Housing Mortgage and Housing Transaction in China: Bridging the Missing Links

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1. Introduction[1]

Market reforms have successfully transformed socialist China over the past two and a half decades. In 2004, China recorded a GDP of about RMB 16 trillion *yuan* (US$ 1.93 trillion), making it the sixth largest economy in the world. Goldman Sachs has predicted that, if the current trend continues, China would become the world's largest economy by 2035, five years earlier than its previous assessment (*The Times,* 21 December 2005). While China's growing economic prominence looks so apparent nowadays, before 1978 it was merely a low-income country in which all resources were under central planning and allocation by a socialist state. Housing was a social welfare product administrated and delivered by state agencies (eg state-owned enterprises and housing bureaus) for its people. Under such a welfare-oriented system, a private housing market and housing mortgages did not exist.

Since the early 1980s, China has gradually restructured its housing system. Market mechanisms, with the objectives to eliminate state housing allocation, promote privatization of public housing and encourage private housing development, were introduced in stages to replace the welfare housing system. Housing has become a commodity that has an exchange value and that individual households can buy and sell in a market. Commodification of housing has dramatically attracted private investment in physical land and property development. It has also led to the emergence and proliferation of a wide range of intermediary services such as property valuation, housing mortgages, property agency and property management in some major Chinese cities like Beijing, Shanghai, Guangzhou and Shenzhen.

This paper examines current development and changes in China's housing mortgage market. It discusses some key factors leading to its tremendous growth in recent years and highlights some institutional constraints that have inhibited its development. The paper describes how spontaneous market-based solutions have emerged in China's property intermediary service sector that address these institutional barriers and improves the overall efficiency of transactions in housing mortgage market.

2. The Housing Mortgage Market in Mainland China

Housing mortgage is a relatively new development in socialist China. It was suggested that the China Construction Bank issued the first housing mortgage loan in 1986, but the mortgage market did not achieve a significant growth until 1998 when the central government determined to end welfare housing distribution, promote home ownership and expedite housing reform (Deng et al., 2005). In May 1998, the People's Bank of China, China's central bank, issued a directive containing the 'Regulations for Managing Individual Housing Mortgage Loans' *(Ge Ren Zhu Fang Dai Kuan Guan Li Ban Fa)* to all Chinese banks (PBOC, 2006). This policy directive served to support the growth of the real estate industry and formalize the home loan procedures of financial institutions. Detailed requirements about the eligibility of borrowers, down-payments, mortgage interest rates, loan terms, mortgage insurance and application procedures were clearly stipulated in the Regulations.

These Regulations constitute the basic policy framework for home mortgage

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lending across all mainland banks. Take the loan conditions offered by the Bank of China as an example (BOC, 2006). The current maximum loan amount shall not exceed 80% of the appraised value or transacted price of a housing property, whichever is smaller. The maximum loan periods shall not exceed 30 years for a RMB loan and 8 years for foreign currency loan respectively. For second-hand property, the maximum loan period shall be 20 years, and the combined housing age and loan period shall not exceed 30 years. Buyers can also borrow from their provident fund accounts to support home purchase (Cong, 1998). The central bank determines the interest rates for both commercial mortgage lending and provident fund lending[2] (Table 1).

Table 1 – Housing Mortgage Interest Rates in Mainland China (As of January 2006)

Housing Provident Fund	Benchmark Interest Rate (p.a.)
Loan periods:	
5 years or less	3.96
More than 5 years	4.41
Housing Mortgage from Commercial Banks	**Benchmark Interest Rate (p.a.)**
Loan periods:	
6 months or less	5.22
6 months to 1 year (inclusive)	5.58
1 year to 3 years (inclusive)	5.76
3 years to 5 years (inclusive)	5.85
More than 5 years	6.12

Remarks: Since 17 March 2005, The People's Bank of China has imposed lowest limits on commercial mortgage interest rates only but released the upper limits. The lowest limits should be 90% of the corresponding benchmark interest rates.

