Liu Tinghuan: China's real estate finance and policy implications

Speech by Mr Liu Tinghuan, Deputy Governor of the People's Bank of China, at the 1st Jiangxi High-level Forum on Real Estate Development and Financial Support, Jiangxi, 26 June 2004.

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It is a great pleasure for me to attend the 1st Jiangxi High-level Forum on Real Estate Development and Financial Support organized by the Land Institute and the Financial Institute of Jiangxi Province. I would like to take this opportunity to share with you my personal observations on china's real estate finance and policy implications. My remarks will fall into three parts: first, I would like to give a brief overview of the current situation and analyze problems in China's real estate financial market；then I will make an analysis of approaches, methods and channels to develop China's real estate finance centering on how to provide financial support to the growth of the real estate sector; finally, I will touch on the issues of supervision and regulation of the real estate financial market.

I. Overview and analysis of the current situation of China's real estate finance

1. China's real estate finance has developed rapidly in recent years.

Since the reform and opening up, China's real estate finance has witnessed rapid growth, from nowhere to a considerable size, along with the reform of national housing system and continuous growth of the real estate market. Especially since 1998, financial support to the real estate industry has been extended from previous single enterprise development loan to both investment and sale credit. The current development of China's real estate finance has the following characteristics:

First, property development and personal housing consumption lending experienced accelerated growth year by year. The outstanding balance of property development loans rose to RMB665.74 billion yuan in 2003, or 3.2 times of 202.89 billion yuan in 1998. Personal housing consumption loans grew rapidly likewise, by RMB1135.36 billion yuan or 26.64 times during 1998-2003, accounting for as high as 75-97 percent of consumer credit.

Second, the growth of property development loans outpaced the growth of total lending of financial institutions markedly. The average annual growth rates recorded 29.43 and 14.62 percent respectively during 1998-2003. While total real estate loans including personal housing loans grew at an average rate of 44.35 percent, highlighting out-performance over other loans.

Third, real estate trust financing expanded rapidly, emerging as the most vigorous financing means recently. China's trust industry has been back on the track of rapid growth after period of rectification. Vigorous development of real estate trust is especially eye-catching. At end-2002 trust assets that went to the real estate sector totaled RMB2.4 billion yuan, up 1.26 billion yuan or 109.93 percent from the beginning of the year and accounting for 2.82 percent of total trust assets. In 2003 real estate trust continued its strong growth, with the funds raised by real estate trust projects exceeding RMB5 billion yuan, more than doubled compared with 2002.

Fourth, the prolonged low interest rate policy contributed to rapid growth of the capital-intensive real estate sector. Now interest rates of financial institutions stand at historical lows after eight interest rate cut in a row since 1996. The official one-year term loan interest rate is 5.31 percent, while housing loan interest rates are lower by one tranch correspondingly. Cheap money not only lessened interest payment burden of property developers, thus increasing profits, but also improved households' power to purchase houses and boosted growth of property demand. Based on the regression analysis, interest rates fall every 1 percentage point, the national housing climate index for the period rises by 0.5 percentage points.

2. China's real estate financial market is still underdeveloped.

We should see that compared with developed countries, China's real estate financial market is still underdeveloped with limited products, heavy reliance on bank loans and some difficulty in real estate financing. In mature real estate financial markets various financial intermediaries provide abundant financing products besides traditional lending for property enterprises, such as public stock issuance, project financing, corporate bond, equity financing, industry fund and real estate trust. In addition, a mature market is featured by a developed secondary market of assets securitization. The secondary market not only improves liquidity of real estate assets and provides effective means for funding financial institutions to diversify and manage risks, but also offers diversified financial products for investors and stabilizes the financing sources for the real estate sector. Furthermore, a sound real estate financial market system has been put in place in mature market economies thanks to efforts for long, comprising comprehensive market structure, function and regulatory framework. By contrast, China's real estate financial market is still underdeveloped, having obvious lag and imbalance, which are reflected in the following aspects:

(i) Single real estate financing channel highlights risk concentration.

First, bank lending constitutes the major channel of real estate financing. According to estimates, over 80 percent of funding for land purchase and property development comes from bank lending directly or indirectly.

Second, market risk and credit risk of real estate investment are highly concentrated on commercial banks. Of the capital chain, bank lending penetrates the whole process of the real estate industry including land reserve and transaction, property development and house sales. Commercial banks incur market and credit risks directly or indirectly in all the activities of the real estate financial market by extending various types of loans including housing consumption loan, property development loan, working capital loan for construction enterprises and land reserve loan.

