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Mortgage Law in China: Comparing Theory and Practice

Gregory M. Stein *

I. INTRODUCTION

China is in the puzzling position of developing free markets while still nominally subscribing to Communist ideology.¹ Nowhere is this tension more evident than in its real estate sector.² Developers are building award-winning office towers, modern shopping malls, and five-star hotels, and tens of millions of urban families are scraping together the money to buy their own apartments.³ At the same time, Communist doctrine prohibits private ownership of property, and all land in China still is owned by the state or by

* Woolf, McClane, Bright, Allen & Carpenter Distinguished Professor of Law, University of Tennessee College of Law (gstein@utk.edu). A.B. Harvard 1983, J.D. Columbia 1986. This article is based on a presentation I gave at a conference at the University of Missouri-Columbia School of Law honoring the career of Professor Dale Whitman. I would like to express my gratitude to Professor Whitman for being a fine mentor and role model to so many of us in the field of real estate finance. It was an honor to participate. Don Clarke, Jeanette Kelleher, Ben Liebman, Xiao Kai, and Xu Duoqi provided enormously helpful comments at different stages of my research on this paper. I am extremely grateful to the many real estate professionals, professors, and students in China who were willing to meet with me and share their experiences. I could not have written this article without their insight and assistance. Thank you to the University of Tennessee College of Law, the W. Allen Separk Faculty Scholarship Fund, Shanghai Jiaotong University Law School, and the Fulbright Scholar Program for supporting my research.

1. See XIAN FA [Constitution] pmbl. (2004) (P.R.C.) (“The basic task of the nation is to concentrate its efforts on socialist modernization by following the road of Chinese-style socialism.”).

2. See Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 1 (P.R.C.) (“This Law is formulated with a view to maintaining the national basic economic system and the economic order of the socialist market, clarifying the ownership of property [and] giving full effect to the meaning of property”); *id.* art. 3 (“During the primary stage of socialism, the State shall adhere to the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side.”). See also Tudi guanli fa [Land Administration Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 2 (P.R.C.) (“The People’s Republic of China adopts socialist public ownership of land, that is, ownership by the whole people and collective ownership by the working people.”).

3. The Property Rights Law establishes an ownership structure for apartments within a larger building that resembles the condominium form of ownership. Wuquan fa [Property Rights Law], arts. 70-83.

agricultural collectives.⁴ This doctrinal confusion does not seem to be holding back the real estate market, particularly in China's major cities, which have been booming for most of the last two decades.

China has adopted numerous written laws and regulations since the 1980s, but property law has lagged behind other areas of civil law. The first Chinese law focusing specifically on property rights became effective on October 1, 2007,⁵ which means that China's breakneck real estate development during the preceding two decades occurred in a nation with no published law of real estate.⁶ China has only haltingly begun to adhere to inter-

4. *Id.* art. 47 (stating, in somewhat circular fashion, "[t]he urban lands are owned by the State. Such rural land and the land on the outskirts of the city as belonging to the State according to law shall be owned by the State."). Other articles in this chapter confirm state ownership of "mineral resources, waters, [and] sea areas," *id.* art. 46, most "natural resources," *id.* art. 48, certain "wild animals and plants," *id.* art. 49, "[t]he radio spectrum," *id.* art. 50, certain "cultural relics," *id.* art. 51, "national defence resource[s]," *id.* art. 52, and certain "[p]ublic facilities like railways, roads, electric power, communications and gas pipes," *id.* The new statute clarifies that land "owned by the State" is owned "by the whole people." *Id.* art. 45. Note as well that the law prohibits the mortgaging of "[o]wnership of the land." *Id.* art. 184.

The new statute clarifies that certain natural resources are not owned by the state, but rather "are collectively-owned." *Id.* art. 48. *See also id.* arts. 58-63 (elaborating on the types of property that are collectively owned and discussing some attributes of collectively owned property); *id.* art. 184(ii) (generally prohibiting mortgaging of land use rights owned by collectives, even if occupied by "house sites, private plots and private hills").

5. Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007) (P.R.C.).

6. While the Property Rights Law bears an effective date of October 1, 2007, China had previously enacted other laws affecting legal rights to property. For example, the Land Administration Law was adopted in 1986, Tudi guanli fa [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004) (P.R.C.), and the Law on the Administration of Urban Real Estate was adopted in 1994, Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995) (P.R.C.). The 2007 Property Rights Law, however, is China's first legislation since before 1949 to address property rights comprehensively. *See generally* 3 CHINA BUSINESS LAW GUIDE 87, 151-52 (Kluwer Law Int'l 2005) (listing and summarizing Chinese laws pertaining to property rights).

One of China's first modern laws, the General Principles of the Civil Law, recognized the right to "possess, utilize, profit from and dispose of . . . property." Ming fa tong ze [General Principles of the Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), art. 71 (P.R.C.). *See generally* ALBERT HUNG-YEE CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 248 (3d ed. 2004) (summarizing provisions of the General Principles of the Civil Law relating to property). But at the time the General Principles of the Civil Law became effective, "Chinese legal thinking about property rights . . . had not yet matured; there also existed ideological obstacles regarding

national rule-of-law standards, and there still is heavy reliance in China on *guanxi*, or personal relationships and connections.⁷ Chinese property rights also are limited by communitarian considerations in ways that are unfamiliar to Americans.⁸ These factors ensure that property law as it is actually practiced in China diverges from the published legal rules. Thus, those who have been buying, selling, and lending against Chinese real estate have been operating in a world of significant legal uncertainty.⁹ Moreover, while a newcomer to American law can learn much by reading statutes, cases, treatises, and academic articles, there are few similar sources in China.

This Article examines Chinese mortgage law as it actually operates in the field, focusing on both legal and business issues.¹⁰ During the summer of 2005, I interviewed dozens of Chinese and Western lawyers, bankers, real estate developers, government officials, judges, economists, real estate consultants, law professors, business professors, real estate agents, law students, and recent homebuyers.¹¹ Their comments offer reliable insights into how China's real estate markets truly function. The discussion that follows draws on these conversations to examine China's budding mortgage law practices,

whether the affirmation of property rights . . . would challenge the socialist principle of public ownership of the means of production." *Id.* at 249.

7. See, e.g., RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 20 (2002) ("the notion that the PRC economy will be able to sustain economic growth without further legal reforms that bring the system into greater compliance with the basic requirements of a thin conception of rule of law is doubtful").

8. See Wuquan fa [Property Rights Law], art. 7 ("The attainment and exercise of property rights shall comply with laws, social morality and shall not do harm to the public interests and the legitimate rights and interests of others."); *id.* art. 84 (2007) ("In the spirit of providing convenience for production, life of the people, enhancing unity and mutual assistance, and being fair and reasonable, neighboring users of the real property shall maintain proper neighborhood relationship.").

9. Yan Song, Gerrit Knaap & Chengri Ding, *Housing Policy in the People's Republic of China: An Historical Review*, in EMERGING LAND AND HOUSING MARKETS IN CHINA 163, 174 (Chengri Ding & Yan Song eds. 2005) ("Progress is impeded by the lack of an appropriate legal framework China's privatization has emphasized deregulation and decentralization, but a comprehensive legal framework for regulation of economic behavior in the emerging housing market has not yet formed.").

10. I have previously described the system of land use rights in China, which serves as a rough substitute for land ownership. Gregory M. Stein, *Acquiring Land Use Rights in Today's China: A Snapshot from on the Ground*, 24 UCLA PAC. BASIN L.J. 1 (2006). See also *infra* Part II. For a thorough comparison of Chinese and American mortgage law, see Dale A. Whitman, *Chinese Mortgage Law: An American Perspective*, 15 COLUM. J. ASIAN L. 35 (2001).

11. Some of my interviewees hold sensitive positions in government or banking and were quite candid in their remarks. Out of courtesy for the generosity of all who met with me, I have chosen to refer to all contacts anonymously.

including how they developed, how they comport with or differ from written laws, and what questions they leave unanswered.¹²

I first visited China as a Fulbright Lecturer at Shanghai Jiaotong University Law School during the spring of 2003. Amazed by the staggering scale of the real estate development in Shanghai, I became curious as to how China was succeeding in building new structures and rebuilding crumbling infrastructure so quickly in a partial legal vacuum. I returned two years later and conducted this field research into the legal and business grounding for the current Chinese real estate boom, interviewing a wide variety of experts in various segments of the Chinese real estate industry. These professionals come from a broad range of fields and backgrounds, with their only shared attribute being a willingness to meet with an inquisitive foreigner.¹³

Several features of the blossoming Chinese real estate sector quickly became apparent. These characteristics remind American lawyers interested in China that their assumptions about the American real estate industry will not necessarily apply in a nation with a strikingly different history and legal culture. First, the legal and business communities have fashioned their business

12. The classic example of field research into the development of informal norms is ROBERT C. ELLICKSON, *ORDER WITHOUT LAW* (1991). Professor Ellickson observes that “rural residents in [California’s] Shasta County were frequently applying informal norms of neighborliness to resolve disputes even when they knew that their norms were inconsistent with the law.” *Id.* at viii. He concludes from this that, “[i]n many contexts, law is not central to the maintenance of social order.” *Id.* at 280. See also Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 *STAN. L. REV.* 623, 654-55 (1986) [hereinafter Ellickson, *Coase and Cattle*] (presenting earlier version of his field-research results).

13. For a thoughtful discussion of the biases that are inherent in this type of information-gathering about the Chinese legal system, see Benjamin L. Liebman, *Watchdog or Demagogue? The Media in the Chinese Legal System*, 105 *COLUM. L. REV.* 1, 11-14 (2005). Professor Liebman observes that personal introductions are critically important when conducting field research in China, a fact that unavoidably leads to biases that can affect research results. *Id.* at 13. See also Ellickson, *Coase and Cattle*, *supra* note 12, at 655 (“cooperative people were undoubtedly somewhat overrepresented in [my research] sample”).

Professor Donald Clarke has observed, “[f]ieldwork can yield interesting and original results, but unfortunately it typically does not yield representative statistics unless great care is taken in selecting the objects of study.” Donald C. Clarke, *Empirical Research into the Chinese Judicial System*, in *BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW* 164, 180 (Erik G. Jensen & Thomas C. Heller eds., 2003) (citations omitted). He also has noted how difficult it is to find reliable sources when conducting research into Chinese Law:

By piecing together information from [a wide range of] sources, Chinese and foreign scholars have been able to assemble a picture of certain aspects of the Chinese legal system. That picture is by no means complete. But fleshing it out requires a great deal of thought about what information needs to be gathered and how it can be gathered effectively.

Id. at 167.

approach largely from scratch. There is little received wisdom, today's leaders have few mentors on whom they can rely, and many so-called experts still operate by trial and error. Second, while China's market is more open today than it has been in at least a half-century, it is far from a free market. The government intervenes in all aspects of the economy to a degree that is surprising to the Western observer. Third, the legal system is not transparent, laws are not always applied and enforced as written, and there is much corruption. "Rule of law" is viewed by many Chinese as a Western construct designed to preserve Westerners' current advantage; it has not yet won its battle against "rule by man."

