

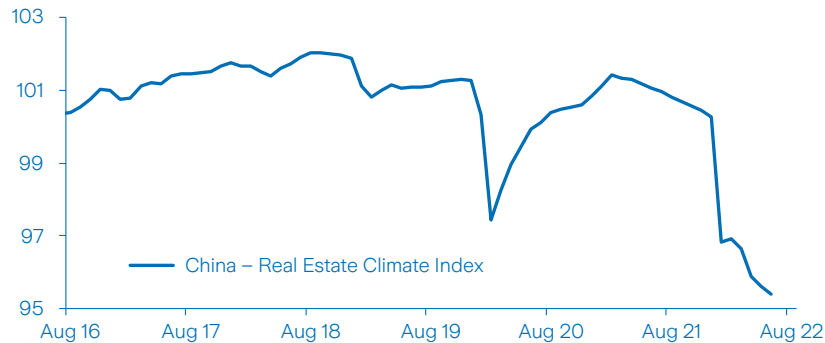
Will China's mortgage crisis be contained?



Last year, a severe property market crisis erupted in China caused by the financial problems of Evergrande, one of China's major real estate developers. In November 2021 we published an extensive Topical Thoughts paper, [Evergrande: A canary in the coalmine?](#), elaborating on the causes and consequences of China's property market problems. It was our assertion that these problems were likely to linger on, at least in the medium term. Indeed, Evergrande recently had to postpone the release of its restructuring plan, after having missed its end-July deadline.

The outbreak of the Covid Omicron strain and the lockdowns in major provinces and cities that followed, as well as supply chain disruptions, severely affected various industries and pushed the property market problems into the background. However, the housing market has moved into the limelight once again due to some homebuyers boycotting their mortgages payments in protest over the delays by developers in delivering homes on time, putting rural banks and property developers under severe pressure. Though we believe that the problems are more idiosyncratic in nature, a nationwide confidence crisis among homebuyers could cause havoc in society and the financial markets if the authorities do not intervene quickly and in a proper manner, which we think they will eventually do.

China's Real Estate Climate Index has collapsed

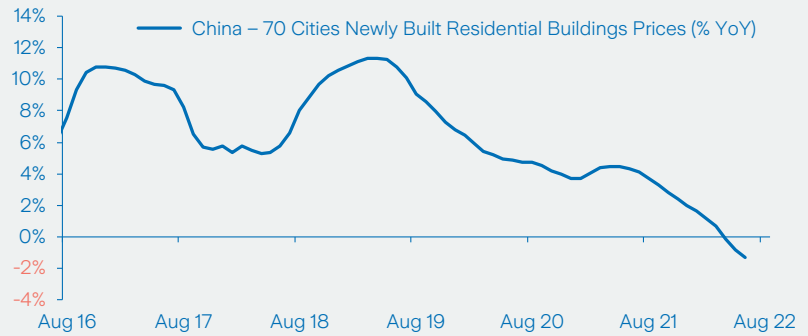


Source: NBS, Bloomberg

Falling home prices and Omicron related lockdowns have hit demand for new homes

China's appetite for new homes has been slow to recover for mainly two reasons: Firstly, new home prices have fallen sequentially for ten months in a row, according to the 70-Cities Newly Built Commercial Residential Index provided by Bloomberg. In a society that believes in property being a store of value and where homeowners had become accustomed to continuously rising home prices, falling prices are causing a wait-and-see attitude, quite different from the 'rush to buy' sentiment that had prevailed before Covid.

Home prices in China are falling



Source: Bloomberg Intelligence

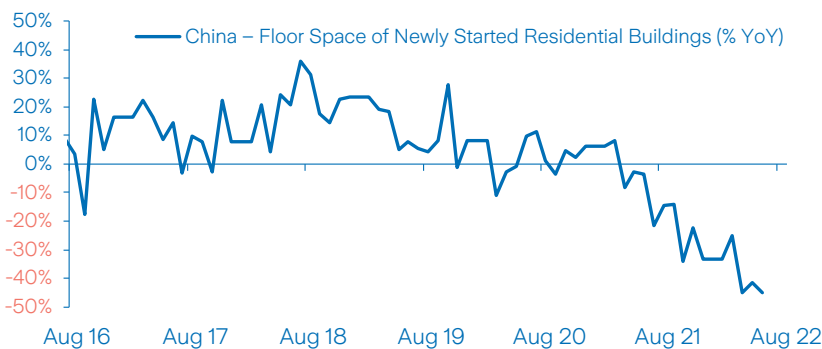
Secondly, severe Omicron related lockdown measures, which affected up to one third of China's population, particularly in the cities of Shanghai and Beijing as well as Jilin province, made it difficult if not nearly impossible to buy new homes, as even showrooms could not be visited. Whereas home sales had been growing by more than 10% YoY before Covid, they were falling by 18% YoY in March of this year, according to China's National Bureau of Statistics (NBS). The slump only intensified during the lockdowns. In April, home sales contracted by a significant 39%, followed by 32% in May. The month of June saw a sequential improvement in demand, though nowhere near pre-Covid levels, as the slowing appetite to buy new homes has now been acknowledged and tackled by the authorities. However, the road to recovery remains bumpy, as statistics for the first half of July indicate another setback versus June.