Source: Translation of interest rate policy of The People's Bank of China in its webpage. [Original in Chinese]

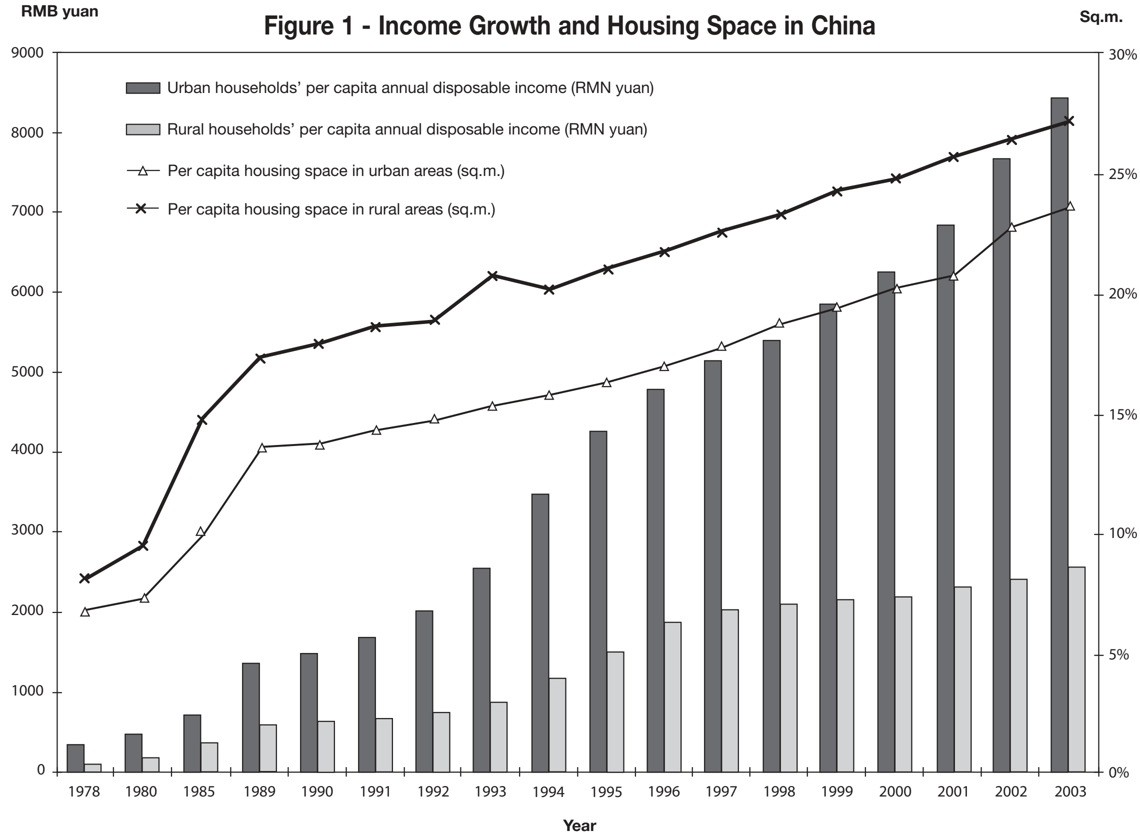
Mortgage rates are fixed for one-year loan contracts but mortgage rate adjustments announced by the central bank for long-term loan (more than one-year) contracts shall commence on the first of January in the following year. Mortgage applicants are required to provide the relevant documents to prove their eligibility, property title and ability to repay the loans. Mortgagee banks may require the provision of guarantees and credit insurance to support loan applications.

The mortgage market in China has grown enormously since the late 1990s when the 'rules of the game' became more transparent. In 1999, China's individual housing mortgage loans amounted to RMB 126 billion *yuan* (US$ 15.6 billion) (Deng et al., 2005). However, by the end of 2004, the outstanding balance of such loans was recorded to reach about RMB 1600 billion *yuan* (US$ 198.5 billion), which had increased by RMB 407.3 billion *yuan* (US$50.5 billion) over that of 2003 (*The People's Daily*, 1 March 2005, p.6). Despite its precipitous growth, housing mortgage loans took up only about 8.5% of total lending in local and foreign currencies, recorded at RMB 18.9 trillion *yuan* (US$2.34 trillion) in 2004, of all financial institutions inChina. This was still a comparatively low percentage compared to that of a mature economy like Hong Kong in which about 23% of bank loans and advances is in housing mortgage loans (Hong Kong Monetary Authority, 2006). Mortgage lending in China is still dominated by several major state-owned commercial banks such as the Industrial and Commercial Bank of China, the China Construction Bank, the Bank of China, and the Agricultural Bank. This situation may change when foreign banks are allowed to provide local loans as a result of progressive financial liberalization after China's accession into the World Trade Organization (WTO).