Fourth, China's legal system is a responsive one. Rather than adopting laws and regulations prospectively – an enormous task for a huge country that has been reforming its legal and economic systems rapidly and dramatically – the Chinese government often drafts them to address the crisis *du jour*. Meanwhile, China's creative business community continuously formulates new ways to approach new problems without waiting for formal government action. Market participants devise novel economic arrangements that subsequent legal developments expressly permit, or at least tacitly tolerate. The business community often seems to be prodding the government to act, and China's legal system must struggle mightily to keep up.¹⁴ In short, formal law lags behind actual practice.

Part II of this Article offers some historical and legal background. Part III examines the types of loans that are available to Chinese borrowers and the types of lenders that are making these loans. These lenders expect to be repaid, and Part IV raises the question of what assets a borrower has available to offer to a lender as security for that repayment. Part V continues by addressing the lending standards these lenders apply before they agree to extend credit. This analysis raises the more general question of where the lenders' funds actually come from, and Part VI discusses the ultimate sources of these funds. Part VII questions how stable the Chinese banking sector actually is, and Part VIII offers some concluding thoughts.

II. THE HISTORICAL AND LEGAL BACKGROUND

Mao Zedong led the Chinese Communist Party to power in 1949, but China arguably did not complete the nationalization of its land until 1982, six years after Mao's death.¹⁵ Ironically, market-based systems began to reap-

14. See Whitman, *supra* note 10, at 36 (describing some "features [of Chinese mortgage law] which are either uncertain in operation, or which are unnecessary stumbling blocks to the smooth and efficient functioning of the market in real estate financing").

15. See PATRICK A. RANDOLPH JR. & LOU JIANBO, CHINESE REAL ESTATE LAW 11 (2000) (noting that nationalization of land in China was not completed until 1982). Jonathan Spence observes that early land reform efforts were extremely violent but intentionally incomplete. JONATHAN D. SPENCE, THE SEARCH FOR MODERN CHINA

pear at about this time, hastened by Deng Xiaoping's rise to power during the late 1970s. Deng ignited China's "reform and opening" policy in 1992, causing the Chinese economy to begin growing rapidly from a nearly dead stop. The Chinese economic system, including its real estate sector, has developed quickly since then, with spectacular acceleration since the mid-1990s. Nonetheless, private ownership of land remained prohibited during this era of transition and still is forbidden today.¹⁶

China amended its Constitution in 1988 to read, "The right to the use of land may be transferred in accordance with the law."¹⁷ This provision does not permit private land ownership¹⁸ but does allow the government to grant land use rights for a specified term.¹⁹ The government thereby created oppor-

490-92 (2d ed. 1999) (estimating that at least one million landlords and family members of landlords were killed during the early stages of Chinese land reform, but noting that rich peasants often were left alone so that adequate food production could be maintained).

16. "According to Marxist theory, land is singled out as incapable of being regarded as a commodity, since it is not a product of man's labour – land exists by itself." Keith McKinnell & Anthony Walker, *China's Land Reform and the Establishment of a Property Market: Problems and Prospects*, in *THE IMPACT OF CHINA'S ECONOMIC REFORMS UPON LAND, PROPERTY AND CONSTRUCTION* 26, 31 (Jean Jinghan Chen & David Wills eds., 1999).

17. XIAN FA [Constitution] art. 10 (2004) (P.R.C.).

18. The sentence immediately prior to the one just quoted, which dates back to the original 1982 adoption of this Constitution, was retained without change and reads: "No organization or individual may appropriate, buy, sell or lease land, or unlawfully transfer land in other ways." *Id.* See also Ming fa tong ze [General Principles of the Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), art. 73 (P.R.C.) (stating that "[s]tate property shall be owned by the whole people" and that "[s]tate property is sacred and inviolable"). The first two sentences of Article 10 of the Constitution indicate that urban land is owned by the state and that rural and suburban land is owned either by the state or by collectives. XIAN FA [Constitution] art. 10. These provisions, when read together, clarify that all land is state- or collective-owned, but that the state now holds the constitutional power to transfer the right to use land.

19. Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 7 (P.R.C.). The legal status of land use rights draws additional support from a constitutional amendment that became effective in 2004, with language that requires the state to pay compensation when it expropriates land. XIAN FA [Constitution] art. 10 ("The State may, in the public interest and in accordance with the provisions of law, expropriate or requisition land for its use and shall make compensation for the land expropriated or requisitioned."). The Land Administration Law offers additional specificity about the legal status of land use rights. See Tudi guanli fa [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 2 (P.R.C.) ("No units or individuals may encroach

tunities for private development²⁰ while it also “avoided abandoning the Marxist principle of state ownership.”²¹ The maximum permissible term for a land use right is seventy years for residential property, forty years for commercial property, and fifty years for industrial and other types of property.²²

The party that acquires a granted land use right technically is required to develop the land within two years,²³ but the government often fails to enforce this deadline. Rights holders may pay an additional fee to extend the term, may initiate the barely acceptable minimum amount of construction before the two-year period expires, or may otherwise seek to extend the initial term. The initial and subsequent holders of land use rights may transfer these rights to others, within certain limits.²⁴ For example, in an apparent effort to head

on or transfer land, through buying, selling or other illegal means. The right to the use of land may be transferred in accordance with law.”).

20. For a discussion of the relationship between security of land tenure in China and economic growth, see Joyce Palomar, *Contributions Legal Scholars Can Make to Development Economics: Examples from China*, 45 WM. & MARY L. REV. 1011 (2004). See also Donald C. Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 AM. J. COMP. L. 89 (2003) (addressing relative importance of security of property and enforcement of contract rights).

21. STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 184 (1999). Later modifications to the Chinese Constitution reflect the uneasy relationship between private property ownership and Marxist doctrine. For example, the following language was added to Article 6 in 1999:

During the primary stage of socialism, the State adheres to the basic economic system with the public ownership remaining dominant and diverse sectors of the economy developing side by side, and to the distribution system with the distribution according to work remaining dominant and the coexistence of a variety of modes of distribution.

XIAN FA [Constitution] art. 6. See also Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 3 (P.R.C.) (“The State shall consolidate and develop unswervingly the public sector of the economy and at the same time encourage, support and guide the development of the non-public sectors of the economy.”); Chengri Ding & Gerrit Knaap, *Urban Land Policy Reform in China’s Transitional Economy*, in EMERGING LAND AND HOUSING MARKETS IN CHINA, *supra* note 9, at 9, 14 (“As a milestone in the evolution of the Chinese Constitution, the 1988 amendment is significant, because it allowed the state to maintain ownership and at the same time promoted land market development without provoking political turmoil.”).

22. RANDOLPH & LOU, *supra* note 15, at 127-28. The constitutional amendment authorized the granting of land use rights, but the State Council established the actual durational limits by regulation. *Id.*

23. Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 25 (imposing penalty of up to twenty percent of fee paid for land use right if land is not developed within one year and allowing for forfeiture of land use right if land is not developed within two years).

24. Wuquan fa [Property Rights Law], art. 143 (“Except as otherwise provided for by law, the owner of the right to the use of land for construction use shall have the

off speculation in undeveloped land, the law prevents the initial holder of a residential land use right from transferring the right to a third party until it has constructed at least 25% of the proposed structure.²⁵

Despite some superficial similarities, the Chinese land use right differs considerably from the common law ground lease.²⁶ A party acquiring a land use right must pay the entire cost for that right in advance;²⁷ the holder of a land use right may not register that right until it has paid the fee in full;²⁸ at

right to transfer, exchange, make as capital contribution, donate or mortgage the right to the use of land for construction use.”); RANDOLPH & LOU, *supra* note 15, at 131-32 (discussing transferability of granted land use rights).

25. *See, e.g.*, Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 38 (prohibiting grantee from further transferring land use right before, “for housing construction projects, 25 percent of the total investment has gone through”).

26. *See* Whitman, *supra* note 10, at 38 (noting similarities and differences between Chinese land use right and Western long-term ground lease); RANDOLPH & LOU, *supra* note 15, at 18-19 (expressing belief that Chinese land use right is derived from German civil law concepts and not from common law ground lease).

27. Although several speakers made this claim, the only statutory support I could find for it is equivocal. Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 38 (“The transfer of real estate with the right of land use shall comply with the following conditions: (1) All the fees in concern with the lease of the right of land use have been paid in accordance with provisions prescribed by the contract for the lease and the certificate of the right to use the land has been obtained.”). Implicit in this language is the suggestion that the contract might provide for payments over time. One Chinese lawyer indicated that the practice requiring advance payment in full has recently been modified and that some owners have been permitted to pay the fee on a periodic schedule that is similar to regular rent payments. This newer method allows the government to spread out its receipt of the income from the sale of the land use right over a period of time.

28. RANDOLPH & LOU, *supra* note 15, at 152. The new Property Rights Law addresses registration. Wuquan fa [Property Rights Law], arts. 9-22, 139. Article 139 provides, “[t]he right to the use of land for construction use shall be set upon registration.” *Id.* art. 39. *See also* Tudi guanli fa [Land Administration Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 12 (P.R.C.) (“Any change to be lawfully made in land ownership, in the right to the use of land or in the purpose of use of land shall be registered.”); Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 35 (requiring registration of ownership of real estate when it is transferred or mortgaged).

The registration requirement also applies to mortgages. *See* Danbao fa [Guaranty Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 30, 1995, effective Oct. 1, 1995), art. 41 (P.R.C.) (“Where a party mortgages [certain types of] property . . . , he shall register the mortgaged property, and the mortgage contract shall become effective as of the date of registration.”); *id.* art. 43 (“Where a party mortgages other [types of] property, he may of his own will, register the mortgaged property, and the mortgage contract shall become effective as of the date of execution.”). There are incentives to register mortgages even when registration is

least in some parts of China, the purchaser apparently may not use borrowed funds for the acquisition of a land use right; the land to which use rights are granted must be developed within a fixed amount of time or the right is forfeited, as just noted; there are official limits on the transferability of land use rights, also as just noted; the holder of the land use right must own the building constructed on that land;²⁹ and land use rights are not subject to landlord-tenant law.³⁰ The Chinese land use right thus is not a ground lease.³¹

optional under Article 43 of the Guaranty Law. *See id.* (“If a party does not register the mortgaged property, he may not defend against the claims of third party [sic].”).

The provisions of the new Property Rights Law appear to mandate registration of mortgages in all cases. Wuquan fa [Property Rights Law], art. 187 (“Where a party mortgages assets [including houses and land use rights], he shall register the mortgaged property, and the mortgage contract shall become effective as of the date of registration.”). *But see id.* art. 199(iii) (referring to claims secured by unregistered mortgages). These provisions of the new Property Rights Law take precedence over any contradictory portions of the earlier Guaranty Law. *Id.* art. 178 (“In case of any discrepancy between the Guarantee Law [sic] of the People’s Republic of China and this Law, this Law shall prevail.”). *Cf. id.* art. 8 (“Where there are laws stipulated otherwise in respect of property rights, such laws shall be observed.”).