Third, some commercial banks and other financial institutions suffer from irrational and irregular business behavior. Commercial banks aggressively grant real estate credit as kind of "good assets", thus they tend to loosen credit requirements and seek quick success. For instance, to woo customers some commercial banks lower the threshold conditions for customer qualifications, oversimplify examination formalities and speed up the process of extending real estate loans. Some commercial banks feel overoptimistic over projects guaranteed by the government and lose sight of the risks. In the meantime, potential default risks of personal housing consumption loans deserve due regard. The business has only developed for three years, so some problems are prone to be concealed and ignored due to small basis, rapid growth and long maturity of housing loans. Furthermore, absence of individual credit information system makes it difficult for commercial banks to conduct strict examination and monitoring of borrowers' credit standing and debt servicing capability.

(ii) Without an integrated real estate financial market framework in place, the market structure is simple, mirrored in the following areas:

First, lacking a multi-tier real estate financial institution framework. The current market is mainly composed of commercial banks and some trust and investment companies, with no presence of specialized mortgage institutions, investment institutions, guarantee institutions and insurance institutions which usually are most important players in mature markets.

Second, lacking a diversified and standardized real estate financial product system. On the one hand, securities offerings of the real estate industry are quite limited. Increasing real estate enterprises have gone listed in recent two years. At end-2003, there are over 70 listed real estate companies with total market capitalization reaching around RMB150 billion yuan. But bond offerings by real estate enterprises are very small, and the ratio of debt financing is on the decline. On the other hand, although real estate trust is dynamic, the size is relatively small with inherent weakness. At present real estate trust mainly serves as "bridge loans", proving early-stage trust funds for real estate projects unqualified for bank loans, failing to perform the function of asset portfolio and transfer of maturities. Besides, real estate industrial fund, mortgage securitization and other real estate financial products are only under discussion or on a pilot program, far from mature.

Third, lacking an independent and effective intermediary service system. At present, the intermediary service system hasn't been put in place in China's real estate financial market. With unclear nature, complex subordination structure, and non-market operation and management, specialized intermediaries such as asset appraisal, credit rating, risk evaluation, financial guarantee and legal consultancy agencies are still weak. More importantly, lacking a sound credit environment, especially weak credit awareness of enterprises, is no good for the healthy development of the real estate financial market.

Fourth, lacking an integrated primary market for real estate finance as well as a secondary market. In the primary market (mortgage market), basically only commercial banks are providing mortgage loans, unfavorable for a diversified and competitive market. The long maturity of mortgage loans necessitates the establishment of a secondary market (mortgage transfer market) to improve liquidity. But the secondary market has not yet been built in China due to shortage of mortgage operators. Low level of mortgage securitization and asset liquidity make financial institutions unable to effectively manage risks. Likewise, it is the lack of a harmonious and integrated primary and secondary market framework that makes the dynamic real estate trust unable to fulfill the function of maturity transfer and risk management.

(iii) Regulation and supervision mechanism for the real estate financial market is to be improved.

The real estate financial market is still fresh in China on the whole. We need to explore and summarize the experiences of regulating and supervising markets and institutions in practice. At present, legal system construction lags quite behind the development of the real estate market. Except for the provisions on the establishment of banks and uses of funds in the Commercial Banking Law, there is no special regulatory framework for real estate finance. Standards on real estate financial businesses need to be established promptly. Under the current separate supervision structure of the financial sector, supervisory agencies are unable to conduct effective and integrated supervision due to various constraints. While promoting the strong growth of this market, the rapid development of the real estate market and the opening up of the financial sector also add difficulties to the regulation and supervision of the real estate financial market.

II. Speeding up the development of the real estate financial market to provide financial support for the growth of the real estate sector.

1. Encouraging real estate financing product innovation and actively expanding financing channels for real estate enterprises.

According to international experiences, financial innovation has brought more and more financial products for the real estate financial market, including various equity, bonds, funds, trust securities and mortgage negotiable securities and so on. Therefore, great efforts need to be devoted to developing diversified real estate financing products and channels along with improving traditional channel of bank lending.

First, encouraging qualified real estate enterprises to finance through equity market. Fund raising through equity market is not only an important financing channel for real estate enterprises, but also a good way to lift their brands and reputation. Take Mr. Lee Ka-shing's Cheung Kong Limited as an example, net assets of the company grew from over 100 million when listed in 1972 to over 130 billion in 2003, making the company an international real estate player. Given China's specific circumstances and relevant provisions of the Law on Securities, at present China shall encourage those truly competent and law-abiding developers to get listed. In addition, taking into account the current small size and large volume of developers, qualified small and medium sized real estate enterprises can be encouraged to finance through the second board equity market.

