Wu Xiaoling: Expanding financing channels of the real estate industry and developing a win-win situation for the real estate and financial industries in China

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, delivered at the Annual Conference of Real Estate Finance in China, Beijing, 5 November 2005.

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Ladies and Gentlemen:

Good morning. It is my great pleasure to attend the "Annual Conference of Real Estate Finance in China, 2005". I would like to take this platform to make a few comments on real estate finance.

All industries and enterprises are in need of financing, with the real estate industry being only one of them. However, the financing issue of other industries is rarely talked about while financing for the real estate industry has become a hot topic for wide discussions. Why is that? I think basically there are three reasons behind it.

First, the real estate industry concerns people's living conditions. To live and work in peace and contentment are the two important preconditions for a harmonious society. The possession of a house ensures the basic life of the people; whether living in a good and comfortable environment concerns the living quality of people. Therefore, the housing policy and the development policy of the real estate industry concerns the achievement of the social development objective, which shall be one of the critical connotations for a well-off society.

Second, the real estate industry enjoys a relatively long industrial chain and promotes the economic development greatly. The economy in China is in a phase of transformation and transition. The commercialization of housing and the urbanization of rural areas are exactly the processes in which the development of the real estate industry and that of other industries are mutually re-enforced. Consequently, the real estate industry shall be one of the pillar industries in national economic development for quite a long period in the future.

Third, the development of the real estate industry concerns national interest and people's livelihood. However, the productive cycle of real estate is so long that there is a process from the emergence of intensive demand for funds until the final payments made by the consumers. Such a mismatch can also be regarded as the timing difference between the demand for and supply of funds, which is a financial issue for sure.

It is the special social and economic role played by the real estate industry and the urgency regarding the financing of the real estate industry that have aroused people's particular interest in the real estate finance.

Real estate finance definitely does not refer to real estate credit only. It covers all the financing modes utilized for the development of the real estate industry such as equity financing, bond financing, credit financing and trust financing. Like the development of other commodity markets, the development of China's housing market must resolve the problems of final effective market demands and the demand for capital in the process of commodity production. The availability of working capital in the process of commodity production depends on whether the final effective demands exist.

In my opinion, the problems of the current real estate finance in China do not mainly revolve on the credit policy for the real estate industry, instead they include the following 2 issues: first, there is not a risk separation mechanism in shape for the financing modes of the real estate industry. Most of the risks are concentrated in banks; second, the housing monetarization reform has not been completed yet. We are still lacking an appropriate solution that shall properly deal with the relationship between carrying out the housing monetarization reform and ensuring the basic living standard of the general public. This leads to some problems yet to be resolved in respect of income allocation, which shall have a negative impact on the effective demands for housing commodities. The former belongs to financial policy issues, while the latter belongs to housing policy and income allocation policy issues, but the latter has great impact on the safety of financial activities. We shall analyze the effective demands in the market as well as the effectiveness of various financing modes given the status quo of income allocation.

We shall make research on the real estate finance in terms of the match between risk and return.

The real estate industry is a capital intensive industry. Prior to World War II in the 20th century, the real estate market in various European and American countries were dominated by house leasing and tenancy. After World War II, the purchase of houses was on rise and gradually became the predominant trade form in the market. However, nowadays tenancy and selling of houses still co-exist in the market in these countries. Thanks to the promotion of housing mortgage loans, ordinary residents are now able to have access to the house purchase market. However, if the mortgage loans are improperly dealt with, they could bring about financial crises such as the crisis of the thrift and loan institutions in 1980s in the United States. Maintaining the co-existence of house tenancy and selling is not only a method to satisfy the housing needs of the low-income people, but also a prerequisite to maintain the free mobility of the workforce. In order to create a certain kind of tenancy and leasing market for the housing industry, and in order to ensure the housing mortgage loans be backed by indisputable securities, the real estate developers must utilize equity financing as the main form. As the real estate industry is a high-risk as well as a high-return industry, the problem of matching risks and returns shall only be better resolved with equity financing mode taking the dominant position.

