 105(2), discussed in 6.2.1 above. These factors will be equally relevant to future regulation by the Minister as they were when prescribed limits were first promulgated by the Minister in 2006.

<sup>181</sup> (a), (b) and (c) above.

<sup>182</sup> Section 105(2)(b).

<sup>183</sup> Section 105(2)(c).

<sup>184</sup> Section 105(2)(a).

## 6.4 An analysis of the new cost of credit

### 6.4.1 A comparison between the current and envisaged cost of credit

It is a useful starting point to compare the nature and cost of current micro-loans exempt from the Usury Act with money loans envisaged in the National Credit Act, which reveals both improvements and shortcomings in the new credit limits. The Usury Act exemption currently provides for a single category of “micro-loans” (usually unsecured, but not by definition), limited by a maximum loan amount of R10 000 and a maximum repayment period of 36 months, charged out at typically 360% per year. Industry practice makes possible a loose distinction between smaller “30-day loans”,<sup>185</sup> sometimes repayable over up to 4 months, and bigger “term loans” of a maximum of R10 000, repayable over up to the maximum 36 months.<sup>186</sup>

The National Credit Act, on the other hand, provides for:

- “Short term” loans (whether secured or unsecured) repayable over 6 months (comparable to the current 30-day loans), but up to a maximum of R8 000 (which is comparable with the current maximum for any loan exempt from the Usury Act), which can be charged out at a maximum of 60% per year and are subject to an initiation fee (maximum 15% of loan amount) and a service fee (maximum R50 per month).
- “Unsecured” loans which have no limit as to size or repayment period (and are therefore not comparable by definition with loans currently exempt from the Usury Act), which can be charged out at a current maximum 38,7% per year and are subject to an initiation fee (maximum 15% of loan amount) and a service fee (maximum R50 per month).

What can be deduced from this comparison? There will be significant changes to the cost of credit and the manner of its calculation, and important positive and negative consequences for consumer protection in general. Four important points will be considered.

- (a) Most importantly, there will be a considerable reduction in industry interest rates from the current typical 360% per year to 60% or 38,7% per year, representing a decrease of some 83% to 89%. This decrease is significant,

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<sup>185</sup> The average size of 30-day loans was R500 per month in 2000 (Ebony “DTI Interest Rate Study” 26).

<sup>186</sup> See 5.3.1 and 5.3.2 above.

and will provide welcome relief to borrowers. The implications of this reduction, however, cannot be considered in isolation, and will be thoroughly analysed in the context of the total cost of credit in 6.4.5 below.<sup>187</sup>

- (b) The introduction of the initiation fee and the service fee for the first time into South African consumer credit law will markedly increase the cost of credit in the industry above the new interest limits.<sup>188</sup>
- (c) The maximum size of short-term loans (which will accommodate the market for 30-day loans) is R8 000, which is considerably higher than the prevailing average 30-day loan of R500,<sup>189</sup> and is therefore inconsistent with current practice. Ebony Consulting International's interest rate study reports that the average size loan is low "as it takes into very strict consideration the capacity of the borrower to repay at the end of the month".<sup>190</sup> Consumers could be tempted to take out much larger (up to R8 000) 30-day or very short-term loans that they can ill afford to do, at a high interest rate of 60% per year. The cost implications of such loans will be demonstrated in Table P below.<sup>191</sup>

Further, consumers could be drawn into agreeing to repay large monthly instalments within 6 months on bigger short-term loans of up to R8 000 at 60% per year. The wiser choice for the consumer would be to take out an unsecured loan, repayable by way of much smaller instalments over a longer period, and subject to a lower maximum interest rate. This problem is compounded by the fact that many lenders could choose to charge only the higher 60% per year on every loan, which will be much more profitable for them, by simply not offering loans in excess of R8 000 repayable over more than 6 months, which of course the law does not oblige them to do. The solution to all these difficulties lies clearly in reducing the maximum size of short-term loans considerably.<sup>192</sup>

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<sup>187</sup> This apparent huge reduction is much diminished, however, when one adds the cost of the additional initiation and service fees.

<sup>188</sup> See 6.4.2 and 6.4.3 below.

<sup>189</sup> Ebony "DTI Interest Rate Study" 26.

<sup>190</sup> *Ibid.* Whether or not this is the reason for the average size loan being low, this is a helpful statistic, and there is no doubt that bigger 30-day loans will be extremely difficult for low income earners to repay.

<sup>191</sup> Table P, example 6 shows that the cost of a one month loan of R5 000 will be 18% per month of the initial loan amount, or R878 per month.

<sup>192</sup> Reg 36 of the Draft National Credit Regulations, published on 20 February 2006, provided for a much lower limit on the principal amount in the case of short-term loans of R5 000 (the whole amount of which was repayable within 4 months). The maximum size of short-term loans could usefully be much lower than even this R5 000 limit.

- (d) Finally, in respect of bigger loans, there has been a change in emphasis from limiting the total size of more expensive loans (currently R10 000) to the requirement that they be unsecured. Lack of security is not a requirement under the current Usury Act exemption, although in practice such exempt loans are almost invariably unsecured. Equally, there will be no limits at all on the size of loans that qualify as unsecured credit transactions and attract interest of up to 38,7% per year. Rather, this will appropriately be left to market forces, since the larger the unsecured loan, the greater will be the risk to lenders of not recovering the loan amount. The overall effect of this is that, whilst unsecured loans of less than R10 000 will be cheaper than the current typical 30% per month, all unsecured loans larger than R10 000 will cost about twice the Usury Act limit of 20% per year, which is the current maximum interest rate for such loans.<sup>193</sup>

#### **6.4.2 The implications of the initiation fee**

The initiation fee will add considerably to the cost of credit. It is limited to a maximum of 15% of the loan amount, which does ensure that initiation fees on small loans will not be way out of proportion to loan amounts.<sup>194</sup> Yet it will nonetheless be extremely onerous for consumers to find the necessary cash to pay the initiation fee up front at a time when they are taking out a loan precisely because they are in need of cash.

Many lenders of different income levels will thus be unable to afford to pay the initiation fee on taking out a loan, particularly in the case of the very poor, and especially those who are borrowing money for consumption purposes.<sup>195</sup> The Act clearly anticipated this possibility, providing that the initiation fee may be paid either on conclusion of the credit agreement or may be charged to the consumer.<sup>196</sup> These people will thus be forced to allow the initiation fee to be capitalised and re-paid in the same number of instalments as the initial loan, subject to the same interest rate as the initial loan.<sup>197</sup> The result will be that the effective monthly cost of credit will increase.<sup>198</sup> The following conclusions can be drawn from the examples used in

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<sup>193</sup> See examples 6, 7 and 8 in Table Q below.

<sup>194</sup> Service fees, by contrast, are limited to a minimum percentage. See Table M above.

<sup>195</sup> 43% of loans were utilised for consumption purposes in 2003 (see Table F in Chapter Five above).

<sup>196</sup> Section 1. Definition of initiation fee.

<sup>197</sup> See the comments of Dr Nkem-Abonta in Trade and Industry Portfolio Committee (24 March 2005) "National Credit Regulations: briefing". It is also possible that the initiation fee could be regarded as a separate short term or unsecured loan, attracting interest at the prescribed rate and subject to the standard service fee of R50 per month permitted by the Act. This possibility is not excluded by the Act.

<sup>198</sup> The extent of this increase will be shown when analysing the total cost of credit in Tables P and Q.

these tables: on short-term loans, the initiation fee will contribute between 28%<sup>199</sup> and 105%<sup>200</sup> to the total cost of credit, whereas on unsecured credit transactions, the initiation fee will contribute between 4%<sup>201</sup> and 22%<sup>202</sup> – much less than short-term loans. In general, initiation fees are smallest relative to the total cost of credit in the case of the larger loans, where they appear to function optimally, and bigger in the case of smaller loans, where they are out of proportion to the total cost of credit.

As stated earlier,<sup>203</sup> it is unclear exactly what costs the initiation fee is intended to cover and for what reason the initiation fee has been introduced at all. The purpose of the initiation fee appears to be to cover disbursements incurred by the credit grantor, rather than to allow the credit grantor to earn a fee that can be pocketed in the form of profit.<sup>204</sup> This being so, it is strange that it is called a “fee”, which is a term widely associated with compensation for services delivered, as opposed to disbursements incurred. Second, disbursements such as credit checks, mortgage bond costs and evaluation costs would surely be more accurately charged if the actual cost of the disbursement were charged, rather than an arbitrary maximum initiation fee. Third, what justification is there for permitting widely differing maximum initiation fees on different size money loans<sup>205</sup> when the disbursements for different size loans will surely be similar? Fourth, the disbursements incurred in respect of a money loan are likely to be minimal when compared to, for example, a mortgage agreement.<sup>206</sup> There would seem to be little justification for charging, for example, an initiation fee of R550 for a money loan of R5 000<sup>207</sup> if it is intended to cover disbursements only, because it is highly unlikely that such disbursements would ever amount to anything close to R550.

If the initiation fee is not to cover disbursements only, then it has to be compensating the credit grantor with a profitable fee for services rendered in initiating the loan. However, what justification could there be for such compensation, when the lender is already earning interest on the loan and charging a monthly service fee? Because the actual cost of disbursements is limited, it seems clear that at least part of the

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<sup>199</sup> Table P, Example 3 – a loan of R500 repayable over 4 months.

<sup>200</sup> Table P, Example 2 – a loan of R500 repayable over 1 month.

<sup>201</sup> Table Q, Example 8 – a loan of R30 000 repayable over 48 months.

<sup>202</sup> Table Q, Example 3 – a loan of R1 638 repayable over 12 months.

<sup>203</sup> 6.2.3 above.

<sup>204</sup> See the comments of Ms Fontes of the Micro-finance Regulatory Council in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>205</sup> Maximum initiation fees will, for example, range from R150 (in the case of a loan of R1 000) to R1000 (in the case of a loan of R9500 or more) – see Table M above.

<sup>206</sup> Such disbursements could conceivably include the cost of credit checks (if any), photocopying, stationery and telephone calls.

<sup>207</sup> See Table M above.

initiation fee will contribute to the compensation of lenders in the form of a profitable fee. If this is so, then it appears that the initiation fee is designed as a method (alongside interest and the service fee) of contributing to the total cost of credit. It will help to keep interest rates lower, arguably to make credit look cheaper, when in fact such credit may not be cheaper.<sup>208</sup>

The actual purpose of the initiation fee remains obscure, and must be satisfactorily explained. If its existence cannot be justified, then it should be removed altogether, or at least implemented with closer reference to actual disbursements incurred, which would introduce its own administrative difficulties. Whatever the purpose of the initiation fee, however, what is certain is that it will markedly increase the cost of credit for the consumer.<sup>209</sup>

### 6.4.3 The implications of the service fee

The effect of the application of the service fee at the flat rate of R50 per month on different size loans is shown as a percentage of the loan amount in Table N below.

**Table N: The effective cost of the service fee on different size loans**

Loan amount	Monthly service fee	Monthly cost of service fee relative to loan amount (% of loan amount per month)	Annual cost of service fee relative to loan amount (% of loan amount per year)
R200	R50	25% per month	300% per year
R500	R50	10% per month	120% per year
R1 000	R50	5% per month	60% per year
R5 000	R50	1% per month	12% per year
R10 000	R50	0,5% per month	6% per year

The smaller the loan amount, the more expensive will be the service fee relative to the loan amount. When this cost is reflected as a percentage, it is apparent that the service fee adds significantly to the cost of the loan, increasing exponentially with smaller and smaller loan amounts. The “flat rate” service fee of R50 per month is out of all proportion to the initial loan amount in the case of smaller loans. It will be

<sup>208</sup> For a full explanation in this regard, see 6.4.4 below.

<sup>209</sup> See 6.4.5 below for a demonstration of the extent of this cost.

exorbitant in the case of very small loans of less than R500 (a cost of 10% per month and more, increasing exponentially), unduly onerous in the case of small loans of between R500 and R1 000 (a cost of between 10% and 5% per month), and is still too high in the case of loans up to R5 000 (between 5% and 1% per month).

The effective cost of credit on a short term loan of R1 000, for example, will be 10% per month, which is double the maximum interest rate of 5% per month<sup>210</sup> after the service fee of R50, or 5% per month, is added. The effective cost of credit on a short term loan of R500 (the average size 30-day loan)<sup>211</sup> will be 15% per month, which is three times the maximum interest rate of 5% per month.<sup>212</sup> The effective cost of credit on a short term loan of R200 will be 30% per month, six times the maximum interest rate of 5% per month,<sup>213</sup> which is the same as the common current interest rate on micro-loans, namely 30% per month, or 360% per year, and borrowers will be left no better off than in current practice. If the initiation fee is paid off in monthly instalments, this will further add to the monthly cost of credit.<sup>214</sup>

This surely cannot have been the intention of the Act, and the negative results in respect of small loans must surely outweigh the advantage of simplicity made possible by a standardised service fee.<sup>215</sup> Such small loans are not uncommon,<sup>216</sup> especially amongst poor communities, and once again it will be the poorest, most desperate people, for whom small loans will mean the most relative to their other incomes, who will pay the most and be hardest hit by the cost of credit in terms of the National Credit Act.

This result is in conflict with the intention of the Act, which provides that the service fee “must not exceed the prescribed amount relative to the principal debt”.<sup>217</sup> The purpose of the Act is would seem to be that the amount of the service fee should vary relative to the principal debt, just as in the case of the initiation fee – that is to say, it should be higher for bigger loans, and lower for smaller loans. This purpose is not

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<sup>210</sup> Reg 42(1), Table A.

<sup>211</sup> Ebony “DTI Interest Rate Study” 26.

<sup>212</sup> That is, after the service fee of R50, or 10% per month, is added.

<sup>213</sup> That is, after the service fee of R50, or 25% per month, is added.

<sup>214</sup> The cost of a loan of R200 will then be 46% per month.

<sup>215</sup> See 6.3.3 regarding the justification for a flat rate service fee. A further inequity is that the flat rate service fee does not distinguish, for example, between consumers who use their cheque accounts on a very limited scale and consumers that are much more active in their financial dealings.

