

Liu Shiyu: Earnestly strengthening commercial real estate management to adjust real estate credit structure and prevent credit risks

Speech by Mr Liu Shiyu, Deputy Governor of the People's Bank of China, at the Conference on Strengthening Commercial Real Estate Credit Management, Beijing, 11 December 2007.

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Housing is a basic need for people's livelihood. The CPC Central Committee, State Council and Party Committees and local governments at various levels attach great importance to housing, and the healthy development of the real estate industry and real estate finance. On August 23, 2007 the State Council convened the National Urban Housing Work Conference, in which new requirements about how to strengthen macro-adjustment of the real estate market and to provide affordable housing to low-income households in a faster manner were put forward. The People's Bank of China (PBC) and China Banking Regulatory Commission (CBRC), in order to implement the spirit of the Urban Housing Work Conference, issued *Notice of the People's Bank of China and the China Banking Regulatory Commission on Strengthening Management of Commercial Real Estate Credit* (hereafter referred to as the "Notice") on September 27, which immediately came to the attention of commercial banks. Requirements outlined in the Notice are followed in an earnest manner to improve credit risk management in the real estate sector. The public is generally positive toward the Notice, whose effect is gradually unfolding. Pursuant to the spirit of the Central Economic Work Conference and the requirements to develop the housing sector and housing consumption, with a view to keep the seriousness, efficacy and development trend of the credit policies, to speed up credit restructuring and to forestall credit risks, the PBC and CBRC, after extensive study and soliciting opinions from commercial banks and relevant authorities, jointly issued the *Supplementary Notice of the People's Bank of China and the China Banking Regulatory Commission on Strengthening Management of Commercial Real Estate Credit* (hereafter referred to as the "Supplementary Notice"), which clarifies some regulations on strengthening the management of housing consumption credit.

Good results achieved in developing the real estate market and real estate finance

With the rapid development of the national economy and the deepening reform of the urban housing system, more houses are being constructed. Real estate sector has become an important driving force for economic growth, and real estate finance dominated by housing development and consumption credit has become an important business of commercial banks. The real estate market and the real estate financial market develop rapidly and have achieved good results.

First, the housing quality in urban areas continues to improve. From 2003 to 2006, the average annual acreage of completed new homes exceeded 600 million square meters, while the per capita acreage grew from 23.5 square meters to 27 square meters. As of end 2006, 80% of urban residents live in independent homes.

Second, housing security system makes continuous headways. As of end 2006, completed acreage of affordable housing (including housing built for employees with collected funds) across China surpassed 1.3 billion square meters, enough to accommodate 1.65 million low-income households. As of October 2007, 644 out of 656 cities established the low-rent housing system, accounting for 98.2% of the total, and improving the living conditions of 681,000 low-income families. As of September 2007, over 100 million employees were covered by the Housing Provident Fund scheme. Housing provident fund contribution totaled 1.5 trillion yuan, with a balance of 900 billion yuan. About 42 million employees enjoyed better housing conditions by utilizing the housing provident fund and applying for housing provident fund loans.

Third, real estate financial businesses develop rapidly. As of October 2007, outstanding commercial real estate loans of major financial institutions stood at 4.69 trillion yuan, accounting for 18.02% of the total RMB outstanding loans. Outstanding loans for real estate development amounted to 1.76 trillion yuan, while outstanding individual housing loans 2.6 trillion yuan, accounting for 6.76% and 9.99% of the total outstanding RMB loans in financial institutions. Outstanding loans guaranteed by housing provident fund reached 450.22 billion yuan, nearly 18% of the individual housing loans issued by commercial banks. A housing financial system combining commercial loans and policy loans take form. Fast-developing real estate consumption loans not only help tens of thousands of households to realize their dreams of having their own houses, but also expand domestic demand, support economic growth and promote social harmony.

Fourth, progress has been made in real estate financial products innovation. In recent years, commercial banks have developed and launched fixed interest payment, grace period payment, housing relay loans and other products that improve efficiency and create more alternatives to borrowers. Some commercial banks tapped the possibility of reverse mortgage loans that link self-occupied housing with pensions. Housing mortgage-backed securities were issued. Pilot programs of commercial housing loans securitization are under way.

China is a developing country with a population of 1.3 billion, out of which over 500 million live in urban areas. It is already an achievement that we have improved the living conditions of urban residents within such a short period of time. Commercial banks have played an important role in this process, which deserves full recognition. Such achievements would be impossible without the leadership of the Communist Party of China, market-oriented reform, opening-up, and priority given to housing, employment, agriculture and other key issues.

