The Current Development of Real Estate Finance in China and its Outlook

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Introduction

The current real estate finance industry in the mainland China lags behind the US market by more than five decades in terms of market sophistication, product availability and funding sources. However, the differences would be much smaller and catching up fast if one measures in terms of market scale, market awareness and the desires of both the regulators and market players to seek improvements and advancements of the market. Housing finance is taking the lead in the industry due to the strong residential housing development in the past few years. Mortgage securitization will be ready to roll in 2004 after several years of studies and preparations. Product innovations like real estate trusts which are based on the Trust Law is adding a new dimension to this infancy industry. Possible similar innovations based on the Trust Law including real estate fund, mortgage trust and REIT[1] might be just around the corner. As new trust products are coming up and flourish, the regulator for trust companies – the China Banking Regulatory Committee (CBRC)[2] may issue a series of guidelines to regulate the trust market. The banking regulator CBRC and the Central Bank – People' s Bank of China (PBOC) are fully aware of the needs for banks to better manage their risks in real estate lending. New guidelines on real estate lending risk management are to be promulgated in early 2004. As the opening up of capital accounts and the revaluation of RMB – the Chinese currency is high on the agenda of the Chinese government, it is possible that foreign real estate investors may find themselves in a favorable environment in the next one or two years when foreign investors are allowed to invest in real estate sector in the form of funds, trust or participate in securitized products. To speed up the development of

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1 **Real Estate Investment Trust, a form of real estate fund prevails in US, Australia and Europe, based on the securitizing the equity of income generating properties.**

2 **The China Banking Regulatory Committee was set up on April 29 2003 to take up the banking regulator role from the Central Bank, People's Bank of China.**

real estate finance market in the mainland, international experience and know-how in investing and managing real estate assets should be of much higher priority than funding. Improvements in risks management, data quality and availability, building process standardization and measurement template etc are much needed in addition to market and legal infrastructure advancements.

Housing Finance Takes The Lead

The real estate market in the mainland has seen its strong growth in the past five years since the stopping of allocation of free housing in 1998. This successful implementation of monetary housing subsidies replacing the physical provision of housing by State-Owned Enterprises coupled with the healthy accumulation of Housing Provident Fund[3] throughout the nation and the strong economic growth in the subsequent years have all contributed to the robust growth of the residential market. Up to the end of 2003, the total outstanding principle balance of residential mortgages has reached RMB[4]1,050 billion which is 55 times of the 1998 amount. It also means an annual growth rate of 43% in the past three years. With the expectation of maintaining the high saving[5], coupled with the high rate of urbanization[6] and the strong macro-economic growth in the next two decades, the growth in the real estate market will remain strong at the current growth rate if not stronger.

On the real estate project lending side, the growth is similarly strong even though the risks are much higher[7]. Up to September 2003, the total outstanding principle balance of real estate project lending reached RMB632 billion according to PBOC figures, representing a 25% annual growth rate in the past three years. Again, with reasons similar to the residential market, the real estate market is forecasted to sustain its growth for the next few years, especially given the growing interests of foreign capital to invest in this sector.

Banking Lending - Risks To Be Better Managed

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[3] The total outstanding principle balance of Housing Provident Fund up to end of 2003 is RMB347 billion with an accumulated total of RMB502 billion.

[4] US$1 equals RMB8.3

[5] The total amount of consumer saving has reached RMB10,000 billion by September 2003.

[6] The urbanization is believed to be 1-1.5% per year in the next 20 years.

[7] Even though no official figures have been released regarding the percentage share of real estate loans in the non-performing assets now being handled by the four Asset Management Companies, it is generally estimated that the non-performing real estate assets has a percentage share of more than 1/3.

Real estate lending, including both residential mortgage and project financing, has been identified by the Central Bank and CBRC as the fastest growing banking assets, apart from auto-finance. Both the PBOC and CBRC have promulgated new guidelines in tightening up the real estate lending risks. This must be resulted from the painful lessons that the Chinese Government has learned from the huge non-performing loans now being deeply discounted and slowly disposed of by the four Assets Management Companies. On June 13, right after the SARS, PBOC issued a new guideline to tighten real estate lending restricting commercial banks from lending to developers for land premium payment, stopping working capital lending to developers, delaying the granting of equitable mortgage to either structural topping out for residential projects or project completion for commercial properties. These measures dealt a blow to the real estate market and the real estate industry was critical in their reactions. Judging from international experience, especially for someone coming from a collapsed property market[8] like Hong Kong, the measures come timely and effectively to prevent an overheating of the real estate market in the mainland. These measures have effectively forced some financially unsound real estate companies out of business and drive a number of innovations in real estate finance.

