FOR PROFESSIONAL INVESTORS – 22 July 2022

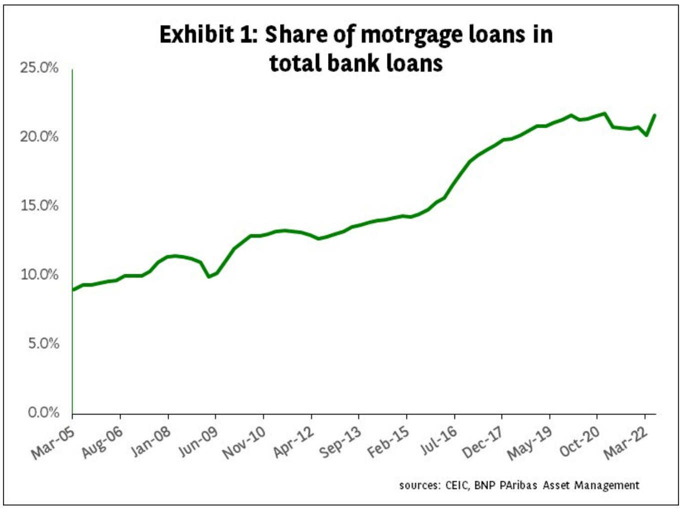
# Chi Flash

## CHINA'S MORTGAGE "BOYCOTT"

*You cannot escape the responsibility of tomorrow by evading it today.*

*Abraham Lincoln*

Recently, an increasing number of homebuyers have stopped making mortgage payments to banks because the construction of the housing units that they bought on pre-sold terms from the cash-strapped developers has been suspended. Mortgage loans have grown quickly and now account for over 20% of total bank loans (Exhibit 1). With developers' liquidity problem threatening to suspend more home construction projects, leading to more mortgage "boycott", the concern is whether this problem will lead to a systemic risk pulling the rug from under the financial system.

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## The problem

The problem stems from developers' extensive use of presales as a major source of funding over the past two decades. The ratio of presales to total new home sales rose steadily from about 58% in 2005 to almost 90% in 2021. Meanwhile, developers' reliance on home sales (including presales) for financing rose from less than a third of their total financing in 2008 to 53% in 2021 at the expense of bank loans, the share of which dropped from almost 20% to just 11%, according to industry data.

In many cases, developers receive the licences to sell homes right after laying the foundations. The presale model has increased developers' leverage significantly by allowing them to get cash quickly to buy more land, which is then used to collateralise more borrowing. But liquidity problem arises when new home sales, and hence revenues, drop sharply during the property market downturn. The government's restrictive property financing policy has aggravated the liquidity squeeze. Cash-strapped developers have reacted by stopping construction of many pre-sold projects, leading to the mortgage boycott problem.

Rising mortgage delinquency could create a contagion risk if crumbling homebuyer confidence reduces property sales, forcing more developers to suspend projects. This could lead to a vicious circle of even lower confidence and more mortgage boycotts, with defaults in the offshore US dollar bond markets (where many developers have borrowed heavily) and an increase in non-performing loans at local banks

## Risk still manageable

Attempts to estimate the impact of the mortgage boycott are fraught with risks because the situation is still fluid and the data quality is low. However, there are official and public data that allow us to gain some visibility on the potential systemic risk.

According to some broker estimates, the mortgages that are at risk would account for about 2% of outstanding mortgage loans at the end of March 2022. [1] Official data shows that total mortgage outstanding in 2Q 22 was RMB40.7 trn, implying that the risky mortgages would be RMB813.2 bn.

Official data also shows that as of March 2022, the Chinese banking system had

- RMB2.91 trn in non-performing loans (NPLs),
- RMB5.85 trn in loan loss reserves, implying an NPL coverage of 200.7%,
- RMB172.41 trn in total loans, implying an NPL ratio of 1.69%, and
- RMB173.1 trn in risk-weighted assets and a 15% tier-1 capital adequacy ratio, implying that the system had RMB25.97 trn in tier-1 capital.

If all of the RMB813.2 bn risky mortgages became NPLs, they would increase banks' NPL ratio by 0.47 ppt (to 2.16% from 1.69%) and erode their NPL coverage ratio by 43.8 ppt (to 156.9% from 200.7%).

*How bad would this be?*

Note that since 2019 Basel III requires that a bank's tier-1 capital must be at least 8% of its risk-weighted assets, and that including a capital buffer the minimum capital adequacy ratio should be 10.5%. The Chinese banking system has an average 15% tier-1 ratio. This means that Chinese banks only need RMB18.18 trn in tier-1 capital (10.5% of RMB173.1 trn) to satisfy Basel III. But we know that the system has RMB25.97 trn in tier-1 capital.

That implies that China's banking system has an excess capital buffer of RMB7.79 trn (RMB25.97 trn – RMB18.18 trn). Deducting the RMB813.2 bn in expected mortgage-boycott related NPL from this capital buffer, the system would still have RMB6.98 trn in tier-1 capital in excess of Basel III's requirements. See Exhibit 2 for a summary.

**Exhibit 2: Potential impact of mortgage boycott on China's banking system**

| | | 1Q 22 (RMB bn) | If 2% of all mortgages became NPLs (add E to A) | Change (Y - X) |
|---|---|---|---|---|
| A | Non-performing loans (NPLs) | 2,912.00 | 3,725.20 | 813.20 bn |
| B | Loan loss reserves | 5,845.00 | | |
| C | Total loans | 172,407.00 | | |
| D | total mortgage loans | 40,660.00 | | |
| E | estimated risky mortgages (2% of total) | 813.20 | | |
| F | NPL ratio (A/C) | 1.69% | 2.16% | 0.47 ppt |
| G | NPL coverage ratio (B/A) | 200.72% | 156.90% | -43.82 ppt |
| H | Risk-weighted (RW) assets | 173,099.00 | | |
| I | Tier-1 capital | 25,965.00 | | |
| | (T-1 capital ratio, I/H) | 15.00% | | |
| J | Tier-1 capital required under Basel III (10.5% of RW assets) | 18,175.40 | | |
| K | **Tier-1 capital buffer (I - J)** | **7,789.61** | **6,976.41** | |

sources: CEIC, BNP Paribas Asset Management estimates 21 July 2022

## The bottom lines

The mortgage boycott is unlikely to cause any systemic risk, unless the problem spins out of control, pushing up mortgage delinquencies by more than the amount of the capital buffer of RMB6.98 trn, or if the rising NPL trend triggers a collapse in confidence. [2]

Crucially, Beijing's policy response to this problem has been swift, with the authorities pondering solutions including allowing mortgage payments holiday for the affected homeowners and mobilising banking, SoE and local government resources to revive the suspended projects and ease funding shortages of developers. [3] More macroeconomic policy easing is also expected to lessen the downside risk to economic growth.

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## References:

[1] See "*Housing Crunch Worsens*", Morgan Stanley Research, China Economics, July 13, 2022.

[2] We have long argued that the odds for a systemic collapse in confidence leading to bank runs wreaking havoc on the Chinese system are close to zero. See "*Chi Time: China's Debt Vulnerability (II) – A Banking Crisis?*" 22 November 2019.

[3] See "*Chi Time: China's Growth Crosscurrents – What's New*?" 20 July 2022.

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