

South Africa
Credit Analysis

Home Loan Guarantee
Company

Rating

Home Loan Guarantee Company

National Insurer Financial Strength.... AA+(zaf)

Rating Outlook

Stable

Sovereign Ratings

South Africa

Foreign Long-Term IDR* BBB+

Local Long-Term IDR* A

Rating Outlook

Stable

* IDR – Issuer Default Rating

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■ Summary

The rating reflects the unique position of Home Loan Guarantee Company (“HLGC”) as a provider of insurance cover to lending institutions to guarantee home loans. These loans are primarily for low-income households in South Africa. The rating also reflects the company’s very strong capital and solvency position, as well as its long track record of sound and active risk management. Partially offsetting factors are the company’s exposure to the South African economy and the execution risks associated with its plans to expand its product offering.

Fitch Ratings considers that HLGC continues to have an advantageous market position as the leading provider of guarantees to low-income homeowners in South Africa. The agency also recognises that HLGC’s premium income is very much dependant on the volumes of loans granted by the lending institutions. The company is likely to benefit from an increase in business volumes following the implementation of the Financial Sector Charter (“FSC”) in South Africa. For the year ended 30 June 2005, revenue growth continued, with gross written premiums up 95% to ZAR5 million (approx. USD0.8m at current exchange rates), following declines in the early part of this decade.

As a specialist insurer, HLGC is significantly exposed to any downturn in the housing market and to any other negative economic and political trends in South Africa. However, Fitch notes that in recent years there has been a strong improvement in the country’s macroeconomic policy framework. This is reflected in the strong sovereign rating of South Africa (local currency Issuer Default rating of ‘A’). This has translated into a favourable claims environment for HLGC as defaults have reduced.

HLGC is continuing to seek to expand its offering. It has finalised the development of a programme to provide home loan repayment protection cover that covers loss for whatever reason including HIV and AIDS-related illness, although the launch of this product now depends on the readiness of the participating banks. The expansion into a new product line, even one that is closely related to its traditional core business, presents a business risk for the company. However, Fitch is comforted by HLGC’s careful approach to this new venture and its good track record of execution and risk management.

■ Expectations

Fitch expects HLGC to retain its leading market position as it develops new products to support low-cost housing needs, and to maintain its strong capital and solvency position.

■ Company Overview

HLGC was incorporated in 1989 as a not-for-profit company. Licensed as an insurance company, it is regulated by the Financial Services Board, part of the Ministry of Finance. The company was formed to address a lack of capacity within the banking and insurance industry to provide support for housing finance for low-income individuals.¹

HLGC provides insurance to banks or other lending institutions against default of the borrower, and does not insure the individual borrower. HLGC provides cover for losses incurred by lending institutions in cases of defaults on loans.

At the time of its formation, many banks were unwilling to lend to individuals without some form of guarantee or insurance policy. HLGC continues to offer these guarantees through its core product, Collateral Replacement Indemnity ("CRI"), although the commercial market appears to have become increasingly willing to offer similar products in recent years. Nevertheless, no one else currently offers products that are quite like HLGC's.

Empirical data to assess the risks that HLGC underwrites is not easily available and this provides a significant barrier to entry for commercial market participants. HLGC has the longest track record and experience in this market, and it takes a proactive approach to managing its risks. HLGC is able to provide a guarantee of up to 50% of the loan.

The provision of housing and financing home ownership in South Africa is affected by the AIDS pandemic. The impact on life expectancy and the state of health has been dramatic in the lower income groups. Consequently, the ability of lower-paid workers to borrow, particularly over the longer term for housing reasons, has been limited. With the difficulties associated in understanding the financial impact of AIDS, banks and lending institutions had historically been reluctant to enter this market on a large scale. Nevertheless, under the umbrella of positive affirmation (see section on *Financial Sector Charter* below), banks are now seeking to increase their lending to this market.

Since the end of 2001 HLGC has been working to develop new products to replace the traditional core product of guarantees to support low-cost housing purchases. This involved the creation of a new programme, which specifically addresses the management of risks of claims emerging from HIV and AIDS-related losses. The product provides a "living benefit" for the sufferers of HIV and AIDS.