<sup>216</sup> The average size of 30-day loans was R500 per month in 2000 (Ebony “DTI Interest Rate Study” 26).

<sup>217</sup> Section 101(1)(c)(iii). My underlining. Exactly the same words are used in s101(1)(b)(i) in regard to the initiation fee.

born out in the Regulations, which may be *ultra vires*,<sup>218</sup> and which should be amended.

To cure this problem, the desired result could easily be achieved by amending the regulations to set the service fee at a percentage of the loan amount, subject to both a minimum and a maximum rand amount. For example, a more equitable service fee could be 1% per month of the initial loan amount, subject to a minimum fee of R10 per month and a maximum fee of R50 per month. These limits would have the result that a service fee of R10 per month would be charged on all loans up to R1 000, a fee of R50 per month on all loans in excess of R5 000, and a *pro rata* amount for loans between R1 000 and R5 000. Although this lower limit may seem very little:

- A service fee of R10 on a loan of R200 will still amount to 5% of the loan amount, causing interest and service fee (without the initiation fee) to be 10% per month of the loan amount (which will still be double the maximum permissible interest).
- A service fee of R10 on a loan of R500 will amount to 2% of the loan amount, causing interest and the service fee to be 7% of the loan amount.

This would appear to be a fairer compromise having regard to the interests of both credit providers and consumers. Credit providers would still be compensated for the administration of every credit agreement, no matter how small the initial transaction, and borrowers of small loans would be protected from exorbitant service fees.

This discussion begs the question whether the service fee is necessary at all on small credit agreements. Why could the interest rate not simply be increased by 1% or another appropriate amount, and the service fee be scrapped altogether? The result of such an approach would be that the amount of these costs would always be in direct proportion to the size of the credit agreement, which is the time-honoured method for calculating interest. The Act itself provides that the service fee “must not exceed the prescribed amount relative to the principal debt”,<sup>219</sup> a provision that seems to have been ignored by the Minister. There can surely be no fairer approach than this for credit provider and consumer alike. Further advantages of such an approach are that the calculation of the cost of credit would be simpler for all parties

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<sup>218</sup> Otto *The National Credit Act Explained* 78.

<sup>219</sup> Section 101(1)(c)(iii).

to understand, and the actual cost of credit would be more evident since it would not be obscured by the service fee.<sup>220</sup>

Rather, the result of the standardised service fee is to maintain the effective cost of credit on very small loans at exorbitant levels which are comparable with those that currently prevail, ensuring that lenders of small amounts (especially 30-day lenders) will be able to continue to do business profitably. A R50 per month service fee on a big loan may not seem like much to a relatively wealthy consumer, but it is enormous for a poor borrower of a small loan. It will usually be the poor, who have little voice in policy-making, who will borrow small amounts and who will pay the most for credit, which appears to have escaped the notice of the Minister. Are such high credit costs justifiable for the reason that they are necessary to keep small lenders in business and thereby ensure continued access to expensive credit for the poor? It would seem not.

For these reasons serious consideration should be given to scrapping the service fee altogether and raising interest rates by an appropriate amount to compensate for the resultant loss of income to lenders.<sup>221</sup>

#### **6.4.4 The danger of masking the total cost of credit**

An issue that has been alluded to already<sup>222</sup> is the concern that the drastic reduction in interest rates will mask or obscure the actual total cost of credit when the initiation and service fees are added. It is possible that these fees could to a large extent remain hidden, with the emphasis being placed on interest rates (which are familiar to consumers) when products are marketed. The first set of credit costs (interest and fees) that were presented to the Minister of Trade and Industry prior to promulgation of the draft Regulations on 20 February 2006 provided for higher interest rates and lower fees, in order “to make expensive credit look expensive”.<sup>223</sup> After a long process and much input from political stakeholders, however, interest rates were lowered and fees increased in the Regulations subsequently promulgated.<sup>224</sup> There is little doubt that this skewing of credit costs away from interest and towards fees, with which consumers will not be familiar, will increase the chances of consumers

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<sup>220</sup> For further discussion in this regard, see 6.4.4 below.

<sup>221</sup> Unless, of course, interest rates are already too high.

<sup>222</sup> See 6.4.2 and 6.4.3 above.

<sup>223</sup> See the comments of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) “National Credit Regulations: briefing”.

<sup>224</sup> *Ibid.*

being misled as to the actual cost of credit and being lured into borrowing money which will end up costing much more than they had initially expected. This result is likely to inhibit disclosure and exacerbate rather than combat over-indebtedness, both of which are important objectives of the Act.<sup>225</sup>

A significant and essential consumer protection measure could be achieved by increasing interest rates relative to fees and decreasing fees relative to interest rates, and still arriving at the same overall cost of credit.<sup>226</sup> This will enable consumers to make a more accurate assessment of the true cost of credit, with no negative impact on the income of lenders.

#### **6.4.5 The combined impact of interest, the initiation fee and the service fee**

##### **6.4.5.1 An illustration of the total cost of credit**

In Tables P and Q below, the total cost of credit is demonstrated in the case of short-term loans and unsecured loans respectively. In each case, a range of appropriate loan amounts and loan periods are assumed, and maximum permissible interest rates, initiation fees and service fees are applied to these amounts.<sup>227</sup> The total cost of credit is reflected in two ways:

- The monthly cost of interest and service fees only, on the assumption that the initiation fee has already been paid on conclusion of the loan.<sup>228</sup>
- The monthly cost of interest, initiation fees and service fees, on the assumption that the initiation fee has been capitalised, i.e. it has been charged to the borrower and is being paid back in the same number of monthly instalments at the same interest rate as the initial loan amount.<sup>229</sup>

Using each of these methods, the total monthly cost of credit is then indicated in rands. Finally, this rand amount is indicated as a monthly percentage of the initial

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<sup>225</sup> Section 3(e)(ii) and s3(g) of the Act respectively.

<sup>226</sup> Assuming of course that the same overall cost of credit is the desired result.

<sup>227</sup> See 6.3.1, 6.3.2 and 6.3.3 for the maximum amounts permissible. It is assumed that the interest, initiation fees and service fees will always be these maximum amounts for the reasons advanced in 6.3.4 above, which also helps to simplify this illustration.

<sup>228</sup> The difficulty with this approach is that the cost born by the borrower of the payment of the initiation fee is not able to be reflected in any way in the total cost of credit.

<sup>229</sup> It is likely that the initiation fee will be charged to the borrower, especially in the case of poorer borrowers, for the reasons given in 6.4.2. This approach is therefore favoured, and is adopted in the analysis of the tables that follows.

loan. This monthly percentage gives the most accurate possible indication of the total cost of credit in each case.

For the sake of simplicity and to allow for useful comparison, only monthly rand and percentage figures are used throughout both tables, in the case of both short-term and unsecured loans. Annualised figures are of course easily able to be calculated by simply multiplying these figures by 12, and have been included in the analysis that follows the tables. It is, however, important not to lose sight of the fact that these are monthly figures only, and that interest rates are traditionally reflected as annual rates. The full extent and impact of high interest rates is often obscured by reflecting them as monthly figures, and the Act saw fit to require that interest “must be expressed in percentage terms as an annual rate”.<sup>230</sup> This requirement is contradicted in Regulation 42(1), which provides that “[t]he interest rate on short term credit transactions and incidental credit transactions must be disclosed as a monthly interest rate”.<sup>231</sup>

It is assumed for the purposes of these calculations that:

- The maximum rates of interest and fees are charged, for the reasons set out in 6.3.4 above.
- The total initiation fee is capitalised i.e. paid off over the same period as the duration of the loan, at the same interest rate (5% per month). If the initiation fee were charged to the consumer as a separate loan, it could attract its own initiation and service fees, which would make the initiation fee more expensive.
- For the purposes of simplicity, interest is charged only on the loan amount,<sup>232</sup> whereas the Regulations allow interest to be charged on unpaid interest and other fees,<sup>233</sup> which would make the total cost of credit more expensive.

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<sup>230</sup> Section 101(1)(d)(i). My underlining.

<sup>231</sup> My underlining.

<sup>232</sup> That is, the calculations are based upon simple interest.

<sup>233</sup> Reg 39(1)(a)(iii) read with reg 40(2).

**Table P: Illustration of the cost of credit in terms of the National Credit Regulations**  
**– short-term loans<sup>234</sup>**

	Amount of initial loan	Duration of loan <sup>235</sup>	Interest (always 5% pm <sup>236</sup> / 60% pa) <sup>237</sup> (R)	Initiation fee, when paid up front (R)	Initiation fee (pm, when paid in instalments) <sup>238</sup> (R)	Service fee (always R50 pm) <sup>239</sup> (%)	Total cost of credit (interest + service fee) <sup>240</sup> R (%)	Total cost of credit (interest + initiation + service fees) <sup>241</sup> R (%)
1	R200	1 month	R10 pm	R30	R32 pm	25% pm	R60 pm	R92 pm
							30% pm	<b>46% pm</b>
2	R500 <sup>242</sup>	1 month	R25 pm	R75	R79 pm	10% pm	R75 pm	R154 pm
							15% pm	<b>31% pm</b>
3	R500	4 months	R25 pm	R75	R21 pm	10% pm	R75 pm	R96 pm
							15% pm	<b>19% pm</b>
4	R1 000	4 months	R50 pm	R150	R42 pm	5% pm	R100 pm	R142 pm
							10% pm	<b>14% pm</b>
5	R1 638 <sup>243</sup>	6 months <sup>244</sup>	R82 pm	R214	R42 pm	3% pm	R132 pm	R174 pm
							8% pm	<b>11% pm</b>
6	R5 000	1 month	R250 pm	R550	R578 pm	1% pm	R378 pm	R878 pm
							6% pm	<b>18% pm</b>
7	R8 000 <sup>245</sup>	6 months	R400 pm	R850	R167 pm	0,6% pm	R450 pm	R617 pm
							6% pm	<b>8% pm</b>

<sup>234</sup> All figures in the tables in Chapter Six are rounded off to the nearest rand or percentage point (or on occasion ½ a percentage point).

<sup>235</sup> Appropriate loan periods for short-term loans of between 1 and 6 months are assumed.

<sup>236</sup> The abbreviation “pm” means “per month” throughout the tables in this chapter.

<sup>237</sup> The abbreviation “pa” means “per annum” throughout the tables in this chapter.

<sup>238</sup> This amount is calculated by applying the formula  $FV = PV(1+it)$  used in Table B of Chapter Five above.

<sup>239</sup> The service fee is expressed as a percentage of the initial loan.

<sup>240</sup> The monthly combined cost of interest and service fee are expressed in rands and as a percentage of the initial loan. It is assumed that the total initiation fee has been paid on payment of the loan.

<sup>241</sup> The monthly combined cost of interest, the initiation fee and the service fee are expressed in rands and as a percentage of the initial loan. It is assumed that the total initiation fee is paid off monthly.

<sup>242</sup> The average size 30-day loan was R500 per month in 2000 (Ebony “DTI Interest Rate Study” 26).

<sup>243</sup> The loan amount of R1 638 has been illustrated since it represents the average size loan for the year ended May 2006 (Micro-finance Regulatory Council “Micro-lending industry overview May 2006 quarter” <http://www.mfrc.co.za/detail.php?s=91>) (accessed 13 October 2006).

<sup>244</sup> The maximum permissible duration of a short term loan.

<sup>245</sup> The maximum permissible short term loan amount.

**Table Q: Illustration of the cost of credit in terms of the National Credit Regulations**

**– unsecured loans<sup>246</sup>**

	Amount of initial loan	Duration of loan <sup>247</sup>	Interest (always 38,7% pa / 3,2% pm) (R)	Initiation fee, when paid up front (R)	Initiation fee (pm, when paid in instalments) (R)	Service fee (always R50 pm) (%)	Total cost of credit (interest + service fee) R (%)	Total cost of credit (interest + initiation + service fees) R (%)
1	R500	6 months	R16 pm	R75	R14 pm	10% pm	R66 pm	R80 pm
							13% pm	<b>16% pm</b>
2	R1 000	12 months	R32 pm	R150	R15 pm	5% pm	R82 pm	R97 pm
							8% pm	<b>10% pm</b>
3	R1 638	12 months	R52 pm	R214	R22 pm	3% pm	R102 pm	R124 pm
							6% pm	<b>7,5% pm</b>
4	R5 000	24 months	R160 pm	R550	R33 pm	1% pm	R210 pm	R243 pm
							4% pm	<b>5% pm</b>
5	R8 000	24 months	R256 pm	R850	R51 pm	0,6% pm	R306 pm	R357 pm
							4% pm	<b>4,5% pm</b>
6	R10 000	36 months	R320 pm	R1000	R46 pm	0,5% pm	R370 pm	R416 pm
							4% pm	<b>4% pm</b>
7	R20 000	36 months	R640 pm	R1000	R46 pm	0,25% pm	R690 pm	R736 pm
							3% pm	<b>3,5% pm</b>
8	R30 000	48 months	R960pm	R1000	R40 pm	0,2% pm	R1010pm	R1050 pm
							3% pm	<b>3% pm</b>

**6.4.5.2 A review of the illustration of the cost of credit by way of selected examples<sup>248</sup>**

(a) A loan of R200:

A one month loan of R200<sup>249</sup> will cost 46% of the initial loan amount (equivalent to 552% per year), amounting to R92 (R10 interest + R32 initiation fee + R50 service fee). Thus on a loan of R200, the sum of R292 will have to be repaid at the end of a month. The total cost of this loan will therefore be approximately:

<sup>246</sup> Table Q is very similar to Table P to allow for comparisons to be made. Thus, unless otherwise indicated in the footnotes to this table, all footnotes to Table P above are equally relevant to Table Q.

<sup>247</sup> Appropriate loan periods of between 6 and 48 months are assumed.

<sup>248</sup> It is assumed for the purposes of this review that the initiation fee will be charged to the borrower for the reasons given in 6.4.2 above.

<sup>249</sup> Table P, Example 1.