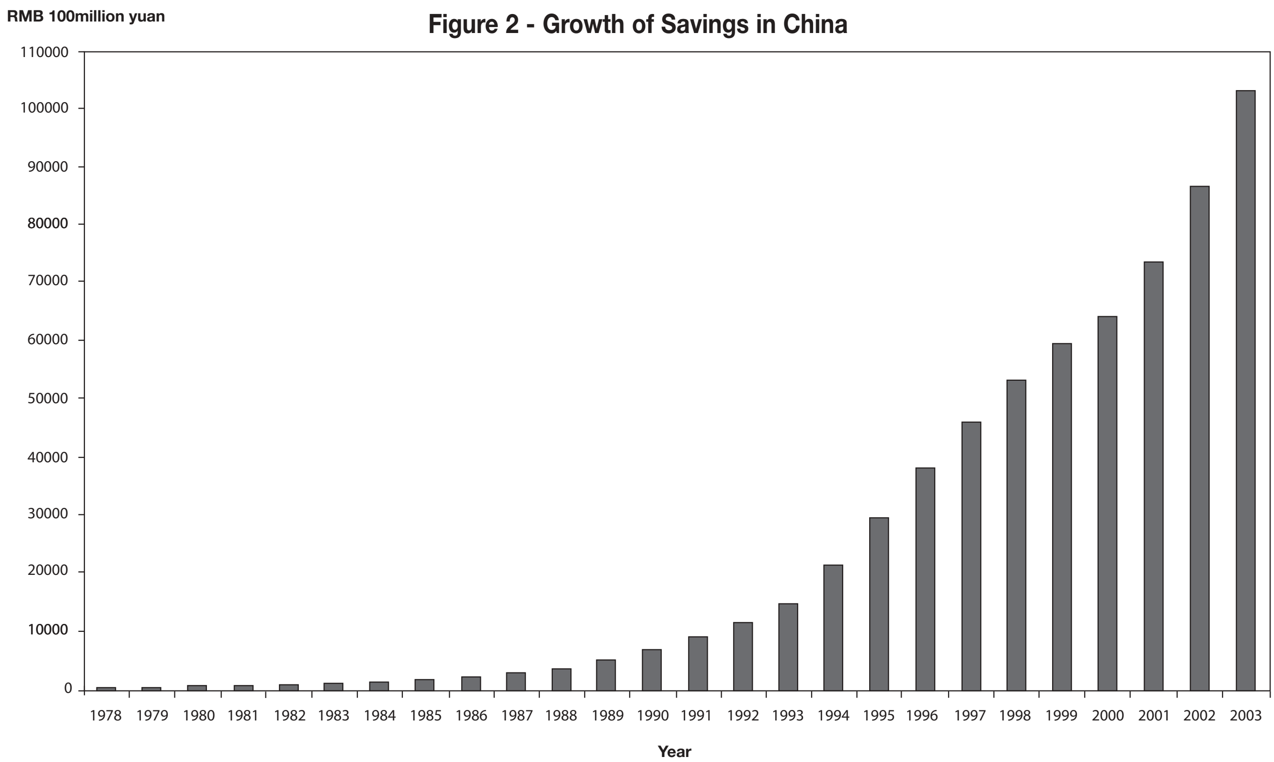
3. Growth Factors and Constraints

The increasing affluence of the Chinese people is a key factor that accounts for the growth of housing mortgage market in China. Open policy and market reform initiated by the then Deng Xiaoping since 1978 have transformed China into a world's factory of great economic fortune. Consistently strong income growth, high saving rates and wealth accumulation of the Chinese population have increased demand for better housing. Between 1978 and 2003, per capita annual disposable income of urban and rural households in China rose 24.7 times and 19.6 times respectively (Fig. 1), while the total time and demand saving deposits rose 492 times (Fig. 2).

[2] China's provident fund system requires both employers and employees to contribute a certain percentage of the monthly employees' salaries to a fund reserve. The reserve is used for Treasury bond investment, securities investment, development loans and mortgage loans. Employees contributing to the fund are eligible to apply for provident mortgage loans.



