by Jack Rodman

Shaky Foundations

The Pillars of Growth Supporting China's Economic and Real Estate Market Are Crumbling

China is now the second largest economy in the world, surpassing Japan. It was not that long ago that pundits said Japan "lost the war" but won the economic battle when Japanese banks comprised seven of the top 10 banks in the world and Japanese investors were buying up assets from Sydney to London to New York City.

The similarities between the Japanese economy in the 1980s and China's economy today are striking: In both instances, the large Asian economy was (and is) a large holder of U.S. debt, had substantial trade friction with the United States, exhibited huge loan growth in the banking sector, and fears of domestic property bubbles grew day by day. We all know how this story ended for Japan — i.e., a lost decade of growth! But how will it play out in China?

I have long believed China's economy has been running on steroids because of the banks' low interest (and questionable) lending, government stimulus funds, poor regulation and abysmal transparency. Notable investors and economists — Jim Chanos, Ken Rogoff, Professor Joseph Gyourko, Victor Shih and Fitch's Charlene Chu — also have begun to see the lack of real fundamentals supporting China's growth. Cracks are appearing that could undermine the Chinese economic engine.

I see a weakening of the four pillars of growth supporting the Chinese economy. This lack of economic sustainability is a growing cause of concern — in fact, each pillar is presently under increased scrutiny and is subject to significant reform by the Chinese government as regulators try to orchestrate an economic "soft landing." All four pillars are built upon the real estate market, and all are showing signs of significant stress.

PILLAR ONE: CHINA'S BANKING SYSTEM

Pillar one is the country's banking system, which has grown remarkably since the largest state banks were listed in 2003 and 2004. Overall loan growth has tripled during the past decade and loans to the real estate industry have grown by more than 800 percent. A recent survey by the People's Bank of China indicated that loans to the real estate sector accounted for 40 percent of all loans in 2009, and bank by bank mortgage loans grew by 50 percent to 100 percent from the previous year.

> ***A very large part of the Chinese economy and Chinese banking system are overly dependent upon the sustainability of a real estate market that is showing multiple signs of distress.***

By my estimate, cumulative real estate–related loans (where real estate is the ultimate collateral) account for more than 40 percent of all loans in the banking system. They consist of mortgage loans that total 20 percent to 25 percent of total loans, developer loans representing another 10 percent, and 5 percent are loans to general contractors who build the buildings. It is difficult to estimate loans to state-owned enterprises that borrowed to buy land and used working capital loans to speculate about the property market; however, another 5 percent of total loans does not seem an unreasonable estimate.

China's real estate loan exposure in excess of 40 percent is greater than Japan's exposure when the Japanese bubble burst and is also far greater than the 25 percent to 35 percent of total bank loans during the U.S. Savings and Loan crisis of the late 1980s.

To help identify weaknesses in this pillar of China's growth, the China Banking and Regulatory Commission in August announced a series of "stress tests" to evaluate the impact on the banking system if property values were to decline as much as 50 percent to 60 percent in coming months due to stringent credit tightening and other measures aimed to take speculators out of the market. But will such measures truly shore up China's banking system?

While no one can predict what China will disclose from the results of the stress tests, it is clear the regulators are deeply concerned and hope to comfort wary investors.

PILLAR TWO: REAL ESTATE MARKETS

In Beijing, the average home (a modest 90 square meters) costs 22 times the average area household income. The affordability multiple increases to 40 to 50 times household incomes for residences in the city center. Most analysts and commentators on China acknowledge that the current price to income ratio is not sustainable. The central government has once again (as in 2007) put the brakes on property speculation through a myriad of new limitations and regulations, but with little to no effect.

The average price of property in 70 cities reportedly fell by less than 1 percent in second quarter 2010 after rising by more than 80 percent in China's largest cities during 2009. Much of the run-up in prices was due to speculation in both property and the yuan. With few investment alternatives, Chinese retail investors binged on property speculation. A public outcry ensued, and the government has once again clamped down on speculators (see "New Policy Changes," page 14).

Other indicators of trouble appeared recently as well. A recent survey of electric meters by the Chinese Academy of Social Sciences found that there are 64.5 million

vacant apartments in China's cities, equal to five times the housing vacancies in the United States.

The first government study on vacancy was published by the government of the Chaoyang District, a wealthy suburb near Beijing's central business district. The study found that 1.33 million square meters of residential space is vacant. The empty residence villas and luxury apartments totaled 521,000 square meters, accounting for 39.2 percent of the total, and 54.9 percent of these homes have remained empty for more than three years. Ordinary flats account for only 18 percent of the empty residences, according to the report.