- Nine times more than the maximum interest rate of 5% per month in terms of the National Credit Act.
- 50% more than the typical cost of a 30-day loan exempt from the Usury Act (30% per month).

(b) A loan of R500:

A one month loan of R500<sup>250</sup> will cost 31% per month (equivalent to 372% per year) of the initial loan amount, amounting to R154 (R25 interest + R79 initiation fee + R50 service fee). The total cost of this loan will therefore be approximately:

- Six times more than the maximum interest rate of 5% per month in terms of the National Credit Act.
- A little more than the typical cost of a 30-day loan exempt from the Usury Act (30% per month).

A loan of R500 repayable over 4 months<sup>251</sup> will cost 19% per month (equivalent to 228% per year) of the initial loan amount, amounting to R96 per month. When R500 is repaid over 6 months at the lower maximum interest rate,<sup>252</sup> it will still cost a considerable 16% per month (equivalent to 192% per year) of the loan amount (R80 per month), which is five times the maximum interest rate of 3,2% per month.

(c) A loan of R1 638.<sup>253</sup>

A short term loan of R1 638 repayable over 6 months<sup>254</sup> will cost 11% per month (equivalent to 132% per year) of the initial loan amount, amounting to R174 per month. This loan will therefore cost:

- More than double the maximum interest rate of 5% per month in terms of the National Credit Act.
- More than one third of the typical 30% per month for loans exempt from the Usury Act.

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<sup>250</sup> Table P, Example 2.

<sup>251</sup> Table P, Example 3.

<sup>252</sup> Table Q, Example 1.

<sup>253</sup> As indicated in Table P, R1 638 is the average size loan for the year ended May 2006 (Micro-finance Regulatory Council "Micro-lending industry overview May 2006 quarter").

<sup>254</sup> Table P, Example 5.

When repaid over 12 months at the lower maximum interest rate,<sup>255</sup> a loan of R1 638 will cost 7,5% per month (90% per year) of the initial loan amount, amounting to R124 per month.

(d) A loan of R8 000:

A loan of R8 000 repayable over 6 months<sup>256</sup> will cost 8% per month (equivalent to 96% per year) of the initial loan amount, amounting to R617 per month. This loan will therefore cost:

- Nearly double the maximum interest rate of 5% per month in terms of the National Credit Act.
- Less than one third of the typical 30% per month for loans exempt from the Usury Act.
- Nearly five times the current Usury Act maximum rate.<sup>257</sup>
- Over 50% more than the envisaged maximum cost of credit for a secured bank loan of R8 000 in terms of the National Credit Act.<sup>258</sup>

When repaid over 24 months at the lower maximum interest rate,<sup>259</sup> a loan of R8 000 will cost 4,5% per month (54% per year) of the initial loan amount, amounting to R357 per month.

(e) A loan of R20 000:

A loan of R20 000 repayable over 36 months at the lower maximum interest rate<sup>260</sup> will cost 3,5% per month (equivalent to 42% per year) of the initial loan amount, amounting to R736 per month. This loan will therefore cost:

- Only a little more than the maximum interest rate of 38,7% per year in terms of the National Credit Act.
- Approximately 2 ½ times the current Usury Act maximum rate for such a loan of 17% per year.

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<sup>255</sup> Table Q, Example 3.

<sup>256</sup> Table P, Example 7.

<sup>257</sup> The Usury Act maximum interest rate is 20% per annum for loans less than R10 000, and 17% per annum for loans greater than R10 000 (GN 1100, *Government Gazette* 26809, 17 September 2004).

<sup>258</sup> The envisaged maximum cost of credit on a secured bank loan of R8 000, repayable over 6 months, will be 60% *per annum*, obtained by adding to the maximum interest rate of 28,7% *per annum* the annualised monthly initiation fee (R167 per month, which is 24% *per annum* of R8 000) and service fees (R50 per month, which is 7,5% *per annum* of R8 000) for the loan period concerned.

<sup>259</sup> Table Q, Example 5.

<sup>260</sup> Table Q, Example 7.

- Not much more than the envisaged maximum cost of credit for a secured bank loan of R20 000 in terms of the National Credit Act.<sup>261</sup>

#### 6.4.5.3 Deductions from the illustration of the total cost of credit

Based on the figures in Tables P and Q and their review above, the following deductions can be made regarding the envisaged cost of credit:<sup>262</sup>

- (a) The smaller the loan, the more expensive it will be. On short-term loans, for example, the total cost of credit is not 5% per month (the maximum interest rate), but 8% per month (96% per year) on a loan of R8 000. This cost rises steadily to 11% per month (132% per year) on a loan of R1 638. Thereafter, the cost of credit rises first steeply, then exponentially to the exorbitant level of 46% per month (552% per year) on a one month loan of R200.
- (b) Although big unsecured loans will be expensive when compared to the current Usury Act maximum,<sup>263</sup> this is not a helpful comparison since loans in excess of R10 000 which are bound by the Usury Act are almost invariably secured.<sup>264</sup>
- (c) The capping of interest rates on smaller loans currently exempt from the Usury Act (a maximum loan of R10 000) will markedly reduce the cost of credit on loans in excess of about R1 000 from the common 30% per month. The cost of credit will be less than one third of this 30% in the case of loans over R5 000,<sup>265</sup> and less than one half of this 30% in the case of loans over R1 000.<sup>266</sup> When these costs are annualised and compared with the Usury Act maximum rate,<sup>267</sup> however, it becomes clear that they are still far too high, despite these reductions.<sup>268</sup>

<sup>261</sup> The envisaged maximum cost of credit on a secured bank loan of R20 000, repayable over 36 months, will be 34,7% *per annum*. The calculation used is the same as in 6.4.5.2 (d) above.

<sup>262</sup> The figures indicated below are estimates only based upon the figures in the tables for purposes of illustration, and do not purport to be 100% accurate.

<sup>263</sup> Some 42% in the case of a loan of R20 000, and some 36% in the case of a loan of R30 000, compared to 17% *per annum* in the case of loans in excess of R10 000.

<sup>264</sup> DTI "Policy Framework" paras 3.4-3.11.

<sup>265</sup> Table P, Example 6, and Table Q, Example 4.

<sup>266</sup> Table P, Example 4, and Table Q, Example 2.

<sup>267</sup> 20% per year for loans less than R10 000.

<sup>268</sup> The cost of a R1 000 loan will be 168% per year, and the cost of a R5 000 loan will be 108% per year (Table P, Examples 4 and 6).

- (d) The impact of the capping of interest rates on loans between R1 000 and R500 will be minimal. The cost of credit will remain excessive, becoming exorbitant the smaller the loan.<sup>269</sup>
- (e) There will be a negative impact on loans of R500 and less, and credit will become more expensive than the already exorbitant current 30% per month. A loan of R500 will cost 31% per month,<sup>270</sup> and a loan of R200 will cost 46% per month, which is over 50% more than the former 30%.<sup>271</sup>
- (f) One month loans will be much more expensive than other short-term loans. If R500 were to remain the average size of a one month loan,<sup>272</sup> then 31% per month (372% per year) will be the average cost of credit on one month loans, and borrowers will be no better off than they currently are. Even if the average size one month loans were to rise to R1 000 by 2007, then 25% per month (300% per year) will be the average cost of credit on one month loans, which is not much lower. The cost of a one month loan of R5 000 is still 18% per month (216% per year), and the cost of a one month loan of R8 000 is nearly 17% per month (204% per year),<sup>273</sup> which is excessive.
- (g) For smaller loans of less than about R8 000, the positive impact of capped interest rates will to a large extent be negated by the high maximum initiation and service fees.<sup>274</sup> This is most marked in the case of the smallest loans: on a one month loan of R500,<sup>275</sup> for example, the monthly interest (R25) will be only 16% of the total cost of credit (R154).<sup>276</sup> On a one month loan of R8 000 the monthly interest (R400) will be only 30% of the total credit cost (R1 342).

For bigger loans the converse occurs, and this is where the initiation and service fees work optimally: on a 36 month loan of R20 000,<sup>277</sup> for example,

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<sup>269</sup> Loans between R1000 and R500 will cost between 14% and 31% per month of the initial loan amount.

<sup>270</sup> Table P, Example 2.

<sup>271</sup> Table P, Example 1.

<sup>272</sup> Ebony "DTI Interest Rate Study" 26.

<sup>273</sup> Interest at 5% per month (R400) + initiation fee at R850 + 5% interest (R892) + service fee (R50) = total monthly cost of credit (R1 342, or 16,8% per month of initial loan of R8 000).

<sup>274</sup> Conversely, the negative impact on borrowers of the service fee and initiation fee is obscured by the interest rate cap.

<sup>275</sup> See Table P, Example 2.

<sup>276</sup> On a one month loan of R200, the monthly interest (R10) is only 11% of the total cost of credit (R92). See Table P, Example 1.

<sup>277</sup> See Table P, Example 2.

the interest of 38,7% *per annum* is 92% of the total cost of credit of 42% *per annum*.

- (h) The impact of the initiation and service fees on smaller loans amounts to a skewing of the cost of credit away from interest and towards these fees, so that interest decreases relative to these fees. This skewing has the dangerous effect of masking the true cost of credit from the consumer for the reasons set out in 6.4.4 above, and thereby misleading the consumer. Further, it will inhibit the Act's objectives of promoting disclosure and combating over-indebtedness.<sup>278</sup>

## **6.4.6 The socio-economic impact of the new cost of credit**

### **6.4.6.1 Policy, regulation and practical results**

From the deductions above, it is apparent that the new structure for costing of credit will work best for the biggest loans in excess of R8 000.<sup>279</sup> This is so clearly evident that it appears to have been designed for such loans. For loans between R1 000 and R8 000, the interest and initiation fees will cause the cost of credit to be far too high. As for small loans of less than R1 000,<sup>280</sup> it is possible that the Minister may have overlooked the resultant exorbitant cost of credit. If this result was intended, then it would seem that the Minister more or less wishes to maintain the *status quo* regarding the cost of credit for such loans. It is a matter for speculation as to why he might have done so. The intention of the Department of Trade and Industry in regard to the cost of credit was "to make credit as cheap as possible and at the same time allow lenders to make a living".<sup>281</sup> In the case of small loans of less than R1 000, it is clear that the Minister has erred in favour of the latter at the expense of the former. Such lenders will be able to continue to charge an effective cost in the region of the current 30% per month (360% per year), ranging from 14% per month (168% per year) on loans of R1 000 to 46% per month (552% per year) on loans of R200. We are therefore likely to see a continuation of "two credit markets" in the money lending sector which was identified by the Department of Trade and Industry and which the Department sought to combat: one market for middle and high-income borrowers benefiting from cheaper credit; the other market for low income borrowers paying

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<sup>278</sup> See 6.4.4 and s3(g) and s3(e)(ii) of the Act.

<sup>279</sup> See 6.4.5.3 (g) above.

<sup>280</sup> In particular one month loans.

<sup>281</sup> See the comments of Dr J Erasmus, Legal Drafter in the Department of Trade and Industry, in Trade and Industry Portfolio Committee (24 March 2005) "National Credit Regulations: briefing".

excessive, and frequently exorbitant, prices for credit.<sup>282</sup> From the practical results of applying the regulated limits on the cost of credit to smaller loans, it seems clear that the Department's stated policy has not been implemented.

The excessive cost of small loans will of course have dire consequences for borrowers. These have already been thoroughly canvassed in Chapter Five above, and the issues raised need not be repeated here.<sup>283</sup> These costs will continue to have a negative socio-economic impact on individuals and poor communities alike, as is the case with loans currently exempt from the Usury Act. The new cost of credit will also impact negatively on borrowers of short-term loans of between R1 000 and R8 000, but to a lesser extent.

#### **6.4.6.2 Impact on individual consumers**

The impact of the new credit costs on individual consumers is demonstrated in Table R below by way of examples of various loan sizes, repayment periods and consumer incomes.<sup>284</sup> The assumed figures upon which this analysis is based are explained in the footnotes to the table below.

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<sup>282</sup> DTI "Policy framework" paras 2.1-2.6. See also 5.1 above.

<sup>283</sup> Such issues include, for example, the implications of consumption finance (5.4 above) and consumer ignorance and illiteracy (5.5 above).

<sup>284</sup> This table is similar to Table B of Chapter Five.

**Table R: Sample survey of variable short term loan sizes and repayment periods at the new cost of credit,<sup>285</sup> viewed against monthly income<sup>286</sup>**

	A	B	C	D	E	F	G	H
	Amount of loan	Period of repayment <sup>287</sup>	Instalment per month <sup>288</sup>	Monthly wage / pension of borrower <sup>289</sup>	Percentage (%) of income available for all other expenses (after loan repayment)	Total interest and fees paid during loan period <sup>290</sup>	Percentage (%) of total income utilised to pay interest and fees during loan period	Percentage (%) of total amount repaid which is utilised to pay interest and fees
1	R200	1 month	R292	R820 <sup>291</sup>	64%	R92 <sup>292</sup>	11%	32%
2	R500	1 month	R654	R820	20%	R154 <sup>293</sup>	19%	24%
3	R500	6 months	R193	R1 000	81%	R659	11%	57%
4	R1 000	1 month	R1 257	R2 000	37%	R257	13%	21%
5	R1 000	6 months	R338	R3 000	89%	R1 032	6%	51%
6	R1 000	12 months	R147	R4 000	96%	R761	2%	43%
7	R1 638	6 months	R387	R2 000	81%	R685	6%	29%
8	R1 638	12 months	R217	R4 000	95%	R970	2%	37%
9	R5 000	6 months	R1 081	R2 000	46%	R1 489	12%	23%
10	R5 000	24 months	R362	R3 000	88%	R3 696	5%	43%
11	R8 000	6 months	R1 730	R4 000	57%	R2 383	10%	23%
12	R8 000	24 months	R579	R5 000	88%	R5 914	5%	43%

<sup>285</sup> It is assumed that the maximum permissible interest rate is charged for the reasons given in 6.3.4 above.