Major problems and challenges at the current stage

I. Major problems in the real estate market

Though the real estate market and the real estate financial businesses develop rapidly, we have also noticed that recently such acute problems as excessively rapid growth of housing prices in certain cities, irrational supply and demand structure, inability of low-income people to afford housing, etc.

1. Commercial housing price has been on the rise. From 2003 to 2005, the y-o-y growth of urban housing price registered 5.1%, 10.8%, 6.5% and 5.3% respectively. As of October 2007, the y-o-y growth of sales prices in 70 large-and-medium-sized cities averaged at 9.5%. Sales prices of newly constructed commercial housing rose by 10.6%, representing an overall upward trend.
2. The mix of housing available in the market is irrational. Aggregate supply is insufficient, especially the supply of medium-and-small-sized apartments. Statistics from the Ministry of Construction show that at the beginning of 2006, only 19.18% of the residential area of commercial housing on sale in 40 big cities was less than 90 square meters. The proportion rose slightly to 25.77% by October 2007, still far behind the regulatory objective stipulated in prevailing rules and regulations.
3. Macro-regulation policies are not completely in force. In recent years, with regard to the rapid price hike and irrational housing mix available, the State Council has adopted a series of policies to strengthen macro-regulation over the real estate market, which have yielded some results, but there are still some policies that are not put in place in a few localities. There is an apparent shortage of medium-and-low-priced and medium-and-small-sized housing. From January to October 2007, investment in housing less than 90 square meters only accounted for 21.46% of the total housing investment. Some developers hoarded land and curtailed supply to

push up prices. From January to October 2007, housing investment grew by 31.4% nationwide, with floor space newly constructed up by 22.6%, but completed acreage by merely 9.1%.

4. Low-income households have difficulties in affordability. At present, nearly 10 million urban households whose per capita floor space of residential housing is below 10 square meters. Among them, 4 million households receive subsistence allowances, accounting for 5.5% of the total number of urban households. At the same time, persistent price hike and slow development in small-and-medium-sized house lease market make it difficult for low-income households to purchase or rent houses in the market.

The above problems, though limited to certain localities and created by structural imbalance, have huge impact on society due to the following reasons. First, mismatch between supply and demand is acute. From the demand side, there is a continuously strong demand as a result of higher income and faster urbanization. From the supply side, the insufficient aggregate demand is coupled with imbalanced mix of housing available and shortage of supply of small-and-medium-sized apartments. From January to October 2007, floor space completed stood at 232 million square meters, up 8.8% y-o-y. Sold space grew by 33.1% y-o-y to 489 million square meters, 2.11 times of space completed, resulting in a slower growth of supply than that of demand. Second, shortage of residential construction land and price hike of land, raw materials and wages push up sales prices. Third, psychological expectations and housing price hike interact. Urban residents prefer purchase to lease, early purchase to late purchase and big apartments to small apartments. After having purchased their own apartments, some people make speculative investment, which further pushes up housing prices. Fourth, housing price hike in the international market is contagious. In recent years, the global housing market has witnessed faster price hike during a longer period time with far more wide-ranging impact than any other period of time before, not only in developed countries such as the US, UK, France, Spain, Italy, Belgium, Denmark, Sweden and Australia, but also in Brazil, India, Thailand and other developing countries. From 2001 to 2006, housing price in the US, France and the UK rose by 54.9%, 50% and 85.4% respectively, while the single-year price hike in the three countries was 11.32% in 2005 for the US, 16.25% in 2005 for France and 24.86% in 2002 for the UK. Driven by economic globalization, worldwide liquidity surplus and international flow of capital, housing price hike spreads globally.

II. Problems in real estate finance

1. The real estate credit is growing excessively fast. As of end of October 2007, outstanding commercial housing loans reached 4.69 trillion yuan, a y-o-y growth of 30.75%, up 1.01 trillion yuan from the beginning of the year, accounting for 28.9% of the total new RMB loans of commercial banks during the same period of time. Outstanding individual housing loan reached 2.6 trillion yuan, 619.2 billion yuan more than the beginning of the year, up 35.57% y-o-y. Entrusted loans with housing provident fund reached 450.22 billion yuan at the end of October, up 96 billion yuan than the year beginning, up 34.87% over the same period of last year.
2. Competition is extremely fierce, creating huge underlying risks. At present, real estate loans, especially individual housing loans, are classified as prime assets. To take more market share, local offices of some commercial banks lower lending criteria, reduce examination steps and relax investigation through distorted practice. As a result, banks assets become less secure. In 2006, competent authorities find out after sampling and surveying housing loans in 16 cities that on average 22.31% of borrowers didn't meet loan officers directly when getting loans. In cities including Zhengzhou, Beijing, Hangzhou and Guangzhou, this proportion is 46.31%, 35.4%, 32.83% and 32.2% respectively.