29. Wuquan fa [Property Rights Law], art. 142 (“The ownership of the building, structure and their accessory facilities built by the owner of the right to the use of land for construction use shall belong to such owner, unless there is evidence to the contrary sufficient to invalidate that.”); *id.* art. 146 (“Where the right to the use of land for construction use is transferred, exchanged, made as a capital contribution or donated, the buildings, structures and their accessory facilities affiliated with such land shall be disposed of accordingly.”); *id.* art. 147 (“Where the buildings, structures and their accessory facilities affiliated with a land for construction use is transferred . . . [or otherwise conveyed], the right to the use of such land for construction use as being occupied by such buildings, structure and their accessory facilities shall be disposed of accordingly.”); *id.* art. 182 (“Where houses are mortgaged, the land use right to the construction lot occupied by the houses shall be mortgaged at the same time. Where the land use right to the construction lot is mortgaged, the houses fixed on the land shall be mortgaged at the same time.”); Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 31 (same). *See generally* JAMES M. ZIMMERMAN, CHINA LAW DESKBOOK 739 (2d ed. 2005) (discussing this issue in context of registration of real estate transfers). *See also infra* notes 47-50 and accompanying text (addressing this issue in context of construction lending).

30. *See* RANDOLPH & LOU, *supra* note 15, at 125-26 (emphasizing that most of Chinese landlord-tenant law does not apply to holders of granted land use rights); *cf.* INVESTMENT IN GREATER CHINA: OPPORTUNITIES & CHALLENGES FOR INVESTORS 105 (CCH Asia eds., 2003) (observing that Chinese land use right displays elements of both leasehold interest and contract right).

31. It should be evident from this discussion that the Chinese land use right is both similar to and different from the Western ground lease. Because Chinese land can be owned only by the government and because ownership of a land use right carries with it ownership of the improvements on that land, the granting of a land use right by definition severs ownership of the land from ownership of the building constructed on that land, just as the Western ground lease does. But because the holder

One obvious question about China's current system of land use rights is what happens to the land use right and the structures on the land when the term of the right expires.³² Since the system of land use rights is only about two decades old while most land use rights are granted for periods of forty years or more, China's legal system and real estate market have had little occasion to address this question so far. It is reasonable to assume, however, that even if Chinese government entities are not required to renew land use rights that are nearing their expiration date, they will be willing to negotiate extensions of these rights in exchange for the payment of a periodic or one-time fee. Pressure to implement such a policy is likely to increase as the first wave of land use rights begins to approach its expiration date and the holders

of a Chinese land use right is required to own the improvements on that land, Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 31, the developer must incur the capital expense of acquiring the land use right in its entirety at the beginning of the construction process. The ground lease structure, by contrast, allows the developer to avoid all or most up-front land acquisition costs. The Chinese land use right, in short, is not a financing device.

32. The new Property Rights Law appears to require the government to renew the land use right, at least for residential property. Wuquan fa [Property Rights Law], art. 149 (stating, "[t]he term of the right to the use of land for building houses shall automatically renewed [sic] upon expiration," while noting that for other uses, the right "shall be renewed according to laws and regulations upon expiration"). This provision does not address the duration of the renewal term, the question of whether the holder of the right must pay an additional fee, or the issue of how any such fee will be calculated.

Cf. Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 21 (providing that (i) holder of land use right that wishes to extend it must apply for such an extension no later than one year before right expires; (ii) such applications "shall be approved"; and (iii) land user shall execute a new contract "and pay fees accordingly for the use in accordance with the provisions"). This article of the statute does not clarify what the duration or price of the extension shall be. *Id.* Professors Randolph and Lou have argued that this article requires the government to renew, effectively giving the holder of the land use right a right of first refusal, but Article 21 does not specifically state this. *Compare* RANDOLPH & LOU, *supra* note 15, at 128-29, *with* Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 21. One expert suggested to me that a more accurate translation of Article 21 is that these applications "should be approved," which implies a greater level of government discretion. *Cf.* Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate], art. 21. Also noteworthy is Article 58 of the Land Administration Law, which states that the government may re-take land formerly subject to land use rights if the holder of the right fails to seek an extension "or, if he has, [and] the application is not approved." Tudi guanli fa [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 58(3) (P.R.C.).

of those rights discover that lenders have become unwilling to finance construction or renovation on the land.³³

The amount of this extension or renewal fee could fall within a wide range.³⁴ At the high extreme, the fee could amount to an annual payment equal to the fair market rental value of the land at the time of the renegotiation, perhaps with periodic increases built in (or, equivalently, a one-time fee that is equal to the discounted present value of this rental stream over the duration of the extension period). Land use rights renewed under such a system would resemble Western ground leases to a somewhat greater extent than current Chinese land use rights do, with the government serving as ground lessor. At the low extreme, the government might seek only a small percentage of the value of the land each year. If this occurs, China will have adopted a real property revenue-generation system not unlike that followed in much of the United States. Under this regime, holders of land use rights could maintain their occupancy for the duration of the renewal term on the condition that they make regular payments to the government in an amount that is far lower than the rental value of the property. The fee a Chinese right-holder would pay to maintain its land use right would be loosely analogous to ad valorem real property tax payments in the United States. If these rights were renewable indefinitely, the holding of a land use right would be tantamount to ownership.

The Chinese land use right system also functions as a zoning arrangement to some degree. When the government announces the availability of land, it places limits on the uses it will permit for that land, and it restates these limits in the written document that it executes with the eventual purchaser of the land use right.³⁵ The government thereby achieves by contract what American jurisdictions accomplish under a variety of land use laws. The establishment and transfer of land use rights is not the only method of land use control in China – and land that is not subject to land use rights is not restricted by these types of controls at all – but the land use right serves as one component of an overall land use system.³⁶ Moreover, the division of

33. See Whitman, *supra* note 10, at 38 (noting the “general expectation that granted land use rights will be renewed upon their expiration”).

34. See, e.g., McKinnell & Walker, *supra* note 16, at 33 (suggesting that Hong Kong’s method of addressing this issue so far has been more effective than China’s).

35. See RANDOLPH & LOU, *supra* note 15, at 391-92 (setting forth provisions regulating land use that are included in an official form of contract for granting of land use rights on state-owned land).

36. For more on the regulation of the use of land in China, see generally Tudi guanli fa [Land Administration Law]. For instance, Article 17 of the Land Administration Law requires that governments at all levels “draw up overall plans for land utilization . . . for national economic and social development, the need for improvement of national land and for protection of the natural resources and the environment, the capacity of land supply, and the demand for land by various construction projects.” *Id.* art. 17.

land into government-owned land and land owned by agricultural collectives also serves as a rudimentary form of zoning.³⁷

III. TYPES OF LOANS AND LENDERS

Commercial loans in China, much like those in the United States, come in two varieties and serve two different objectives. A developer may seek a project loan, which is essentially a construction loan, and also may seek a cash-flow loan to be used for daily operation of the completed building, which resembles the American permanent loan. Project loans usually are issued for a term of twelve to eighteen months, suggesting that construction schedules in China are extremely fast, and certainly much faster than in the United States. Any visitor to China can attest to the fact that developers erect buildings very quickly. Construction sites often operate – noisily – twenty-four hours per day, seven days per week, with plenty of willing laborers from the provinces to keep projects moving ahead unrelentingly.

Project loans are disbursed in periodic installments,³⁸ but borrowers sometimes can negotiate for a modest amount to be advanced initially in a lump sum. Although project loans are available for terms of more than twelve months, one developer explained that his company prefers loans with a term of no more than twelve months because the loan then is considered a short-term loan. Short-term loans require the borrower to meet fewer application formalities and are less closely supervised. If construction ends up taking longer than the projected twelve months, it is relatively straightforward for the borrower to obtain an extension of the term of the project loan,

37. One expert observed that some agricultural collectives own land that has been converted to commercial uses. This land frequently is located in suburban areas where the neighboring city has sprawled, raising the value of the collective's agricultural land and making it more attractive to commercial developers. The collectives fear that if this land is requisitioned by the state and converted from allocated to granted land, the developer or the state will enjoy the profit that results from converting farmland to commercial use. Some of these collectives have received permission to build commercial structures on their allocated land themselves. This places them in a position in which they can retain the profits resulting from the change in land use and pass them along to the members of the collective in the form of dividends. *See also* RANDOLPH & LOU, *supra* note 15, at 61 n.8 (discussing this phenomenon). Note, however, that collective-owned land may not be mortgaged. Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 184(ii) (P.R.C.); Danbao fa [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), art. 37(2) (P.R.C.).

38. *See* Danhao fa [Guaranty Law], art. 59 (defining "[a] mortgage of maximum amount" as a mortgage of property "to secure the creditor's claims which occur successively during a given period of time and to the extent of the total amount of the claims"). *See also* Wuquan fa [Property Rights Law], arts. 203-07 (addressing, but not defining, mortgages of maximum amount).

thereby avoiding the stricter regulations that would have applied had the developer sought a longer-term loan from the outset.

Cash-flow loans generally are not relevant to the construction of residential buildings, as the developer conveys the residential units upon completion of the building and the individual residential buyers secure their own financing. For commercial buildings that are to be rented out, cash-flow loans with a term of three to five years are common,³⁹ and the same lender that provided the project loan for the building frequently will extend the subsequent cash-flow loan to the developer. Interest rates tend to be lower for cash-flow loans than for project loans, presumably reflecting the lower risks of holding developed property as compared to developing it.

Despite the availability of cash-flow loans, one developer explained, developers would prefer to sell units, even in commercial buildings, rather than retain them. This preference may reflect a belief that the market is near its peak now and there is nothing to be gained by waiting to sell. Whether the developer plans to sell the completed units or retain them, defaults on project and cash-flow loans are rare, because property values have been increasing steadily. Property owners thus have both the incentive and the ability to keep their loan payments current.

The experts I met all agreed that commercial real estate lenders are almost exclusively domestic mainland Chinese banks. Other loan funds come from lenders in Taiwan and Hong Kong. Nations with large expatriate Chinese populations, such as Australia, Canada, and the United States, also serve as significant sources of mortgage loan funds.

Residential loans pose particularly interesting issues. By all accounts, prices for residential real estate in Shanghai far exceed what the typical buyer ought to be able to afford. Yet buyers keep buying and lenders keep lending, and the default rate has remained low. Nearly every person I spoke with confirmed that lenders require verification of official income before they will lend to a residential buyer, and nearly all of these people agreed that the income statements employers supply to lenders often overstate the typical applicant's income significantly. (One Chinese expert vehemently disagreed, insisting that a typical bank analysis was more rigorous than this.) While most lenders recognize that these statements probably are unreliable, they make these residential loans anyway and merely require the untrustworthy documentation for their files. Lenders, in short, routinely extend credit fully aware that the actual official income of the average borrower to whom they lend will be insufficient to cover the monthly loan payment. In addition, there are no national credit reporting agencies in China, which means that

39. As foreign lenders have entered this market, the terms for cash-flow loans have begun to increase. One foreign lender is reportedly extending permanent loans with twelve-year terms.

lenders have no dependable means of assessing the overall financial reliability of their loan applicants.⁴⁰

So how do residential buyers make their payments? To begin with, reported income is only part of the story for most Chinese. In addition to the income reported from their official – and therefore taxable – jobs, many workers earn “gray” income from various sources. As I heard repeatedly, this income usually is in cash, some of it may not be legal, and nearly all of it goes untaxed by the government. Lenders assume, and perhaps receive informal assurances, that their borrowers have other sources of income that cannot be officially verified. In addition, borrowers frequently obtain short-term loans from family members to help them make their regular payments on their acquisition loans. Thus, the purchase of a residential unit becomes a family affair, and several generations may be contributing to the purchase.