<sup>286</sup> Simple interest is assumed, that is interest on the capital only, not compound interest, which includes interest on interest. This is done in order to make the calculations simpler. If interest were to be compounded, the cost of credit would be higher. Reg 39(1) read with reg 40(2) allows interest to be charged on unpaid interest and all other costs.

<sup>287</sup> A spread of repayment periods is assumed in the examples, with the emphasis being on short-term loans of 1 or 6 months, charged at a maximum 5% per month (60% per year). Several longer term "unsecured" loans are included, which can be charged at the lower current interest rate of 38,7% per year.

<sup>288</sup> The monthly instalments are calculated by adopting the following formula:  $FV = PV(1+it)$  (FV = future value; PV = present value; i = interest rate; t = time). The present value is the loan amount plus the initiation fee, which is assumed to be capitalised, and the standard service fee of R50 is then added.

<sup>289</sup> The bulk of the client base of micro-lenders earned between R2 000 and R4 000 per month in 2003, and it is for this reason that figures in this vicinity have been assumed for the incomes of borrowers in column D of the table [MFRC Submission to the Portfolio Committee on Indebtedness dated 17 June 2003 (Appendix para 5.1)].

<sup>290</sup> This amount is calculated as follows: instalment per month x number of months, less loan amount.

<sup>291</sup> This amount equates to the current monthly old age state pension.

<sup>292</sup> See Example 1 of Table P above.

<sup>293</sup> See Example 2 of Table P above.

The following deductions can be made from Table R:

- (a) Many very low income earners (eg pensioners) borrowing relatively small amounts will remain vulnerable, as they already are under the Usury Act exemption.<sup>294</sup> The borrowers in examples 2 and 4 will have available only 20% and 37% respectively of their income to pay for all their other expenses (Column E). The result of having taken out this loan will be that they have only a small percentage of their original low income to live on.
- (b) Between 10% and 19% of borrowers' total income is used to service the loan in question – that is to say, to pay interest and fees during the loan period – in 6 of the 8 examples of short-term loans (Column G). The impact of the cost of credit on the personal incomes of borrowers is lower than the impact on borrowers under the Usury Act exemption,<sup>295</sup> but is nonetheless still alarming.
- (c) Between 21% and 57% of the total repayments made are utilised towards the payment of interest and fees (Column H). These figures are much lower than the same figures in relation to loans under the Usury Act exemption when the cost of credit is 30% per month on all loans,<sup>296</sup> but again are still considerable.

#### **6.4.6.3 One-month loans and the debt spiral**

Tables P and R above show that one month loans are much more expensive than other short-term loans. Thus, on a loan of R200, R292 will have to be repaid at the end of a month,<sup>297</sup> and on a loan of R1 000, R1 257 will have to be repaid at the end of a month.<sup>298</sup> It is unlikely that many low-income borrowers will be able to afford to pay back such loans,<sup>299</sup> and frequently repeated loans will have to be taken out to fund in full the re-payment of previous loans. This will result in debt spirals and subsequent debt traps, and borrowers will in effect remain permanently indebted. This disastrous phenomenon has been thoroughly discussed in 5.3.1 above, and is equally relevant here.

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<sup>294</sup> See 5.2, Table B, Note (a) above.

<sup>295</sup> See 5.2, Table B, Note (b) above.

<sup>296</sup> See 5.2, Table B, Note (c) above, in which over 73% of total repayments made are utilised towards the payment of interest in most cases.

<sup>297</sup> The cost of credit will be 46% on this loan. See Table P, Example 1 above.

<sup>298</sup> Interest at 5% per month (R50) + initiation fee at R150 + 5% interest (R157) + service fee (R50) = total monthly cost of credit (R257, or 25,7% per month of initial loan of R1000).

<sup>299</sup> Hawkins "The cost, volume and allocation of consumer credit in South Africa" para 4.7.1.

In Table S below the new cost of credit is applied to a number of loan amounts.<sup>300</sup>

**Table S: Illustration of the application of the new cost of credit to one-month loans and resultant debt spiral**

	Month	Loan amount	Cost of credit <sup>301</sup>	Re-payment amount	Income
Example A	1	R200	R92	R292	R820 (old age pension)
	2	R292	R107	R399	
	3	R399	R133	R532	
	4	R532	R161	R693	
	5	R693	R194	R887	
Example B	1	R500	R154	R654	R1 000 (wage)
	2	R654	R186	R840	
	3	R840	R225	1065	
Example C	1	R1 000	R257	R1 257	R2 000 (wage)
	2	R1 257	R311	R1 568	
	3	R1 568	R375	R1 943	

In Example A, by Month 2 the loan repayment is already double the initial loan. By Month 3 the pensioner's loan repayment (R532) amounts to 65% of his monthly pension of R820. By Month 5, the loan repayment (R887) exceeds the pension. In Example B, by Month 3 the loan repayment (R1 065) has already exceeded the worker's wage of R1 000, and the loan repayment in Month 3 in Example C almost exceeds the total wage.

Table S confirms that debt spirals and debt traps will continue to occur on a wide scale when the new cost of credit is applied, and could prove to be one of its greatest dangers.

<sup>300</sup> This table is similar to Table C, Chapter Five above in which the debt spiral was demonstrated in the case of loans currently exempt from the Usury Act.

<sup>301</sup> In each case the cost of credit is calculated as follows: Interest at 5% per month + initiation fee at 15% of loan amount (+5%) + service fee (always R50).

#### **6.4.6.4 Over-indebtedness and poverty**

The vast majority of borrowers of micro-loans are from low income groups,<sup>302</sup> and levels of indebtedness and consumption debt are increasing in the poorest households.<sup>303</sup> Further, the poorest households carry the greatest debt servicing burden.<sup>304</sup> All of this has been discussed at length in Chapter Five in relation to the impact of current interest rates exempt from the Usury Act. The excessive cost of credit on smaller short-term loans in terms of the National Credit Act will ensure that these trends continue, and will contribute to the perpetuation of poverty.

#### **6.4.7 Suggested amendments to the Regulations**

For the reasons set out above, the overall cost of credit is too high for all loans of less than about R5 000, and becomes more and more expensive the smaller the loan.<sup>305</sup> The cost of all short-term loans is too high, once again the more so the smaller the loan.<sup>306</sup> Finally, the costs of the initiation and service fees are far too high relative to interest, negating the gains made in interest rate reduction<sup>307</sup> and masking the true cost of credit.<sup>308</sup> Changes to the credit costing structure should therefore aim to reduce the overall cost of credit on all loans less than R5 000 (especially short-term loans). This can be achieved primarily by significantly reducing the cost of the initiation and service fees, if they are to be retained at all, and reducing the maximum limit on the size of short-term loans. A number of amendments to the regulations that the Minister could adopt are therefore suggested below.

##### **6.4.7.1 Remove or reduce the initiation fee**

The reason for the introduction of the initiation fee is not clear. Its purpose, whether it be to provide compensation for disbursements and/or fees for profit, is obscure and therefore questionable.<sup>309</sup> Unless its purpose can be satisfactorily justified, then it should be removed. It will not be practicable to implement an initiation fee with closer

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<sup>302</sup> MFRC "Submission to the Portfolio Committee on Indebtedness" (Appendix para 5.1).

<sup>303</sup> Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000" 5–9.

<sup>304</sup> According to the Human Sciences Research Council "Household Indebtedness in South Africa in 1995 and 2000" 7–8, 60,2% of regular disposable income of households in the poorest income category (less than R5 000 per year) was used to service debt in 2000.

<sup>305</sup> 6.4.5.3 (a) to (e) above.

<sup>306</sup> 6.4.5.3 (f) above.

<sup>307</sup> 6.4.5.3 (g) above.

<sup>308</sup> 6.4.5.3 (h) above.

<sup>309</sup> See 6.4.2 above.

reference to disbursements incurred, and credit providers could be permitted to charge reasonable disbursements incurred on presentment of an invoice.<sup>310</sup>

If the initiation fee can be justified and must remain for good reason, then it must be reduced considerably. The envisaged initiation fee will make an enormous contribution to the total cost of credit on smaller loans,<sup>311</sup> and is therefore a major factor in maintaining high credit costs. The following reduction is therefore proposed:

(a) The maximum initiation fee on both short term and unsecured credit transactions should be reduced to R50 per credit agreement, plus 5% of the amount in excess of R1 000, but never to exceed R1 000.<sup>312</sup>

(b) The initiation fee may never exceed 5% of the total principal debt (reduced from 15%).<sup>313</sup>

The effect of this proposed reduction is demonstrated in Table T below, which can be compared with Table M above since the same size loan amounts have been used.

**Table T: Effect of proposed lower initiation fees on different size loans**

Loan amount	Initiation fee	Initiation fee as a percentage of loan amount	Method of calculation
R200	R10	5%	5% of R200
R500	R25	5%	5% of R500
R1 000	R50	5%	5% of R1 000
R2 000	R100	5%	R50 + R50 (5% of R1 000, which is the amount in excess of R1 000)
R5 000	R250	5%	R50 + R200 (5% of R4 000, which is the amount in excess of R1 000)
R8 000	R400	5%	R50 + R350 (5% of R7 000, which is the amount in excess of R1 000)
R20 000	R1 000	5%	R50 + R950 (5% of R19 000, which is the amount in excess of R1 000)
Loans greater than R20 000	R1 000	Less than 5%	The maximum limit [reg 42(2)]

<sup>310</sup> The type of disbursements that may be recovered could be listed in the regulations, and should not include minor expenses such as photocopying, telephone calls and stationery. This approach could, however, introduce a degree of uncertainty and the potential for abuse, so a regulated initiation fee may still be necessary.

<sup>311</sup> Between 28% and 105% of the total cost of credit in the case of short-term loans (Table P, Examples 3 and 2).

<sup>312</sup> Compare reg 43(2).

<sup>313</sup> Compare reg 43(3).

#### 6.4.7.2 Remove or reduce the service fee

The “flat rate” service fee of R50 per month on all credit agreements results in the service fee on small loans being way out of proportion to the loan amount, increasingly so the smaller the loan.<sup>314</sup> The service fee is too high for loans less than R5 000, and exorbitant for loans less than R500. Further, there is an enormous disparity between the cost of the service fee relative to bigger loan amounts on the one hand, and the cost of the service fee relative to smaller loan amounts on the other hand.<sup>315</sup> The service fee on a loan of R10 000 will be 0,5% per month of the loan amount, whilst the service fee on a loan of R200 will be 25% per month. This disparity is untenable, being unfair and discriminatory, and having terrible consequences for borrowers of small amounts, who are invariably very poor.

The Act in any event provides that the service fee “must not exceed the prescribed amount relative to the principal debt”.<sup>316</sup> The term “relative” can have no other meaning than that the service fee should be proportionate to the principal debt, which is the foundational principle underlying percentages and interest, and the regulations thus appear to be *ultra vires*. That being so, why should there be a service fee at all which is measured, for example, at 1% of the principal debt? A better approach would be to scrap the service fee altogether on short-term loans, and raise the interest rate by the desired amount, if indeed this is necessary. The resultant advantages would be that the cost of credit would be simpler to understand for both the lender and the borrower, easier to administer, and the actual cost of the debt will not be obscured.

Should it be found necessary to retain the service fee for good reason,<sup>317</sup> then it must be considerably reduced relative to the initial loan amount. In order to combat the disparities referred to above, the regulations could be amended to provide for a service fee at a percentage of the loan amount (eg 1% per month), subject to a minimum fee (eg R10 per month) and a maximum fee (eg R50 per month).<sup>318</sup>

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<sup>314</sup> See Table N above.

<sup>315</sup> *Ibid.*

<sup>316</sup> Section 101(1)(c)(iii).

<sup>317</sup> A good reason for retaining the service fee could be that it is necessary in order to ensure that credit providers are adequately compensated for the smallest loans, even if this will have the result that the cost of servicing a loan relative to the loan amount is somewhat higher in the case of small loans than larger loans.

<sup>318</sup> The practical results of this proposal are set out in 6.4.3 above and Table U below.

#### **6.4.7.3 Lower the maximum size of short-term loans**

The maximum limit on the size of short-term loans (R8 000) is inconsistent with current practice.<sup>319</sup> The average size loan to allow for the “optimal functioning”<sup>320</sup> of the 30-day credit market – considering the capacity of the borrower to repay the loan at the end of the month – was R500 in 2000.<sup>321</sup> Even if this figure were to be doubled in 2007, it would still be way below the R8 000 maximum. It will simply be unaffordable for a borrower to repay R9 360 on a loan of R8 000 at the end of a month or to repay R5 878 on a loan of R5 000.<sup>322</sup> Even if such a loan were repaid over 4 or 6 months, it would still be too expensive.<sup>323</sup>

The maximum limit on the size of short-term loans should therefore be lowered from R8 000 to no more than R5 000, or even as low as R3 000.<sup>324</sup> The result will be that bigger loans will always be subject to the lower interest rate for unsecured loans, the total cost of credit will be lower, and instalments will be more affordable.<sup>325</sup> Further, this will prevent lenders from offering bigger loans on only a short term basis and thereby benefiting from the higher interest rate.

#### **6.4.7.4 Setting appropriate levels for interest rates**

It is beyond the scope of this study to conduct a comprehensive empirical analysis in order to propose definitive figures to achieve a desired result for the cost of credit. Rather, a suitable approach to achieving such a result, which has regard to all the issues raised in this chapter, is suggested below.

The drastic reduction in interest rates in the Regulations will mask or obscure the actual total cost of credit when the initiation and service fees are added.<sup>326</sup> It is therefore essential that these fees be reduced relative to interest rates if they are not to be removed altogether.<sup>327</sup> If the same overall cost of credit is desired, then interest rates can be increased in turn. Lower fees relative to interest rates will ensure that borrowers are not misled as to the true cost of credit.

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<sup>319</sup> See the discussion in 6.4.1(c) above.

<sup>320</sup> Section 105(2)(b).

<sup>321</sup> Ebony “DTI Interest Rate Study” 26.

<sup>322</sup> 6.4.5.2(f).

<sup>323</sup> A loan of R8 000 repayable over 6 months will cost R617 per month.