The CBRC is also working on a new set of real estate lending risk guidelines for commercial banks to better manage the risk with more detail and clearer risk requirements. My company[9] was invited to draft this new set of guidelines and it is expected to be promulgated in early 2004. One of the major requirements in this new set of guidelines is to promote standardization of loan data and risk assessment method for all residential mortgage lending.

Real Estate Finance Innovation – It Has Just Began

Bank borrowing has all along been the single source of funding for real estate projects in the past few years. The tightening of real estate lending, the promulgation of the Trust Law[10] and the reform of all the trust companies[11] have given rise to innovations in the real estate finance market

[8] The property price in Hong Kong has dropped over 65% since it reached its peak in 1997.

[9] Advantage China Holdings Ltd, through its wholly-owned subsidiary in Beijing, was invited by CBRC in August 2003 to help draft the new set of guidelines for commercial banks in managing their risks in real estate lending.

[10] The Trust Law was promulgated on October 1 2001.

[11] The Central Bank has forced the reform of 200 trust companies after the catastrophe of the Guangdong International Trust Investment Company in 1999. Right now, there are only 54 trust companies left after the recapitalization and reforming processes.

last year. Trust companies in some major cities have issued over 16 real estate trust schemes involving over RMB5.4 billion. Most of these trust schemes are borrowing in nature with amount ranging from RMB30 million to RMB500 million and with maturity of 1-3 years. Due to the very limited investment opportunities available to the investing public, most of these trust schemes met with overwhelming responses. Some of these trust schemes have helped those developers who have to rely on bank loan to pay the land premium to meet their obligations. Some other real estate trust schemes serve as bridging loans to help fund the construction in order to achieve a certain milestone to meet the pre-sale requirements. Due to the fact that real estate trust scheme is relatively new, no set rules prevail. In order to make the trust scheme attractive to investors and at the same time maintaining effective risk management measures, varieties of product features and risk management measures have been adopted by different trust companies for different real estate projects.

However, all real estate trust schemes issued so far have been dealing with just one single project. Since the Trust Law and the relevant regulations on trust company allow trust scheme to be formed in the form of fund, there are already some trust companies attempting to issue trust scheme in the form of real estate fund.[12] This is especially desirable when there is no law or code on fund apart from those for securities investment scheme. The difficulties for trust companies to issue and manage real estate fund lie in the following four areas:

1. there is no professional real estate fund management professionals in most of these trust companies
2. the line between trustee and the fund management becomes blur with the existing arrangement that the trust company can act as both trustee and manager of the fund
3. the maximum limit of only 200 units can be issued in one trust scheme is one of the major hurdle for real estate fund when the total fund size always have to be at least on the high side of several hundred million RMB
4. it is unclear as to whether foreign capitals can invest in domestic trust scheme either in RMB or foreign currencies

[12] **By referring the real estate trust as real estate fund means the trust scheme will invest in a known or blind pool of real estate projects, a maturity of more than 5 years, with professional fund management team and with a much higher return than what real estate trust schemes currently offer.**

Having said that, it is highly likely that real estate funds in the form of trust will be issued by some trust companies in 2004. There will be ample opportunities for foreign real estate funds and fund managers to participate in this virgin market. One have to work out the way to structure the participation arrangement so as to meet both the regulatory requirements and commercial mission.

Interestingly, even without REIT code or law in the mainland China, there was a trust scheme issued end of last year in the form of REIT by a trust company for an income property in TianJin. The difficulties and challenges faced by regulators to cope with the market developments are becoming more and more of a reality as the market evolve and innovate much faster than expected. Fortunately, the banking regulator, CBRC, takes the stance to regulate new products only after significant number of cases have been tried by the market. This in turn means more rooms for the market to innovate and to come up with products suitable for local environments.

Securitization – The Prince for 2004

On the securitization market which is an important component of the real estate finance market, not much progress can be seen in either the mortgage-backed securitization or other asset-backed securitization. This was mainly due to the fact that there is no securitization law and other relevant laws relating to special purpose vehicle (SPV) etc to allow for securitization structure. Under the current Company Law in China, it does not allow the setting up of SPV. Thus, a true sale of real estate asset with insolvency remote arrangement which is one of the most important features of mortgage-backed securitization would almost be impossible to achieve. Fortunately, there are good news to those who are interested in securitizing real estate debt assets in China. The first good news is that the draft securitization law and relevant laws for SPV and its articles will be ready for the legislation process in first half of 2004. Thus, if those drafts are passed into laws, one can expect the mortgage-backed securitization together with several other types of asset-backed securitization transactions will be on the roll subsequently.

