Innovation and Risk Prevention Strategies in China's Real Estate Financial System

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Abstract: The real estate industry is a pillar of the national economy in China, playing a crucial role in the stable development of the financial market, which further solidifies the status of real estate finance in China's socio-economic landscape. With the development of the economy, people's demands for living conditions and housing quality have increased. Against this backdrop, public interest in real estate finance continues to rise. This paper examines the current state of China's real estate financial system and explores strategies for innovation and risk prevention in real estate finance.

Keywords: Real Estate Finance; Innovation; Risk Prevention Strategies

1. Introduction

Under the overarching principle of "housing is for living in, not for speculation," the development logic of China's real estate market has undergone fundamental changes. The real estate financial market in China has gradually formed alongside the development of the real estate market. As an emerging component of the financial market, the healthy and orderly growth of the real estate financial system contributes to the optimization of the future real estate market and the improvement of people's quality of life and living conditions. After more than twenty years of rapid development, the risks associated with real estate finance in China have significantly increased. Therefore, how to innovate in real estate finance and prevent risks has become a major challenge currently faced by China's real estate financial system.

2. Real Estate Finance System

2.1 Definition of Real Estate Finance System

The real estate finance system refers to the financial institution system established around real estate finance, including commercial banks, trust institutions, and various other financial institutions. The purpose of constructing a real estate finance system is to establish a financial market system that enhances the liquidity of real estate mortgage loans, giving full play to the important role of financial markets, thereby mitigating the issues of excessively long investment return periods and excessive inventories in the real estate industry [1].

2.2 Current Status of Real Estate Finance System

China's real estate financial market is an emerging market, currently dominated by the primary market, while the secondary market is still in its infancy. The primary market of the real estate finance system is primarily composed of commercial banks, supplemented by non-bank financial institutions, housing provident fund centers, and other institutions. Since 2023, the stable and healthy development of the real estate market have been supported by finance, and in accordance with the relevant requirements of the《Notice on Improving the Current Financial Support for the Stable and Healthy Development of the Real Estate Market》, financial institutions have consistently maintained reasonable and moderate real estate financing. The People's Bank of China disclosed that at the end of 2023, the balance of renminbi real estate loans stood at RMB 52.63 trillion, representing a year-on-year decrease of 1% and a growth rate 2.5 percentage points lower than that at the end of the previous year.

Over the past three years, China's real estate loan balance has shifted from continuous growth to fluctuating upward trends, with growth rates significantly slowing down. Overall, the development of China's real estate finance system currently faces significant challenges, urgently requiring the identification of a new breakthrough, and creating a new model for real estate finance is a promising direction.

2.3 Characteristics of Real Estate Finance System

2.3.1 Long Return Cycle

The capital utilization in real estate, from investment to output, can take several years at the fastest, or over a decade, or even several decades to fully recover. Financial institutions providing financing, investment, and loans for real estate generally require a relatively long period to receive the principal and interest, resulting in a long return cycle for real estate financial products and services. For instance, the process from acquiring land to construction, completion inspection, and acceptance for real estate developers is complex and time-consuming, combined with the fact that home buyers usually purchase homes through installment payments, both of which prolong the capital recovery cycle.

2.3.2 Strong Capital Appreciation Ability

The once nationwide popular "property speculation groups" ignited a buying frenzy for several years across the country due to recognizing the appreciation potential of real estate funds. On the one hand, real estate funds can generate substantial returns, which is one manifestation of the appreciation of real estate financial assets. During the reproduction process of real estate, continuous capital movement can achieve value appreciation repeatedly. Financial institutions also tend to allocate funds to real estate investment or real estate credit activities to preserve and increase the value of their assets. On the other hand, real estate financial products and services rely on real estate with strong inflation resistance. Real estate presents considerable appreciation opportunities. Tempted by higher investment returns, financial institutions may also develop an interest in real estate investment.

2.3.3 Large Capital Scale

Real estate is a bulk commodity, evident not only in its area and volume but also in the value it contains. The funds required for real estate can range from tens of thousands to millions, tens of millions, or even billions. Both the production and circulation stages of real estate require substantial capital investments and extensive human and material resources. Therefore, real estate finance has significant financing needs. Meanwhile, the demand for purchasing homes through commercial bank loans has driven continuous innovation in real estate financial credit products and services, forming a huge total amount and scale of real estate financial credit funds.

