

How to save China's property market?

Look to how America rescued Silicon Valley Bank

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On July 24, 2023, China's Politburo met to discuss the economic situation and lay out economic plans for the second half of the year. Officials took in the analysis of pressing issues facing the economy, no doubt putting considerable focus on real estate. The politburo came away from the meeting with a resolution to "adapt to major changes in the relationship between supply and demand in the property market, be responsive in adjusting and optimizing real estate policies, and make good use of the policy toolbox for city-specific policies to better meet housing needs and promote the stable and healthy development of the real estate market." This expression was soon interpreted as preparation at the government level to inject stimulus into the industry; Chinese real estate stocks listed domestically and abroad promptly shot up in value.

On July 28, 2023, the Ministry of Housing and Urban-Rural Development published an article on its official website in which Minister Ni Hong was quoted saying he would continue to consolidate the stabilization and recovery of the real estate market, vigorously support rigid and improving housing demand, and implement measures including reducing down payments on a first home as well as loan interest rates, improve housing exchange tax relief, and "recognize the house not the loan" in personal housing loans. These are being seen as refinements of central government policies to boost the real estate market.

Since mid-2021, the development of China's real estate industry has undergone a major shift. Real estate developers have been facing increasingly tight capital constraints, and some developers have been unable to maintain sufficient financial stability. Many developers have defaulted on their dollar debts, causing huge losses to overseas investors. Due to a lack of funds, construction has stopped at many sites, leaving eyesores for half-completed edifices and gossipers for bystanders. The market expectation that housing prices will only ever rise has taken a severe knock, sending the property market into a perpetual winter.

Real estate is a pillar of the Chinese economy. According to some studies, upstream and downstream industries including steel, cement and housing interiors account for as much as 25% of China's GDP for short. To revitalize China's economy, real estate must be dragged out of the doldrums. Given the importance of property to China's economy, there is some truth in this perspective. What is still unclear is how we should rescue developers.

Curbing property risk contagion

Developers are housing construction operators, and key players when it comes to connecting

stakeholders such as banks, home buyers, construction firms and officials. In this overall real estate downturn, developers face a multifaceted crisis. The direct manifestation of this is that the capital chain is tight. Danger is rife, and has already caught Evergrande Real Estate (referred to as Evergrande). If the developer slips and runs out of money, a direct consequence is that the building under construction will cease to grow, and could become an “unfinished building.” There are, following from this, at least four channels of contagion risk.

First, suspending work on many construction sites infringes on the legitimate interests of property buyers. The laying down of tools will alert people to potential issues in other developments, and this will feed into doubt about buying a new apartment. As caution spreads, developers will have trouble shifting new homes, and their capital chain will further degrade, threatening more developments and the legitimate interests of home buyers.

Second, for homebuyers who had made a down payment and begun repaying their mortgages already, work suspensions make them face the possibility that they would not be able to get their home in the end. If they can't move in, why keep up with monthly mortgage repayments? Once these home buyers stop lending to developers to plump up supply, their mortgages turn into non-performing bank loans. You might say that if the buyer stops repaying their loan and cuts off supply, the bank will take possession of the home, and the down payment can be used against the bank's related losses, cushioning the bank from damage. There is some truth to this, but as mortgage payments were suspended because construction stopped, no actual assets would be there to recover. Transfer of home ownership from the buyer to the bank would not change this.

Third, developers' financial structures are fragile to breaking point, directly affecting the security of financing parties, whether banks, institutional investors, or individual investors. The more important problem is that our financial institutions, mainly banks, hold land and homes as collateral for loans in huge quantities. When a developer is in danger, the bank will naturally wonder whether if there is a problem with a city investment company? Is there a problem with the land banking center? These institutions will inevitably face even more stringent loan conditions, and related loans will come with even greater risks.

Fourth, developers are in danger. To save their skins, they have been known to sell off homes in their possession for less than their value to recover some funds. Falling housing prices and tight funding chains for developers mean land prices drop. This will not only reduce the value of collateral in the hands of the banks, but also weaken local government solvency, already a tenuous thing. When banks are impacted by the downturn in the real estate market, non-performing loans will increase, so banks will tend to shrink loans to reduce operating risks. The reduction in bank loans will worsen the overall environment in which today's macro economy runs, leading to falling incomes and slowing growth.

On the surface, real estate-related output accounts for about 25% of China's GDP, but once the market starts to decline, its impact may amount to much more. A major problem facing the real estate sector now is developments that pack up before they are finished. To mitigate some of the problems arising from this, "guaranteed building delivery" has taken center stage in discussions. This helps not just power economic and financial realms, but also has a tremendous impact on the entire housing scene. Making this a priority is smart.

In China, the real estate market is no small matter. Now that there is a problem in the real estate market making risk potentially contagious. We need to take measures to curb the spread of this risk, so as to prevent it from threatening the entire macro economy.

Aggressive expansion breeds risk

For the health of the economy as a whole and the financial system, the property market should be salvaged, but should neigh-on bankrupt developers be rescued?