¹ Low income refers to monthly earnings of less than ZAR7,500.

The associated mortality risk is, in many cases, covered by life insurance policies from mainstream providers. This is a change from the past, when HIV and AIDS-related death claims were generally excluded from life policies. HLGC has written its first policy although the full implementation of the product now depends on the readiness of the participating banks.

The Housing for HIV Foundation, has been set up to provide funding for counselling and treatment for borrowers affected by HIV and AIDS. Getting such treatment and counselling will be a pre-condition of payment of benefits under this product. Operational costs for the foundation are funded by the HLGC, in terms of a loan agreement, and reimbursement has already commenced.

When potential claims from missed loan instalments are notified, HLGC interacts with the defaulting borrowers to determine the reasons for default. Where this indicates an AIDS-related illness, the borrower is encouraged to go for voluntary counselling and testing. Thereafter, as required, affected borrowers participate in appropriate treatment programmes. If medical treatment, as facilitated by HLGC and its medical partners, is sought by the borrower, payment is made to the lender for any missed loan repayments and the lender does not sell the property in execution or evict the borrower.

The HLGC has created a niche position in the low-income housing market by following a proactive approach in managing the risks.

Advances in medical science for the treatment of HIV/AIDS in recent years have resulted in very significant improvements in life expectancy for sufferers. In particular, the period during which people that are HIV positive can continue a relatively normal lifestyle, including the ability to continue in full-time employment, has risen dramatically over the last decade. The expectation of continued medical advances and the slow liberalisation of the pharmaceutical industry, and thus the likely wider availability of treatments, should enable further progress in this area.

■ Financial Review

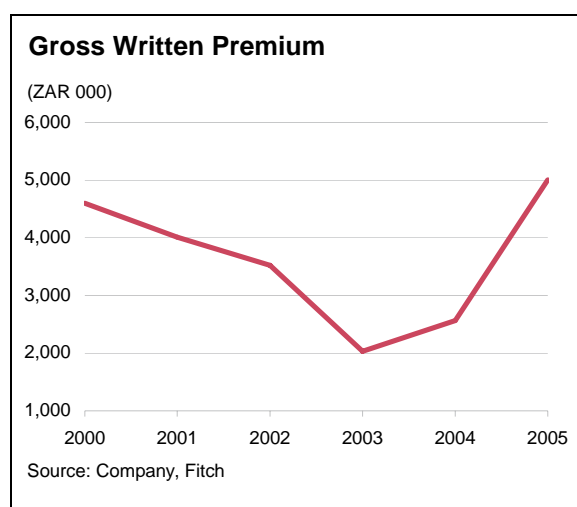
The traditional methods of reviewing the financial performance of insurance companies are not entirely appropriate for HLGC as a not-for-profit organisation with unique products and structure.

The company aims to cover the cost of claims through premium income and its operational expenses through investment income earned from capital and retained surplus. The comments that

follow give greater detail on the unique structure of this company.

Operating Performance

The company's performance for the year ended 30 June 2005 was robust. Revenue growth continued, with gross written premiums up 95% to ZAR5 million, following premium decline in the early part of this decade. Fitch expects premium growth to continue in line with increased lending by banks (see *Financial Sector Charter* below) and also to reflect the pace of economic growth currently being experienced in South Africa.



The underwriting profit increased significantly to ZAR37.1m from ZAR26.4m in FY04, mainly through solid investment returns. However, the company reported a net loss of ZAR0.6m (FY04: profit of ZAR6.5m) due to ZAR35m in expenses.

Almost all the expenses, ZAR34m, related to set-up costs for the Housing for HIV Foundation, which was a necessary prerequisite for developing and launching the HLDG product. The costs incurred in developing the treatment and counselling facility under the aegis of the foundation are currently capitalised as a loan asset in its balance sheet. Under the terms of the loan, HLGC was to receive USD75,000 from the foundation every six months for 10 years, although this has now been increased to USD90,000 to reflect some costs that had not previously been expensed (e.g. legal costs).