Source: China Statistical Yearbook 2004



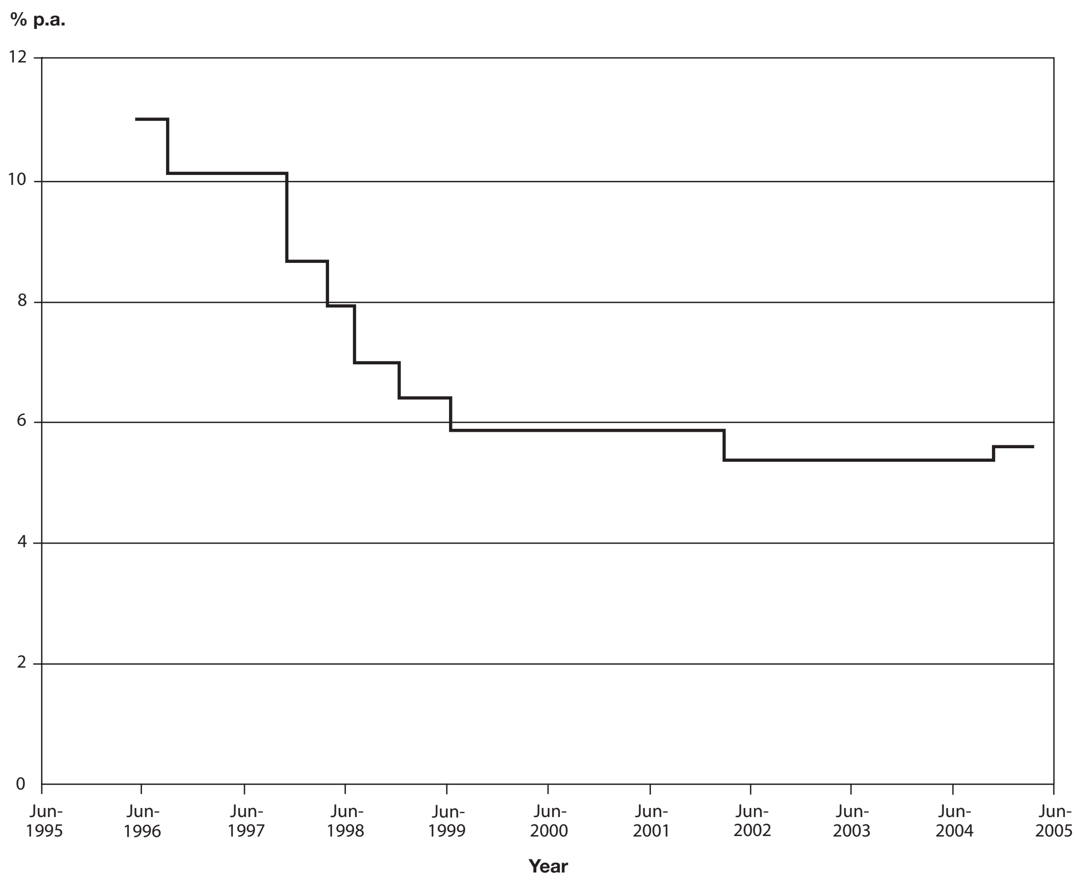
Source: China Data Online

Households are more willing and better able to spend more on housing consumption and improve their living conditions. A shortage of housing space, which was an acute problem in pre-reform socialist China, is considerably alleviated. This has been made possible not only because of the expansion and diversification of investment in housing production, but also because of the concomitant increase in mortgage lending.

Government's positive policy towards the housing sector is another important force that supports mortgage market development in China. Housing mortgage comes with property ownership and transaction. When the socialist state establishes clean, private property titles and allows housing transactions, demand for mortgage loans has naturally emerged. For example, Guangzhou, one of the earliest mainland cities implementing housing reform, re-activated housing transactions in 1979 and commenced the sale of state housing units at cost to existing tenants as early as 1989. Thus, when the country formally abolished welfare housing allocation by 1998, Guangzhou had already achieved a comparatively high home ownership rate. Housing transactions continued to rise as the city government implemented many favourable measures to reduce the costs of transacting. These included, for instance, a substantial reduction of contract tax *(Qi Shui)*, streamlining approval procedures for the sale of subsidized housing *(Fang Gai Fang)*, provision of a one-stop government office to service the housing market, and shortening the time required to process and register individual housing transactions.

