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China's Mortgage Boycotts Signal Deeper Problems in Its Real Estate Sector

By LI Yao and ZHOU Na

On 30 June 2022, homebuyers of a real estate project in Jiangxi province issued a "Mortgage Payment Suspension" letter online,[1] triggering a rapid spread of mortgage boycotts across China. According to statistics shared on github.com,[2] as of 7 August 2022, homebuyers of more than 300 projects announced a halt to mortgage repayments in 26 provinces and municipalities, mostly in China's central and coastal regions (Figure 1). Over 90 developers are affected, including troubled private real estate companies, such as Evergrande, Sunac, Dangdai, Aoyuan, Kaisa, some listed private developers including Longfor and Zhixin, and Greenland, a state-controlled developer.

The mortgage strike has raised concerns in China's real estate and financial sectors alike and further dampened households' propensity to buy new homes. According to the National Bureau of Statistics (NBS), the real estate sector contributed 13.8% to China's gross domestic product or GDP (7% from construction and 6.8% from real estate) directly in 2021. Some studies estimated that the property sector accounts for up to 30% of China's GDP.[3] Slumps in housing sales and debt defaults of several major developers prompted serious concerns that the mortgage strike could be the "Last Straw" of China's "Lehman Moment", a situation that could be much worse than the Evergrande crisis at the end of 2021.

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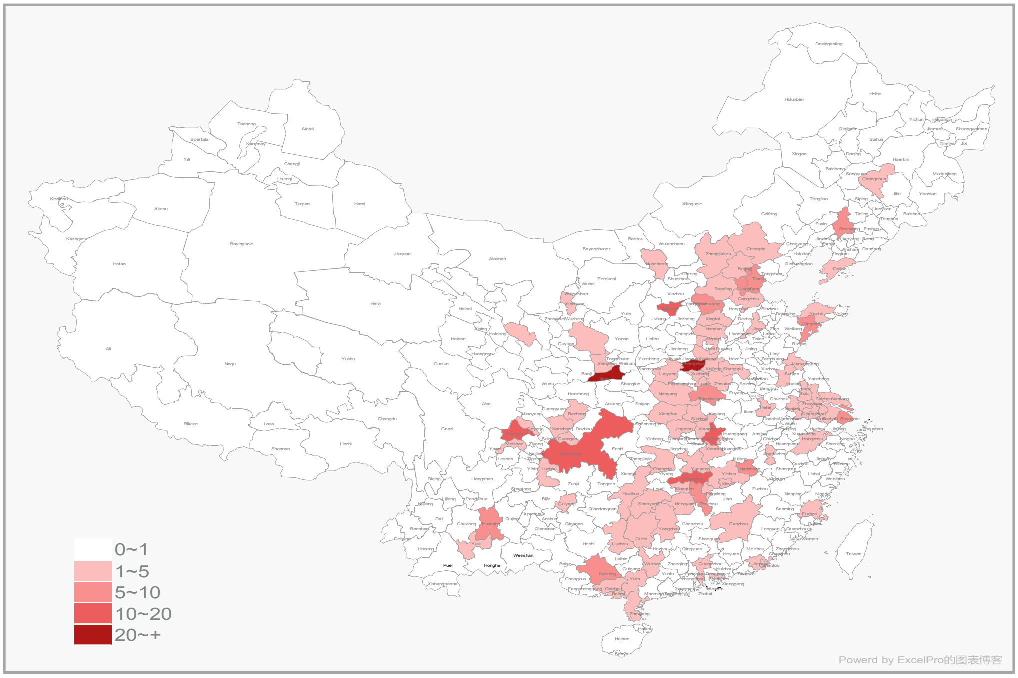
[1] On 30 June 2022, homebuyers of Evergrande Longting, a halted presold residential project in Jingdezhen, Jiangxi province, issued an on-line open letter demanding the resumption of the construction by end October 2022, to avoid their withholding of mortgage payment from November.

[2] https://github.com/WeNeedHome/SummaryOfLoanSuspension, accessed 7 August 2022.

[3] https://www.cnbc.com/2021/11/09/chinas-property-market-debt-an-issue-for-the-economy-george-magnus.html, https://www.bloomberg.com/news/articles/2022-07-16/china-s-property-sector-remains-biggest-drag-on-economy, accessed 12 August 2022.