To those who want to do securitization before laws relating to securitization are passed, one can rely on the Trust Law to achieve the insolvency remote feature[13]. Certainly, the first case of real estate

[13] According to Clause 15 of the Trust Law, as long as the trustor is not the sole beneficiary of his trust, the entrusted asset will be segregated from other assets of the trustor and is under the responsibilities of the trustee.

asset securitization using the Trust Law is still something to be happened. Products like mortgage-backed securitization, mortgage trust[14] etc. can be seen as potential projects to be launched in the near future.

It would also be interesting to know that a policy bank in China is working on the creation of a mortgage corporation similar to Fannie Mae in the United States. Whether the regulators will approve the proposal to create a Chinese Fannie Mae still left to be seen. One thing for sure is that securitization will be the Prince in 2004 in China.

Apart from securitizing residential mortgage loans for banks, there are other mortgage-backed securitization opportunities available in the market, namely, commercial mortgage-backed securitization (CMBS)[15]. With the fast development in the last few years, a number of quality commercial properties have been developed in some big cities in the mainland. These properties include office buildings, shopping centers, regional malls, service apartment and hotels, with reasonably good qualities. One of the major challenges for these commercial property owners is the difficulty in obtaining permanent financing or syndication loan from commercial banks. The lack of long-term funding like pension and insurance fund[16] is one of the reasons of rendering the take-out financing infeasible in this part of the world. Thus, developers have to rely on sales of property and short-term loans provided by commercial banks to sustain its rental operations. Securitizing either as a form of long-term borrowing using CMBS structure or as a form of equity securitization in the form of REIT for these income properties will open up another avenue for the structure finance players. It is also possible that these Chinese income properties may be securitized as REIT or other form in overseas markets in a few years time.

Standards and Standardization - The Key To Fast Track Market Development

Having mentioned about so many new windows of opportunities coming up in the real estate finance market in China, it is also high time the standards in real estate market be improved. Market transparency, data quality and availability, building process standardization and risk management skills

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[14] **Mortgage trust is a trust scheme issued to attract investment money to be used as mortgage loan for lending to property purchasers.**

[15] **CMBS is to structure a debt securitization for a commercial property which has steady and predictable income stream.**

[16] **Currently, insurance companies in the mainland China are not allowed to invest in instrument other than bank deposit, treasury notes and those bonds specified by the State Council. Thus, no insurance or pension money can be channeled into the real estate finance market at all.**

are among many other facets that demand immediate improvements in order to meet the standards of international investing money. The lack of transparency, lack of quality data and the lack of building process templates made the comparison of risks and measurement of returns a work just better than wild guess. Centralizing data, standardizing development process, improving institutional design to increase transparency and efficiency all will contribute to the reduction of hidden or unknown risks in the real estate industry.

According to industry observations, there are significant amount of foreign capitals interested in tapping the high growth real estate market in the mainland China. However, there have been very little foreign real estate investment funds invested in the China market so far, not to mention successful ones. The big gap in the current market infrastructure in the real estate finance market in China and the expectation from outside funds will hinder the development of the market. With this hurdle, the real estate finance market development will be too slow to cope with the needs of the real estate market. Also, China will miss the right to use cheaper international money. As of today, foreign real estate funds typically require to have at least 25-30% of IRR[17] for investment projects in China. This high return target reflects a significant risk premium has been added these funds to protect themselves from loss due to “unforeseeable” factors caused by reasons mentioned above. If major improvements can be made in the market infrastructure in the near future, it is possible a more reasonable rate of return will be expected. With the participation of international money, the market advancements will be much faster and more robust.

Conclusion

The real estate finance market in the mainland China is moving much faster than any market outside China in the past. This was partly due to the enormous scale of the real estate development. Thus, more funding and investment options are needed. Another reason for this fast evolution of real estate finance market was because China is learning and borrowing quickly from other countries. Chinese regulators play the very crucial roles in facilitating the market development and controlling the systemic risks from happening. Better risk management, securitzation, trust and investment fund will be the key development of the real estate finance market in 2004 and beyond. How soon foreign investors and fund managers

[17] **Internal Rate of Return**

can take part in the real estate finance game in China would pretty much depend on how soon the market infrastructure can be improved.

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