In addition, with the promulgation of the 'Management Regulations for Housing Provident Fund' *(Zhu Fang Gong Ji Jin Guan Li Tiao Li)* by the State Council in 2000, borrowing from the provident fund provided the Guangzhou population with an alternative source of finance to support home purchase. This is an attractive option to home buyers because its interest rates are much lower than commercial mortgage rates. Furthermore, overall lending rates in China were considerably and progressively cut from 1996 (Fig. 3). All these factors have contributed to providing a powerful boost to the housing market. In Guangzhou, for instance, commodity housing transactions within its eight urban districts exceeded

Figure 3 - Mortgage (one-year) Interest Rate Movement in China, 1996-2005



Source: The People's Bank of China.

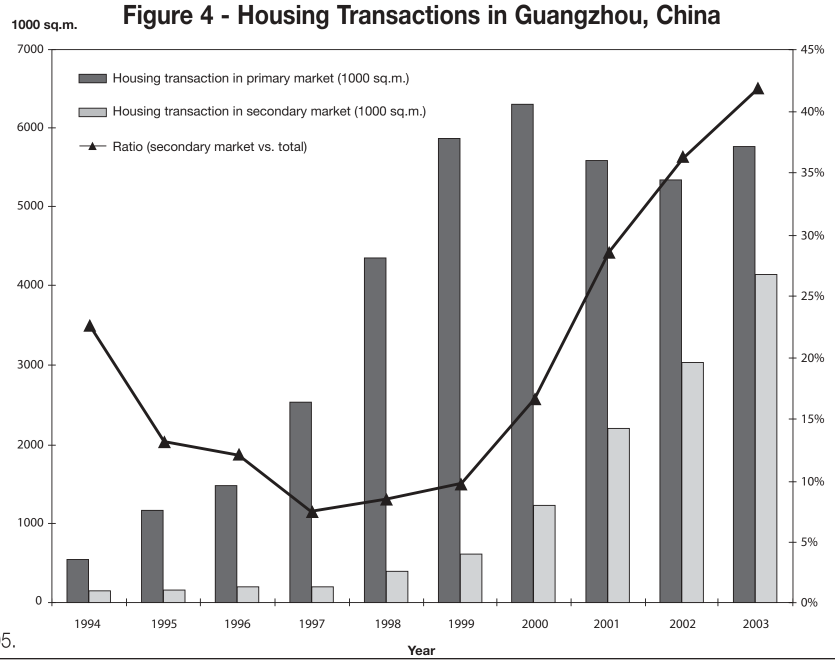
7.44 million sq. m. with a total value of RMB 43.5 billion *yuan* (US$5.4 billion) in 2004, representing an increase of 17.6% and 30.4% over last year's figures respectively (Tan et al., 2005, p.5).

Housing mortgages are a lucrative business for Chinese banks because it generally gives a high profit margin and a low default rate. The cost of funds, as represented by China's current saving deposit interest rates, are only between 0.72% and 3.6%, whereas mortgage interest rates range between 5.22% and 6.12%. Housing mortgage default rates, according to informed sources, are within 1-2%. Despite these favourable features, the growth of housing mortgages is constrained by history as well as the complex institutions of housing market. State-owned commercial banks are under the strategic direction of the central bank and hence their mortgage loan conditions show little competitive variations to customers. Another reason is that the loan business of Chinese banks remains heavily biased towards construction lending to property developers and housing mortgage for first-hand property. Since the late 1980s, China has experienced an unprecedented scale and speed of property demolition and land development. Numerous high-rise buildings are constructed on greenfield sites and new floor areas are completed to replace old structures on brownfield sites. Much of these development activities have been financed by commercial bank loans. These are then followed by tie-in selling of mortgage loans to buyers upon project completion.

Chinese banks are generally more interested in offering home mortgages for first-hand housing (ie new housing) than for secondary market (ie existing housing). Cost consideration and risk management are two major reasons. First-hand housing units in new development projects tend to have much clearer and less complicated property titles and hence the costs of due diligence are less. Operating costs are also much lower than those for secondary housing mortgages because the banks can achieve an economy of scale in mortgage lending for the entire building project. For instance, a small mortgage team of the bank can handle and process all applications for mortgage loans from buyers of all the housing units of a single project in a cost-effective and wholesale manner. Furthermore, as a precautionary measure against credit risk, Chinese banks normally require project developers to provide guarantees of repaying the mortgage loans in case of default on the part of home buyers. This measure is a safeguard against possible bank losses associated with fraudulent mortgage applications from related parties to developers.