According to information provided by the *Report on China's Real Estate Market 2003~2004*, the leverage ratios of China's real estate enterprises are relatively high. The leverage ratios of the top five listed companies in Hong Kong are basically kept at a level between 30% to 40%, while those of domestic real estate companies stand at around 75%. The report also shows that among the 24.6% of the self-raised capital 13.3% belongs to self-owned capital. Such a high leverage ratio could bring huge loss to debtors once the market risks arise. According to the Report, the return on self-owned capital is 21.17%, which does not match the risk borne by debtors when compared to the cost of financing. With the maturing of financial markets, the principle of matching risks with returns shall be absorbed into the financing mode for real estate industry, and it is an inevitable trend that the ratio of developers' equity financing will be increased.

China's economy is now in a transition period when many reforms are not compatible with each other perfectly. When we put forward the reform of housing commercialization and monetarization, the state reduced or halted direct input into the housing industry but failed to open the equity- financing channel to real estate developers. A multi-level capital market has not developed not only to real estate developers but also to all the enterprises, leading to the result that many enterprise flocked to get listed in the stock market. If they did not succeed in the direct financing market but have to develop, the financing burden thus completely falls on banks. In order to support the housing monetarization reform and promote the development of the real estate industry, the People's Bank of China has issued a series of credit policies to contribute to the development of real estate credit since 1998. The rapid development of the real estate industry should be a benefactor of the housing credit policy formulated by the PBC, otherwise the real estate industry shall not be so sensitive to the adjustment of the PBC' credit policy. However, there should be a limit on risks borne by banks, otherwise the financial stability could be threatened. The difference between bank credit and direct financing goes as follows: bank loans are able to create purchasing powers, which could lead to asset bubbles if improperly controlled; direct financing brings about circulation of the realistic purchasing powers, which could enhance fund utilization via efficient capital allocation. Therefore, it is an urgent task to expand the direct financing channels after the central bank adjusted the real estate credit policies in line with the needs of macro economic control.

Given the current restrictions on financing via public offerings on the part of real estate developers, private placements shall be a possible approach worthwhile studying actively. The stipulation of "200 contracts" in the *Provisional Rules on Entrusted Funds by Trust and Investment Companies* as well as the stipulation that "the issuance of securities to specific objects that amount to more than 200 persons accumulatively shall be regarded as public offering in the revised *Securities Law* enacted on October 28 this year leaves room for privately-raised trust funds, privately-offered stocks and bonds. The privately-raised trust funds can be used for project development or real estate investment, i.e. real estate purchasing. The privately-offered stocks can solve developers' capital raising problem to some extent.

In recent years, the real estate trust plan becomes quite popular, but the biggest problem inherent in its development is that loan trust plans being the majority while real estate trusts, i.e., trusts with income relying on the rents of real estates, are rare. When real estate developers fail to meet the loan conditions set by banks and then turn to loan trusts, the funds entrusters will assume excessive risks and an imbalance between risk and return will take shape. A few days ago, China Banking Regulatory Commission put forward supervision requirements on loan trusts stipulating quite similar criteria as those set on bank loans, therefore, loan trusts thus would not resolve financing problems of developers with insufficient equity. Equity funds instead of credit funds shall be established for the real estate industry if the developers' problem of insufficient equity needs to be resolved via trust funds, so that funds owners shall bear the investment risks at the same time when they enjoy the investment returns. The real estate trust is in essence an industrial investment fund. The underlying assets of trust funds used for real estate development are illiquid, difficult to price and have relatively high demands on risk-taking capacity of the entrusters. Therefore, this type of financing products shall mainly target qualified investors. Given the fact that we have neither rules regulating private funds nor classifying standards on qualified investors, people who are lacking in risk identification ability and risk bearing capacity are hence usually involved in collective trust plans, leading to relatively high market risks. As both the value of underlying assets and the number of units of privately-offered real estate funds are not high, problems of limited scope and low liquidity also exist for privately-offered stocks, consequently, the above two financing modes both face quite a few restrictions. To establish real estate investment trust fund via public offering or issuing beneficiary certificates based on specialized management shall be the future development direction as well as a sustainable developing mode for direct financing of the real estate industry, and it shall also be an important financing mode to support investment in house leasing market. I hope the current reform on non-tradable state shares and the implementation of the newly revised *Securities Law* shall expedite this process so as to develop a win-win situation for both the real estate industry and the financial industry.