With home prices appreciating as rapidly as they have in the past several years, many buyers are making their purchases largely for investment purposes. If their loan payments become more than they can handle, they can sell their apartments quickly and at a significant profit. In fact, I heard over and over of investors who buy multiple residential units with the idea of selling them within a few months. These buyers do not expect to rent the apartments out, and many units lack such basic features as interior doors and plumbing fixtures. The owners hold these apartments empty and wait a few months while the property appreciates. As a result, many of the new residential units in Shanghai have never actually been occupied. These apartments are commodities, not residences.

The murkiness and unreliability of lending standards, particularly for residential loans, probably goes a long way toward explaining why a secondary market in real estate loans has not yet developed in China.⁴¹ Some Chinese real estate experts were simply unfamiliar with the concept of a secondary mortgage market, and several greeted my inquiries about such a market with “*mei you*,”⁴² signifying “we don’t have this.” Other experts seemed keenly aware of the absence of a market in which residential mortgage loans can be securitized and the need for such a market, with one professor explaining that the government previously had prohibited the securitization of mortgage loans,⁴³ a policy it has recently taken steps to reverse. Several experts

40. I was told that this problem exists to an even greater degree in the growing automobile loan industry, with lenders having great difficulty tracking down this mobile collateral after a borrower defaults.

41. *See generally* Whitman, *supra* note 10, at 57-58 (describing beneficial features of secondary mortgage market).

42. This universal response translates literally as “don’t have,” but I quickly grasped that this multi-purpose rejoinder can signify anything from “I don’t understand” to “don’t bother me.”

43. This professor implied that the government wants the lenders’ percentage of nonperforming loans to go no higher than it currently is. By compelling banks to

stated that there have been securitizations in China, but upon further questioning, it appeared that they were actually speaking of participations: in every such case, the speaker was referring to the sale of fractional interests in a large mortgage on a single property rather than the issuance of securities backed by a pool of smaller mortgages.

Given the low rate of residential loan defaults during the past decade – an era in which the number of homeowners has mushroomed – banks simply may not see any reason to reduce or spread the risk of holding a portfolio of individual mortgage loans. A small group of lenders controls a huge share of the residential market, and these lenders may see little need to sell loans to raise cash when they already hold enormous reserves of depositors' savings.⁴⁴ The government appears to recognize the value of securitization and the ways in which the availability of securitization would ease overall access to credit and help smooth out regional disparities in the availability of funds. Several speakers referred to new tax and accounting policies dating back to 2005 that are designed to encourage the growth of a secondary mortgage market, and one spoke of an increase in the number of domestic ratings agencies. This seems to be one area in which foreign participants in the Chinese real estate market will have many skills and much experience to offer. However it happens, China soon may see the growth of a secondary mortgage market. So far, though, the Chinese real estate industry has been able to flourish without one.

IV. WHAT DOES THE BORROWER HAVE TO OFFER AS SECURITY?

Developers in China, like those in the West, would prefer to limit their personal risk and maximize their leverage by borrowing funds. They may take advantage of several direct and indirect sources of loans. To a certain extent, they may be able to mortgage their land use right to a lender in exchange for funds to be used for the acquisition of that right or the development of a structure to be built on the land.⁴⁵ They can mortgage the partially

retain their most desirable loans, the government helps to ensure that the banks maintain or improve the overall quality of their portfolios.

44. See *infra* note 72 and accompanying text.

45. As a first approximation, it is correct to say that Chinese legal usage of the term "mortgage" is similar to American usage. Article 33 of China's Guaranty Law states:

Mortgage as used in this Law means that the debtor or a third party secures the creditor's rights with property listed in Article 34 of this Law without transference of its possession. If the debtor defaults, the creditor shall be entitled to convert the property into money to offset the debts or have priority in satisfying his claim from the proceeds of auction or sale of the property

Danbao fa [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), art. 33 (P.R.C.). Both this Article and

completed building to a bank. The developer can pre-sell units – in particular, residential apartments – and require that each buyer pay a deposit to reserve a unit. This prepayment is, in essence, a loan from the buyer to the developer to be used to finance construction. And developers frequently delay payments to contractors, forcing these contractors to finance construction involuntarily.

Different experts provided different answers to the question of whether banks would lend in return for receiving a mortgage on an unimproved land use right. One Chinese lawyer stated that lenders will not lend funds to developers to pay for the granted land use right itself. The buyer must pay the government in full with its own cash when the buyer acquires the right. Lenders simply are unwilling to lend until they know that the borrower already has acquired the land use right. A Chinese developer confirmed this point with respect to Shanghai, but indicated that the practice differs in Shenzhen, another booming real estate market. One law professor disagreed with the lawyer, stating that developers are permitted to mortgage an unimproved land use right in order to obtain a loan for the development of the structure to be built on that land. Perhaps that professor was recognizing that such loans are legally permissible, without commenting on whether banks

Article 179 of the Property Rights Law define “mortgagor,” “mortgagee,” and “mortgaged property,” and the latter provision states that “if the debtor defaults, the creditor shall have priority in satisfying his claim from such [mortgaged] property.” Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 179 (P.R.C.). *See also id.* art. 143 (“Except as otherwise provided for by law, the owner of the right to the use of land for construction use shall have the right to transfer, exchange, make as capital contribution, donate or mortgage the right to the use of land for construction use.”); *id.* art. 170 (“Unless otherwise stipulated by laws, holder [sic] of security interest shall have priority in satisfying its claim if a debtor defaults in its obligations.”).

Article 180 of the Property Rights Law lists seven different types of property that may be mortgaged, including houses and land use rights, while article 34 of the Guaranty Law lists six different types, with much overlap between the two groupings. Wuquan fa [Property Rights Law], art. 180; Danbao fa [Guaranty Law], art. 34. Leaseholds are not specifically enumerated on either list and apparently are not mortgageable. *See RANDOLPH & LOU, supra* note 15, at 244-46 (discussing desirability of permitting leasehold mortgages). Note again that “[i]n case of any discrepancy between the Guarantee [sic] Law of the People’s Republic of China and this [Property Rights] Law, this Law shall prevail.” Wuquan fa [Property Rights Law], art. 178.

Other types of mortgageable property include items that would be considered personalty in the United States, and thus not subject to mortgage law. *See, e.g.,* Danbao fa [Guaranty Law], art. 34(2), (4) (listing such items as “machines” and “means of transport”). But note that separate chapters of the Property Rights Law and the Guaranty Law address pledges. Wuquan fa [Property Rights Law], arts. 208-22 (addressing pledges of “movables”); Danbao fa [Guaranty Law], arts. 63-74 (same); Wuquan fa [Property Rights Law], arts. 223-29 (addressing pledges of “rights,” including commercial paper, securities, and intellectual property); Danbao fa [Guaranty Law], arts. 75-81 (same).

routinely grant them.⁴⁶ Or perhaps banks are willing to lend against a land use right if the funds are to be used for construction, which means that the value of the security will be increasing, but not if they are to be used for acquisition, where the value of the security remains constant. In the first of these two cases, however, the lender presumably is receiving a mortgage on the improvements and not just on the naked land use right.

These potentially inconsistent responses collectively suggest not just that each professional's experience with the application of these rules and policies is different, but also that bank policies and government regulations continue to evolve over time and vary from place to place within China. Frequent changes in the rules may reflect the degree to which the government wishes to encourage or discourage development as the market matures, as well as the accrual of experience over a relatively brief span of time. I was told by one developer that it was possible several years ago for a developer to function by mortgaging a land use right as security for the loan used to purchase that right, without contributing any of its own money. If this comment is accurate, it suggests either that banks were willing to live with 100% loan-to-value ratios at the time because the government was struggling to encourage private development or, perhaps, that government entities were selling land use rights for less than their true fair market value.

In the current, overheated climate, mortgage loans that may once have been available for developers to acquire land use rights appear to have become scarce, as state-controlled lenders try to cool the market gradually. Banks may have come to the realization that they have been shouldering too much development risk and now may be seeking to place more of this risk on their borrowers. Note also that government entities that are selling land use rights may impose their own requirements, on top of any applicable bank limitations, as a means of slowing down the pace of development. To illustrate, one expert advised me that interested bidders now must deposit 30% of the estimated value of the land use right with the government before they qualify to bid on it.

Whether or not banks will extend loans secured by mortgages on undeveloped land use rights, they will lend for the construction of the building itself and will insist on receiving a mortgage on the improvements.⁴⁷ Improvements are mortgageable, and a mortgage on an existing building automatically creates a mortgage on the underlying land use right.⁴⁸ This point

46. There does not appear to be any legal prohibition on such a loan. Wuquan fa [Property Rights Law], art. 180 ("The following property . . . may be mortgaged: . . . (ii) Land use right to building lot . . .").

47. See RANDOLPH & LOU, *supra* note 15, at 247-48, 253-54 (discussing how mortgages operate when securing future advances used to construct improvements). See also *supra* Part III (discussing project loans).

48. See, e.g., Danbao fa [Guaranty Law], art. 36 (stating that mortgage on either land use right or residential improvements on that land automatically creates mortgage on both). Cf. Wuquan fa [Property Rights Law], art. 200 (noting that mortgage

further demonstrates that the Chinese land use right and the Western ground lease function in quite distinct ways, despite some apparent similarities.⁴⁹ The ground lease allows the Western developer to operate without the need to acquire fee title to the underlying land, so that the lease functions as a financing device. By contrast, the Chinese developer must purchase the underlying land use right at the outset and, as just noted, may be unable to finance this purchase. This distinction serves as a reminder that the principal purpose of the Chinese land use right is to allow the Chinese government to sever official state ownership of the land from the private right to develop it. It also reminds the Western observer yet again of the uneasy tension in China today between the private right to develop property and the socialist conception of common ownership of land.⁵⁰

When banks are considering whether to lend, they require the loan applicant to submit four documents: (1) the land certificate from the government, evidencing that the borrower is the holder of the land use right; (2) the zone certificate, indicating that the height and bulk of the proposed building comply with the requirements of the applicable architecture zone;⁵¹ (3) the land zone certificate, demonstrating that the proposed use is permissible in that land zone; and (4) the construction permit, which authorizes construction.⁵² These documents are analogous to an American developer demonstrating that they hold title to the property, that their plans comply with all applicable zoning laws, and that they have received a building permit. Although banks do technically require the submission of these four documents, the first of these four – evidence of the land use right – is the most important one to the lender. It is the land use right that will serve as security for the

on land that is subsequently improved does not create security interest in improvements and that, upon foreclosure, land and improvements may be sold together but mortgagee shall receive none of proceeds attributable to improvements); Danbao fa [Guaranty Law], art. 55 (same); Chengshi fangdichan guanli fa [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 51 (P.R.C.) (suggesting that mortgage on undeveloped land use right does not encumber home subsequently built on that land). See also ZHONGZHI GAO, INVEST IN CHINA: A PRACTICAL GUIDE TO REAL ESTATE LAW 147 (2005) (“It is of practical use to distinguish mortgage of land from mortgage of land and buildings on the land.”).