The foundation is now fully operational, so HLGC does not expect to incur any further expenses in respect of it. Some of these expenses are now expected to be reversed (at FY06), as they do not relate to HLGC.

The company operates on the basis of ongoing education of borrowers, which is seen as a proactive

risk management tool. Much effort, and therefore cost, is expended on the education of borrowers, and clearly this does not produce a directly measurable return. Payment of claims will only be made to those individuals willing to undertake appropriate educational and medical programmes. Traditional expense ratio analysis is therefore likely to produce apparently poor figures. The company operates on the basis that all educational costs are funded through returns on its investments, funded from its substantial capital base. For FY05 HLGC's administration expenses increased to ZAR34.2m from ZAR19.9m, while gross investment income increased to ZAR43.7m from ZAR30.0m.

Premium and Pricing Structure

For the CRI product, single premiums are payable in advance, equating to either 9% or 10% of the maximum amount guaranteed, the latter including the SASRIA coupon. The guarantee period is for five years.

Once the National Credit Act has been effected, the premiums will be charged at 0.7% of the outstanding loan amount, and will be renewable annually. There are a number of factors that can influence the claims experience over the lifetime of a typical loan. The insurance premium can be reset each year to reflect the ongoing loss experience of HLGC. A further benefit is that the annual premiums will add top-line stability to HLGC.

Claims Handling

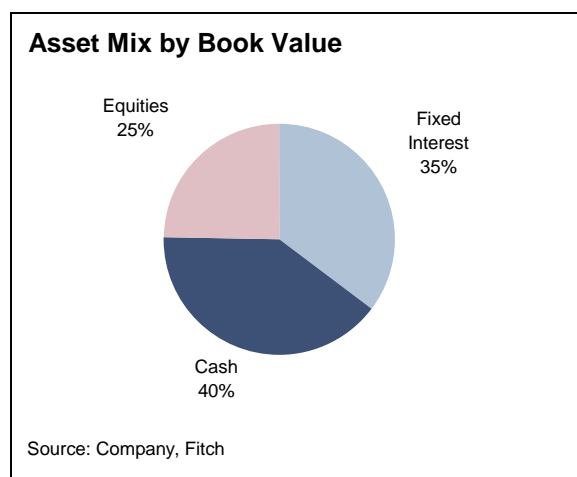
HLGC's primary aim, as a social not-for-profit organisation, is to minimise repossessions. The claims-handling process is highly proactive. For the CRI product, the company receives notification from the lending institution when a payment is missed on any loan. An agent will then visit the borrower and provide counselling and assist in devising a revised payment schedule. As a result, only about half of arrears result in eventual seizure and sale of the property.

As mentioned earlier, HLGC is currently benefiting from a fairly benign claims environment. To control costs and increase operational flexibility, the claims team and the education team have been merged.

Asset Quality, Liquidity and Cash Flow

The company typically holds assets in high-quality, mostly liquid, fixed-income instruments. However, exposure to equities is considered to be an appropriate investment strategy in a high-inflation environment. In such circumstances, real assets, such as equities and real estate, tend to give some protection against the devaluing impact that high inflation can have.

As such, in 2004 the company increased the proportion of equity in its asset allocation. Fitch considers its investment strategy to be reasonable given the company's very strong capital position (see **Capital Position/Profile** below). The following chart shows the breakdown of the asset mix by book value as at the end of January 2006.



The company holds a highly liquid portfolio of assets, and claims payments are not typically volatile. Management of liquidity does not therefore demand a high level of sophistication. At the balance sheet date, the company held cash in excess of the total annual claims payments, which is clearly a prudent position.

Reinsurance

In the past HLGC utilised reinsurance protection provided by Centre Re, London. This involved the payment of 30% of the annual gross written premium. As a not-for-profit organisation, and without the ability to raise fresh capital, management viewed the protection afforded by such an arrangement as a prudent method of protecting the capital base. This programme was commuted for ZAR1.5m in FY05.