<sup>324</sup> R3 000 would still be much higher than the average size micro-loan, which is currently R1 638.

<sup>325</sup> See Table U below for an illustration of the cumulative effect of the amendments suggested.

<sup>326</sup> See 6.4.4 above.

<sup>327</sup> This provides another reason for reducing the initiation and service fees.

If the fees are to be removed or reduced, how can suitable interest rates be established? It is not appropriate to address the issue of interest rate levels alone, but rather to do so in the context of the cost of credit as a whole. In order to ensure that an equitable result is achieved, it is necessary to “work backwards”, so to speak: to decide first on the desired total cost of credit for different sizes and types of loans<sup>328</sup> (without overlooking the smallest loans),<sup>329</sup> and then to set appropriate levels of interest and fees, with fees much lower relative to interest than in the Regulations. If, for example, it is decided that the fees must remain, suitable levels for these fees should first be established and then applied to different sizes and types of loans. The difference between the desired total cost of credit and the cost of the initiation and service fees will then give an indication of the level at which interest rates should be set.

This approach can be adopted by applying different suggested figures for interest and fees to tables P and Q above on a “trial-and-error” basis, and testing the resultant total cost of credit against the desired total cost determined at the outset. In order to illustrate this approach and by way of an exercise, the suggested amendments to the regulations proposed above<sup>330</sup> are applied to different sizes and types of loans in Table U below.<sup>331</sup> Having done so, and in order to achieve an equitable total cost of credit, fair interest rates could be set at 4% per month for short-term loans and remain the same as in the Regulations for unsecured loans.<sup>332</sup> The results of applying these interest rates and fees are illustrated in the table.

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<sup>328</sup> The extreme right hand column of Tables P, Q and U (below).

<sup>329</sup> The various skewed results for the total cost of credit according to the Regulations, demonstrated in 6.4.5.3 above, strongly suggest that the Minister did not have regard to the resultant total cost of credit for different sizes and types of loans when establishing levels for interest and fees.

<sup>330</sup> In 6.4.7.1 to 6.4.7.3.

<sup>331</sup> Table U is modelled on Tables P and Q above, and is a combination of both tables.

<sup>332</sup> Reg 42 of the Draft National Credit Regulations, published on 20 February 2006, provided for a lower maximum interest rate on “short-term loans” of 4% per month, or 48% *per annum*. It is not clear why this limit was increased to 5% per month in the final Regulations.

**Table U: Illustration of the application of reduced interest and fees to different loan sizes and types<sup>333</sup>**

	Amount of initial loan	Duration of loan <sup>334</sup>	Interest (4% pm for short-term loans/38,7 % pa for unsecured loans) (R)	Initiation fee, when paid up front <sup>335</sup> (R)	Initiation fee (pm, when paid in instalments) <sup>336</sup> (R)	Service fee <sup>337</sup> (%)	Total cost of credit (interest + service fee) <sup>338</sup> R (%)	Total cost of credit (interest + initiation + service fees) <sup>339</sup> R (%)
1	R200	1 month	R8 pm	R10	R11 pm	R10 pm	R18 pm	R29 pm
							9% pm	<b>14% pm</b>
2	R500	1 month	R20 pm	R25	R26 pm	R10 pm	R30 pm	R56 pm
							6% pm	<b>11% pm</b>
3	R1 000	6 months	R40 pm	R50	R10 pm	R10 pm	R50 pm	R60 pm
							5% pm	<b>6% pm</b>
4	R1 000	12 months	R32 pm	R50	R5 pm	R10 pm	R42 pm	R47 pm
							4% pm	<b>5% pm</b>
5	R5 000 <sup>340</sup>	1 month	R200 pm	R250	R260 pm	R50 pm	R250 pm	R510 pm
							5% pm	<b>10% pm</b>
6	R5 000	12 months	R200 pm	R250	R27 pm	R50 pm	R250 pm	R277 pm
							5% pm	<b>5,5% pm</b>
7	R8 000	24 months	R256 pm	R400	R24 pm	R50 pm	R306 pm	R330 pm
							4% pm	<b>4% pm</b>
8	R10 000	36 months	R322 pm	R500	R24 pm	R50pm	R372 pm	R396 pm
							4% pm	<b>4% pm</b>
9	R20 000	48 months	R645 pm	R1 000	R40 pm	R50 pm	R695 pm	R735 pm
							3,5% pm	<b>4% pm</b>
10	R30 000	48 months	R967 pm	R1 000	R40 pm	R50pm	R1 017 pm	R1 057 pm
							3% pm	<b>3% pm</b>

<sup>333</sup> This table includes short-term and unsecured loans, with the maximum size of short-term loans set at R5 000 (according to the suggestion in 6.4.7.3 above), repayable over 6 months. Fees and interest are reduced according to the suggestions in 6.4.7.1, 6.4.7.2 and 6.4.7.4 above.

<sup>334</sup> Appropriate loan periods for short-term loans (up to R5 000) of between 1 and 6 months and longer term unsecured loans are assumed.

<sup>335</sup> The proposed initiation fee on both short-term and unsecured loans is R50, plus 5% of the amount in excess of R1 000, but never to exceed R1 000 and never to exceed 5% of the principal debt.

<sup>336</sup> In this column it is assumed that the total initiation fee is being paid off over the same period as the duration of the loan, at the same interest rate (4% per month). This amount is calculated by applying the formula  $FV = PV(1+it)$  used in Table B of Chapter Five above.

<sup>337</sup> The service fee is calculated at 1% per month of the loan amount, subject to a minimum fee of R10 and a maximum fee of R50.

<sup>338</sup> The monthly combined cost of interest and service fee are expressed in rands and as a percentage of the initial loan. It is assumed that the total initiation fee has been paid on payment of the loan.

<sup>339</sup> The monthly combined cost of interest, the initiation fee and the service fee are expressed in rands and as a percentage of the initial loan. It is assumed that the total initiation fee is paid off monthly.

<sup>340</sup> The maximum permissible short term loan amount.

In Table V below, the cost of credit in the examples in Table U is compared with the cost of credit for the same examples in terms of the National Credit Regulations.

**Table V: Comparison of the cost of credit in terms of the National Credit Regulations and suggested amendments**

	Amount of initial loan	Duration of loan	Total cost of credit (interest + initiation fee + service fee) in terms of National Credit Regulations (Tables P and Q). R (%)	Total cost of credit (interest + initiation fee + service fee) – in terms of suggestions in Table T. R (%)	Percentage decrease (%)
1	R200	1 month	R92 pm	R29 pm	68%
			46% pm	14% pm	
2	R500	1 month	R154 pm	R56 pm	63%
			31% pm	11% pm	
3	R1 000	6 months	R130 pm	R60 pm	54%
			13% pm	6% pm	
4	R1 000	12 months	R97 pm	R47 pm	51%
			10% pm	5% pm	
5	R5 000	1 month	R878 pm	R510 pm	42%
			18% pm	10% pm	
6	R5 000	12 months	R362 pm	R277 pm	23%
			7,5% pm	5,5% pm	
7	R8 000	24 months	R357 pm	R330 pm	8%
			4,5% pm	4% pm	
8	R10 000	36 months	R396 pm	R396 pm	0%
			4% pm	4% pm	
9	R20 000	48 months	R735 pm	R735 pm	0%
			4% pm	4% pm	
10	R30 000	48 months	R1 057 pm	R1 057 pm	0%
			3% pm	3% pm	

The following deductions can be made from the suggested reduced interest and fees (Table U) and the comparison of the results of these reduced figures with the results for the same examples in terms of the National Credit Regulations (Table V):

- (a) In terms of the suggested changes, the cost of credit on the smallest loans (including one month loans) is substantially reduced, but is still 14% per month in the case of a loan of R200, and 11% per month in the case of a loan of R500. Loans in excess of R10 000 cost 4% per month and less, as is the

case under the Regulations. It is therefore still questionable for reasons of fairness that the smallest loans should be over three times more expensive than the bigger loans, which may need to be given closer attention. It is acknowledged, however, that the nature of the initiation and service fees (assuming, of course, that there are good reasons for them to remain) dictate that every loan, no matter how small, should bear a minimum cost in respect of these fees.<sup>341</sup> Thus, so long as these fees are included, smaller loans will always be more expensive than larger loans. A key question is therefore raised once again by this illustration: should the initiation and service fees remain? One of the most important results of these fees is the disparity between the cost of credit for bigger relative to smaller loans, which it seems the Regulations were designed to achieve.

(b) When comparing the Regulations with the suggested changes in Table V, it is immediately apparent that the biggest decreases in the cost of credit occur in the case of the smallest loans (68% for a loan of R200), with the smallest decreases in the case of loans up to R10 000 (e.g. 8% for a loan of R8000).<sup>342</sup> The cost of credit for loans of R10 000 and more will remain the same. This result has achieved an appropriate partial reversal of the Regulations' exorbitant cost of credit for small loans as opposed to larger loans.

(c) The suggested changes have also achieved a reversal of the skewing of interest rates relative to fees. The interest on a one month loan of R500, for example, amounts to only 16% of the total cost of credit in terms of the Regulations.<sup>343</sup> Interest on the same loan in terms of the suggested amendments amounts to 36% of the total cost of credit.<sup>344</sup> The interest on a 6 month loan of R1 000 amounts to 38% of the total cost of credit in terms of the Regulations,<sup>345</sup> and 67% in terms of the suggested amendments.<sup>346</sup> Increased interest relative to fees will combat the masking of the true cost of

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<sup>341</sup> It is furthermore acknowledged that the cost of smaller, higher risk loans has to be higher than larger loans to compensate for such risk, failing which there will likely be little credit in the form of small loans available at all.

<sup>342</sup> See the right hand column of Table V.

<sup>343</sup> 6.4.5.3 (g) above.

<sup>344</sup> Table U, Example 2. Note that the nature of one-month loans is such that interest will always be low (being for one month only) relative to the initial initiation fee, which will be the same no matter what the duration of the loan.

<sup>345</sup> The interest of R50 per month (5% of R1 000) is 38% of the total cost of credit, which is R130 per month.

<sup>346</sup> Table U, Example 3.

credit from the borrower, and subsequent misleading of the borrower.<sup>347</sup> It will further enhance the Act's objectives of promoting disclosure and combating over-indebtedness.<sup>348</sup>

This exercise has served to demonstrate a suitable approach to determining equitable levels for the total cost of credit on different sizes and types of loans, and could serve as a useful starting point to this end. Further adjustments to the fees and interest rates could be made in order to achieve better results, which could be tested by applying these adjustments to Table U above.

#### **6.4.8 The likely growth of the unregistered sector**

In 5.8 above it was argued that in the new era of the National Credit Act, the unregistered micro-lending sector is likely to grow relative to the registered sector, partly as a result of the legacy of the past 14 years of no interest caps. This section will show that the envisaged growth of the unregistered sector will also be due in part to the financial and administrative constraints of the Act on credit providers, and should therefore be read in tandem with 5.8.

A person must apply to the National Credit Regulator to be registered as a credit provider if that person provides credit in at least 100 credit agreements or the total principal debt on all outstanding debts exceeds the amount of R500 000, an amount prescribed by the Minister.<sup>349</sup> These limits are high, and there are therefore numerous smaller micro-lenders who are not required to register as credit providers, and the Act does not prohibit them from trading as such. They are therefore partially exempt from the Act.

If, however, an unregistered micro-lender at any stage exceeds either of the limits referred to above, then any credit agreement subsequently concluded will be unlawful and subject to the remedies contained in section 89(5).<sup>350</sup> Further, all loans from unregistered lenders will still be subject to the usual limits on the cost of credit in the Act.<sup>351</sup> If these limits are exceeded, the offending provisions will be unlawful and

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<sup>347</sup> 6.4.4 above.

<sup>348</sup> See 6.4.4 and s3(e)(ii) and s3(g) of the Act.

<sup>349</sup> Section 40(1) read with National Credit Act (34/2005): Determination of Thresholds, GN713, 2006, *Government Gazette* 28893, 1 June 2006.

<sup>350</sup> See 6.2.6 above.

<sup>351</sup> A loan made by an unregistered lender falls within the definition of a "credit transaction" in terms of s8(4)(f) of the Act and, as such, it will be either a short term or an unsecured credit transaction and therefore subject to the regulated limits on the cost of credit applicable to such transactions.

subject to the remedies contained in sections 90(3) and 90(4) as read with section 89(5).<sup>352</sup> Importantly, in neither event will the unregistered lender's conduct be an offence, as was the case in terms of the Usury Act, so this will no longer be a deterrent to unlawful trading.<sup>353</sup> The civil remedies do, however, include the possible cancellation or forfeiture to the State of the lender's rights to recover the amount loaned,<sup>354</sup> which is a severe penalty that might well discourage unregistered lenders from acting unlawfully.

Such civil remedies will of course assist only if affected borrowers go to court to protect their rights. In order to do so, affected borrowers will need to know that lenders are acting unlawfully and be able to access and afford legal representation in order to undertake the necessary litigation. It is therefore likely that relatively few unlawful credit agreements or provisions of credit agreements will be brought before the courts.

As explained in 5.8 above, there has for many years existed a large unregistered micro-lending sector, estimated by Ebony Consulting International to be more than one half the size of the registered sector.<sup>355</sup> This informal sector appears to have traded unlawfully for many years with little recourse to the courts, charging very high interest rates. It is very likely that this sector will continue to trade unlawfully<sup>356</sup> – although the civil remedies will be more severe, there will be no criminal sanction. The unregistered sector is furthermore likely to grow relative to the registered sector. With the lower total cost of credit, especially on bigger loans, there will be little incentive for many formerly registered lenders to register. They may choose not to do so, but rather to operate unlawfully, “driven underground” by the Act's limitations on the cost of credit and other administrative burdens and costs.<sup>357</sup> It is therefore possible that low income groups will become more marginalised and driven to illegal credit facilities outside the protection of the Act where they will pay more for credit as

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<sup>352</sup> See 6.2.6 above.