3. New Models of Real Estate Financial Innovation

The development of the real estate industry has always been closely intertwined with the financial sector, primarily in terms of financing. Under the new normal, due to the downturn in the real estate market, the investment attributes of real estate have gradually faded, and home buyers' demand has increasingly shifted towards rigid demand. Without the previous crazy buying and speculation, the upward trend in housing prices has naturally been subdued. However, land prices and financing costs have continued to rise, forcing real estate enterprises to seek new financing models and attempt to use financial innovation as a new profit growth point in real estate. In terms of participation, there are mainly three new models: establishing financial institutions independently, cooperating with financial institutions, and acquiring stakes in financial institutions.

3.1 Establishing Financial Institutions by Enterprises

The most direct way for real estate enterprises to venture into the financial sector is to establish a financial segment within the group's organizational structure, forming the group's own financial institutions and expanding its business scope [2]. Financially strong real estate enterprises will choose to establish a comprehensive presence, simultaneously developing businesses such as insurance, banking, securities, and asset management, rapidly expanding in the financial sector. Smaller real estate enterprises are more likely to first test the waters in popular financial areas, such as internet finance and community finance, making full use of their own real estate resources to expand their businesses on this basis.

3.1.1 Aiming for a full license through a financial holding group.

For example, by relying on comprehensive financial innovation in real estate, Greenland Group has created a full industrial chain of asset management finance with a "investment + investment banking" approach. Greenland Finance's innovative and diversified business model, relying on real estate resources and capable of generating independent profits, is expected to become a new growth point, such as internet finance, special opportunity investment funds, PPP models, acquiring stakes in financial institutions, and equity investment funds.

3.1.2 Establishing a financial platform relying on real estate resources.

For example, Fantasia Holdings Group is gradually transforming into a financial holding group with finance as the lever and services as the platform, creating "grassroots finance" through a community service platform, mainly including micro-loans and P2P lending among homeowners. If a community homeowner has a capital turnover need, based on data such as the homeowner's past payment history in the community, after being evaluated by a professional evaluation system, the system will finally make a decision on whether to lend money to the homeowner; additionally, it can help banks with credit evaluations or provide micro-loans to individuals through its own microfinance companies, charging interest or commissions.

3.2 Cooperating with Other Financial Institutions

An increasing number of real estate enterprises have gradually recognized the benefits that finance brings to the real estate market. Therefore, some real estate enterprises have attempted to cooperate with external financial institutions, such as private equity funds, REITs, asset management institutions, and other traditional financial institutions.

3.2.1 Cooperating with financial institutions under the parent company for resource sharing

Some real estate enterprises have large group parent companies with strong backgrounds and financial strength. Real estate is only one of their diversified businesses, and other segments may even have stronger scale and profitability than the real estate segment. Amid the accelerating trend of state-owned enterprise reforms, some large groups are attempting to integrate various business segments under the group's name, allowing previously independently developed businesses to support each other, striving to produce a 1+1＞2 effect. For example, China Merchants Property Development has cooperated with China Merchants Bank to increase the attractiveness of the industrial parks developed by China Merchants Property through financial means, supporting industrial development and driving regional economy and surrounding residential sales and consumption. Such cooperation cannot be simply described as finance serving real estate business or finance relying on real estate development, but rather as the driving force for the overall economy after cooperation between the two, ultimately enhancing the group's overall strength.

3.2.2 Cooperating with funds to achieve asset-light commercial real estate

This real estate financial innovation model refers to real estate enterprises themselves not participating in the operation and management of funds but rather introducing external fund equity, acquiring existing mature property projects, and jointly investing in the development of new projects with funds. The highlight of this model is that it can borrow the fund's capital advantages to achieve "asset-light," reducing the capital pressure brought by heavy assets, and leveraging larger business scales with less corporate own funds; at the same time, through the brand benefit and management output of commercial real estate, various fees are charged to obtain diversified revenues and improve the overall asset return level. For example, Vanke began cooperating with funds to develop and operate property modules as early as 2014, achieving investment exits from heavy-asset commercial real estate and constructing Vanke's "asset-light" model, ensuring profits can be obtained in all operating links of the property and significantly reducing capital pressure and operational risks.

4. Potential Risks in the Real Estate Financial System

4.1 Systemic Risks

Due to the close relationship between the real estate industry and the real estate financial system, fluctuations in one will affect the stability of the other. As a pillar industry of China's national economy, the real estate industry has always been a focus of national attention. Therefore, the country's macro-control and micro-adjustments to the real estate industry are relatively frequent, and the real estate financial system will also be indirectly affected by policy changes. For example, when the government and the central bank believe that the real estate market is developing too rapidly, to prevent the housing market from overheating, they suppress it from the policy level, such as restricting credit issuance and imposing real estate taxes, which increases the cost of individual home purchases and repayment pressure from the demand side; from the supply side, it makes it difficult for real estate enterprises to timely recover funds, which in turn leads to an increase in the non-performing loan ratio of commercial banks.