FIGURE 1 DISTRIBUTION OF MORTGAGE BOYCOTTS AT PREFECTURE CITY LEVEL



Source: By the authors using data from https://github.com/WeNeedHome/SummaryOfLoanSuspension, accessed 7 August 2022.

In response, China Banking and Insurance Regulatory Commission (CBIRC), the regulatory authority, commercial banks, governments of affected localities and developers have made announcements to manage the situation. Since 23 July 2022, the spread of mortgage boycotts seems to have been contained as no new boycott announcement has been reported. Nevertheless, many long-standing problems in China's real estate sector are far from being resolved.

RESPONSES OF DIFFERENT PARTIES

CBIRC issued two emergency responses, on 14 and 17 July 2022, respectively. It emphasised that the key is to "guarantee the delivery of homes" and the CBIRC will guide financial institutions to facilitate risk management in a "*market-based approach*". There is no mention of a direct government bailout or financial support to resolve the crisis. According to the "Notice on Providing Good Financial Service in Mergers and Acquisitions (M&A) Related to Projects of Key Real Estate Enterprises at Risk", jointly issued by the central bank and CBIRC in December 2021, the "*market-based approach*" may refer to financial support and services rendered for the M&A of key real estate enterprises or their projects at risk. In April 2022, at a meeting, the authorities urged five state-owned asset management companies and 18 banks to rescue real estate companies at risk through measures such as purchasing their liabilities.[4]

Many commercial banks had issued notices in relation to the mortgage boycott and, by 18 July 2022, these encompassed 21 commercial banks including six state-owned banks, nine national share-holding banks and six local banks in the Yangtze River Delta region. Among them, 15 disclosed that the amount of housing loans involved totalled about RMB2.5 billion, or around

4 https://asia.nikkei.com/Spotlight/Caixin/Chinese-banks-and-bad-debt-managers-urged-to-rescue-real-estate, accessed 19 July 2022.

0.01% of total housing loan. The Agricultural Bank and ICBC reported the largest amounts of more than RMB600 million each. However, some gave much higher estimates than those reported by Chinese banks. For example, Deutsche Bank calculated that about RMB1.8 trillion to RMB2 trillion of mortgages are affected. S&P Global Ratings and Capital Economics reckoned total mortgage debt at risk to be RMB2.4 trillon or even RMB4 trillion (10% of China's total mortgage balance by the end of Q2 2022 and 3.5% of China's GDP in 2021) respectively.[5]

Some local governments have also responded. Xi'an, for instance, issued the "Work Measures to Prevent More Delayed Delivery of Commercial Housing" on 14 July 2022, the first official policy response to the mortgage boycotts. The document covered 13 areas, including compliance with land purchase funds management regulations, monitoring of the process of projects, management of pre-sale funds, allocation of construction funds, detailing of bank responsibilities and enforcement of real estate credit management regulations. On 19 July 2022, the Henan Asset Management Co. revealed online[6] that it will set up a Zhengzhou Real Estate Relief Fund with a government-backed developer Zhengzhou Real Estate Group to bail out the stalled projects in Zhengzhou, the city that has the most mortgage boycotts. It is the first state-backed bailout proposal so far.

Some developers pledged to resume construction and guarantee the delivery of homes. Evergrande is reported to be working hard to deliver homes in the Pearl River Delta region (PRDR). The construction of 59 presold properties in Guangzhou, Foshan and elsewhere in the PRDR has fully resumed. Xinli Holdings is reportedly attempting to fulfil the delivery promise by pushing sales, negotiating the rollover of loans and setting special funding accounts. Shimao Group has categorised its projects into "normal delivery" and "tough delivery", and promised to allocate group level resources to support delivery for those in the latter category.

MAJOR CAUSES OF THE CURRENT CRISIS

The problems exposed by the mortgage strike are long-term in many respects, including an unbalanced risk allocation in the real estate sector, local government's excessive dependence on land revenue, and the policy dilemma between strict regulation and promoting development of the real estate industry.