49. See *supra* notes 26-31 and accompanying text.

50. See *supra* note 2 (highlighting these contradictions).

51. Interestingly, one experienced real estate developer told me that the obtaining of this certificate in Shanghai requires the developer to demonstrate, among other things, that the building contains defense facilities, such as underground tunnels, to be used in the event of a war. In the alternative, the developer may pay a fee in lieu of providing these facilities.

52. Note that different experts translated the names of these documents into English in slightly different ways.

repayment of the loan. In fact, some years ago, this submission was the only one banks required.

Obtaining these four certificates, which are prerequisites for the receipt of a project loan, requires significant cash outlays from the prospective borrower. One developer estimated that obtaining these four documents consumes roughly 30% of the typical development budget, with most of that expense attributable to the cost of purchasing the land use right. The charge for obtaining a land use right is even higher if it includes demolition and relocation expenses. These costs are passed along to the acquirer of the right by the entity selling the right if the seller must remove structures and occupants from the land, as is often the case in urban developments.⁵³ Since all or a significant part of this money must be laid out before the developer is eligible for a mortgage loan, it appears that current policies limit development to entities that are both well-capitalized and well-connected. Smaller entities probably have tremendous difficulty raising the funds for these initial outlays, and commercial lenders may not be willing or allowed to advance any portion of these amounts.

One expert indicated that project lenders insist that a new building be at least partially constructed before they will lend and accept a mortgage. If this is a common practice, then developers must be in a position not just to acquire the land use right and the other necessary documentation, but also to commence construction with their own funds. They will not be able to borrow any funds until the project is partly completed. The incomplete structure then will serve as security for a loan of the funds needed to continue construction. This requirement increases still further the amount of equity the developer must raise before it is in a position to borrow any construction funds.

Loan-to-value ratios are an additional subject of discussion between developers and their lenders. Developers and lawyers suggested to me that a typical loan-to-value ratio falls in the range of 50% to 80%. This is a term the two parties may negotiate heavily, with more experienced and reliable developers receiving relatively larger loans than their fledgling counterparts.⁵⁴

One small developer bemoaned her complete inability to procure bank loans, because banks will not deal with a company so small. This developer must finance construction entirely via equity, raising funds by selling shares in her company. Even large developers, who are more likely to obtain conventional loans, decry the bureaucratic squabbles they must survive before being able to proceed. One developer noted to me that in a typical project, the developer must obtain 120 government “chops” (official seals), down somewhat from 160 in earlier years. These government requirements are

53. See Stein, *supra* note 10, at 29-35.

54. See also INVESTMENT IN GREATER CHINA, *supra* note 30, at 309 (noting that Shanghai’s regulations limit loan-to-value ratios to 80% of face value or net book value or 90% of current cash value, depending on type of property).

applied unevenly, however, and a lack of *guanxi* on the part of the builder may lead to stricter-than-normal application of these rules to its project.

Developers also obtain significant funding from the eventual buyers of the residential or commercial units in their projects. These entrepreneurs are able to pre-sell residential units from promotional brochures and artists' renderings in many of China's white-hot urban areas. Huge buildings often sell out in hours, before the developer has even broken ground. The consumer will sign a purchase contract and put down a deposit, typically in the 20% range. The buyer also must pay part of the remaining purchase price then or soon afterwards, with this second payment often amounting to an additional 20-30%. The developer will establish a payment schedule for delivery of the remaining funds, with the final payment usually due before occupancy. One consultant described buyers as receiving their key when they make the final payment. If the developer breaches, the contract provides for contract remedies, which could turn out to be useless to the buyer if the project has failed. But with the market generally humming, such breaches are not common, and I was told that lenders often support developers who are struggling.

Buyers in this situation must produce some of their acquisition funds when they sign the contract and the rest before the unit is complete. Yet most buyers plan to borrow up to 80% of the money they will need to purchase their unit, which appears to raise a cash-flow problem for most purchasers. If they must pay for the unit before it is complete, they will need to come up with all of the acquisition funds before they have the mortgageable asset their lender is sure to demand. One agent indicated to me that when he bought his own home, the bank was willing to lend him funds to pay for the unit before it was completed, but he was never able to make clear to me what security the lender received while the apartment was under construction. During this fourteen-month period, however, the agent was making scheduled payments on an incomplete apartment at the same time that he was continuing to pay rent on his existing apartment. He acknowledged the risk and expense he incurred but stated that he had no alternative if he wished to become a homeowner. The cost of financing one's home while it is being built appears to be part of the expense of buying a new residence in China.⁵⁵

55. Professors Randolph and Lou state that a purchaser in this situation "can grant a mortgage on the pre-purchased property." RANDOLPH & LOU, *supra* note 15, at 246. This mortgage is recordable. *Id.* at 247. When the unit is completed, the purchaser formally obtains the land use right from the developer and the mortgage is re-registered to encumber the land use right. *Id.* Their statements pre-date the new Property Rights Law by several years. Under the new law, a buyer may apply for "pre-notice registration," which serves as notice of the buyer's interest in the property prior to the official transfer of the land use right. Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 20 (P.R.C.). However, the buyer's rights lapse if the transfer of the land use right is not registered "within three (3) months from the date on which such registration can be registered [sic]." *Id.* Moreover, lenders today will not lend to unit

One expert told me that prospective buyers actually receive two ownership certificates from the developer, one signifying their ownership interest in the underlying land use right and the second covering the unit. He claimed that banks will accept a security interest in the first of these certificates even before the residential unit is completed. The expert who advised me of this practice noted that it is commonplace, but questioned whether it truly is legal or enforceable. I was unable to confirm whether any such ownership certificate covering the land use right has any practical value: will a lender accept a mortgage on this ownership right as security if it may not be able to enforce that mortgage and if the lender is most likely junior in priority to the developer's interest in the land use right and the new structure, both of which may themselves have been mortgaged?

Two different experts told me that both the government and lenders have begun to frown on pre-sales by developers, given the risk to the eventual consumer that the seller will breach its contract and given the manner in which these sales shift costs from the seller to the buyer. Both indicated that developers now are prohibited from selling any units before receiving government approval, which will not be granted until the building is approximately 70% completed.⁵⁶ A bank representative suggested that lenders, too, have begun to discourage pre-sales that take place too early in the construction process, and that banks now may require that developers refrain from selling units to the public until the outer skin of the building has been completed. Obviously, this will be an issue of great importance to a developer that is trying to piece together the financing for a new project.

Contractors serve as another source of funds for developers. It is common practice for construction companies to undertake significant amounts of construction and to pay for the building materials they have used long before the developer pays them for their labor and reimburses them for their cash outlays. Competition for work is sufficiently tight that contractors may not receive their first payment until they have completed roughly one-third of the work. Given that much of the labor for urban construction projects is furnished by migrant laborers who lack permits to serve as urban construction

buyers until a project is 80 percent complete. If developers continue to insist on pre-sale consideration, they will create cash-flow problems for prospective buyers and substantially reduce the pool of eligible buyers.

56. The Law on the Administration of Urban Real Estate provides that new homes may not be pre-sold until "[t]he funds put into the development construction hav[e] reached twenty-five percent or more of the total investment for the construction project, computed on the basis of the commercial houses provided for presale, and the schedule of construction and the date of completion for delivery hav[e] been set," but also states that the developer must obtain a "certificate of permission for the presale of commercial houses" from the local government's administrative department in charge of housing. *Chengshi fangdichan guanli fa* [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 44(3)-(4) (P.R.C.).

workers, it seems likely that the contractors are passing these delays along to their workers, slow-paying undocumented peasants who often do not speak the local dialect and who are in no legal position to complain.

If a project fails, the contractor may never receive payment at all. Similarly, late payments from developers to contractors do not always bear interest. It is at least plausible to assume that contractors factor these risks into their bids. Whether or not this is the case, contractors who are paid slowly end up serving as another source of construction financing for the developer.⁵⁷

I was told that, in an attempt to slow the real estate market and protect contractors, the government has recently prohibited the practice of using contractors as reluctant lenders. To the extent that these new rules have been effective, developers must either begin the project with more money of their own or borrow funds from other sources. Developers have found ways to circumvent these limitations, however, and contractors have grudgingly gone along. For example, the developer may sell an interest in the ownership entity to the contractor. Such a sale transforms the contractor from a creditor entitled to payment into a minority co-owner that must contribute labor and materials to the entity in return for its ownership stake.⁵⁸

Interestingly, several different experts informed me that there is no legal mechanism in place in China for a lender to perfect a security interest in rents. Borrowers may pledge the income stream from tenant rentals to their lenders, but lenders have no way to perfect their security interest in this collateral. On new residential and commercial construction that will be sold upon completion, this shortcoming is unlikely to have much relevance, since there are no rent-paying tenants in possession and never will be. Nonetheless, these experts expressed frustration with this gap in Chinese real estate practice. It seems likely that China will have to permit this type of perfection at some future time.

V. LENDING STANDARDS

Although banks do require the submission of certain documents before they will extend credit, such as the income statement noted above,⁵⁹ few of the experts I met expressed much confidence in lenders' internal financial lending requirements. From their perspective, the only preconditions of any significance to lenders are those that are imposed to ensure that the project is

57. By contrast, in a typical American construction loan, the developer pays the contractor on a monthly basis, one month in arrears, and often holds back 5-10% of the amount due as a retainage. The developer borrows the bulk of these funds from its construction lender. Interest on the ever-growing construction loan balance accrues on a monthly basis and compounds.

58. Stein, *supra* note 10, at 20-21.

59. *See supra* note 40 and accompanying text.

legally permissible and socially desirable. Banks appear to make the decision to lend based solely on the legality of the project and the government's wish to see the project proceed and are far less concerned with the financial viability of the completed development. When I asked one American expert who works in China whether Chinese developers gathered data or prepared feasibility studies for proposed new projects, he laughingly replied, "A lot of these buildings were just built." He did concede that this approach has changed recently, with some banks adopting lending standards more familiar to Westerners.

This lack of concern with "the numbers" of a given project may reflect inexperience relative to Western institutions, though one would think that lenders would develop that sort of expertise relatively quickly. More likely, it is a reminder that nearly all banks in China are state-owned or state-controlled, unlike typical Western lenders. The government uses the banking system as an instrument of social policy, subsidizing construction of politically desirable projects even if those projects are not otherwise financially viable.