Over time, the track record of the company and the development of greater risk-monitoring capabilities rendered its reinsurance arrangements inappropriate. With effect from 1 July 2003, the company entered into an agreement with the United States Agency for International Development ("USAID"), which provides a more appropriate level of protection for its ongoing book of business.

HLGC continues to seek alternative cover and is in talks with European insurers on commercial terms.

The main hurdle in setting up the reinsurance programme has been finding suitable attachment points that would allow reasonable cover. While the reinsurance cover is being negotiated, Fitch is comforted by the surplus capital and risk management techniques employed by the company.

Loss Reserves

The traditional business of providing loan guarantees to banks and other lending institutions is relatively long tail in nature. With the change in business mix in the future, the company will have a greater ability to re-price risks that develop loss patterns outside of its original expectations. It has had no significant experience of adverse loss reserve development thus far. Fitch notes that the company seeks external actuarial assessment of reserves.

Capital Position/Profile

In terms of traditional capital adequacy measures, the company reports an extremely strong position. Regulated as an insurance company, HLGC has to report its solvency position, i.e. the ratio of net assets to net written premium. At the balance sheet date, this ratio amounted to 34x. This is clearly a very strong position, and it offsets the limited access to further funding that the company has as a not-for-profit organisation. When viewed from an economic capital position, i.e. comparing available resources with the potential needs of HLGC, its capital position remains very strong.

Financial Sector Charter

The FSC is a voluntary commitment developed by the sector as a whole, representing banks, long and short-term insurers and other financial institutions. It was agreed in October 2003 by 10 industry associations in the financial sector, including the Banking Council, the Life Offices' Association and the South African Insurance Association.

The FSC took effect from 1 January 2004 and will remain in effect until 2014. In addition to normal empowerment objectives, it addresses areas such as increasing financial services to low-income individuals and to small and medium-sized black-owned businesses, as well as other areas regarded to be national priorities, such as low-cost housing. To meet their obligations under the FSC, lenders are likely to use more of HLGC's products. Fitch expects the wider scope of the CRI product and the introduction of the aids risk management programme to benefit HLGC's sales.

Profit & Loss Account

Year Ending 30 June (ZAR 000)	2001	2002	2003	2004	2005
Non-Life Technical Account					
Gross Written Premiums	4,014	3,523	2,033	2,565	5,004
Premiums Ceded	-1,204	-1,057	-610	0	0
Net Written Premiums	2,810	2,466	1,423	2,565	5,004
Change in Unearned Premium Reserve	-681	-20	790	-594	-3,110
Net Premiums Earned	2,129	2,446	2,213	1,971	1,894
Gross Claims Paid					
Gross Claims Paid	-801	-994	-1,406	-1,682	-846
Reinsurance Recoveries	0	0	0	0	0
Net Claims Paid	-801	-994	-1,406	-1,682	-846
Change in Claims Case Reserves	-956	-3,011	559	1,969	-1,250
Change in Incurred but not Reported Reserve	-1,393				
Net Claims Incurred	-3,150	-4,005	-847	287	-2,096
Administrative Expenses					
Administrative Expenses	-2,133	-1,940	-4,698	-4,457	-8,174
SASRIA Commission	63	61	42	56	110
Reinsurance Rebate	0	0	0	0	1,500
Other Underwriting Income/(Expenses)	1,864	4,675	-1,566	153	1,310
Total Underwriting Expenses	-206	2,796	-6,222	-4,248	-5,254
Technical Investment Income (Net of Inv. Expenses)	20,993	18,284	12,510	28,397	42,594
Non-Life Underwriting Result	19,766	19,521	7,654	26,407	37,138
Non-Technical Account					
Investment Income (Total Gross)	20,993	18,847	14,336	29,966	43,686
Investment Expenses		-563	-1,826	-1,569	-1,092
Less Technical Investment Income	-20,993	-18,284	-12,510	-28,397	-42,594
Non-Technical Investment Income	0	0	0	0	0
Operating Result	19,766	19,521	7,654	26,407	37,138
Non-Insurance Activities					
Non-Insurance Activities	0	0	0	0	89
Amortisation of Goodwill and Intangibles	0	0	0	0	-3,655
Other Income/(Expenses)	-15,113	-18,280	-20,302	-20,302	-34,185
Pre-Tax Income	4,653	1,241	-12,648	6,494	-613
Tax	0	0	0	0	0
Reported Net Income	4,653	1,241	-12,648	6,494	-613