The unbalanced risk allocation in the real estate sector

China's real estate sector has been a key driver of growth for more than two decades since the country began reforming its housing market in 1998.[7] Today, the real estate sector plays an outsized role in China's economy, as it is intricately linked to core industries and performance of local governments. The main stakeholders of China's real estate sector include homebuyers or homeowners, developers, local governments, financial institutions, suppliers of construction materials, contractors and various service providers. Although key resources of the sector, namely land and funding, are strictly regulated and controlled by local governments and financial institutions, the entire process of project development and management lies with the developers. They become the resource allocator of projects and the intermediary connecting other stakeholders; their performance hence has a direct impact on all involved.

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5 https://www.spglobal.com/ratings/en/research/articles/220726-china-s-mortgage-strike-puts-almost-rmb1-trillion-in-bank-loans-at-risk-says-report-12453848 and https://www.economist.com/finance-and-economics/2022/07/21/fresh-woe-for-chinas-property-sector-mortgage-boycotts, all accessed 12 August 2022.

6 http://www.henanamc.com.cn/2022/07-19/156154.html, accessed 19 July 2022.

7 http://finance.china.com.cn/news/special/ggkf40years/20181114/4808825.shtml, accessed 19 July 2022.

Given their pivotal positions, the developers could easily expand their businesses using readily accessible financing sources and at relatively little financial risk, which further inflate their ambition and recklessness. As a result, the risks fall disproportionately on other stakeholders, including homebuyers. Indeed, when a developer goes bankrupt during construction, buyers are still legally committed to pay for the bank loans of their home purchase, even if the project has been abandoned midway during construction.

Suppliers of construction materials, contractors and other service providers face similar disproportionate risks, as developers often use commercial bills (a form of unsecured, short-term debt) backed by their own corporate credit to settle payment.[8] In the case of Evergrande, a number of listed companies including Three Trees (603737.SH), Gold Mantis (002081.SZ), Yonggao Shares (002641.SZ), Quanzhu Shares (603030.SH) and E-House Enterprise Holdings (02048.HK), face cash flow problems due to the shrinking market value and endless repayment rollover of Evergrande's commercial bills.

Regulatory tightening of the real estate sector

The mortgage boycotts across China are not unexpected. Due to the government's consecutive regulatory tightening, the real estate sector has become sluggish and various risks have emerged, including operational and financial risks for developers, debt risks for local governments, possibilities of a real estate market crash and systemic financial risk to the entire economy.

Since 2010, the central government's concern for property bubbles and associated systematic financial risks have prompted several rounds of policy adjustments to stabilise housing prices. Subsequently in 2016, China's central government further tightened control under the banner that "housing properties are for living not for speculation". Several regulations including restricting purchases, loans and sales, and imposing strict price and market supervision have since taken effect. In 2020, a new wave of regulatory tightening had profoundly affected the real estate sector. For example, the "three red lines" policies, formulated in August 2020, have limited developers' annual increase of interest-bearing liabilities according to three financial conditions, namely debt-to-asset ratios, net debt ratios and cash-to-short debt ratios.

These policies have finally cooled China's housing market after two decades of housing boom. The first sign of a real estate downturn became evident in September 2021 when property prices took a dip. Monthly growth of 70 cities' prices for resale properties dropped from 0.1% in August 2021 to -0.4% in September 2021. As of mid-2022, housing market had yet to turn around, particularly in second- and third-tier cities and in the resale market.

Local governments' revenue pressure

A direct and significant impact of mortgage strikes is a serious drop in local government's revenue, as the strikes further drag down housing and land sales and prices. Income from land use right transfer (hereafter land income) has been a key source of local government's revenue. Before the pandemic, land income constituted 30% to 40% of local revenue; during the pandemic, it rose to around 45% when tax revenue has since declined as a result of economic downturn and tax cuts (Figure 2).

