China Debt Dynamics

Bailing out the banks – the hidden significance of Beijing property support measures

ShoreVest
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On May 17, the People's Bank of China (PBoC) rolled out a package of property support measures that the Chinese press hailed as being "historic." For over a year, local authorities had taken the lead in trying to revive housing demand, to little effect. The May package – a collection of measures that significantly reduce the cost of borrowing for would-be homebuyers – saw Beijing take control.

Its efforts already seem to be working. Housing sales – particularly of existing rather than newly constructed homes – have spiked in large cities. Authorities are undoubtedly hoping demand will soon spillover into small cities as well.

Still, it's too early to declare Beijing's newest efforts a success. Government support has generated a spike in housing sales before, but the uptick fizzled out after a few months. Moreover, authorities seem to understand that cheaper credit isn't enough to turn things around. The May package also included a measure designed to reduce developers' stock of unsold housing inventory, which has been growing quickly and is contributing to low prices.

However, while well-intentioned, it could take a year or more before the measure – a relending facility to finance state-firms purchase of developers' inventory – makes a dent in housing inventory. In fact, while Beijing is clearly hoping that it's laying the foundations for a long-term market recovery, we think the more immediate impact will be to reduce banks' bad loans. China's banks will still need to continue disposing of nonperforming loans (NPLs) at the elevated pace we've seen over the last four years. However, the measure will help bolster banks' stability and ensure cleanup efforts are sustainable.

The measures

The property support package included four measures:

- The official mortgage rate floor was scrapped. Previously, the PBoC had imposed minimum interest rates on all home mortgages. Most recently, the floor was set at 20 bps below the five-year loan prime rate (LPR) of 3.95% for first mortgages. However, since September 2022, cities where the housing market has been especially weak have been permitted to set their own floor below the PBoC's minimum, and even eliminate the floor entirely. As of the end of March, 139 of China's 343 cities had done so. That right has now been extended to all cities.
- The minimum down payment ratio for first-home buyers was cut from 20% to 15% and for second-hand homes from 30% to 25% – the lowest rates since mortgages were introduced in 1992.
- The interest rate on housing provident fund (HPF) loans was cut by 25 bps. HPFs are funds that employers and employees contribute to that employees can borrow from when they buy a home. The HPF interest rate for first-time buyers dropped to 2.35% for loans five years or less, and to 2.85% for longer-term loans.
- The PBoC set up a 300 billion yuan relending facility to purchase developers' unsold inventory. The PBoC will lend the funds to 21 major banks at an interest rate of 1.75%. The funds will then be loaned to local state-owned enterprises (SOEs) that will purchase housing inventory from developers and convert it into affordable housing. In January 2023, the PBoC set up a RMB 100 billion facility to do exactly the same thing, albeit on a trial basis in eight cities only. It took a long time for the program to get off the ground. The first loan was made in Q4 2023.

Authorities hope lower mortgage rates and minimum down payments will have an immediate impact on demand for new housing. Specifically, they're likely hoping the measures will revive demand in China's biggest cities - Shanghai, Beijing, Shenzhen, and Guangzhou – where authorities have been fairly restrained in their efforts to revive the market. But without a recovery in the biggest cities, it's difficult to imagine a widespread revival taking hold.

Soaking up inventory

The PBoC's plan to fund SOEs purchase of housing inventory might help housing demand in the long term. At the end of April, inventory levels were 24.5% higher than a year earlier. By some estimates, at the current pace of housing sales it will take two and half years to sell developers' inventory - assuming they don't build anymore. With such a glut of housing on the market, prices will remain low and would-be homebuyers reluctant to buy until prices fall further.

However, it's widely believed that 300 billion yuan isn't enough to make a meaningful dent in unsold inventory and that the PBoC will need to put up at least 1 trillion yuan. That might eventually happen, but it means the facility will likely have little impact on housing demand for at least a year, if not longer.

Turning NPLs into healthy loans

The immediate beneficiaries of the program are the banks.

Developers need to sell inventory in order to repay their loans. The PBoC's new lending facility seeks to address that problem by setting up SOEs as buyers of last resort.

The question is, how much will SOEs pay? Speculation in Chinese media is that SOEs will pay "land plus construction costs," which will leave developers out of pocket for marketing and other costs. Moreover, they won't make any profit on the transaction.

However, the price SOEs are willing to pay might be much lower. Affordable housing – accommodation provided by the government to migrant workers – is significantly cheaper than commercial housing. To keep costs down, local governments have traditionally provided land on which affordable housing is constructed at negligible cost.

In contrast, the cost of land accounts for about 35% of the price homebuyers pay for commercial housing. Meanwhile, the size of commercial housing is a minimum of 70 square meters, significantly larger – and more expensive to build – than the 40 square meters typical of affordable housing.

Consequently, state firms will need to pay significantly less than what developers originally intended to charge - and probably less than the cost of land-plus-construction.

Given the steep discounts involved, developers will probably only receive enough to pay their debts, at least in part. The contractors and suppliers who built the housing will get paid at least some of what they're owed by developers, but to get prices low enough to profitably convert developments into affordable housing, they may need to accept haircuts. It's unlikely there will be anything left over for bondholders.

And the winner is...

The unambiguous winner is the banks. When developers get paid, their first responsibility will be to repay the banks. Banks are secured creditors – they don't lend to developers without collateral. Typically, the loan-to-value is between 60% and 70% – that is for every RMB 100 worth of collateral, banks lend 60-70 yuan. When a developer defaults, the bank should be able to sell the collateral at a steep discount without suffering a loss.

However, in this market, it's unclear whether banks would be able to sell the collateral – especially new residential developments in immature markets – at any price in a timely manner. ShoreVest's experience in recent years has been that the completed commercial properties in mature markets that we have used as collateral can generally sell quickly, because there is immediate commercial need for such assets. But new residential developments, which make up the majority of developers' stock of assets, have been much slower to sell. Having developers sell their inventory to state firms provides a way out. It allows developers to pay down their loans and banks to avoid accumulating nonperforming loans (NPLs).

The irony is the banks are funding their own bailout. The loans provided to state firms will be used by developers to repay their bank loans. On banks' balance sheets, high-interest loans to developers will be replaced by low-interest loans to state firms.

Making it work

This is not a cure-all. Not all housing inventory can be converted into affordable housing. Unsold units in ghost towns will remain on developers' books, as will apartments in new districts on city fringes that aren't served by subways or adequate public transport. Moreover, some cities are so overbuilt that unsold housing could potentially outstrip the demand from migrant workers.

It will also take time to ramp up. Getting the pricing right will be difficult, particularly if SOEs want to ensure they can generate a profit in the long term on their investment.

Still, we expect the program to play a major role in relieving pressure on banks, particularly if the PBoC expands the relending quota once the initial 300 billion yuan is utilized.

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