<sup>353</sup> Section 17 of the Usury Act. If the unlawful conduct of an unregistered lender comes to the attention of the National Credit Regulator, however, it may issue a notice to the lender to stop acting unlawfully, and failure to comply with such a notice will constitute an offence (s54).

<sup>354</sup> Section 89(5)(c).

<sup>355</sup> Ebony “DTI Interest Rate Study” 35.

<sup>356</sup> Abedian “Consumer Credit Bill: the debate rages on” (2006) *Leadership* 41 at 42 argues that unregistered lenders will be less likely to make the transition to the registered sector since the lending volumes of the unregistered sector will increase to meet increased demands for credit in this sector.

<sup>357</sup> As argued in 5.8 above, this likely trend will also be attributable to the legacy of no interest caps in the last 14 years.

a result of the formal sector not being willing to give them loans.<sup>358</sup> The Free Market Foundation of Southern Africa had this to say regarding the prospect of interest rate caps:<sup>359</sup>

“Levels of exclusion from access to formal / legal credit under this scenario is as a consequence likely to be systemically increased with a concomitant escalation in illegal credit extension activities. The Bill is therefore likely to reinforce and exacerbate the dual credit market presently in existence.”

This likely growth of the unregistered sector at the expense of the registered sector will be an unfortunate direct consequence of the imposition of limits on the cost of credit, and the Department of Trade and Industry will have to develop mechanisms to control such illegal trade. It is submitted, however, that the need to limit the cost of credit for the reasons explained in this study far outweighs the risk of the growth of the unregistered sector. This is clearly the approach of the legislature and the Department of Trade and Industry too, and is therefore no longer a moot point.

## **6.5 Legal challenges to the high cost of credit on smaller loans**

In 6.4 above a number of problems were identified in the Regulations that cause the cost of credit to be too high on smaller loans, and the socio-economic impact of these high costs was demonstrated. Suggested changes to the Regulations were then proposed, and it is hoped that the Minister will effect the necessary amendments, which would be a relatively simple task.<sup>360</sup> If the Minister fails to do so, however, then aggrieved consumers will have to resort to the courts for legal recourse. A number of possible legal bases for challenging the high cost of credit on smaller loans are discussed below. The first two legal bases<sup>361</sup> concern legal recourse to which a borrower can resort in the case of individual small loans. The second two

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<sup>358</sup> Submission by the Free Market Foundation of Southern Africa to the Portfolio Committee on Trade and Industry regarding the National Credit Bill [B18-2005] (19 August 2005) pg 6 (unpublished). See also Ebony Consulting International “DTI Interest Rate Study” <http://www.mfrc.co.za/detail.php?s=12>.

<sup>359</sup> *Ibid.*

<sup>360</sup> The Department has indicated that it will monitor the market closely, and will change the Regulations should the market go for the maximum interest rates and fees, or should existing products be re-priced. It remains to be seen, however, how willing the Department will be to change the Regulations because of an inherent fault therein, no matter what the market does.

<sup>361</sup> 6.5.1 and 6.5.2 below.

legal bases<sup>362</sup> concern challenges to the Regulations which make possible excessive credit costs on small loans.

### **6.5.1 Application of the *in duplum* rule**

The Act has caused the *in duplum* rule to become an increasingly important mechanism for limiting the cost of credit, provided that consumers and their advisers know about their rights in terms of this rule and take the necessary steps to enforce them. In terms of section 103(5) of the Act, all interest, fees and other costs that accrue during the time that a consumer is in default under a credit agreement may not together exceed the unpaid capital of the principal debt at the time the debt was incurred. Given the high cost of smaller loans, the chances of default will be extremely high, and it will not take long for interest and fees to exceed the unpaid capital. This was clearly demonstrated in 5.7 above with reference to Table B, and the application of the *in duplum* rule to Table R and S above, which contain the new credit costs, will yield a similar result.

### **6.5.2 Common law illegality of the high cost of credit on smaller loans**

The excessive credit costs on small loans may still be able to be challenged by consumers in terms of the common law on a case by case basis, notwithstanding the National Credit Regulations. As is the case in regard to loans exempt from the Usury Act,<sup>363</sup> the residual common law will still be applicable in view of the presumption that a statute alters the common law as little as possible, and the courts will interpret an act as ousting the common law only if this appears clearly from the intention of the legislature.<sup>364</sup> The question then is: was it the intention of the legislature to provide for excessive cost of credit in the case of smaller loans? The background to the Act<sup>365</sup> indicates a contrary intention, namely to combat poverty and the dual economy, and to promote consumer protection through various means, including the capping of the cost of credit.<sup>366</sup> This intention is borne out in the Act,<sup>367</sup> which provides that when the Minister prescribes methods for calculating maximum interest rates and fees, the Minister must consider, *inter alia*, the social impact on low income

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<sup>362</sup> 6.5.3 and 6.5.4 below.

<sup>363</sup> 5.7 above.

<sup>364</sup> Du Plessis *Re-interpretation of Statutes* (2002) 177-178.

<sup>365</sup> The Credit Law Review process, culminating in the Department's Policy Framework for Consumer Credit.

<sup>366</sup> DTI "Policy Framework". See also 6.1.1 above.

<sup>367</sup> Section 3, s101–s106.

consumers.<sup>368</sup> When one considers the exorbitant cost of credit on small loans demonstrated in 6.4 above, it is clear that the Regulations do not accord with the intention of the legislature.

Agreements that are contrary to public policy, as informed by constitutional values, will not be enforced.<sup>369</sup> Public policy has been thoroughly discussed in 2.3 and 5.7.2 above, and need not be repeated here. An argument that the cost of credit on a small loan is excessive and therefore contrary to public policy would have to consider: current industry practice and the purpose of the Act; the combined impact of interest and fees on the total cost of credit; the negative socio-economic impact of the high cost of credit on small loans;<sup>370</sup> and the specific circumstances of the lender, the borrower and other aspects of the case before the court. It is interesting to note that nearly all the issues raised in 5.7.2 above<sup>371</sup> will be relevant to a public policy enquiry regarding the cost of credit in terms of the Act. It therefore appears that a court would be able to declare a very high cost small loan contrary to public policy and unenforceable, even if such loan complies with the cost of credit limits in the Regulations.

The extremely high cost of credit on a small loan could amount to “extortion and oppression akin to fraud”, and the offending clause could be declared usurious and unenforceable.<sup>372</sup> Alternatively, the usurious nature of the offending clause could be pleaded as a ground in support of a claim that a high cost small loan is contrary to public policy. Once again, common law usury has been discussed at length in 3.1 and 5.7.3 above, and need not be repeated here.

The defence to a claim that a provision of a loan agreement is unenforceable due to common law illegality will likely be that the provision is lawful in that it complies with the Regulations, even if they are flawed. A court might then take the view that such a claim cannot be upheld, and that appropriate proceedings would rather be to challenge the flawed Regulations themselves, in which event an aggrieved borrower would need to proceed in terms of 6.5.3 or 6.5.4 below.

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<sup>368</sup> Section 105(2)(c).

<sup>369</sup> Smalberger JA in *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A) 8C-D, read with Cameron JA in *Brisley v Drotsky* 2002 (4) SA 1 (SCA) 34H–35B, and *Napier v Barkhuizen* 2006 (4) SA 1 (SCA) 7A–B.

<sup>370</sup> 6.4.6 above.

<sup>371</sup> These issues are relevant to the question of whether or not a loan exempt from the Usury Act which is charged at the typical 30% per month is contrary to public policy.

<sup>372</sup> *Dyason v Ruthven* 311–312; *Reuter v Yates* 858; *SA Securities Ltd v Greyling* 356.

### 6.5.3 Judicial review of the service fee

The Act requires that the service fee “must not exceed the prescribed amount relative to the principal debt”.<sup>373</sup> The maximum service fee prescribed by the Minister, however, is simply set at R50 per month for every type of credit agreement, irrespective of its size.<sup>374</sup> This fee bears no relation to the principal debt, but is rather simply a fixed amount.<sup>375</sup> As such, it renders the service fee in Regulation 44 *ultra vires*, and it seems that an application to have this provision set aside on review would be successful.<sup>376</sup>

### 6.5.4 Judicial review of various regulations that contribute to the excessive cost of credit

It is possible that a number of offending regulations could be set aside on review on the basis that their combined effect causes the cost of credit on short-term loans to be excessive and, as such, are contrary to the purpose of the legislation.<sup>377</sup> The offending provisions would be: the maximum interest rate and initiation fee in regard to short-term credit transactions only [contained in regulations 42(1) and 42(2)]; the maximum initiation fee and service fee [contained in regulations 43(3) and 44]; the maximum deferred amount of R8 000 in the definition of a short-term credit transaction [contained in regulation 39(2)(a)(i)].

It is beyond the scope of this study to attempt to build a comprehensive case in this regard. Such a case would to a large extent rely on the arguments contained in 6.4 and Chapter Five above. Briefly, in such proceedings one would need to show how the different elements of the cost of credit combine to cause the total cost of credit on small loans to be excessive, pursuing all the arguments set out in 6.4.1 to 6.4.5 above. One would then go on to demonstrate the devastating socio-economic

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<sup>373</sup> Section 101(1)(c)(iii).

<sup>374</sup> Reg 44.

<sup>375</sup> Otto *The National Credit Act Explained* 78.

<sup>376</sup> The procedure for such review proceedings are discussed in further detail in 6.5.5 below.

<sup>377</sup> By launching review proceedings against the Regulations, one would be able to attack only the limits on the interest and fees. The initiation and service fees are introduced in the Act, and an attack on their existence (the justification for which existence has been questioned in 6.4.2 and 6.4.3 above) would necessitate a direct challenge to the constitutionality of the sections of the Act which introduce these fees. Such a challenge would probably be based upon an alleged infringement of the right to equality (s9) and the right to dignity (s10), with a view to having these sections declared unconstitutional in terms of s172(1)(a) of the Constitution. On the available information as to the purpose and desirability of such fees, it would seem that such a challenge would not succeed. In any event, it appears that the problem of the excessive cost of small loans can be cured by amending the Regulations, as has been demonstrated in 6.4.7 and this paragraph, and a review of the offending Regulations would therefore suffice.

impact of excessive credit costs on low-income individuals and communities with reference to the arguments in Chapter Five and 6.4.6 above. The intention of the legislature in regard to the setting of maximum limits on rates of interest and fees would then need to be established, and it would be necessary to show that the legislature's intention is not borne out in the Regulations.

In establishing the intention of the legislature, it would be necessary first to consider the background to the Act<sup>378</sup> and the general purposes of the Act.<sup>379</sup> One would then need to address the cost of credit provisions in Part C of Chapter 5 of the Act in general, before considering the provisions that enable the Minister to prescribe maximum rates of interest and fees for each sub-sector of the consumer credit market.<sup>380</sup> The intention of the Act in regard to the desired levels of the cost of credit is most explicitly set out in section 105(2):

“When prescribing a matter contemplated in subsection (1),<sup>381</sup> the Minister must consider, amongst other things –

- (a) the need to make credit available to persons contemplated in s13(a);<sup>382</sup>
- (b) conditions prevailing in the credit market, including the cost of credit and the optimal functioning of the consumer credit market; and
- (c) the social impact on low income consumers.”

The court would therefore have to test the total cost of credit against these three factors which the legislature requires the Minister to consider. In short, it would be argued that the devastating socio-economic impact of the excessive cost of credit on small loans must lead the court to conclude that the Minister failed to consider “the social impact on low income consumers”, at the expense of the other two factors.

### **6.5.5 The nature of the proposed judicial review proceedings**

The judicial review proceedings referred to in 6.5.3 and 6.5.4 above would be launched in terms of the Promotion of Administrative Justice Act (PAJA),<sup>383</sup> which

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<sup>378</sup> 6.1.1 and 6.5.2 above.

<sup>379</sup> 6.1.2 above.

<sup>380</sup> Section 103(6) and s105.

<sup>381</sup> Section 105(1) empowers the Minister to prescribe a method for calculating a maximum rate of interest and maximum fees applicable to each subsector of the consumer credit market.

<sup>382</sup> These persons are historically disadvantaged persons, low income persons and communities, and remote, isolated or low density populations and communities.

<sup>383</sup> Act 3 of 2000. In *Minister of Health and another NO v New Clicks South Africa (Pty) Ltd and Others (Treatment Action Campaign and Another as Amici Curiae)* 2006 (2) SA 311 (C), five members of the court held that PAJA was applicable to both the recommendations of the Pricing Committee (regarding

was enacted to give effect to section 33 of the Constitution.<sup>384</sup> The Act defines administrative action as any decision<sup>385</sup> taken by an organ of state<sup>386</sup> when, *inter alia*, “exercising a public power or performing a public function in terms of any legislation”.<sup>387</sup> Although the definition of “decision” in section 1 does not specifically include subordinate legislation, “it is clear that the definition ... is not intended to exclude ministerial regulations and proclamations”.<sup>388</sup> The Act would therefore be applicable to a review of the offending provisions of the National Credit Regulations. Review proceedings can be instituted in, *inter alia*, the High Court within whose area of jurisdiction the party whose rights have been affected is domiciled or ordinarily resident.<sup>389</sup>

There are three general grounds for review in administrative law, namely: irrationality, unreasonableness and proportionality. The extent to which they could be applicable to the National Credit Regulations is briefly considered below.

#### 6.5.5.1 Reasons for administrative action

Review proceedings cannot be instituted until the reasons for an administrative action have been provided.<sup>390</sup> Any person whose rights have been “materially and adversely affected”<sup>391</sup> (namely, the applicant in the review proceedings) by administrative action (namely, the prescribing of offending regulations by the Minister of Trade and Industry) may within 90 days of coming to know of the administrative act request that the administrator<sup>392</sup> concerned (namely, the Minister) furnish written reasons for the action.<sup>393</sup> The administrator must, within 90 days of receiving the

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the pricing system for the sale of medicines) and the subsequent making of regulations by the Minister of Health, one member of the court held that PAJA was only partially applicable, whilst the five other members of the court did not find it necessary to decide whether or not PAJA is applicable. Chaskalson CJ concludes at para 118: “Properly construed, therefore, ‘administrative action’ in s33(1) of the Constitution, includes legislative administrative action.”