While tens of millions of Chinese are in need of affordable housing, developers are far less inclined to build affordable housing because it is less profitable than luxury housing. The fallacy is that developers can actually sell luxury housing to anyone other than speculators. This is all driven by the commonly understood formula by which local governments depend on property sales and land use fees for their municipal financing — the high cost of the land puts pressure on developers to maximize the value of what they build in order to recoup their investment. The higher the land sales price, the greater the fee paid to local government. It is not a virtuous cycle.

Additionally, rental income to home price (value) ratios makes no sense in China. Owners of residential property are earning only 1 percent to 2 percent on their investments — if they are fortunate enough to find a tenant. Their investments are completely based on capital appreciation, and they are funding a negative carry. The stress tests imposed by the government on the banks are targeted at the luxury segment of the residential market.

Compounding this problem is the overbuilt commercial property market. The supply of commercial office

New Policy Changes

National Policies	
Mortgage	For first-time buyers, miniumum down payment for homes greater than 90 square meters is raised to 30 percent (from 20 percent); down payment is raised to 50 percent (from 40 percent) for second home buyers, and mortgage rates are raised to 1.1 times benchmark rate (from various discounts before). In areas where prices have increased rapidly or supply is tight, commercial banks have the discretion to suspend mortgage on third home and to nonresidents (i.e., those who cannot produce proof of at least one year of local taxation or social security contributions).
Loans to developers	For developers that are found to hoard and speculate on land, suspend lending to new projects, approval of IPO or refinancing plans.
Increasing supply of land and houses	Local governments should publish residential land supply plans, increase land supply in areas with rapid property price increase. Land used for public housing, cheap rentals and small mass market housing should be 70 percent or more of total residential land supply. Local construction plans and the distribution of central government subsidy are accelerated.
Others	Head of local governments are held responsible for stabilizing housing prices. Ministry of Finance will accelerate its study of an appropriate taxation policy regarding housing consumption and real estate returns. News media are required to report the success of government policy tightening and to guide a healthy market expectation.
Local variations	
Beijing	Additional home purchases are restricted to one per family. Mortgages on third homes and to nonresidents are suspended. 2010 new starts and purchase of public houses will be 136,000 units; 2010 completion of public houses 46,000 units. Upon obtaining the pre-sale approval, developers should make public all houses available for sale and their prices within three days.
Qingdao	Mortgages on third homes and to nonresidents are suspended. 2010 residential land supply will be increased by 30 percent; land used for public housing and small mass market housing should not be less than 70 percent for the next three years. 2010 new starts of public houses will be greater than 8,000 units; complete renovation of old city within three years. Upon obtaining the pre-sale approval, developers should make public all houses available for sale and their prices within 10 days.
Shenzhen	Mortgages on third homes and to nonresidents are suspended. 2010 new starts of public houses will be 50,000 units. The transaction of government subsidized properties will be forbidden.

Sources: Official announcements from various ministries and local governments, Xinhua news network

buildings in large cities has doubled during the past five years, with little sign that the building boom is likely to abate any time soon. Beijing's CBD vacancy rate reached 47.9 percent in first quarter 2010, according to a report by Jones Lang LaSalle. In Shanghai, a recent study by Collier's International indicated that from 2010 to 2014, developers plan to build 3.6 million square meters of office space, which would double the supply of office space.

Concurrently, rents in the new buildings in Beijing and Shanghai have plummeted as landlords attempt to attract tenants from existing properties but face fierce competition from other owners. On average, class A rents in these markets have fallen by more than 50 percent from less than two years ago, mainly through extended periods of "free rent" and fit-out allowances.

Amazingly, with the skyline full of empty buildings — many vacant since their completion in 2007 and 2008 — there have been few (if any) instances of banks foreclosing on these properties (see "Comparison of New Supply, Vacancy, Net Rents and Valuations," below). Banks do not want to report loans as nonperforming or spend money to foreclose and have to "mark to market" the carrying value of their commercial loan portfolios.

While residential property prices have skyrocketed, the value of commercial office buildings has been fairly stable, hovering around 30,000 yuan (US$TK) per square meter while adjacent residential apartments could sell for as much as 90,000 yuan to 120,000 yuan (US$TK to US$TK) per square meter. Go figure!