Local governments have loosened purchase restrictions for mortgages, while China's central bank, the PBoC, has enabled banks to provide needed liquidity. The PBoC also cut the 5yr Loan Prime Rate (LPR) by 15bps and reduced the lower-bound range of mortgage interest rates by 20bps for first-time home buyers, which reduced the minimum mortgage rate by 35bps. Despite a pickup in mortgage applications, other indicators for June reveal that the property market remains in a challenging situation: new construction starts decreased by 45% YoY in June, floor space under construction tumbled 48% YoY, and land purchases by real estate developers plunged 53% YoY according to the WIND and CEIC databases referring to national statistics, quoted by Barclays Research and Goldman Sachs.



source: iStock

Residential floor space under construction keeps tumbling

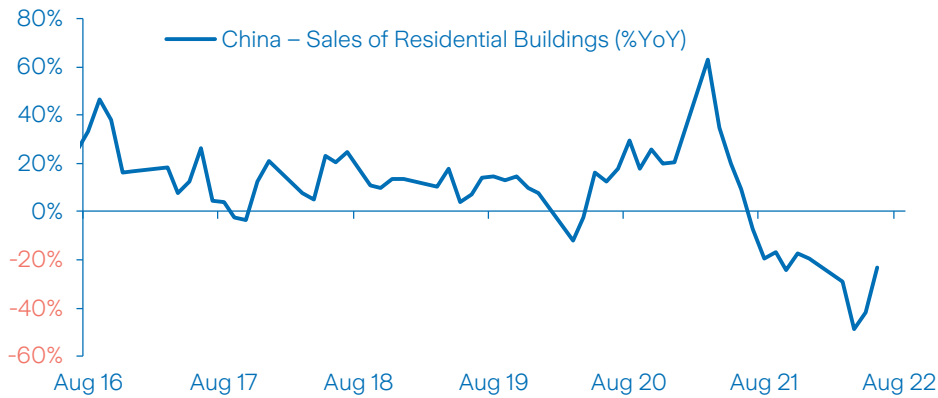


Source: Bloomberg Intelligence

The pre-sales quota has risen significantly to 90%

However, just as glimmers of hope have started to re-emerge in the property market, renewed concerns have also started cropping up. Pre-sales allow developers to get paid before completing construction, sometimes at very early stages of construction. In China, the share of pre-sales to total new home sales in volume terms has increased substantially over the last few years, from 58% in 2005 to nearly 90% last year, according to the WIND database quoted by Nomura. Pre-sale regulations are interpreted in a more flexible manner in lower tier cities. (In China, cities are categorised into four tiers, with major cities like Beijing, Shanghai and Guangzhou categorised as tier-1, while smaller provincial cities are subsumed as tier-3 and tier-4 cities.)

Home sales suffer from Covid lockdowns and deteriorating confidence



Source: Bloomberg Intelligence

In 2014 the PBoC injected significant funds into smaller tier cities to support the pre-sale program. Some developers were allowed to sell homes immediately after laying house foundations. While banks are required to put at least part of the funds received by homebuyers into escrow accounts managed by local governments, regulations seem to have been handled rather loosely, with escrow funds being released to the developers earlier than legally allowed. Developers then used these funds to buy new land instead of proceeding with home construction, starting a vicious cycle. Last year, developers relied on pre-sale funds to finance more than half of their operations, while the share of loans by financial institutions has shrunk to just slightly above 10%, according to research by Nomura.

Mortgage payment boycotts by homebuyers have started a vicious cycle

As it became clear that pre-sold properties might not be finished on time some homebuyers ceased paying their mortgages to protest the delay. However, with pre-sale funds invested elsewhere, rising costs and dwindling revenues have made it exceedingly difficult for developers to deliver pre-purchased homes at this point.

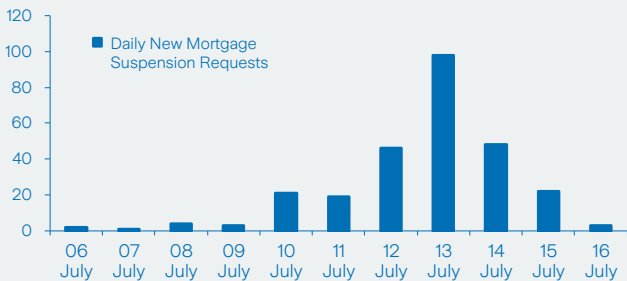
The mortgage boycott erupted in Q2 in the provinces of Jiangxi, Henan and Hunan and has since broadened to several, mainly central Chinese provinces. Most of the more recent boycotts and demonstrations have happened in Zhengzhou, the capital of Henan province, where rural lenders have been affected.