<sup>384</sup> The Constitution of the Republic of South Africa, 1996. Section 33(3) of the Constitution requires that national legislation be enacted to give effect to the s33 rights to just administrative action.

<sup>385</sup> In s1, “decision” is defined in paragraph (g) as, *inter alia*, “doing or refusing to do any other act or thing of an administrative nature”.

<sup>386</sup> An “organ of state” is defined in s1 as bearing the meaning assigned to it in s239 of the Constitution. Section 239, in turn, defines an organ of state as, *inter alia*, any functionary or institution exercising a public power or performing a public function in terms of any legislation.

<sup>387</sup> Section 1.

<sup>388</sup> Burns and Beukes *Administrative Law under the 1996 Constitution* 3 ed (2006) 131.

<sup>389</sup> Section 1, definition of “court”. This definition extends the common law jurisdiction of the courts with regard to review proceedings, and will make it easier and cheaper for an applicant to launch such a review.

<sup>390</sup> Section 5.

<sup>391</sup> Section 5(1).

<sup>392</sup> An “administrator” is defined in s1 as, *inter alia*, an organ of state.

<sup>393</sup> Section 5(1). This request could be made by addressing a letter to the Minister.

request, give that person adequate reasons in writing for the administrative action.<sup>394</sup> The review must be instituted within 180 days of knowledge of the administrative action.<sup>395</sup> All periods of time mentioned above can be adjusted on application and on good cause shown.<sup>396</sup> Proceedings for review of the relevant regulations will be able to be instituted only after 1 June 2007 when the new limits on the cost of credit become effective, but it is possible that the request for reasons could be made earlier and in anticipation of the coming into force of the regulations.

### 6.5.5.2 Irrationality as a ground for judicial review

Should the reasons given by the Minister for the offending regulations not be satisfactory, the application for judicial review can be instituted. A challenge to the Regulations is most likely to succeed on the ground of irrationality. PAJA provides that, at the instance of any person, a court has the power to judicially review an administrative action if, *inter alia*, the action itself is not rationally connected to the purpose for which it was taken<sup>397</sup> or the purpose of the empowering provision,<sup>398</sup> or the action was taken because “relevant considerations were not considered”.<sup>399</sup>

The offending regulations identified in 6.5.4 above could therefore be reviewed and set aside if the court were to find that:

- (a) the relevant regulations do not accord with the purpose of the Regulations, namely to provide appropriate limits on the cost of credit;<sup>400</sup> or
- (b) the relevant regulations do not accord with the purpose of the National Credit Act, namely to limit the cost of credit to appropriate levels after due consideration of the provisions of section 105(2) of the Act, which includes the social impact on low-income consumers;<sup>401</sup> or
- (c) the Minister did not adequately consider the social impact on low-income consumers.<sup>402</sup>

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<sup>394</sup> Section 5(2). Section 5(3) provides that if the administrator fails to furnish adequate reasons, it will be presumed in review proceedings that the administrative action was taken without good reason.

<sup>395</sup> Section 7(1)(b).

<sup>396</sup> Section 9.

<sup>397</sup> Section 6(2)(f)(ii)(aa).

<sup>398</sup> Section 6(2)(f)(ii)(bb).

<sup>399</sup> Section 6(2)(e)(iii).

<sup>400</sup> Section 6(2)(f)(ii)(aa), read with Chapter 5 of the National Credit Regulations, from which the purpose of the Regulations can be implied.

<sup>401</sup> Section 6(2)(f)(ii)(bb), read with s101(1)(b)–(d) and s105 [in particular s105(2)] of the National Credit Act.

<sup>402</sup> Section 6(2)(e)(iii), read with s105(2)(c) of the National Credit Act.

These grounds for review could be pleaded together or in the alternative, although it would seem that the ground referred to in (b) above would provide the most compelling basis for review.

Likewise, the service fee in Regulation 44 could be set aside on review on the basis that the regulation does not accord with the purpose of section 101(1)(c)(iii) of the National Credit Act,<sup>403</sup> namely that the service fee may not exceed the prescribed amount relative to the principal debt. Such a review would be bolstered by ground (c) above.

In the constitutional era, however, it is arguable that the enquiry should go further than the purpose or intention of the enabling legislation. In *Minister of Health and another NO v New Clicks South Africa (Pty) Ltd and Others (Treatment Action Campaign and Another as Amici Curiae)*,<sup>404</sup> for example, Sachs J held that “the power and the constraint come not only from the empowering statute, but from the Constitution, which governs the manner in which the statute must be applied”.<sup>405</sup> It is helpful to quote him extensively on this point:

“In my view, if rationality is required as the minimum for the legality of primary legislation, something more than mere rationality will be needed to ensure the legality of subordinate legislation. The functionaries who are responsible for drafting subordinate legislation are exercising a public power of great significance, but with no overt checks and balances. It is they who are responsible for translating the general precepts of the statute into operational standards and processes. Even if they choose to consult widely and actively, their ultimate deliberations will ordinarily take place behind closed doors. The principles of accountability and responsiveness require that the procedures for public involvement they establish in each case be reasonably related to the material they have to consider. If challenged, they should be able to account for the regulations they have adopted, and to do so in a manner that shows a reasonable fit between the requirements of the empowering statute, the material at their command and the final text.”

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<sup>403</sup> Section 6(2)(f)(ii)(bb) of the Promotion of Administrative Justice Act.

<sup>404</sup> 2006 (2) SA 311 (C).

<sup>405</sup> Para 632. Sachs J was referring to the constitutional requirement of legality, which “requires compliance not only with the empowering statute, but with general constraints on the exercise of public power flowing from the nature of our constitutional democracy, in particular the requirement that government be open, responsive and accountable”.

Sachs J thus provides a sobering reminder of the weighty responsibilities of the authors of subordinate legislation and the necessity for close scrutiny of such legislation on review.

### 6.5.5.3 Unreasonableness as a ground for review

Unreasonable administrative action, on the other hand, generally relates to the unreasonable exercise of a discretionary power or abuse of a discretionary power, and the courts have for years struggled to find a consistent approach to this concept in terms of the common law.<sup>406</sup> The Constitution provides that “[e]veryone has the right to administrative action that is lawful, reasonable and procedurally fair”,<sup>407</sup> although there is no definition of reasonableness in the Constitution.

This ground for review is captured in section 6(2)(h) of PAJA:

”A court or tribunal has the power to judicially review an administrative action if –

- (h) the exercise of the power or the performance of the function authorised by the empowering provision, in pursuance of which the administrative action was purportedly taken, is so unreasonable that no reasonable person could have so exercised the power or performed the function.”

A conclusive interpretation of this provision is problematic. On a literal interpretation, the legislature seems to have adopted a limited view of unreasonableness, with the focus placed on the state of mind and subjective attitude of the administrator rather than the objectively unreasonable result of the action.<sup>408</sup> Burns and Beukes argue that this provision cannot be confined to the administrator’s subjective state of mind only, but should be given a wide interpretation to include the question of whether or not the decision itself is unreasonable.<sup>409</sup> On this wider interpretation, it is arguable that the offending regulations are unreasonable and therefore fall within the ambit of section 6(2)(h) of PAJA.

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<sup>406</sup> Burns and Beukes *Administrative Law under the 1996 Constitution* 390.

<sup>407</sup> Section 33(1).

<sup>408</sup> Burns and Beukes *Administrative Law under the 1996 Constitution* 399–400.

<sup>409</sup> Burns and Beukes *Administrative Law under the 1996 Constitution* 400.

#### **6.5.5.4 The role of proportionality in controlling administrative action**

The principle of proportionality “requires a reasonable and justifiable relation between the objectives of the administrative decision and the facts and circumstances which were taken into consideration by the administrator in reaching the decision”.<sup>410</sup> It invokes a duty on decision-makers to consider available alternatives and to opt for the least restrictive or least drastic option where possible.<sup>411</sup> There is no direct reference to disproportionality as an independent ground for review in terms of PAJA. Plasket, however, argues that the formulation of section 6(2) of PAJA allows for the principle of proportionality to be invoked:<sup>412</sup>

“The Act could not have intended that the consideration of alternatives and issues of proportionality be excluded. Parliament did not have the power to do this as its constitutional mandate was to pass national legislation to give effect to the right to just administrative action, which includes the right to reasonable administrative action. The consideration of alternatives and the proportionality of administrative action are part of the right in its common law form and, therefore, of its constitutional form too.”

It would therefore seem that a low-income consumer being charged a disproportionately exorbitant amount for a small loan (as opposed to a very much cheaper big loan) could appeal to the principle of proportionality in review proceedings.

#### **6.5.5.5 Remedies in proceedings for judicial review**

A number of possible remedies are set out in section 8 of PAJA. In the judicial review proceedings contemplated in 6.5.3 and 6.5.4 above, the applicant would seek to have the offending regulations set aside<sup>413</sup> and remitted for reconsideration by the Minister of Trade and Industry, possibly with specific directions in this regard.<sup>414</sup> On this basis the problematic regulations could be reviewed and set aside, and the Minister would then have to apply his mind again to prescribing regulations that have due regard to all the relevant purposes and considerations of the National Credit Act and Regulations.

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<sup>410</sup> Burns and Beukes *Administrative Law under the 1996 Constitution* 408.

<sup>411</sup> Plasket “The Fundamental Right to Just Administrative Action: Judicial Review of Administrative Action in the Democratic South Africa” (PhD thesis, Rhodes University, 2002) 382–383.

<sup>412</sup> Plasket “The Fundamental Right to Just Administrative Action: Judicial Review of Administrative Action in the Democratic South Africa” 383–384.

<sup>413</sup> Section 8(1)(c).

<sup>414</sup> Section 8(1)(c)(i).

### 6.5.6 Other legal remedies

Further possible legal remedies for borrowers of small loans which have been canvassed earlier in this chapter and are not strictly relevant to the cost of credit include:

- (a) A court order declaring a loan agreement to be reckless, which could result in the setting aside of all or part of the borrower's rights and obligations under the agreement, or the suspension of the force and effect of the agreement for a determined period.<sup>415</sup>
- (b) A finding that a consumer was over-indebted at the time of the conclusion of the agreement, in which event the court may order the suspension of the force and effect of the agreement and the restructuring of the consumer's obligations under any other credit agreements.<sup>416</sup>
- (c) A court order declaring an unlawful loan agreement (e.g. a loan from an unregistered lender) void, all instalments refunded to the consumer and the credit provider's rights to recover the loan amount cancelled or forfeited to the state.<sup>417</sup>
- (d) A court order that a provision of a loan agreement (e.g. a provision allowing for interest or fees in excess of the maximum amounts permissible) is unlawful, in which event the offending provision will be declared void, and the provision will be severed or altered, or the entire agreement will be declared unlawful.<sup>418</sup>

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<sup>415</sup> Section 83(2). See also 6.4.1 above.

<sup>416</sup> Section 83(3)(b). See also 6.4.1 above.

<sup>417</sup> Section 89(5). See also 6.2.6 above.

<sup>418</sup> Section 90. See also 6.2.6 above.

## Chapter Seven

### Conclusion

#### Outline

Most of the conclusions which will be mentioned in this chapter have already been thoroughly discussed in the thesis, and they therefore need not be repeated in detail here. This chapter will draw together a summary of only the specific findings made in this study, and will not attempt to summarise the entire thesis.

#### 7.1 The rapid growth of the micro-lending industry with no interest rate limits

For nearly 14 years, from 31 December 1992<sup>1</sup> to date, there has been no limit on the interest rates that registered micro-lenders may lawfully charge,<sup>2</sup> and until 1 June 2007 there will continue to be no such limit.<sup>3</sup> Thus, at a stroke of the ministerial pen in 1992,<sup>4</sup> the micro-lending industry was legitimised, making possible “limitless profit” for lenders “unbounded by any finance charge limit at all!”<sup>5</sup> There is little evidence of any research into the question of interest rate limits having been conducted by the Department of Trade and Industry prior to this decision.<sup>6</sup> The Minister’s decision appears to have been made without proper planning and foresight, ignorant of its consequences, with which we still live today. Very soon, the industry spiralled out of control, growing rapidly year-on-year, with registered micro-lenders charging exorbitant interest rates, typically 30% per month, or 360% *per annum*. The Minister belatedly attempted to retrieve the situation in 1999,<sup>7</sup> but this attempt was swiftly set aside in the *Lurama* decision, because of procedural irregularities.

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<sup>1</sup> Notice in terms of section 15A of the Usury Act 73 of 1968, GN R3451, *Government Gazette* 14498, 31 December 1992.

<sup>2</sup> Excluding a period of less than six months during 1999 when the 1999 Exemption Notice was in force.

<sup>3</sup> Proclamation No. 22, Commencement of the National Credit Act, 34 of 2005, *Government Gazette* 28824, 11 May 2006.

<sup>4</sup> The 1992 Exemption Notice.

<sup>5</sup> Yacoob J in *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Minister of Trade and Industry* 2006 (11) BCLR 1255 (CC) paras 9–10.

<sup>6</sup> *The South African Law Commission Working Paper 46 – Project 67: The Usury Act and Related Matters: New Credit Legislation for South Africa* (proposed to the South African Law Commission by JM Otto and NJ Grové) (1991), Chapter 4, para 1.5.1 did give attention to this issue, and recommended that interest rate limits should be retained

<sup>7</sup> The 1999 Exemption Notice.

