# CHINA: Mortgage boycotts threaten financial and social instability

- Homebuyers in at least 80 cities have halted mortgage payments to protest housing developers' stalled progress on finishing construction of pre-sold apartments.
- In a worst-case scenario, the issue could trigger systemic financial risk and social instability, given housing's role as a bedrock of the broader financial system.
- But our base case is that regulators will succeed in containing the crisis by strong-arming state-owned banks into supporting troubled developers so that they can complete stalled projects.

Pre-sales are the dominant model in China's housing, accounting for over 90% of all sales of newly-built housing in the first half of 2021, before the current market downturn began. Under the pre-sale model, homebuyers purchase flats that are not yet completed, and developers use presale revenues to help finance further construction, reducing their reliance on loans, bonds, and equity finance.

But the sharp drop in home sales this year, combined with financial regulations intended to combat excessive developer debt, has left many homebuilders short of cash and unable to complete ongoing projects. Some 28 of the top 100 developers by sales have either defaulted on bonds or negotiated debt extensions with creditors over the past year. Market weakness has unleashed a vicious cycle in which falling sales leads to developer distress, which weakens homebuyers' trust that developers can deliver promised flats, which leads to even weaker sales.

The latest reports indicate that payment boycotts are currently affecting mortgages linked to around 230 housing projects in 80 cities, largely in Henan, Hunan, and Jiangxi provinces (though not all mortgagors in each project are participating in the boycott). The largest share of stalled projects belongs to Evergrande, which has been in severe financial distress since last year.

If the mortgage halts spread no further than these 230 projects, the macro impact would be modest, but there is significant concern more projects will be affected. Of the RMB 37.5tn (USD 5.6tn) in total Chinese mortgages outstanding, estimates of the share that could eventually be affected by payment halts range from 0.3 to 4%.

Moreover, a further blow to housing market confidence would harm the broader economy, which remains heavily reliant on housing construction and associated industries like steel, cement, home appliances, furniture, and realty services. In recent weeks, housing sales have rallied as Covid-19 lockdowns eased and stimulus measures took hold. This modest housing recovery in turn contributed to signs in June economic data of a growth rebound. Now, however, the boycotts could send housing-market sentiment back into the doldrums, derailing the nascent recovery.

## Policy response

Policymakers are likely to act quickly to contain this emerging crisis. Financial regulators and the Ministry of Housing and Urban-Rural Development reportedly convened a meeting with banks this week to discuss the problem. The property market is the ultimate foundation for financial stability in China, and the banking system is highly exposed. Home mortgages account for about 20% of total bank loans, and developer loans comprise an additional 6%. Beyond these two loan categories, property serves as collateral for many other corporate and household loans.

The mortgage boycotts also threaten social stability if homebuyers believe that the government is leaving them at the mercy of developers who have reneged on promises, even as banks take legal action against delinquent mortgagors. Moreover, in an extreme scenario, the weak economy – including high unemployment and uncertain job security – could prompt some homebuyers whose pre-sale flats are only marginally behind schedule to seize on an excuse to halt payments.

The policy response is likely to take several forms. First, policymakers will pressure banks to increase financial support for developers so that they can complete stalled projects. This support will include encouraging stronger, state-owned developers to acquire weaker developers or their individual projects. Regulators will also encourage capital-raising by small and medium-sized banks, who can use the capital injections to support troubled developers. For banks unable to raise capital on the open market, local governments may inject capital directly, including by using proceeds from local government bonds, whose issuance is likely to accelerate as part of broader economic stimulus efforts.

Finally, local governments will intervene to mediate between homebuyers, banks, and developers. Local governments can offer grace periods for developers to complete stalled projects, strong-arm banks into providing the necessary financing, and reassure homebuyers that flats will eventually be delivered.

## Will it be enough?

The risk is that these efforts are insufficient to prevent a full-blown crisis. Severe restrictions on developer borrowing that began in 2020 – notably the "three red lines" policy – triggered the housing market stress that began last year. But in recent months, policymakers had already moved to partially unwind such restrictions and stimulate the housing market. The problem is that even with restrictions eased, widespread developer defaults and weak housing sales have made banks and bond markets unwilling to provide finance. Similarly, given the uncertain outlook for the housing market, financially strong developers have little appetite to acquire weaker rivals, despite government encouragement.

Despite these risks, our base case is that regulators will succeed in preventing a systemic crisis. The mortgage boycotts appear to be driven by legitimate concerns about unfinished flats, rather than by households that are financially unable to meet payment obligations. Moreover, policymakers have not yet exhausted their toolkit for stimulating the housing market, as they have not wanted to backtrack fully on progress achieved in recent years towards discouraging speculation, moral hazard, and excessive developer debt. The government still has capacity to force state-owned banks to support troubled projects, even if bankers are unenthusiastic about doing so. The government also has the fiscal resources necessary to enable banks to provide this support without impairing their balance sheets.

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