In summary, two of the pillars of China's growth story are both showing signs of considerable stress. Chinese banks are presently in the market trying to raise additional capital after lending more than US$1.4 trillion last year in response to the government's stimulus efforts. Chinese regulators are working feverishly to stop the speculation and spiraling home prices through a variety of monetary, tax and other measures. Meanwhile residential property values continue to increase.

PILLAR THREE: DISGUISED POLICY LOANS

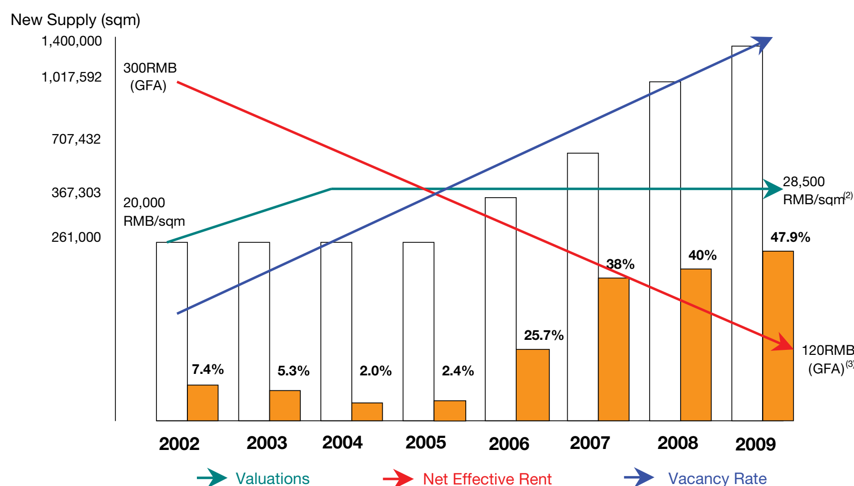
The third pillar was uncovered by Northwestern University economics professor Victor Shih more than a year ago. He found as much as 12 trillion yuan (US$TK billion) in loans channeled from state-owned banks into local government investment vehicles used to build everything from real estate (municipal buildings and entire cities), highways, subways, bridges, infrastructure projects and so on. Recently, the government announced that these loans account for 20 percent of all outstanding bank loans — and as much as 23 percent of these loans have no visible means of repayment. Most of the loans are for long-term infrastructure projects to maintain employment with little prospects of near-term cash flow to service the debt. Standard & Poor's also released a study with similar findings but concluded that the Chinese banking system could weather the storm and a modest increase in nonperforming loans would follow.

No one really knows how much money is outstanding, despite the government's estimate of 20 percent of all loans, but analysts' estimates range as high as 24 trillion yuan (US$TK billion) — half of China's GDP — that could be tied up in these long-term infrastructure projects. Regardless, the government has cracked down on bank loans to local government investment platforms, and the prospect of a "soft landing" is uncertain.

Municipal governments in China are prohibited from raising municipal finance by issuing bonds. Nor can municipalities legally guarantee loans made to local government investment vehicles. Banks made these loans because the local government pledged land as collateral and the banks believed that, as part of the central government's stimulus package, there was an implied guarantee (or moral hazard).

Local governments contend that, after completing the infrastructure projects and building new roads to new towns, the adjoining land would greatly appreciate in value. Sale of these land parcels would generate billions of yuan from which to repay the local government investment vehicle loans and to fund municipal services. However, this practice is under intense scrutiny, under the belief that it contributed to higher land prices and ever-increasing home prices. The concept of implementing a property tax in lieu of a land sales tax is under consideration but has its own issues, such as imposing a new tax on already cash-strapped homeowners, dubbed "mortgage slaves" in the Chinese media. Authorities have ordered the banks to establish very large loan loss reserves against potential risk from local government loans.

Beijing CBD Class A Office[1]
Comparison of New Supply, Vacancy, Net Rents and Valuations



1Class A office excludes Class B and strata-title (condominiumized) buildings which could double supply if included in total office stock.

2Average sales price per square meter from actual transaction data of gross floor area.

3Net effective rents for large 5,000-square-meter (exclusive of management fees), three- to five-year term.

Source: Global Distressed Solutions LLC

PILLAR FOUR: RECKLESS LOAN GROWTH

The fourth pillar was recently disclosed in a report by Fitch, which indicated that the record loan growth in China in 2009 could have been

understated by as much as 28 percent when considering loans to trust companies that purchased and packaged (through an informal securitization) potentially high-risk real estate loans (often to one borrower). The trusts then sold these loans though the selling bank's retail windows as "wealth management products" to their high-net-worth customers. The trust companies, despite having little capital, "guaranteed" the investors' return of principal and offered interest rates of at least two times the official deposit rate. The trust companies used the proceeds to lend to developers at annual interest rates ranging from 15 percent to 20 percent, pocketing the spread between the deposit rate and the fee of 1 percent to 3 percent paid to the bank for use of their retail space.

