**Developers Told Not to Cross the Three Red Lines**

By Michael Hart

As 2020 finished it became clear that amidst the challenges of Covid-19 the Chinese economy had grown while many other countries had seen their economies shrink. But regardless of how a specific country's economy did, many companies and individuals saw their debt levels increase. Higher debt levels mean less flexibility going forward, so as economies start to recover, expect to see people take a hard look at their debt. Developers and other real estate market participants where debt is a central part of their operation model will certainly be looking at their debt levels and structures too.

A recent series of reports by global financial services firms such as S&P Global and UBS have looked at debt in the property sector. The impetus for this review was because of some new policies the Chinese government released in late 2020 where they formulated guidelines for developers called "The Three Red Lines."

**Background**

Put simply, the government has indicated the property market is an important part of the country's economy, but that it must remain healthy so it can continue to contribute in a positive way.  The government has said here are three new metrics that developers need to abide by.

| **Three Red Lines** |
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| 1. Liability to asset rations of less than 70% |
| 2. Net gearing ratio of less than 100% |
| 3. Cash to short-term debt ratio of more than 1x |
| Source: UBS, S&P Global |

Think about the first rule like an individual mortgage restriction.  Developers can borrow, but shouldn't borrow too much relative to their total assets, in this case not more than 70% of their total asset value.

The second rule focuses on gearing, which means the relationship between debt and a company's equity levels or overall value. Gearing ratios vary a great deal by industry. Industries that have large amounts of fixed assets can have higher levels of debt and thus higher gearing ratios, while those with fewer assets should have lower gearing ratios. Real estate is one of the industries that has a naturally high gearing ratio, but developers are encourage to be cautious about how much total debt they take on.

The final red line encourages companies to have enough cash on hand to be able to fund a full year of short-term debt payments. There have been some missed bon payments by developers over the past year and so this rule reminds developers to be better prepared.

**Restrictions**

So how are the rules applied? Basically, think about the red lines as a traffic light. If developers are considered healthy, they have a green light and can continue to borrow money, but at a measured pace. If they violate one of these three red lines, they get a yellow or caution light and the amount they can borrow is reduced and the more of the red lines they cross, the more restricted they will be.

| Color Code | Number of red lines breached | Allowable annual growth in debt |
|---|---|---|
| Green | 0 | 15% |
| Yellow | 1 | 10% |
| Orange | 2 | 5% |
| Red | 3 | 0% |

**The Long Game**

UBS, an international financial services firm, recently published a succinct summary of the key drivers for the Three Red Lines campaign.

| **Three Red Lines: Why and why Now ?** |
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| **To control house prices:**<br>China's government is mindful of the marked rise in house prices that has occurred during the past 15-20 years, which has made property unaffordable for millions. |
| **Manage land markets:**<br>Higher land prices feed into home price growth. Developers are partly responsible many aggressively suck up land parcels to build their land banks and bid up land prices. |
| **To ration credit to the real estate sector:**<br>Government authorities are concerned about the amount of capital absorbed the real estate industry. Reining in lending to the real estate sector is also party of the governments strategy to channel lending to more productive areas of the economy. |
| **To lower cyclicality:**<br>The local real estate market is highly cyclical, largely due to on-off policies like home purchase restrictions and property price caps. The government wants to stabilize markets by bringing in what they describe as a "long-term mechanism for the real estate market." |
| **Real estate developers are systemically important:**<br>Real estate is a significant part of China's economy with strong linkages to numerous upstream and downstream industries. The Chinese government is thus putting stricter controls in place to ensure a more sustainable future. |
| Source: UBS (www.ubs.com) |

**Moral Hazard**

The concept of moral hazard occurs when some party is told not to do something, but if they do and they suffer negative consequences, they are then rescued, which may encourage them to take the same risks again in the future with the believe they will be saved again.

A good example was in the 2007-8 financial crisis in the USA, many banks had large amounts of debt and during the crisis they ran into liquidity problems and were forced to turn to the government for help. The government provide assistance and the economy slowly recovered. Only one major bank was allowed to go bankrupt and many pundits concluded that the American government effectively encourage future reckless behavior by banks because they government didn't allow them to fail.

The strength and importance of the real estate industry to China's economy has created a moral hazard particularly for some provinces where local developers may get preferable treatment. The government doesn't want developers to take on risks they can't cover, but in case they do, the government may be impelled to bail them out in order to save an important part of the economy. With this new "Red Line" policy, the central government has put forth a simple and standard way to evaluate and control risk.

**Conclusion**

In China, the real estate sector has been and continues to be an important part of the economy. Over time there has been consolidation meaning there are fewer larger developers and they are generally better managed, but the government wants to see good governance improve even further.

The central government has shown it understands that real estate sector uses debt, but has also made it clear it expects developers to use debt responsibility. The concept of the three red lines lays out clearly to local governments, developers, banks and investors how to think about what is a reasonable level of debt. This helps eliminate the moral hazard and ensures that as the economy continues to mature, real estate will continue to play an important role and that it can do so responsibly.

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