3. Mortgage refinance loans and additional mortgage loans are granted without proper approval. The multipliers of mortgage refinance loans and additional mortgage loans generally fluctuate with the value of real estate, likely to magnify housing credit when the economy grows and housing price soars. In addition, most credit is used to purchase more houses or to invest in the stock market, creating more potential risks to the banking system and accumulating more bubbles in the real estate and stock markets. As of end-August 2007, outstanding mortgage refinance loans and additional loans in 16 major cities reached 41 billion yuan, 3.5 times of that in the same period of last year.
4. Weak loan management unveils risks associated with “fake mortgage”. A few branches and sub-branches of commercial banks defy the requirements of “three examinations”. Some of them even collaborate with real estate developers and real estate agents to make up housing mortgage loan contracts in order to grant loans for real estate developments under the name of housing consumption loans, or to help developers to speculate on difficult-to-sell buildings through “fake mortgage”.

Attach great importance to lessons drawn from real estate markets in other countries

Real estate markets in many countries and regions have experienced cyclical fluctuations or even bubble bursts. This is particularly true in recent years when some developed countries and developing countries are on the downside of the curve after continuous price hike. A few of them are exploring measures to achieve “soft landing”, which deserves our close attention. The real estate bubble in Japan in the 1990s, real estate bubble in Hong Kong after the Asian financial crisis and the sub-prime crisis this year in the US are well known. Some valuable points can be summarized after in-depth and comprehensive analysis of the above crises and other problems in the international real estate market.

First, real estate industry is an important driving force or a pillar industry for a country or region. Real estate industry concerns over 50 other industries, so the development of the real estate industry closely relates to the overall economic growth. When economy is in the upside curve of the cycle, the real estate industry grows continuously. But when economy goes downward, real estate industry experiences shrinking investment and consumption. If real estate bubbles burst due to economic or political factors, housing prices will plummet before economic slowdown at a faster rate than overall economic growth, inflicting greater impacts on consumer confidence and economic growth than any other industry.

Second, real estate industry is a typical capital-intensive industry, and its development provides space for financial development and innovation. However, real estate industry influences the financial sector. If banks fail to prevent risks associated with real estate loans, relax lending criteria, and grant more individual mortgage loans and development loans, then bubbles are likely to appear or accumulate, whose burst will threaten the banking system or even financial security, and further influence economic, social and political stability.

Third, housing is a basic need for people’s livelihood as well as a public good. It is necessary for the government to adopt guarantee measures, and for financial institutions to perform social responsibilities. However, new risks will be triggered if banks are allowed or encouraged to provide excessive loans to low-income households. Before the sub-prime crisis in the US, most low-income borrowers were too optimistic about their income and applied for loans that they couldn’t afford to repay. But the market is volatile; the running of the economic cycle is not at the control of borrowers. When income shrinks or interest rate resets, borrowers will have to pay more, and potential risks translate into actual crisis.

Fourth, securitization and credit derivatives have played a positive role in terms of diversifying home loan risks, expanding real estate finance to more financial institutions and other institutional investors, and diversifying risks in the banking system. However, if commercial banks, investment banks, institutional investors, auditors and rating agencies are

myopic and weak in information disclosure, risks connected with real estate finance are likely to be covered or underestimated. In the US sub-prime crisis, underestimation of the risks associated with sub-prime loans-backed securitization products or credit derivatives makes the sub-prime crisis unnoticeable, abrupt and highly contagious.

Fifth, it is necessary to improve or relax financial control in order to fully display the fundamental role of the financial market in resources allocation and to provide a favorable environment for financial innovation. However, governments shall master the laws governing the functioning of market. If governments don't perform market supervision, early warning and forward-looking risk guidance, they will fail to prevent risks from happening.

Sixth, in the process of economic integration, it is a logical choice for developing countries to open up to the outside world and utilize foreign capital in order to achieve fast economic development. However, due to surplus liquidity and cross-border capital flow, foreign capital will have a greater impact on domestic capital markets, especially the markets in countries and regions that experience persistent economic growth and local currency appreciation, which are more likely to fall prey to hot money.