Secondary housing mortgage is comparatively disadvantaged because no guarantee from developers is available and it is also difficult for banks to achieve cost economy in such retail banking business. The Project developer is no longer a contractual party in transactions of second-hand housing and will not provide a guarantee to support such mortgages. Furthermore, according to an internal audit of a Chinese bank, processing every single application for second-hand mortgage loans by a local branch office would involve at least two man-days of an account manager and other administrative expenses, which are considered relatively uneconomical in relation to the small value of the subject loan (Hu, 2003). However, when the economy becomes increasingly mature, secondary housing units will eventually constitute the mainstay of all housing market transactions. This is happening in a place like Guangzhou which has spearheaded other mainland cities in terms of housing market maturity. Its volume and proportion of second-hand

Figure 4 - Housing Transactions in Guangzhou, China



Source: Tan et al., 2005.

housing transactions have risen rapidly since 1998 (Fig. 4). In 2003, for instance, more than 40% of housing space transacted in its urban districts came from the secondary housing market.

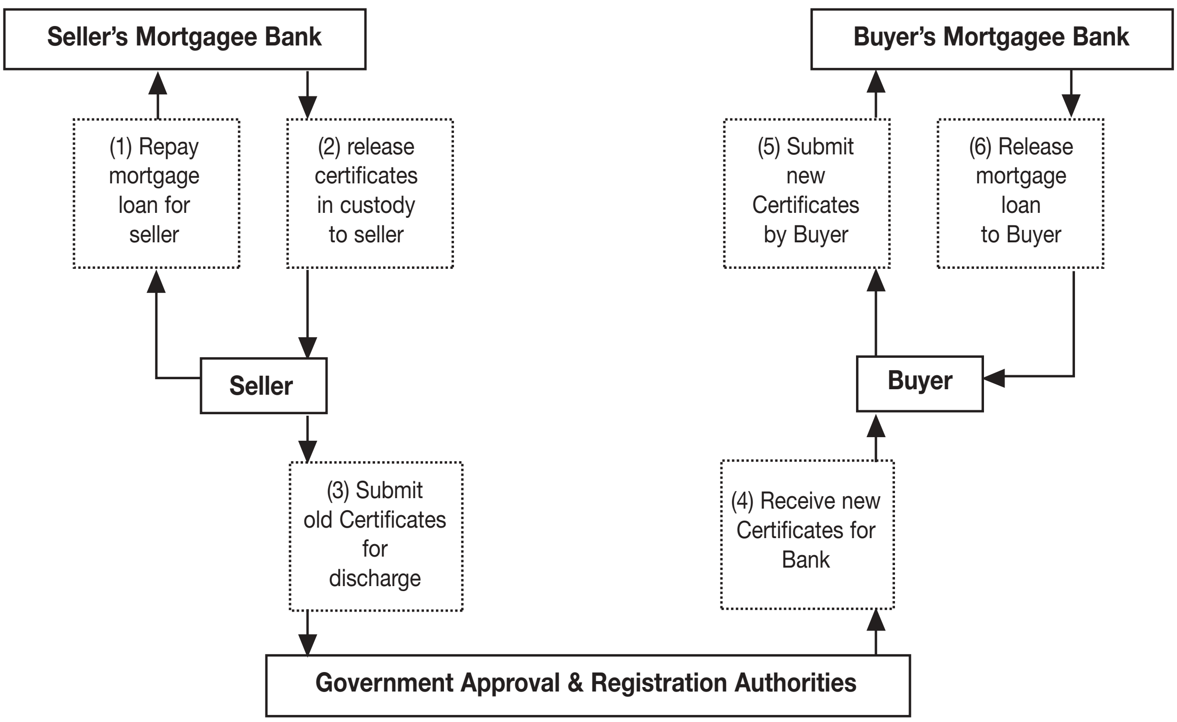
4. Bridging the Missing Link

Chinese banks have to face up to this trend. In Guangzhou, for example, a mortgage loan service for second-hand housing was first offered in 1998, three years after that for the primary housing market. This undoubtedly provided a key input to the enormous growth of housing transactions in the secondary market. Another major factor, which is often neglected, is the role played by property agents in facilitating housing transaction process. Property agents are commonly regarded as middlemen in providing property market information and matching vendors and buyers in property transactions (Jud, 1983; Bailey, 1991; Aronld, 1992; Bridge, 2001). Such interpretation ignores a peculiar financial intermediation function performed by some mainland Chinese property agents in facilitating the growth of housing mortgage loans for second-hand housing units. This is an unusual function because property agents are normally expected to bridge an 'information gap' rather than a 'financial gap' between buyers and sellers in housing transactions.