Local land incomes, which fell sharply in the first half of 2022, had dropped by almost 30% year-on-year in the first quarter of 2022 (Figure 3). A local government received an average of

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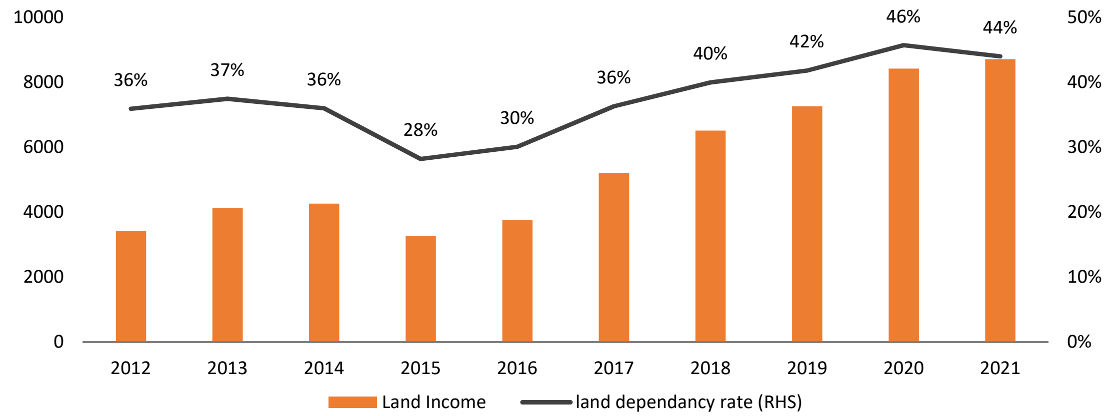
8 Li Yao and Sarah Y Tong, "China's Evergrande Crisis: Lessons from The Financial Sector Perspective", *EAI Background Brief,* no. 1627, 10 February 2022.

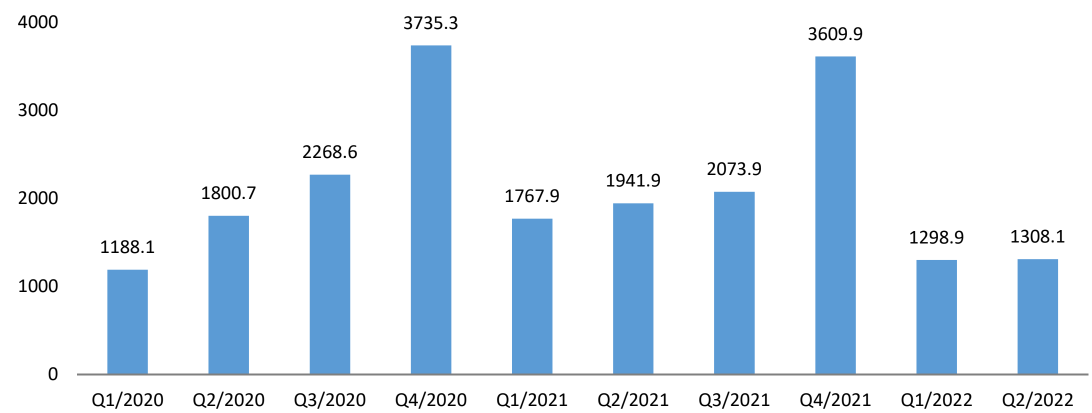
around RMB2.6 trillion in local land income in the first half of 2022, an amount that is much lower than the RMB3.7 trillion of the same period in 2021.

FIGURE 2 LOCAL LAND INCOME (BN YUAN) AND LAND DEPENDANCY RATE



Source: Ministry of Finance, www.mof.gov.cn.

FIGURE 3 QUARTERLY LOCAL LAND INCOMES (BN YUAN)



Source: Ministry of Finance, www.mof.gov.cn.

The rising number of failed auctions in the land market signals more pain down the road. For the first half of 2022, the share of failed auctions for concentrated land supply in Beijing, Nanjing, Chengdu, Hefei, Shenyang, Fuzhou, Tianjin, Ji'nan and Wuhan had all risen year-on-year. Among them, Tianjin recorded the highest share at 64%. During the same period, the overall rate of unsold land (including failed auctions and withdrawal of land by government) for the 21 cities was 15.8%, an increase of 1.2 percentage points over the last round of supply in 2021.

Policy dilemma

China's real estate sector and related government behaviours have been much criticised in recent years for the skyrocketing prices and high price-to-income ratios, excessive dependence of local government finance on land sales revenue, opaque and high financial leverage and interest burden of developers. The mortgage strike has also sparked criticism on the sector's presales model, especially the lack of effective regulations. The government is facing many challenges and dilemmas. Should it appease the protesters? How to reconcile varying policy targets between central and local governments when responding to the challenges? And how to balance between risk management and economic development?