The government has since clamped down on this practice and is investigating trust companies and considering ways to bring them under more formal regulatory authority. However, Standard Chartered Bank recently reported that as much as US$555 billion may be outstanding through the issuance of these products, although no one can ascertain how much is currently outstanding as disclosure and transparency are extremely poor because the products are not strictly regulated.

For the Chinese banks' part, this practice has been quite advantageous. They moved high-risk loans off their balance sheets by selling to the trust companies, thus reducing their capital adequacy requirements and complying with China Banking Regulatory Commission (CBRC) requests to reduce their exposure to real estate developers and property companies. The banks earned high fees of 1 percent to 3 percent and satisfied their wealthy customers' demands to invest in these products, avoiding the risk of losing them to a competitor institution willing to sell these products.

The government is frantically backpedaling to get the genie back in the bottle and has told the banks they have to consolidate the trust loans by the end of 2011 and post huge loan loss reserves against potential defaults by the debtors. Losses would flow back to the wealthy investors who bought this paper from the bank and probably believed it was "insured" or would be guaranteed by the bank in the event of a default.

I am amazed that the recent disclosures in the United States at the U.S. Securities and Exchange Commission about the Lehman Bros. Repo 105 program to move high-risk assets off balance sheet, coupled with HSBC's problems in Hong Kong having sold Lehman bonds through its retail branches, would not raise danger signs that the banks are taking on financial risk related to the failure of these products. But like most questionable practices in China, everyone tends to look the other way when everyone's making money. As this article goes to press, the CBRC issued new capital requirements for the trust companies that they must hold net assets of at least 200 million yuan (US$TK million) or 40 percent of net assets, whichever is greater. There are daily reports in the Chinese media attempting to quantify the risk to the banks if the underlying debtor defaults.

Authorities have ordered the banks to establish very large loan loss reserves against potential risk from local government loans.

CHINA SYNDROME

I believe a very large part of the Chinese economy and Chinese banking system is overly dependent upon the sustainability of a real estate market that is showing multiple signs of distress. Analysts have recently simulated financial sector loss ratios if property values were to decline by 25 percent to 30 percent.

While damaging to bank capital adequacy and profitability, Standard & Poor's, Citibank and other banking analysts have taken comfort that the system could sustain itself and not create a systemic meltdown à la the global financial crisis. The recent CBRC announcement to stress test the banks with the assumption that property values decline by 50 percent to 60 percent could produce another outcome.

Recently, Professor Joseph Gyourko, a professor at the Wharton School at the University of Pennsylvania, estimated that a property value decline of 40 percent coupled with a loss of confidence by investors could trigger a systemic problem for the banks. The reason is that so much of the recent mortgage lending was at higher loan-to-value ratios — approaching 80 percent of superheated property prices (reminiscent of the U.S. subprime residential mortgage experience).

Add to this the problems of the trust companies that made loans to developers as well as the bank loans to local government investment platforms, all secured by real property, the combined risk to the financial system is significant. Should there be a loss of confidence in the banking system, China has all the building blocks for a financial Armageddon with severe global implications.

China's State Council has repeatedly said it will not be accountable to back up local governments if and when they default on their obligations. These statements are reminiscent of 1989, when the now infamous Guangdong International Trust and Investment Corp. (GITIC) failed, crippling China's growth and resulting in multibillion-dollar losses and an equal number of lawsuits. Like local government investment platform debts, the local government international trusts and investment corporations (dubbed "ITICs"), numbering in the thousands, grew at an explosive rate, and despite their proliferation, there was little regulation. Ultimately, the government closed GITIC and other ITICs and left creditors to fight it out through the bankruptcy courts, which were not very kind to foreign investors.

No one knows if the central government will come to the rescue of the local governments this time around. At this time, it appears the banks will be on the hook for any of the losses incurred from these highly questionable loans.

Given these circumstances, it is no wonder that once again all eyes are focused on China and how it will work its way out of these problems. The size and magnitude of the problems dwarf previous experiences, and even with US$2.5 trillion dollars in foreign exchange reserves, the mandarins in Beijing will be challenged to orchestrate a soft landing. ❖

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