Source: Company, Fitch

Balance Sheet

(ZAR 000)	2001	2002	2003	2004	2005
Assets					
Cash (%)	6.6	8	8.3	6.8	6.5
Securities* (%)	92.4	89.5	87.1	88.2	88.0
Tangible Assets (%)	0.2	0.2	0.3	0.3	0.2
Intangible Assets (%)	0	0	0.1	0.1	0.0
Other Assets (%)	0.8	2.2	4.2	4.5	5.2
Total Assets	188,892	193,701	180,696	186,483	198,688
Liabilities					
Unearned Premiums	5,569	5,589	4,798	5,393	8,502
Claims Reserves	1,201	4,212	3,654	1,685	2,935
Total Technical Reserves	6,770	9,801	8,452	7,078	11,437
Other Insurance Liabilities	-	-	-	-	-
Other Liabilities	4,594	5,131	6,123	6,699	15,412
Contingency Reserves	433	350	203	256	500
Total Liabilities	11,797	15,282	14,778	14,033	27,349
Net Assets					
Paid-Up and Other Capital	-	-	-	-	-
Other Net Assets	177,095	178,419	165,918	172,450	171,339
Total Net Assets	177,095	178,419	165,918	172,450	171,339

* Includes equity exposure
Source: Company, Fitch

Home Loan Guarantee Company

(%)	2001	2002	2003	2004	2005
Reserve Analysis					
Solvency Margin (Surplus % NPW)	6,302	7,235	11,660	6,713	3,424
Net Premiums Written % Surplus	1.59	1.38	0.86	1.49	2.92
Net Technical Reserves % NPW	241	397	594	276	229
Growth of Surplus %	2.7	0.7	-7.0	3.8	-0.5
Net Claims Reserves % NPW	241	397	594	276	229
Surplus + Technical Reserves % NPW	6,543	7,633	12,254	6,989	3,653
Technical Reserves % Surplus	3.8	5.5	5.1	4.1	6.7
Earnings Analysis					
Claims Ratio	112.1	162.4	59.5	-11.2	41.9
Expense Ratio	75.9	78.7	330.1	173.8	163.3
Combined Ratio	188.0	241.1	389.7	162.6	205.2
Pre-Tax Return on Equity	2.7	0.7	-7.3	3.9	-0.4
Post-Tax Return on Equity	2.7	0.7	-7.3	3.9	-0.4
Profit Before Tax % Net Premiums Written	165.6	50.3	-888.8	253.2	-12.3
Revenue Analysis					
Growth of Gross Premiums Written	-12.8	-12.2	-42.3	26.2	95.1
Growth of Net Premiums Written	-12.8	-12.2	-42.3	80.3	95.1
Growth of Net Premiums Earned	50.2	14.9	-9.5	-10.9	-3.9
Growth of Profit Before Tax	-51.5	-73.3	-1,119.2	-151.3	-109.4
Asset Exposure Analysis					
Cash as % Surplus	7.0	8.7	9.1	7.4	7.5
Quoted Investments as % Surplus	98.4	97.0	94.7	95.4	101.8
Miscellaneous					
NPW % GPW	70.0	70.0	70.0	100.0	100.0
PBT % NPW	165.6	50.3	-888.8	253.2	-12.3
Free Asset Ratio	1,501.2	1,167.5	1,122.7	1,205.3	626.5
Return on Assets	2.5	0.6	-7.0	3.5	-0.3
Gross Premiums Written as a % of Capital	2.3	2.0	1.2	1.5	2.9
Gross Technical Reserves as a % of Capital	3.8	5.5	5.1	4.1	6.7

Source: Company, Fitch

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