4.2 Non-Systemic Risks

Non-systemic risks mainly stem from the behavior of individual enterprises in the real estate market, including operational risks, liquidity risks, credit risks, etc. Since the implementation of the policy of "not speculating on home ownership" and the severe impact of the COVID-19 pandemic on the overall economy, the transaction activity in the real estate market has declined in the past two years, weakening financial institutions' risk appetite for real estate and plunging the real estate industry into financing difficulties. Many real estate developers (including listed real estate enterprises) have experienced a series of debt defaults, delayed housing deliveries, and even unfinished buildings. For example, in 2021, Evergrande Group blindly pursued diversified expansion in its business operations, leading to the deterioration of various financial indicators and ultimately triggering a debt crisis and operational risks.

4.3 Credit Risks

The balance of real estate loans has always occupied a significant proportion of the asset business of financial institutions. In the real estate financial system, credit risks mainly manifest as debtors' failure to repay loans on time. The credit status of borrowers is an important factor in the process of real estate financial innovation. Poor credit or the possibility of default by borrowers can lead to a decline in the quality of financial institution assets and an increase in the default rate, thereby generating credit risks. For instance, the investment cycle of real estate projects is relatively long, and various unforeseen situations may arise during the project construction process, such as policy changes and deteriorating market conditions, disrupting the repayment plans of real estate developers during the mortgage loan term. Once a large number of borrowers are unable to repay their home loans or real estate developers face capital chain ruptures and fail to pay loan principal and interest on time, it will lead to an increase in loan default rates, an increase in non-performing loans of commercial banks, and ultimately impact the entire financial system.

5. Prevention Strategies for Real Estate Financial Risks

5.1 Improving the Real Estate Financial Policy System

In the face of financial risks caused by the decline of the real estate industry, various departments have successively issued relevant policies to support the steady development of the real estate market, such as supporting banks and trusts in lending to real estate enterprises and projects, enabling local governments and banks to adjust down payment ratios and loan interest rate floors based on city-specific policies, and relaxing risk assessment requirements. To create a sound real estate financial system, the government further needs to adjust and optimize real estate financial policies, using policy directives to constrain and regulate transactions in the real estate financial market and safeguard the legitimate rights and interests of financial institutions, real estate enterprises, and home buyers. For instance, maintaining policy continuity and consistency to stabilize expectations in the real estate market; transitioning the real estate industry from the Hong Kong model to the Singapore model as soon as possible; and strengthening monitoring and early warning of real estate liquidity and financing risks to prevent systemic collapses or unexpected crises.

5.2 Accelerating the Securitization of Mortgage Loans

Currently, China's real estate financial system is still dominated by the primary market, while the secondary market, characterized by strong liquidity, helps mitigate some financial risks.

To develop the secondary market of the real estate financial system, accelerating the securitization of real estate mortgage loans can be considered, but this measure must be based on strict compliance with relevant national laws, regulations, and policy guidelines. The securitization of mortgage loans, combined with the liquidity of the secondary market, can greatly boost the confidence of home buyers and investors in the real estate industry and have a certain effect on addressing the current deep recession in the real estate sector [3]. Since China's derivatives market developed later, promoting the securitization of mortgage loans also requires vigorously advancing the innovation of various securities instruments, optimizing systems, strengthening market-oriented principles, and enabling securitized mortgage loan products to freely circulate in the secondary market through risk isolation and asset restructuring.

5.3 Encouraging Central and Local State-Owned Enterprises to Participate in Resolving Real Estate Risks

Addressing real estate financial risks requires not only unilateral efforts by the government but also assistance from other social forces. Supportive policies should be prepared to encourage central and local state-owned enterprises (SOEs) to participate in resolving real estate financial risks. For example, central and local SOEs can provide loans from their idle funds to troubled real estate enterprises. If these troubled enterprises can resume normal operations later, then the central and local SOEs can successfully exit by selling their shares, thereby obtaining corresponding returns and achieving a win-win situation.

6. Conclusion

On the whole, China's real estate financial system is still in its maturity stage and faces issues such as inadequate risk prevention measures. Therefore, the real estate financial system needs to embark on a path of innovation, researching and developing a new model that suits China's national conditions. At the same time, with the support of relevant policy directives, relevant departments and entities should effectively implement risk prevention strategies to further promote the stable and healthy development of China's financial support for the real estate market.

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