Many Westerners today view the modern Chinese economy as moving quickly toward capitalism, but one Westerner with significant experience in China's real estate market described China's economy to me as "the farthest thing from a free market you can get without being centrally planned." This odd combination of lenders that are charged with advancing specific government ends and developers that seek to maximize profits and returns while minimizing risks leads to outcomes that differ in important ways from those seen in Western real estate markets.

One expert suggested that developers actually prepare two feasibility studies at the outset of their projects, a bare-bones form for the lender, providing evidence that all legal hurdles have been cleared and that the project is viewed as politically necessary, and a more realistic one for internal consumption only, demonstrating that the development actually will be profitable. A second speaker, who was extremely knowledgeable about China's banking system, advised me that the banks themselves also have two different sets of standards. As a starting point, all banks must comply with guidelines imposed by government agencies charged with bank oversight. In addition, each bank's board of directors sets internal credit policies for that bank, and these internal policies are likely to be more stringent than the bare minimum levels established by banking regulators. One real estate developer argued that banks actually take the decision whether to lend quite seriously, hiring experts to analyze the property, having the land surveyed, and undertaking research as to the strength of the market.

Another real estate specialist, discussing the rapid early development of the Pudong New Area in Shanghai, commented that for publicly desirable projects in that zone, banks were required to lend. In contrast, for projects offering an entirely private benefit, developers had to negotiate with banks individually to obtain loans. Private projects that the government saw as having significant public benefit could always count on receiving a green light

from their state-supported lender.⁶⁰ This approach presumably enhances the municipal bottom line for jurisdictions that are attempting to upgrade and modernize quickly, since ostensibly private projects with significant public benefit will not look as if they were built with any direct outlay of government money. The solvency of the government-controlled bank that has been forced to underwrite a quasi-public improvement that will not produce adequate cash flow is another story.⁶¹

There is a more benign explanation for the fact that real estate loans do not seem to be evaluated on the basis of the economic viability of the project. The short history of the post-Mao real estate market has been one of steadily appreciating real estate values, and most real estate loans have been successfully repaid. Under this explanation, the banks initially adopted a rather short-sighted view of the lending process, and their over-optimism has been repeatedly rewarded ever since. To the extent that banks are accurately assessing projects at all, they may be willing to make risky loans in the belief – supported by all of their recent experience – that the project will appreciate rapidly and the borrower will repay the loan. Several speakers acknowledged that China's banks face serious problems arising from nonperforming loans but argued that most of those loans were made to enterprises engaged in businesses other than real estate. Some obsolete state-owned manufacturing enterprises possess few assets of value that an unpaid lender can pursue. Real estate borrowers, by contrast, have pledged to their lenders an asset that is both valuable and appreciating.

If this explanation is true, developers will be sure to keep paying their loans even if their debts currently exceed the value of their assets, because they have faith that the project soon will increase in value and be “in the black.” This view is bolstered by most of China's recent history, which for the Chinese real estate market is the only history that exists. We can expect China to learn from tough experience at some point in the future, when the inevitable pullback occurs.

Note as well that many of the experts I met focused their discussions on the booming residential markets. Since residential units generally are sold upon completion (if not sooner), the developers recoup their investments quickly, pay off their loans, and move on to the next project. New residential

60. The government also uses its control over the transfer of land use rights as a means of directing specific uses toward (or away from) specific districts. See Peter T.Y. Cheung, *Guangzhou and Tianjin: The Struggle for Development in Two Chinese Cities*, in *CITIES IN CHINA: RECIPES FOR ECONOMIC DEVELOPMENT IN THE REFORM ERA* 18, 46-47 (Jae Ho Chung ed., 1999). Shanghai's government apparently used this power to centralize the foreign banking industry in the Pudong New Area. *Id.* (noting that “foreign banks have to set up their branches or headquarters in Pudong first if they would like to be given the authority to carry out renminbi business in the future”). See also Stein, *supra* note 10, at 25 (making similar point about Pudong's foreign banks and international schools).

61. See *infra* Part VII.

owners have so much on the line – including, often, the residence and life savings of themselves, their parents, and their grandparents – that they will find some way to pay off their acquisition loan. Commercial developments may fare differently. In these settings, the owner may hold the project for a longer time for investment income, and the owner's ability to repay a mortgage loan depends on the receipt of a reliable flow of tenant rents.

One real estate expert provided a more worrisome explanation for the lack of connection between creditworthiness and credit availability. In this speaker's view, the government and its banks help favored candidates invest in real estate. This speaker's implication – not stated outright – is that a successful project will indirectly redound to the benefit of the bank officials who agreed to fund it. Banks lend to favored developers, who surreptitiously reward the decision-makers. While this expert did not directly accuse bank officers of corruption, one real estate professional did tell me, "Law is for the honest people. Like you and me. They restrict people like you and me." The first real estate expert was more optimistic about the future, however, noting that behavior of this type is becoming less common as the market matures and grows more internationalized, as key lenders consider public offerings of their shares, as the government struggles to slow down a very hot real estate market, and as the government and the public become more attuned to the difficulties that institutionalized government graft can cause.

More generally, lending officers at state-owned banks face institutional incentives that do not always lead to the maximization of profits. In Western nations, bank profitability may translate into bonuses for key loan officers while bank losses may send these same officers to the unemployment line. Those who make credit decisions have a direct personal interest in the success or failure of their employers' projects. But Chinese banks are state-owned and must satisfy government policymakers rather than shareholders who demand transparency and profits.

One real estate consultant explained to me that banks assign a lending quota to each of their lending officers and that the officers' bonuses depend solely on meeting these targets. Employees are not rewarded for making good lending decisions or penalized for making poor ones. The pressure simply is to lend, and there is little linkage between the fate of the bank and the fate of those who work for the bank. If loans become troubled as the project progresses, similar incentives come into play. There is no reason for a state-owned bank to concede that an earlier lending decision was a poor one; rather, the bank is likely to lend still more money to keep the project afloat. It is easy to avoid the negative publicity of acknowledging a bad loan when the bank's money supply is essentially unlimited and no one ever gets to see the books.

Opaque procedures that encourage speedy development may have been exactly what China needed in the 1980s and 1990s, as a rapidly evolving government nurtured a new market in real estate. But the government has become concerned that today's markets are dangerously overheated and has taken steps to slow the market as gently as possible. For example, the pre-

vailing rate on home mortgage loans was raised to 6.93% in 2007 in an effort to cool the residential market.⁶² Some banks charge higher rates on loans to purchase second homes, presumably on the theory that the luxury investment market needs to be restrained to a greater extent than does the market in owner-occupied primary residences. Banks also have increased the minimum down payment from 20% to 30%, with some banks charging even more.

For the same reason, the government has imposed several new taxes and raised rates on some existing taxes that affect the real estate market.⁶³ In addition, some units of government have become more inclined to enforce the requirement that the initial holder of a land use right build on the property within two years. Until recently, that standard term had been routinely ignored.⁶⁴ While neither of these recent changes directly affects the relationship between borrower and lender, both are manifestations of the government's desire to keep appreciation of real estate prices in check and both suggest that there will be further tightening in lending standards.

The government also seems worried that ordinary citizens who invest their nest eggs in real estate could suffer dramatic losses if real estate prices drop precipitously.⁶⁵ Chinese law provides for a foreclosure right similar to the one available in the United States,⁶⁶ which means that a real estate recession might cause many new homeowners to lose their recently purchased

62. Interest rates generally have climbed during the past several years, from 4.12% (with government workers entitled to a reduced rate of 3.58%) to 5.27%, then to 5.51%, and then to 6.12%, before settling at the 2007 rate of 6.93%. See Li Xinran, *Fixed-Rate Mortgage Suspended as Interest Rate Raised*, SHANGHAI DAILY.COM, May 22, 2007, http://www.shanghaidaily.com/sp/article/2007/200705/20070522/article_316770.htm. Published sources do not provide consistent confirmation of these rates, and different banks sometimes charge different rates. See, e.g., *Major Banks Confirm New Property Loan Rates*, PEOPLE'S DAILY ONLINE, Mar. 22, 2005, http://english.people.com.cn/200503/22/eng20050322_177819.html.

63. The government, for example, charges a new 1.5% transfer tax. Additional taxes apply to larger apartments, which are defined as those that exceed a baseline of 120 square meters (about 1,270 square feet) by more than 20%. In addition, the government implemented a new 5.5% tax on gains if an owner sells property within one year of purchasing it. These recent changes demonstrate the government's inclination to restrain the market.

64. See *supra* note 23 and accompanying text.

65. The individual right to invest is specifically protected under the new Property Rights Law. Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 65 (P.R.C.) ("The legal savings, investment and returns of individuals shall be protected by law."). Investment performance, of course, is subject to the vagaries of an unsettled and rapidly developing market.

66. *Id.* arts. 195-200; Danbao fa [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), arts. 53-58 (P.R.C.). See generally Whitman, *supra* note 10, at 65-79 (comparing American and Chinese foreclosure processes).

dwellings. Article 195 of the Property Rights Law, for example, provides that an unpaid lender “may, through agreement with the mortgagor, be paid out of the proceeds from the conversion of the mortgaged property or from the auction or sale of the mortgaged property,” or else the lender may bring suit.⁶⁷ Article 198 states that a foreclosed mortgagor retains the excess of the sale proceeds over the balance of the debt but remains responsible for paying any shortfalls,⁶⁸ and the following section clarifies the rights of junior lenders.⁶⁹ Despite the government’s concerns, one banker informed me that the default rate by homebuyers still is only about 1.5%, a fact that likely reflects the ever-increasing value of residential real estate.⁷⁰ Similarly, a commercial developer indicated that the default rate on commercial property held for rental income is very low.

VI. SOURCES OF FUNDS: LENDERS AND THE GOVERNMENT

The amount of construction in China is shocking and is one of the first things a Western visitor notices. A half-century of pent-up demand is being met in a decade or two by a nation whose citizens want to make China’s presence known to the world. To some extent, this requires large outlays of government funds, particularly for the building of infrastructure. Nonetheless, many new projects are being built and financed privately.⁷¹ This raises a key question: where do the banks in a rapidly developing but still poor nation come up with the funds their borrower clients are demanding? Or, stated more bluntly, where is all this money coming from?

Much of the money seems to come from the savings of China’s 1.4 billion citizens. Along with its huge population, China has a very high savings rate, estimated to be in the range of forty percent; by contrast, the savings rate in the United States is 0.8%.⁷² Until recently, there were few consumer

67. Wuquan fa [Property Rights Law], art. 195.

68. *Id.* art. 198.

69. *Id.* art. 199.

70. In the fourth quarter of 2006, the default rate in the United States increased to 4.95%. Press Release, Mortgage Bankers Association, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey (Mar. 13, 2007), <http://www.mortgagebankers.org/NewsandMedia/PressCenter/50974.htm>. For sub-prime loans, the rate increased to 13.33%. *Id.*

71. Keep in mind that the term “private” can have a very different meaning in China. Entities that are developing real estate may be state-owned or state-controlled, and the same is true for the lenders that finance their projects. My use of the term “private” covers the range from truly private entities, including those owned at least in part by non-Chinese, to government-influenced entities – both developers and lenders – that are attempting to operate somewhat like private businesses.