Before answering this question, we need to see that the current plight of some developers is caused by a combination of factors. First, the economy has entered a stage of high-quality development from a stage of high-speed growth, and disposable income growth has slowed or declined. What's more, people's expectations about future income are less optimistic than before. As this is the case, demand for home ownership naturally declines. Second, the impact of the previous real estate control policies. The report of the 19th National Congress of the Communist Party of China in 2017 insisted that "housing is to live in, and not for speculation". Since then, the government has successively promulgated policies to regulate real estate, which has disrupted the operations of certain developers. However, the current policies have been relaxed a lot, so the impact of these factors on developers will gradually decrease over time. Thirdly, and most importantly, we must see that the current difficulties of some developers tend to be self-induced. Developers have aggressively expanded for over 20 years, rewarded handsomely for it. Those focused on risk control often lagged behind. Over time, everyone reached a consensus that rising property prices were inevitable, at least for the foreseeable future. In such a situation, some developers brewed up hugely risky operations. This risk was previously covered by high housing prices, but now housing prices are no longer rising, so the risk has become a crisis. Since these developers have enjoyed the dividends of development, they should also learn to survive the cold winter of the industry, and the government is not obliged to pay for their operations.

Speaking of this, the author considers the case of the US government's handling of Lehman Brothers' collapse in 2008 (Lehman for short). Lehman was then the fourth largest investment bank on Wall Street and had a decisive influence on the entire financial system. However, due to the aggressive expansion of its operations, it held baskets worth of "toxic" assets. When conditions changed, those assets turned into massive losses, and Lehman soon became an insolvent investment bank. No one in the market dared to do business with Lehman anymore, causing the equivalent of a run on Lehman. For any financial institution, a run is an unbearable challenge, and Lehman is no exception. At the

time, US regulators considered bailing out the bank, yet this rescue would have been the equivalent of providing free insurance for Lehman's past risk-taking. Would this have been fair to companies operating in a stable way? What would taxpayers think if their money was used to rescue such a company? In the end, the U.S. regulatory authorities gave up on Lehman, causing its collapse. The bank went bankrupt quickly, and the financial crisis began to reach its climax. While the cost of not rescuing Lehman was high, it served as a warning to companies that took too many risks that mistakes are costly...and expensive.

Going back to the reality in China, when real estate has been booming in recent years, many developers accumulated a lot of wealth, and expanded their operations at will, causing trouble later. A case in point is Evergrande. If Evergrande were to be hauled out of its hole, we would face the same problems as the US regulators faced with Lehman back then. What's fair to developers with stable operations and taxpayers.

Silicon Valley Bank Model

So far, some readers may find it a bit strange. On the one hand, I have mentioned that the risks in the property market must be controlled, and developers play a central role in the real estate market. On the other hand, I noted that developers should not be rescued. This seems contradictory. What solutions would the author have to the current conundrum?

That's a good question.

A lot can be learned from how the US regulatory authorities dealt with Silicon Valley Bank. In March 2023, due to huge flaws in its risk control mechanism among other reasons, Silicon Valley Bank suffered a run on its reserves. The US deposit insurance system has an insurance limit of USD 250,000, but most of Silicon Valley Bank's deposits exceed that limit. If it were really operated according to the regulations, many people would have suffered losses. To avoid such losses, depositors made the rational choice to try to withdraw their deposits, all at once.

Silicon Valley Bank suffered a run, but will other banks like it face the same problem? If this phenomenon cannot be curbed, then a single spark can start a prairie fire, and the crisis may sweep from Silicon Valley Bank to the entire banking industry. If rescued, the problems we have looked at above will reoccur, leaving regulatory authorities in a dilemma. In the end, the supervisory authority proposed a package. Deposit insurance would no longer be restricted to USD 250,000. Meanwhile equity stakes in Silicon Valley Bank were all leveled, and senior executives dismissed. Covering all deposits curbed the contagion of run risks, and punishing shareholders and executives of Silicon Valley Bank made them bear responsibility for risky behavior, so that they could not feel unaccountable when something goes wrong.

In actual fact, the way Silicon Valley Bank's run was handled was far from perfect. The bottom line on deposits means that depositors do not need to be held accountable for the quality of the bank's operations. Existing studies have shown that this worsens a bank's governance model and grows risk. But the actual operation is not writing academic papers after all. We have to learn to accept

what we cannot change. Everything is agreed in compromise. But no matter how we compromise, those primarily responsible cannot get away unscathed.

In 2008, now notorious developer Evergrande failed to go public. The capital chain was extremely tight, and the company's future hung by a thread. Then the "four trillion" economic stimulus plan was brought in, ushering in a round of rapid economic rebound. Even real estate saw more high growth. The expansion of Evergrande in the early stage was extreme, enabling it to leapfrog the competition. Those who ventured to play with fire were not swallowed by it, but rather enjoyed the warmth. If Evergrande had collapsed then, would so many developers still desperately seek to expand aggressively?

The market economy respects the independent business decisions of each entity. The payoff is that these business entities need to be responsible for their own actions. If there is no sense of discipline, when market conditions are good, companies enjoy the dividends of development, and when they are in crisis, they lean on public resources. This is not in line with the laws of the market economy. In order to minimize the threat of real estate to the entire economy and finance, we should actively take measures to "guarantee the delivery of buildings" and take steps to restructure developers' debts, but we also need to consider, like the Silicon Valley Bank example, letting developers who take other people's money risk losing their entire equity value.

Finally, I would like to emphasize that we should take measures to rescue real estate, but the target of this should be home buyers themselves. Developers should take due responsibility for their actions, otherwise our market system will be seriously damaged, and greater risks may arise in the future. This is something we would dearly like to avoid.