Protesters have demanded that mortgagors regain access to bank savings (which were frozen when they ceased mortgage payments), as well as the expedited completion of unfinished homes by developers and an end to the misuse of funds in escrow accounts.

The mortgage boycott is growing

What started on Monday, July 11, when homebuyers had stopped mortgage payments for 28 projects, accelerated to 321 projects in 93 cities in 26 provinces within a week, based on Bloomberg research. The number of open letters and pleas on social media appears to be exploding, though we expect the situation to calm down following quick local government action.

New mortgage suspensions seem to have peaked



Source: E-House, CRIC, JP Morgan (Estimates)

What will the impact on banks, developers, and the property market be overall? Based on a study by JP Morgan published on July 14 (China Banks and Property: Assessing impact of delayed delivery of pre-sold projects and mortgage suspension), mortgage loans make up about one fifth of total loans or slightly more than one tenth of banking assets. Assuming that about one fifth of mortgage loans are collateralised by work-in-progress projects, of which again one fifth or less could delay delivery, the share of affected critical loans seems manageable.

Depending on how the progress of completion is defined, which differs among banks, about one half of mortgage loans for pre-sale projects are in escrow accounts. Homebuyers need to service their mortgages even if project completion is delayed according to law, which enables banks to sue debtors. Should that come to pass, the loans will be classified as non-performing (NPL) within 60-90 days, unless a payment holiday is given. Vice versa, credit lines to distressed developers will not be forgiven unless there is a local government initiative.

Making a series of further plausible assumptions, JP Morgan concludes that, on average, one third of 2022 bank earnings could be negatively affected by defaults on mortgages and developer loans, with some divergences between various banks based on their financial health. The non-performing loan ratio could increase by 100bps, which still appears to be manageable. Government intervention to ensure project delivery and payment holidays for affected mortgagors could lead to an even more favourable outcome.

A spill over of local problems needs to be avoided

While we believe that the scale of the current pre-sale mortgage crisis seems to be manageable on a nationwide basis, particularly if swift countermeasures by local governments, banks, developers, and regulators are taken, it should be acknowledged that a broader, nationwide crisis of confidence could have more devastating consequences. Negative newspaper and social media reports could affect sentiment towards banks, property companies and their listed stocks, as has been observed recently. Rising scepticism or fears could affect the broader willingness

to buy new homes and apply for mortgages. While speculative investors, betting on the never-ending increase of home values would likely be the first to avoid investing, a withdrawal of buyers subscribing to the Communist Party's 'homes are for living, not speculating' campaign would be a much more significant issue. This could lead to a vicious cycle of further bankruptcies amongst developers or smaller banks, though we believe authorities are likely to intervene in time to tackle outstanding problems.

Property equity prices have collapsed 60% from March 2021 to August 2022

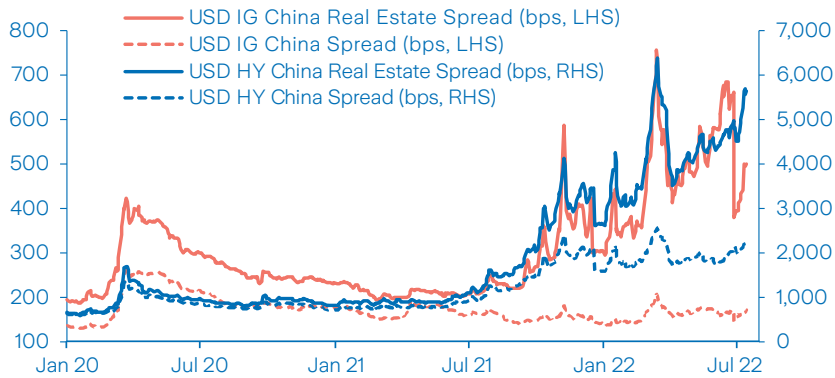


Source: MSCI, Bloomberg

Credit markets had predicted oncoming stress

The Chinese credit markets have witnessed significant volatility in the property sector since late last year when concerns around Evergrande first emerged. As we had highlighted in last year's note, this was to be expected. Indeed, the confidence of investors had been shaken in May when high profile developer Sunac China Holdings announced, as quoted by Bloomberg, that it had missed payments on dollar coupons, and then again in early July when another major developer, Shimao Group Holdings, announced its default on a USD note, as Bloomberg also reported. The recent mortgage payment issues have further eroded sentiment, as companies previously considered safe havens also saw a significant impact on bond prices. Given the relatively large hits that bond prices have taken this year, the key question is how much distress is in the price already. In our opinion, while distress and defaults are likely to continue along with price volatility, market pricing already reflects most of the angst, and any supportive policy action from the government or a change in property market dynamics could lead to stabilisation in the longer term. The risk to the downside is that if the troubles facing property developers undermine broader confidence, the issues could become systemic.

Chinese real estate significantly underperformed other credit sectors



Source: Bloomberg

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