Second, fostering and developing real estate bond market. The existing Company Law imposes strict requirements on bond issuers, providing that only shareholding limited companies, wholly state owned companies and limited liability companies established by over two state-owned enterprises or other state-owned investment agencies are qualified for issuing bonds apart from other conditions on asset-liability ratio, capital level and guarantee. Further more, China's bond market features small size and great interest rate risks. Therefore, relevant issues such as qualifications for real estate enterprises to issue corporate bonds and risk management should be studied to actively explore effective means and rational channels of bond financing by real estate enterprises. It deserves our attention that some real estate enterprises have successfully issued off balance sheet bonds based on the property development project in recent years. Off balance sheet bonds (excluded from the balance of sheet despite the issuance in the name of property project) are different from on balance sheet bonds in many ways such as risks and accounting treatment. So relevant regulations should make a distinct line between them.

Third, transforming property fund trust to real property trust. At present a lot of so-called property trust are executed in line with relevant provisions of bank lending, serving as the proxies of bank lending to a large extent. While trust companies are at a disadvantage to banks in terms of capabilities of monitoring and managing trust loans, operations and experiences, hardly playing the role in effectively diversifying and managing risks. Therefore, as supervision over real estate trust is strengthened, trust financing should be standardized and developed to improve the real estate financial market and to offer comprehensive financial services to each activity of the real estate sector including development, acquisition, purchase and sale, leasing and management.

Fourth, actively advancing real estate finance innovation and developing various real estate financial products for which conditions are ripe. In particular, study on effective means to develop real estate loans securitization shall be made a priority at present. So far the discussions on mortgage securitization are dominated by on balance sheet practice of China Construction Bank and off balance sheet practice of the China Development Bank. Some questions like whether to conduct asset securitization within the financial institution or to establish a separate specialized agency can be explored further based on China's reality. All in all, experimental action shall be taken actively rather than hanging around theoretical debates.

2. Accelerating the development of the primary real estate financial market and steadily pushing ahead with the development of the secondary market.

First, the primary market shall be developed into a diversified and competitive market with considerable size. On the one hand, the primary market with considerable size can not only provide sufficient funding sources for the growth of the real estate market, but also lay the groundwork for setting up and developing the secondary market. In the U.S housing mortgage assets securitization was introduced in the 1970s, and commercial mortgage securitization began in early 1990s. Whilst as early as the beginning of the 1970s, even before the birth of mortgage-backed assets securitization, the primary mortgage market had reached a substantial size with the outstanding balance hitting near USD300 billion. On the other hand, diversified primary market is conducive to fostering competition of fund supply and demand and improving efficiency of resource allocation. The U.S. primary real estate finance market mainly consists of savings and loan associations, commercial banks, credit unions, life insurance companies and real estate trust investment funds. Hence, it is necessary to study effective channel, timing and method to introduce new financial institutions, broaden financing sources and expand the primary real estate financial market.

Second, mortgage securitization shall be pushed forward to build the secondary real estate financial market. Mortgage securitization refers to conversion of mortgage loans extended by financial institutions to securities (mainly bonds against mortgage loans as collateral), which can be traded on the secondary market and resold to investors, thus fulfilling the purpose of financing and transferring risks of mortgage loans to myriad market investors. Functioning of the secondary market not only provides stable funding sources for the primary market, but also greatly enhances security and liquidity of mortgage loans, thus achieving the objectives of diversifying and managing risks and proving a medium and long term investment instrument with relatively good credit rating for the securities market. In the U.S. mortgage-backed securities guaranteed by the Federal financial intermediaries have similar credit ratings to government bonds. Furthermore, because of higher yielding in the secondary market, mortgage-backed securities enjoy good popularity among medium and long term investors such as insurance and pension funds.

3. Stepping up the development of real estate financial intermediaries to improve the institutional structure of real estate financial market.

In line with the objective of an integrated real estate financial market, a multi-tier real estate financial institutional structure shall be put in place. Various financial institutions engaged in mortgage lending, real estate financial guarantee, property trust, property leasing and property insurance shall be included in the institutional framework. First, feasibility of other financial institutions' entry to the real estate market (such as insurance companies and investment fund) shall be studied actively. Second, the development and improvement of other real estate financial institutions such as trust and fund shall be encouraged. Third, agencies that engage in operating real estate loans securitization and guarantee provision shall be fostered and developed to establish an institutional structure of secondary market. Fourth, real estate financial insurance system with mortgage insurance at the core shall be put in place. Mortgage insurance and property quality insurance shall be developed forcefully together with the existing moderate housing property insurance, real estate liability insurance, and real estate personal insurance.

4. Fostering specialized intermediary service institutions actively to build the service supporting system for the real estate financial market.