72. A recent *China Daily* article estimated that Chinese spend only about 60 percent of their income. Zhang Ran, *Personal Savings Hit Record US\$1.7 Trillion*, CHINA DAILY, Jan. 17, 2006, at 1, available at <http://www.chinadaily.com.cn/english/>

goods on which Chinese citizens could spend their disposable income, and even now many Chinese appear to be saving as much as they can in case the future is not as bright as the present. Chinese parents generally may have only one child, which means that families, and thus child-rearing expenses, are relatively small.⁷³ The lack of a comprehensive social security system combined with the knowledge that a child without siblings may end up supporting two parents and four grandparents has encouraged some fairly frenzied savings. Meanwhile, the average family in China, particularly in urban areas in the eastern part of the nation, is quickly becoming much wealthier. So the amount of private savings potentially available for lending continues to grow.

Families that wish to invest for the future have limited choices about where to place their savings, and bank accounts seem to be one of the few safe alternatives. Banks, however, pay a low interest rate of 0.72% on savings accounts,⁷⁴ which means that Chinese savers will not get rich placing their savings in the bank. The nation's nascent stock markets in Shenzhen and Shanghai have been plagued by volatility, and many people still view the stock market with great apprehension. Overseas investment opportunities are virtually nonexistent in a nation with strict currency controls.⁷⁵ So for the

doc/2006-01/17/content_512872.htm. The personal savings rate in the United States during the third quarter of 2007 was 0.8%. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE, NATIONAL ECONOMIC ACCOUNTS, PERSONAL SAVINGS RATE, *available at* <http://www.bea.gov/briefrm/saving.htm> (last updated Aug. 30, 2007). Comparisons of this type can be misleading. Americans are more likely than Chinese to be able to rely on income sources that may not be reflected in the savings rate, including future social security benefits; pre-tax savings accounts such as 401(k) plans and IRAs; capital gains; and home appreciation. *See, e.g.,* Milt Marquis, *What's Behind the Low U.S. Personal Saving Rate?*, FRBSF ECONOMIC LETTER (Federal Reserve Bank of San Francisco), No. 2002-09, Mar. 29, 2002, at 1, *available at* <http://www.frbsf.org/publications/economics/letter/2002/el2002-09.pdf> (noting ways in which measurements of US savings rate are incomplete).

73. Note, however, that some Chinese breadwinners are supporting aging parents as well.

74. Bank of China currently pays 0.72% interest on renminbi demand deposits, with somewhat higher rates available for lump-sum deposits committed for fixed time periods. Bank of China, RMB Deposit Rates, <http://www.bank-of-china.com/en/common/rmbdeposit.jsp?category=1099376639100> (last visited June 7, 2007). One consultant advised me that a typical Chinese bank earns 60% of its income from the spread between the interest rate the bank receives from its borrowers and the much lower interest rate the bank pays to its depositors.

75. *See* Janet Ong, *China May Ease Rules on Investing Overseas*, INT'L HERALD TRIB., Sept. 22, 2004, *available at* <http://www.iht.com/articles/2004/09/22/bloomberg/sxchina.php> (noting that "China bans its citizens from buying stocks abroad to prevent an exodus of foreign reserves," while also recognizing that China must comply with World Trade Organization rules and must provide its citizens with adequate investment options).

typical Chinese investor, real estate and low-rate interest-bearing savings accounts seem to be the safest options. Many invest in both. As a result, Chinese banks are well-stocked with funds to lend, and Chinese citizens have been competing aggressively to find real estate in which to invest.

In fact, one of the reasons supplied to me most regularly for the success of residential real estate markets in certain Chinese cities is the lack of alternative investment vehicles for the typical citizen. Savings accounts pay minimal interest, the erratic stock exchanges are viewed with intense suspicion, and apartments are appreciating at an enormous, if unsustainable, rate. So every Chinese saver wants to buy an apartment now and sell it within a few months, in the hope that the crash will not occur until the month after that. Many of the people I spoke with, never having experienced a prolonged price drop in a relatively free market, do not appear to believe that a real estate crash will ever occur, or they acknowledge the possibility without seeming to recognize the practical effects it would have on them and on their nation.

One real estate developer claimed that the government simply prints money and supplies it to the banks as needed. Elementary macroeconomic theory suggests that this approach, if followed to any material extent, would lead to inflation. I heard several anecdotal complaints that prices in China have been on the rise, but inflation does not appear to have been a widespread problem in China during the past several years (outside of the residential real estate markets in prime locations!). However, it is difficult to know exactly how much inflation there truly is in a nation where the market remains so heavily controlled by the government.

Even if the government is not increasing the money supply as a means of meeting borrowers' demands or supporting insolvent financial institutions, it may well be using existing government revenues for those purposes. If this is the case – a plausible theory in a nation with numerous state-owned banks that are reportedly insolvent – then the government is simply serving as an indirect lender. Instead of spending its tax receipts and other revenues directly on infrastructure or other development, the Chinese government could be using some of those same revenues to support banks that lend for these same purposes without any realistic prospect of being repaid. Chinese citizens thus may be supporting China's banks indirectly, by paying taxes to a government that dispenses some of these revenues to banks for lending to real estate developers, and directly, by placing significant private savings in those same banks.

Another possible explanation is that China's favorable trade imbalance with Western nations, particularly the United States, provides indirect funding to China's lending institutions. Manufacturing facilities raise huge amounts of cash by selling their wares to American consumers. These manufacturers may be saving some of their money in China's banks, where the funds are available to be lent to real estate developers. And since many of these manufacturers are owned at least in part by the same Chinese state that controls these banks, the government is essentially a huge entrepreneur. This

giant manufacturing company, with hundreds of millions of employees, is diversifying its portfolio by reinvesting its profits from its primary manufacturing business into real estate loans in Shanghai, some of which it knows and expects will never be repaid.⁷⁶

The question of where the banks get their money ultimately is inseparable from the question of where the Chinese government obtains its money, because the banks are government-owned and the government is supporting the nation's real estate boom. Perhaps the best and most complete answer to this key pair of questions was the one supplied to me by a forthright government official. I asked this man the more general question of how the Chinese real estate market has been able to perform so well so rapidly, particularly when compared to corresponding markets in other developing nations. He supplied three cogent answers, with the first of the three being the most notable.

As this gentleman delicately stated, the primary source of financial support for China's government, and thus for its lending institutions, is "our ancestors," by which he meant prior generations of Chinese. The Chinese government currently owns all the land in the nation aside from land owned by agricultural collectives, and the government retains the power to requisition agricultural land whenever it chooses. It nationalized the land it owns over the course of roughly three decades, usually paying the prior owners of the land little or nothing in the way of compensation.⁷⁷ In the early rounds of these condemnations, rural landlords were the principal targets, but by the 1970s, the government was taking the remaining private urban land.

Today, the Chinese government supports its operations in large part by selling off land use rights in this same land, often to the same types of real estate professionals who were the primary targets of uncompensated nationalization during Mao's time. There are currently no ad valorem property taxes in China, so unlike American jurisdictions at the city and county level, China cannot depend on a steady stream of revenues flowing from a stable real property tax base. China relies instead on income taxes,⁷⁸ real property transfer taxes, and, most significantly, proceeds from the sale of long term

76. For a discussion of China's plans for investing its "immense reserves of foreign currency," see Jim Yardley & David Barboza, *China to Open Fund to Invest Currency Reserves*, N.Y. TIMES, Mar. 9, 2007, at C3. See also Keith Bradsher, *Dollars to Spare In China's Trove*, N.Y. TIMES, Mar. 6, 2007, at C1 (addressing China's foreign investments).

77. For the most part, these seizures were uncompensated. *But see* RANDOLPH & LOU, *supra* note 15, at 9-11 (discussing history of land nationalization since 1949 and noting disagreement among Chinese scholars as to when this process was completed).

78. Collection of income taxes appears to be problematic in an economy so heavily reliant on cash and in which so many people appear to have gray-market income. See *supra* note 40 and accompanying text. I witnessed a large public rally, complete with a uniformed brass band, encouraging citizens to pay their income taxes.

rights to use the same land that the government requisitioned between 1949 and 1982.

Stated more directly, the Chinese government is funding its operations in significant part by selling to private parties land that it previously seized from other private parties. Putting aside the irony that the Chinese government came to power promising to reduce the harmful influence of landlords and now is supporting itself by selling these landlords' former holdings to real estate developers, this method of raising funds creates long-term structural problems for government operations.

To begin with, different levels of government in China have become participants in and beneficiaries of the current real estate boom, and not just referees or superintendents of it. The urban population is growing and China's citizens are demanding higher living standards, so municipal governments must ensure that housing and infrastructure continue to improve in both quality and quantity. Municipal governments such as Shanghai depend on the revenues from the regular sale of land use rights and are in the best position to fund this continued growth and modernization if real estate values keep appreciating. Their participatory role in the real estate market places these government entities in direct conflict with the central government, which wants to maintain social order by ensuring that residential real estate remains affordable and that the gap between the haves and the have-nots does not grow too large.

The central government, in other words, must ensure that Shanghai, Inc., which holds huge tracts of very valuable real estate, does not act in a way that is harmful to the nation as a whole. For example, the central government has established quotas for the amount of land that can be converted from agricultural-collective ownership to government ownership, which is a prerequisite to the sale of land use rights in agricultural land by municipal governments. This national limit both slows real estate development on the outskirts of urban areas and reduces the amount of land that is lost to agricultural use.⁷⁹

79. The central government appears to be concerned about the loss of farmland for two distinct reasons. First, it wants to ensure that China remains capable of feeding itself. See George C.S. Lin & Samuel P.S. Ho, *China's Land Resources and Land Use Change*, in *EMERGING LAND AND HOUSING MARKETS IN CHINA*, *supra* note 9, at 89, 116 (suggesting that China's land resources will not remain adequate for its growing population). Second, it wants to avoid the social upheaval that would be associated with a massive and rapid relocation of tens or hundreds of millions of peasants who migrate to urban areas because they have lost their land, along with the dignity (and retirement security) that farming provides. See PEERENBOOM, *supra* note 7, at 482 (noting prevalence of land disputes).

So, for example, the Land Administration Law states, "Overall plans for land utilization shall be drawn up in accordance with the following principles: (1) strictly protecting the capital farmland and keeping land for agriculture under control lest it should be occupied and used for non-agricultural construction." *Tudi guanli fa* [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong.,

These municipalities have great incentives to sell the most desirable land first, and to sell off land at a rate that is too rapid to be sustainable over the long term. Downtown property is being cleared of run-down residential and commercial buildings, some of which have not seen any maintenance in more than half a century.⁸⁰ This land commands the highest price in the market for land use rights, suggesting that sales of less central land in future years will generate lower prices on an inflation-adjusted, per-square-meter basis. The government thus will have to sell larger and larger tracts faster and faster if it hopes to continue to feed its habit of operating off the proceeds of sales of land use rights. Governments that maintain their solvency by selling off a finite natural resource tend to mine the most accessible ore first. Their remaining assets are less valuable and may run out altogether.