This 'missing link' stems from a mismatch of property registration and mortgage banking systems in China. The Chinese government requires a compulsory registration of all title transfers of real properties. Registration of a title transfer, with the issue of a new 'Certificate of Property Title' *(Fang Chan Zheng)* by the government authority to replace the previous one, will formally vest legal ownership title of a subject property to a newly registered buyer. If the buyer wishes to apply for a mortgage loan, this Certificate is normally held by the mortgagee bank in custody, and the government authority will also register the bank's interest by issuing a 'Certificate of Other Rights Over Property' *(Ta Xiang Quan Zheng)* to the mortgagee bank. China's national banking law prescribes a mortgagee bank to possess such a Certificate before releasing a mortgage loan to a borrower. Complication occurs when a second-hand housing property under transaction is subject to an existing mortgage loan.

An individual seller has to retire the entire housing mortgage loan first *before* his mortgagee bank could agree to release the two Certificates so that the government authority could amend the registration record. The problem is that, a prospective buyer will *not* get a mortgage loan unless he could submit a new 'Certificate of Property Title' and the said property is already clear of other outstanding rights held by third party (Fig. 5). Thus, buyer and seller may enter into a deadlock if *both* of them have to rely on housing mortgages to complete the transaction. This situation would not happen in western cities within which the redemption of an existing loan and the grant of a new loan for a property can take place concurrently. Mortgagee banks and conveyancing lawyers communicate with one another to complete money transfer in

Figure 5 - Mortgage Loan Procedures for Second-hand Housing: Without Property Agent



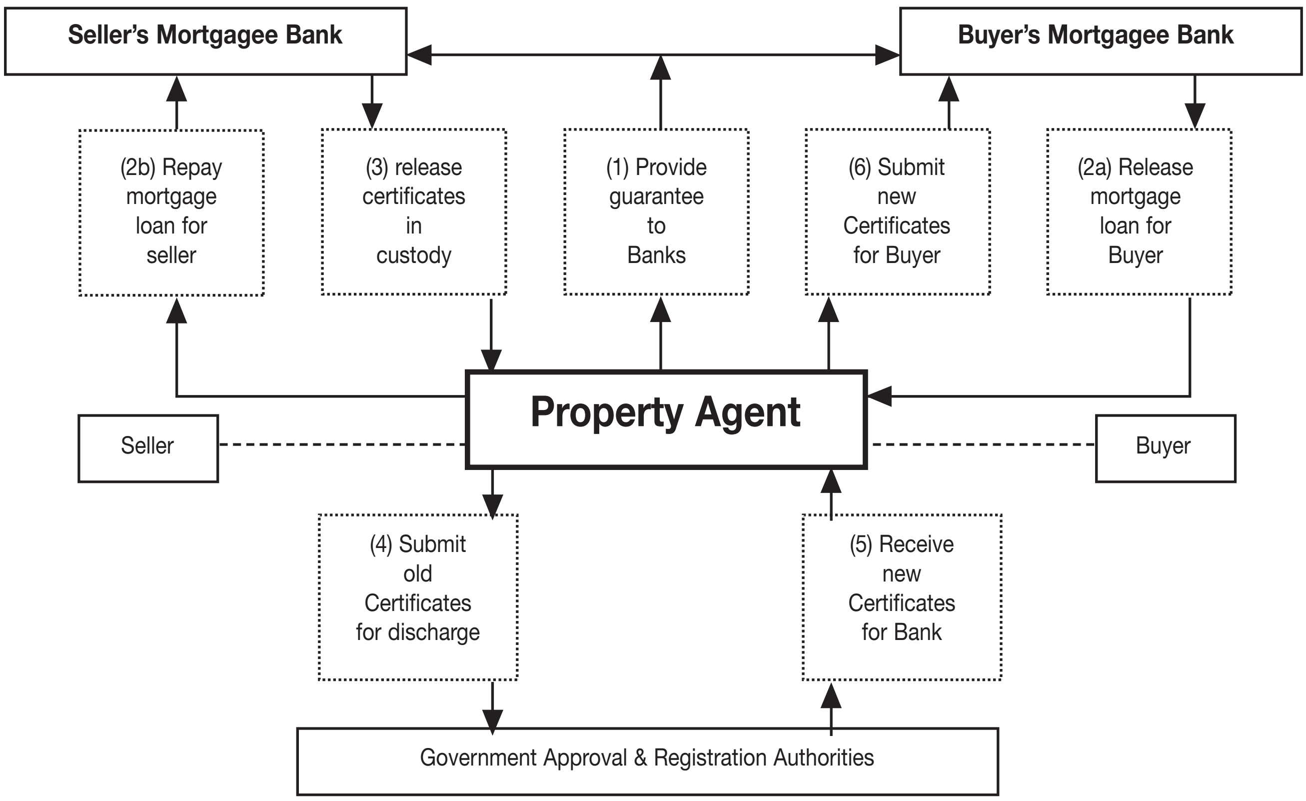
the absence of agreed buyers and sellers. In so far as mortgage lending is concerned, no such mechanism has been established in China.