With the establishment and perfection of the socialist market economy, labor division will be increasingly diversified. If financial institutions are to survive, grow and succeed in the complex market environment, they have to rely on a comprehensive and efficient supporting system. At present the information supporting system needs to be worked out urgently, because in face of such a complex and volatile market it is impossible and uneconomical to rely on one or a couple of real estate financial institutions to collect and analyze all the information needed for lending decisions. Therefore, relevant parties shall take an active approach to foster a sound policy and legal environment and nurture an independent, fair and standardized institutional framework of specialized intermediary service agencies that adapt to modern financial system.

Specifically speaking, first, efforts shall be made to foster and develop a number of intermediary service agencies with sound competence and professional integrity, such as credit rating, asset and project evaluation, property and specialized project consulting agencies. Second, relevant government departments shall also set up and develop consulting, evaluation and service agencies in response to the needs of market growth so as to provide specialized, rapid and efficient public services to the market in the areas of collecting, processing and publishing information. Only when independence and advantages of those specialized institutions in mining market information and building market discipline mechanism be brought into full play, can capabilities of real estate financial institutions in risk analysis and management be improved effectively. Third, the establishment of information network of real estate and finance shall be speeded up to push forward the computerization of transaction, settlement, management and surveillance.

III. Strengthening policy guidance and regulation and improving legislation to promote healthy and orderly development of the real estate financial market.

1. Strengthening supervision over the real estate financial market and standardizing financing behavior of real estate enterprises.

Efforts shall be made to enhance supervision of property lending as well as to continuously support growth of the real estate sector. Drawing on the historical lessons of non performing loans buildup when credits were highly concentrated in the processing industry (such as refrigerators, color TVs and washing machines) in early 1980’s and the real estate sector in early 1990’s (the real estate bubble in Hainan Province and in Beihai City of Guangxi Province), close attention shall be paid to the issue of real estate lending concentration so as to guide commercial banks to expand other lending businesses in a timely manner. Meanwhile, real estate credit management shall be strengthened to investigate and punish property lending irregularities and intensify risk management and prevention.

2. Working out relevant policies to create a sound external environment for the development of real estate finance.

First, regulatory agencies shall explore rational and effective supervisory approaches to keep up with the market developments. Second, property lending structure shall be adjusted to improve the operation mechanism and build a diversified, multi-tier and competitive institutional framework of real estate financial market. Third, public service system for the real estate financial market shall be established and continuously developed. Efforts need to be made in speeding up the construction of individual credit information system, building market risk early warning system and statistics index system and imposing information disclosure practice.

3. Establishing policy real estate financial institutions to guide the development of the market.

Without the secondary market in place, commercial banks incur great liquidity risks of mortgage loans. Hence policy real estate financial institutions shall be introduced based on international experiences combined with China’s reality. Under current circumstances, specialized policy real estate financial institutions can be considered to be initiated with a view to setting specific standards and providing mortgage guarantees for medium and low income earners.

4. Building and improving the legal and regulatory system of the real estate financial market as soon as possible to provide legal guarantee for the market evolution.

For the time being China's legislation and regulation on real estate finance are far from mature, which are reflected in the following aspects: First, the administrative level of legislation is not high. Regulations governing real estate finance complementary to the Law on the People's Bank of China and the Commercial Banking Law need to be established over the current low efficacy administrative rules. Second, relevant laws and regulations are dispersed without a holistic approach. Third, some laws and regulations fail to keep up with rapid development of China's real estate finance and thus need to be adjusted and amended. Fourth, some clauses of laws are abstract and weak in operation. Therefore we shall speed up the legislation and improvement of laws and regulations on the real estate financial market. Study of legal environments in mature markets shall be intensified to learn from their experiences. Next, overhaul of the existing laws and regulations shall be expedited to amend and complement them in line with the reality of the market developments and pratical requirements. Finally, regulations on real estate financial products for which conditions are ripe or the market is dynamic and has an urgent demand shall be enacted as soon as possible. Industrial fund is a good case in point, which needs early regulations as legal basis of operation.

5. Paying close attention to property asset prices to prevent financial risks.

The international experiences have shown that real estate prices are closely related to the quality of financial assets and the stability of financial market in market economies. Instability of the property market may directly lead to real estate financial market turbulence and financial risks, endangering macro-economic stability. Therefore, it is necessary for the central bank to pay close attention to property asset prices, to regulate the market and prevent and mitigate financial risks through monetary and credit policies.

Distinguished guests, ladies and gentlemen,

China is in the historical stage of new industrialization, urbanization and building a moderately affluent society in an all-round way. Real estate development and finance have broad prospects. I hope that property developers and financial institutions can collaborate and seek common growth to make new and greater contributions to the healthy development of China's real estate industry.