Earnestly strengthen real estate credit management

In recent years, the PBC and CBRC have issued a series of policy guidelines and supervisory regulations in accordance with state policies on housing development and consumption, with the purpose to promote the healthy development of the real estate financial businesses and to prevent financial risks. Not long ago, in order to accomplish the tasks put forward in the urban residential housing work conference, the PBC and CBRC jointly issued the Notice, which specifies the requirements on how to strengthen commercial housing credit management. Regulation of real estate credit is emphasized from different perspectives: 1) stricter management of real estate development loans; 2) strengthened management of housing consumption loans, especially prohibition of mortgage refinance loans and additional mortgage loans for unspecified purposes and fluctuating with the valuation of real estate; 3) guidance of individuals' consumption and investment and higher minimum down payment ratio and lending interest rate for second home mortgages; 4) inclusion of solely foreign-invested commercial banks and joint-stock commercial banks into the regulatory policy system; 5) strengthened credit information management in the real estate sector to fully leverage the credit information system that includes both enterprises and individuals.

Recently the PBC and the CBRC issued the Supplementary Notice in accordance with housing consumption policies and other policies at the state level. First, the number of home loans is calculated by households (including loan applicants, their spouses and children). In China, housing is a necessity for family life, so it is more reasonable to calculate the number of home loans by households, both in line with our national situation, and conducive to the enforcement of the Notice, guidance and promotion the reasonable allocation of real estate resources and strengthening the macro-regulation of the real estate industry. Second, given the reasonable demand of residents to improve their living conditions, households having purchased the first home with loans whose per capita residential space is lower than the local average level, first home loan rate applies if such households apply for a second mortgage, so as to curtail irrational demand (including speculation) and improve people's living conditions. This policy is consistent with the Notice. After borrowers present information of total living space certified by real estate administrative authority according to their registration information, commercial banks decide whether first home loan rate shall apply against living space information, residential permit and other documents, while the average per capita residential space comes from last year's figure released by statistics department. Second home interest rate applies to re-borrowers who don't conform to the above conditions. Third, the Supplementary Notice prescribes that housing provident fund loans are also subject to the Notice. Either housing provident fund loans or commercial loans are the

liabilities of households. Housing provident fund loans will not exempt from market volatility. Therefore, second home loan rate applies to households who are in housing provident fund loan scheme and who are applying for commercial loans.

There are some requirements concerning how to further implement the Notice and the Supplementary Notice.

First, reach a common understanding. Regional offices of PBC, CBRC and commercial banks shall carefully study the spirits of the 17th CPC Congress and Central Economic Work Conference, implement the scientific approach to development, exercise tight monetary policies, strengthen regulation over real estate credit, improve management of real estate credit risks, speed up real estate credit restructuring, drive forward real estate financial innovation so as to promote the healthy development of the real estate market.

Second, streamline risk management stipulations. Headquarters of commercial banks shall improve and unify bank-wide real estate credit management stipulations, and all their branches and sub-branches shall grant real estate loans in strict conformity with such stipulations. Units and staff responsible for real estate financial businesses shall explain lending policies to their customers in order to safeguard the seriousness of credit policies.

Third, make sure that all relevant policies are put in place. Principles and policies on real estate credit regulation are specified in the Notice and Supplementary Notice. They key is implementation. Mortgage refinance loans and additional mortgage loans shall be eradicated steadfastly to achieve zero mortgage refinance without specific information or real transactions and zero additional mortgages. Commercial banks shall refrain from accepting applications with false information or certificates, and notify local banking associations.

Fourth, improve financial services for protective housing development. Commercial banks, in addition to improving commercial credit risk management, shall restructure the credit mix to give priority to ordinary commercial housing and affordable housing and households capable of making repayment and applying for loans to buy self-occupied houses. At the same time, commercial banks shall improve their services for affordable housing and low-rent housing in the preconditions of risk control and in accordance with the state housing guarantee system. Improve the low-rent housing system, regulate the construction and distribution of affordable housing and earnestly do a good job in housing guarantee for low-income households.

Fifth, go on with real estate financial innovation. Real estate finance is an important part of financial innovation. If we attributed sub-prime crisis to financial innovation, we will run the risk of mistaking the phenomenon as the root cause. In recent years, real estate financial innovation has made initial achievements through concerted efforts. We should summarize experiences, continue to push ahead with financial innovation, improve the efficiency of resources allocation, identify and diversify financial risks in the real estate sector so as to promote the healthy development of the real estate financial market.