The central government has reiterated the principle that housing is for living in, not for speculation. It will keep the current tight housing market regulation and enhance policy effectiveness in order to stabilise housing demand, promote the healthy development of the industry, and stabilise prices and market expectations.

To avoid possible systematic financial risk and reduce moral hazard problems of stakeholders in the real estate sector, the central government's policy responses are reasonable. As discussed earlier, some homebuyers of projects undertaken by developers with good financial conditions such as Longfor and Zhixin, or in first-tier cities including Beijing, Shanghai and Shenzhen where housing prices are still rising, have also participated in the mortgage strike. Materials suppliers of halted projects have reportedly suspended shipments, hence forcing a stop to construction.[9] In addition to the panic caused by the fast spread of mortgage boycotts, moral hazard can also be a reason behind some of the cases.

Local governments have responded with their own policies and measures to address the slump of the property market. Since the beginning of 2022, more than 100 cities have eased control measures to support the housing market. Some modified buyers' qualification standards. Zhengzhou encouraged the elderly to move to the city to join their offspring or relatives who live or work in the city and every qualified family is now eligible to buy one additional apartment. Others lowered financial restrictions on homebuyers. Beihai decreased minimum down-payment from 60% to 40% of the apartment's prices for families buying their second property. A few cities also incorporated housing subsidies in social policies to attract talents and encourage childbirths. Some local governments provided housing subsidies and set lower thresholds for *hukou* registration for those who buy urban houses.

Many cities have introduced policies targeting troubled projects, such as the launch of special funding in Zhengzhou. Some have also set up one-on-one pairing where specific officials or departments have been designated to help companies or projects in trouble.

Some of these new policies are short-lived as they are in an experimenting stage. On 20 May 2022, the Nanjing government announced the easing of all restrictions for both local and out-of-town homebuyers for the purchase of their second property, only to be withdrawn a few hours later.[10]

A LONG WAY TO GO

For years, China has taken great pain to rein in its real estate industry. However, considering the sector's importance to post-COVID economic recovery and local governments' fiscal sustainability, the government may have to relax some of its tight measures on property developers, at least in the short term.

Meanwhile, institutional reforms to enhance the sector's healthy development will remain on the agenda, both at the central and local government levels. In June 2019, the government released the "Guiding Opinions of the Ministry of Housing and Urban-rural Development on Accelerating the Implementation of Construction Guarantee System in House Building and

[9] https://cj.sina.com.cn/articles/view/2895952624/ac9cbaf00010169y0, accessed 27 July 2022.

[10] https://www.zaobao.com.sg/wencui/social/story20220521-1274908, accessed 27 July 2022.

Municipal Infrastructure Projects". It advocates that banking and insurance institutions guarantee and insure the various stages of real estate projects to help rebalance the risk distribution of the real estate sector. Following the release, many local governments have introduced implementation regulations and measures.[11] The results have yet to be seen. While this is a relatively new area for Chinese insurance companies, banks are less eager due to their already complicated relationship with developers. Meanwhile, the development of insurance products for contracts between developers and homebuyers are not included in either central or local governments' plans. Real estate-related insurance may also be hindered by other factors, including adverse selection problems prevalent in the insurance industry and prejudice among some Chinese against insurers.

The recent mortgage boycotts have once again demonstrated that much more needs to be done for China's real estate sector to achieve a significant advancement in its institutions.

LI Yao and ZHOU Na are Research Fellows at the East Asian Institute, National University of Singapore.

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[11] https://www.szggzy.com/zcfg/ygwy1/szszcfg8__zcfg/jsgc1/szszcfg3/content_315120.html, http://www.tj.gov.cn/sy/zwdt/bmdt/202109/t20210909_5588128.html, http://jst.sc.gov.cn/scjst/c101430/2019/11/4/2b0f6852ce864211bccbce05fcea191c.shtml and http://zjt.hunan.gov.cn/xxgk/xinxigongkaimulu/tzgg/tzgg2jzgl/201911/t20191118_10521647.html, all accessed 7 August 2022.