Property agents have emerged to bridge this 'missing link' in the transaction process. For instance, some large property agency firms in Guangzhou provide an innovative package of 'mortgage services' for home sellers and buyers in order to facilitate transactions and close more deals. These services include offering short-term financial guarantees to the banks, performing the initial evaluation of buyers' repayment capability, providing temporary custody of the key certificates on behalf of mortgagee banks and completing title transfer registration with government departments (Fig. 6). These services relieve the financial burden of sellers from retiring the existing loans before sale completion, and reduce the risks faced by Chinese banks in releasing mortgage loans before receiving the custodial certificates. Mainland Chinese property agents have expanded beyond their conventional match-making function into financial intermediary business, which is crucial to the growth of China's housing mortgage market under its imperfect institutions.

5. Conclusions

After nearly three decades of market reform, China has now emerged to become a continent of tremendous economic opportunities. Strong economic growth, improving household incomes and rising wealth have led to an increasing demand for better housing. Privatization of housing under socialist market reform has activated

Figure 6 - Mortgage Loan Procedures for Second-hand Housing: With a Property Agent



Source: Authors

individual housing transactions and increased home ownership of the Chinese population. Housing mortgage was a latecomer to socialist China but its development is indispensable to a healthy growth of its housing market. Provision of home mortgage loans by Chinese banks facilitates more transactions of private housing especially in the secondary market in major Chinese cities. The total value of home mortgage loans has increased by more than ten-fold within the past five years. Mainland Chinese banks currently dominate the market, but with the gradual opening of the finance industry under the WTO agreement, entry of more efficient foreign banks is expected to impose a stronger competitive threat to local players. This paper suggests that there is still a huge growth potential of China's housing mortgage market. At present, individual housing loans take up less than 10% of overall bank lending. This is a low percentage compared to countries with a mature housing market. We argue that the development of China's housing mortgage market, especially for second-hand housing transactions, is constrained by inefficient institutions of title registration and mortgage bank lending systems. Nonetheless, market liberalization and profit opportunities have encouraged a spontaneous emergence of private solutions to provide a 'missing link' that gets over such inefficiencies. Some mainland Chinese property agents are found to provide a comprehensive package of services including property appraisal, property title validation, loan eligibility screening and financial intermediation for buyers, sellers and mortgagee banks. Their enterprising activities, emerged out of competition rather than government order, serve to reduce the costs of transacting in the housing market. Without these unconventional services, the housing mortgage and transaction markets in China could not have achieved their current level of market maturity and vibrancy. These market practices, somewhat neglected in the literature, are entirely dissimilar to those of their counterparts in a mature economy. Future prospects for the home mortgage and the housing market in China are embedded in the evolution of these institutions and the innovative activities of the organizations involved.

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