## 7.2 The dire consequences of excessive interest rates

Excessive interest rates have caused heinous socio-economic hardships and suffering for low-income individuals and communities. A high percentage of personal income is used merely to service micro-lending debt,<sup>8</sup> leaving very little of borrowers' personal income to pay for other household expenses.<sup>9</sup> Further, a very high percentage of the total amount repaid to micro-lenders is in respect of interest on debt,<sup>10</sup> and borrowers of 30-day loans are very soon caught in debt traps from which they are unable to escape.<sup>11</sup> The considerable size and rapid growth of the industry has the effect that tens of billions of rands are lost to lower-income communities in the form of interest on micro-loans every year,<sup>12</sup> thus contributing to the perpetuation of poverty. Levels of indebtedness are high and appear to be increasing.<sup>13</sup> The problem of over-indebtedness is further compounded by high levels of consumption finance<sup>14</sup> and consumer ignorance and illiteracy.<sup>15</sup> Thus, by allowing the micro-lending industry to function without legislated and enforced interest rate limits since 1992, the Government has effectively made possible the exploitation of the ignorance of lower-income communities, which arguably amounts to legislated economic abuse.

A further negative consequence of the failure to cap interest rates is the likely growth of the unregistered sector when the new limits on the cost of credit become effective in 2007, due in part to the legacy of no interest rate limits for the past 14 years.<sup>16</sup> This could lead ultimately to less credit being available and to many people being denied access to any credit at all.<sup>17</sup> Had the necessary considered research been undertaken more than a decade earlier,<sup>18</sup> the industry could have been properly regulated with interest rate limits from the outset, and would not have been beyond the control of the Department of Trade and Industry to the extent that it is today.

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<sup>8</sup> Note (b) to Table B.

<sup>9</sup> Note (a) to Table B.

<sup>10</sup> Note (d) and (e) to Table B.

<sup>11</sup> Illustrated in Table C.

<sup>12</sup> See 5.6 above.

<sup>13</sup> Most poorer households earning less than R25 000 per year showed increases in levels of indebtedness of over 200% between 1995 and 2000 (Table K).

<sup>14</sup> 43% of micro-loans were used for consumption purposes in 2000 (Table F).

<sup>15</sup> 32% of the adult population of South Africa were functionally illiterate in 2001 (Table G).

<sup>16</sup> See 5.8. This likely growth will of course also be due to the advent of the imposition of limits on the cost of credit in terms of the National Credit Regulations.

<sup>17</sup> Ebony Consulting International "DTI Interest Rate Study" <http://www.mfrc.co.za/detail.php?s=12> (accessed 14 March 2006).

<sup>18</sup> This research could have taken the form of the credit law review process initiated in 2002.

### 7.3 Legal recourse and the need for legislative intervention

What legal recourse, if any, does a borrower have in the face of an exorbitantly-priced loan legitimised by exemption from the Usury Act?<sup>19</sup> Contract provisions that are contrary to public policy, as fortified by constitutional values, can be declared to be unenforceable.<sup>20</sup> The courts have made steady progress in recent years in developing this principle, which is a promising ground for recourse, but it is unfortunately limited in several respects.<sup>21</sup> First, a suitable test case will need to be brought before the court (preferably the Supreme Court of Appeal), demanding an appropriate set of facts, enabling the question of public policy to be the decisive issue before the court. Second, it will normally be worthwhile for a litigant to incur the expense of fighting an opposed case only when there is a large amount of money at stake, which will of course not be so in the case of micro-loans. Third, the borrower must be able to afford to pay the necessary legal fees, which a recipient of a small loan is unlikely to be able to do. Fourth, once seized with an appropriate case, many courts may be hesitant boldly to develop the law in regard to contractual fairness in the face of the almost sacrosanct principle of freedom of contract and *pacta sunt servanda*. Finally, even if the Supreme Court of Appeal were to make a finding that a high credit cost provision in a micro-loan is contrary to public policy and therefore unenforceable, such a finding would have limited impact beyond similar micro-loans that are actually challenged in court on this basis.

It is, furthermore, possible to challenge a high-interest loan on the ground that it is usurious if it amounts to “extortion or oppression akin to fraud”, after examining the particular circumstances of each case.<sup>22</sup> It is uncertain, however, how much the courts would be willing to rely on common law usury, which is based upon cases that are nearly 100 years old. This legal basis will further be subject to the same five constraints raised in regard to public policy. Finally, the common law *in duplum* rule can assist borrowers when unpaid interest equals the outstanding capital, in which event interest stops accruing.<sup>23</sup>

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<sup>19</sup> The common law illegality of high interest-bearing loans is reviewed in 5.7.

<sup>20</sup> *Sasfin v Beukes* 1989 (1) SA 1 (A); *Brisley v Drotsky* 2002 (4) SA 1 (SCA); *Napier v Barkhuizen* 2006 (4) SA 1 (SCA).

<sup>21</sup> A full discussion in this regard is set out in 2.6 above – the conclusion to Chapter Two.

<sup>22</sup> *Dyason v Ruthven* 1860 Searle 282 at 311–312.

<sup>23</sup> See, for example, *Standard Bank of South Africa v Oneanate Investments (in Liquidation)* 1998 (1) SA 811 (SCA) 827H.

For these reasons, the development of the common law towards contractual fairness in the micro-lending industry in general, and fairer interest rate levels on micro-loans in particular, could not be relied upon. The considered view of the legislature was therefore that broad, policy-based legislative intervention was required.<sup>24</sup> Thus, the Consumer Protection Bill,<sup>25</sup> published on 15 March 2006, is concerned with, *inter alia*, fundamental consumer rights<sup>26</sup> and promotes contractual fairness, introducing the notions of unreasonable, unfair, unjust and unconscionable transactions.<sup>27</sup> Further, the National Credit Act<sup>28</sup> seeks to regulate every conceivable sector of the consumer credit market. The common law of contract remains the milieu within which money is lent, but it is now overlaid with legislation, resulting increasingly in a legislated form of contract law.

## **7.4 The cost of credit in terms of the National Credit Act**

The cost of credit in terms of the National Credit Act and its impact has been thoroughly analysed in Chapter Six.<sup>29</sup> Suggested amendments to the Regulations have been proposed,<sup>30</sup> and potential legal challenges discussed.<sup>31</sup> What follows is therefore a brief summary of these findings.

### **7.4.1 Shortfalls in the credit costing structure**

A thorough analysis of the cost of credit in terms of the Act and Regulations reveals the following shortfalls. First, the overall cost of credit on all loans of less than about R5 000 will be too high, becoming more and more expensive the smaller the loan, and exorbitant in the case of the smallest loans. Second, the cost of all short-term loans is too high, once again the more so the smaller the loan. Third, the cost of the “flat rate” service fee of R50 is exorbitant for small loans and way out of proportion to the initial loan amount. Fourth, the cost of both the initiation and service fees is far too high relative to interest, negating the gains made in interest rate reduction. Fifth,

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<sup>24</sup> The principle of “freedom of contract” has to some extent been modified by legislation in a number of areas of law, in order to give greater protection to consumers (see 2.5). Further, the South African Law Commission Report on Unreasonable Stipulations in Contracts and the Rectification of Contracts (Final Report; Project 47) (1998) addressed directly the issue of fairness in the law of contract.

<sup>25</sup> Draft Consumer Protection Bill, GN R418, *Government Gazette* 28629, 15 March 2006.

<sup>26</sup> Sections 7–76 of the Bill.

<sup>27</sup> Sections 52–54.

<sup>28</sup> Act 34 of 2005.

<sup>29</sup> 6.4.1– to 6.4.6.

<sup>30</sup> 6.4.7.

<sup>31</sup> 6.5.

the expensive initiation and service fees relative to interest have the effect of masking the true cost of credit.

#### **7.4.2 The impact of the excessive cost of smaller loans**

Since the cost of credit on short-term loans of less than R1 000 will be comparable with the current typical 30% per month, low-income individuals and communities who borrow small amounts are likely to suffer the same socio-economic hardships that they currently do. Most of the conclusions drawn in Chapter Five and 7.2 above will therefore still be relevant to these loans in the new era, including the grave danger of debt entrapment and over-indebtedness. This impact will to some extent be offset by the numerous progressive consumer protection measures introduced in the Act, including: the measures to combat over-indebtedness and reckless credit;<sup>32</sup> the rather drastic provisions relating to unlawful credit agreements and unlawful provisions of credit agreements;<sup>33</sup> provisions in regard to disclosure;<sup>34</sup> and a number of other consumer rights.

#### **7.4.3 Suggested amendments to the Regulations**

In considering the question of appropriate levels for the cost of credit, it is necessary to have regard to: (i) section 105(2) of the Act, which sets out the factors which the Minister is required to consider when prescribing limits on the cost of credit, as well as (ii) Regulation 45(2), which sets out the factors that the National Credit Regulator is required to consider when making periodic recommendations to the Minister in regard to the cost of credit. In short, a balance needs to be struck between keeping credit as cheap and accessible for borrowers as possible (on the one hand), and ensuring that it remains economically viable for moneylenders to advance smaller loans (on the other hand).

In order to address the shortfalls referred to above, the following amendments to the National Credit Regulations are therefore suggested:<sup>35</sup>

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<sup>32</sup> Sections 78–88.

<sup>33</sup> Sections 89–90.

<sup>34</sup> Section 92(1) and s93(1).

<sup>35</sup> If the initiation or service fees were to be removed, the Act would also have to be amended.

- (a) The initiation fee should be removed if its purpose cannot be satisfactorily justified. Alternatively, the maximum initiation fee on both short-term and unsecured credit transactions should be considerably reduced to approximately R50 per credit agreement, plus 5% of the amount in excess of R1 000, but never to exceed R1 000, and never to exceed 5% of the total principal debt [cf Regulations 42(1) and 43(3)].
- (b) The monthly service fee on short-term loans should be removed, unless there is good reason for it to remain.<sup>36</sup> Alternatively, the maximum service fee should be considerably reduced relative to the loan amount, to approximately 1% per month of the loan amount, subject to a minimum fee of R10 per month, and never to exceed R50 per month [cf Regulation 44].
- (c) The maximum permissible rate of interest on short-term loans should be reduced to approximately 4% per month [cf Regulation 42(2)].
- (d) The maximum deferred amount in the definition of a short-term credit transaction (i.e. the maximum limit on the size of a short-term loan) should be reduced to no more than R5 000 [cf Regulation 39(2)(a)(i)].

When these suggested amendments are applied in a number of examples<sup>37</sup> and compared with the cost of credit in terms of the Regulations,<sup>38</sup> the amendments appear to adequately address the shortfalls in the Regulations referred to above and to achieve a fairer result, having regard to the need to balance the interests of both micro-lenders and borrowers.

#### **7.4.4 Legal challenges to the high cost of credit on smaller loans**

Finally, there are several legal bases that could be used to challenge the high cost of credit on smaller loans in terms of the Regulations. These include the application of the codified *in duplum* rule<sup>39</sup> and a challenge to the common law legality of high interest provisions on the basis of public policy or usury law.<sup>40</sup> A more far-reaching

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<sup>36</sup> Interest could be increased in turn to compensate for the loss of the service fee, should this be deemed necessary to achieve an equitable result.

<sup>37</sup> Table T.

<sup>38</sup> Table U.

<sup>39</sup> Section 103(5).

<sup>40</sup> Such a challenge would, however, be subject to the same constraints as those explained in 7.3 above.

high impact challenge, however, could take the form of an application to have a number of offending provisions of the Regulations set aside on review in terms of the Promotion of Administrative Justice Act.<sup>41</sup> Chief amongst these is the service fee of R50 per month, as also several provisions whose combined effect causes the cost of credit on short-term loans to be excessive and, as such, contrary to the intention of the legislature. Such provisions could be set aside on the ground of irrationality, although the ground of unreasonableness could be relevant, and proportionality could also have a role in controlling the Minister's administrative action.

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<sup>41</sup> Act 3 of 2000.

Appendix A

## Micro-lending loan amortisation

(loan of R1 638 at 30% per month, repayable over 24 months, borrower earning R3 000 per month)

VARIABLE	Input	Output
Loan amount	R 1 638,00	
Number of months	24	
Interest rate per month	30%	
Required payment per month		R 492,31
<b>DISPOSABLE INCOME RAMIFICATIONS</b>		
Monthly wage / pension	R 3 000	
Percentage of income available for other expenses after loan payment		84%
<b>TOTAL INTEREST COST</b>		<b>R10 177,37</b>
<b>TOTAL PAYMENTS</b>		<b>R11 815,37</b>
Percentage of total income utilised to pay interest charges in the loan period		14%
Percentage of total amount repaid utilised to pay interest charged		86%

<b>Loan amortisation schedule</b>				
<b>(loan of R1 638 at 30% per month, repayable over 24 months)</b>				
<b>Month</b>	<b>Payment</b>	<b>Interest</b>	<b>Capital portion</b>	<b>Balance outstanding</b>
				R 1 638,00
1	R 492,31	R 491,40	R 0,91	R 1 637,09
2	R 492,31	R 491,13	R 1,88	R 1 635,91
3	R 492,31	R 490,77	R 1,54	R 1 634,38
4	R 492,31	R 490,31	R 1,99	R 1 632,39
5	R 492,31	R 489,72	R 2,59	R 1 629,80
6	R 492,31	R 488,94	R 3,37	R 1 626,43
7	R 492,31	R 487,93	R 4,38	R 1 622,05
8	R 492,31	R 486,62	R 5,69	R 1 616,36
9	R 492,31	R 484,91	R 7,40	R 1 608,96
10	R 492,31	R 482,69	R 9,62	R 1 599,35
11	R 492,31	R 479,80	R 12,50	R 1 586,84
12	R 492,31	R 476,05	R 16,25	R 1 570,59
13	R 492,31	R 471,18	R 21,13	R 1 549,46
14	R 492,31	R 464,84	R 27,47	R 1 521,99
15	R 492,31	R 456,60	R 35,71	R 1 486,28
16	R 492,31	R 445,88	R 46,42	R 1 439,85
17	R 492,31	R 431,96	R 60,35	R 1 379,50
18	R 492,31	R 413,85	R 78,46	R 1 301,04
19	R 492,31	R 390,31	R 101,99	R 1 199,05
20	R 492,31	R 359,71	R 132,59	R 1 066,46
21	R 492,31	R 319,94	R 172,37	R 894,09
22	R 492,31	R 268,23	R 224,08	R 670,00
23	R 492,31	R 201,00	R 291,31	R 378,70
24	R 492,31	R 113,61	R 378,70	R 0,00

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