Land use rights last for forty, fifty, or seventy years, depending on the purpose for which they are conveyed, and the government receives the entire fee for the sale of the land use right at the time of the initial conveyance.⁸¹ It is entirely possible that the government will dispose of the right to use all of the most desirable land well before the first round of land use rights begins to expire. Recall that the current system of transferrable land use rights has

June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 19 (P.R.C.). Further, when planning what land is to be used for urban construction, “[a]ttention shall be paid to making full use of the existing land earmarked for construction and using little or no land earmarked for agriculture.” *Id.* art. 22. The new Property Rights Law states, “[t]he State adopts special protection with regard to the agriculture land, strictly limiting the transfer of agriculture land to construction land so as to control the total quantity of the construction land.” Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 43 (P.R.C.). Expropriation of “basic farmland” requires approval by the State Council. Tudi guanli fa [Land Administration Law], art. 45. *See generally id.* arts. 31-42 (addressing protection of cultivated land).

Note also that those who illegally convert cultivated land to other uses are subject to criminal prosecution. Xing fa [Criminal Law] (promulgated by the Standing Comm. Nat’l People’s Cong., July 1, 1979, revised Mar. 14, 1997, Dec. 25, 1999, Aug. 31, 2001, Dec. 29, 2001, Dec. 28, 2002, Feb. 28, 2005 & June 29, 2006, effective June 29, 2006), art. 342 (P.R.C.) (authorizing punishments for violation that include imprisonment, detention, and fines).

80. It is hard to argue that some of these marginally habitable structures merit preservation. But the occupants of these structures receive compensation that reflects the low value of these units. This guarantees that there will continue to be massive residential relocation within major metropolitan areas, as poorer downtown residents use their compensation to purchase newer units in less costly outlying areas, while middle-class Chinese spend their newfound wealth on downtown apartments. *See Stein, supra* note 10, at 31-32. This process guarantees the destruction of many older urban communities, along with their vibrant street life. For an excellent discussion of Chinese condemnation issues, see Chenglin Liu, *Informal Rules, Transaction Costs, and the Failure of the “Takings” Law in China*, 29 HASTINGS INT’L & COMP. L. REV. 1 (2005).

81. *See supra* notes 22, 27 and accompanying text.

existed only since the late 1980s and that sales of land use rights did not begin in earnest until a few years later, which means that most land use rights still have many years to run. This suggests that the government will have to wean itself of its addiction to these sale proceeds at some point before the first round of land use rights begins to expire.⁸² The problem is not just that the land that is left in ten or twenty years will be less desirable, it is also that there may not be any marketable land left by then at all.

If the government discovers that it has run out of marketable land before a substantial number of land use rights expire, its only alternative will be to locate new funding sources, such as additional taxes, an approach that is likely to be as unpopular in China as it is anywhere else. Even when land use rights do begin to expire in significant numbers, Chinese law is unclear as to whether these rights must be renewed upon expiration of their initial term and whether the holder must pay an additional fee to the government if the holder does have automatic renewal rights.⁸³ So even if China does budget the remaining land judiciously, it will not necessarily be able to raise additional funds by renewing or reconveying land use rights a couple of decades from now.

The Chinese government official who spoke so openly about China's reliance on the sale of land it had previously nationalized offered two additional reasons why China's real estate market has grown so quickly. Bond financing has stimulated Chinese real estate development, although this official indicated that the amount of bond financing is relatively small. In addition, "our own income" has been beneficial, by which he was referring to the frequent use of Build-Operate-Transfer ("BOT") financing.

In a typical BOT deal, a private entity is authorized to build a public project, such as a toll road or a bridge. The private entity is permitted to operate the project for a specified period of time, perhaps twenty years, so that it can recoup its costs and earn a profit through the imposition of user fees, such as tolls. At the end of the stated time period, the project reverts to government control.⁸⁴ In a similar way, private entities that agree to construct

82. This discussion assumes that the holders of land use rights will have to pay to extend them. If the government is required to grant these extensions without charge (an option that, from today's perspective, seems not to be feasible), then the government's problems will be even more dire. See *supra* notes 32-34 and accompanying text.

83. See *supra* notes 32-34 and accompanying text. Presumably, if an existing land use right expires and the right to use the same land then is transferred to a different holder, that new holder would have to pay a new fee for this land use right, reflecting its market value at the time of the renewal.

84. Essentially, this structure differs little from a twenty-year land use right with no renewal option. For an American example, see J.K. Wall, *Public-Private Funding Model for Indiana Toll Road Gains Speed*, INDIANAPOLIS STAR, Nov. 15, 2006 (discussing proposed 75-mile toll road in Indiana to be financed privately and leased to private operator for 75 years).

quasi-public facilities may be awarded desirable land use rights nearby. In effect, they are being paid in kind for their provision of a public facility. One real estate expert stated that these types of projects initially became popular in Hong Kong and have spread from there to the mainland. In Shanghai, the Xintiandi historic preservation project apparently has run at a loss since its inception, but the developer that renovated Xintiandi also received valuable land use rights to neighboring downtown land.

It thus appears that most of the loan financing and other financial support available to real estate developers in China has been borrowed or seized from past, present, and future generations of Chinese. Past generations involuntarily supplied their land to the government, which now is selling it off at an enormous profit. The land is a necessary input for real estate developers, while the sale proceeds are essential to government units struggling to provide vital services to a huge population. Today's Chinese are placing their savings in banks that lend to developers and also are paying taxes that are used directly to furnish new infrastructure and indirectly to support insolvent banks. They also may be paying somewhat higher prices for goods if the government is, in fact, meeting currency shortfalls by simply printing more of it. Future generations of Chinese may pay the rest of the bill if they contribute higher taxes years from now, if they otherwise provide the funds that the government will need to repay its obligations, and if they must renew their expiring land use rights at unexpectedly high prices.

VII. THE STABILITY OF THE CHINESE BANKING SECTOR

Most banks operating in China are owned or controlled by the Chinese government, and these banks' lending decisions are more likely to reflect official government policy than astute business judgment.⁸⁵ This unusual set of motivations causes the Western observer to wonder whether China's banks are financially viable. Since the competition facing the typical Chinese bank is almost entirely domestic, and thus responsive to the same internal political stimuli, China's banks appear to have little to fear from their local competitors. The same non-business factors that cause one bank to make a poor business decision likely cause that bank's rivals to make similarly poor business decisions. Every Chinese bank is wearing the same pair of weighted shoes.

A bank also is a business, however. It collects money from its borrowers, who are paying interest on their loans, and must pay interest to its own depositors from these collections. If China's banks make too many loans that are financially unwise, then at some point they may become insolvent. The government may be able to sustain these banks temporarily with infusions of funds – these banks are, after all, instruments of state policy and can be kept

85. *See supra* Part V.

afloat with general operating revenues from the government.⁸⁶ But if huge, money-losing banks are on China's balance sheet, they could become an enormous drain on China's economy.

As previously noted, China has an astronomical savings rate, and many of China's savers place some of their money in interest-bearing bank accounts.⁸⁷ While the rate banks pay on savings accounts is relatively low, the enormous amount of money currently on deposit in China creates an extremely large interest burden and places great pressure on Chinese banks to lend out their deposits at a higher rate. The larger the proportion of nonperforming loans, the greater the pressure banks feel to ensure that the rest of their portfolios perform adequately.

This business pressure is compounded by the government's continuing insistence on funding projects that it deems worthy. The financial demands of depositors combined with the policy mandates of the government make it imperative that China's banks lend briskly. This probably explains why loan officers must meet lending quotas based on volume rather than on the ultimate success or failure of the projects being funded.⁸⁸ Several different experts confirmed that the modus operandi of Chinese banks seems to be to lend first and worry later. When I asked one lawyer how the system manages to work, he replied, "As long as the economy keeps growing . . ."

Estimates of the proportion of nonperforming loans vary. I frequently heard knowledgeable experts – several affiliated with Chinese banks – state that 30-40% of loans held by Chinese banks are nonperforming. One bank attorney told me that the official estimate is in the 20-23% range. A Western attorney advised me that one of his clients, who purchases nonperforming loans from Chinese financial institutions, believes a more accurate number would fall in the 40-50% range. A Chinese expert summarized the issue more tersely: all banks in China are insolvent. Nearly every expert agreed that the four leading Chinese banks, which control a huge segment of the lending market, are insolvent. Another Chinese banker denied the existence of the problem altogether.

In an effort to address the problem of nonperforming loans, the Chinese government recently established four asset-management companies. The four largest banks in China have been transferring the weakest loans in their portfolios to these asset-management companies, thereby improving the financial stability of the transferor banks. It is widely believed that these transfers were consummated as a precursor to public offerings of the stock of the four banks. These transfers do not solve anything, of course; they simply shift the nonperforming loans to the four new government-controlled entities. To the extent the government must bail out its ailing financial sector, only the form of the problem has changed. Instead of supporting four banks with large

86. See *infra* notes 90-91 and accompanying text.

87. See *supra* notes 72-75 and accompanying text.

88. See *supra* p. 1339.

numbers of nonperforming loans, the government now must support the four asset-management companies instead.

Several experts informed me that the asset-management companies are attempting to sell some of these nonperforming loans to foreign banks at discounts of up to 80%. If this is so, then the overseas buyers are gambling that they will be able to recover at least a percentage of the face value of these debts. The Chinese government, meanwhile, is capping and liquidating its losses on these loans, giving up the slim possibility of recovering all of the loan proceeds down the road and receiving instead a small but certain payoff now. By disposing of these loans at such a steep discount, the government is indirectly subsidizing the banks' earlier poor lending decisions, many of which were made under government pressure to fund projects the government deemed meritorious.

One way or another, the government – though not necessarily the same arm of the government – is footing part of the bill for unwise decisions made by Chinese lenders in the past. The net expense differs little from the price the government might have paid had it funded some of these projects directly or even built them itself.⁸⁹ When a bank suffers a loss in China, that state-owned entity is indirectly passing these costs along to the entire population. The ultimate sources of these funds are the same as those noted earlier, and include income tax revenues, transfer tax revenues, sales of land use rights, bond financing, and user fees and tolls. It therefore is critically important to China that the current real estate boom, which serves as the wellspring for many of these revenue streams, continues.

Several real estate experts, while acknowledging the problems facing China's banking sector, argued that the banks' problems do not arise from real estate loans. Real estate developers nearly always pay their loans. Most of their projects, particularly residential developments, are sold upon completion, so the developers retire their debts quickly and move on to the next project. The buyers, meanwhile, generally are owner-occupants or investors, and they are able either to make their mortgage payments or to flip the properties quickly and at a profit. These experts claim that as long as real estate prices continue to increase, the rate of nonperforming real estate loans is likely to remain small.

All of these experts seemed dismissive of the idea that real estate prices might ever drop precipitously, a phenomenon unknown in the modern iteration of the Chinese real estate market. If such an event were to occur,

89. Note that one governmental entity may be profiting at the expense of another. For example, a municipal government may have benefited from the construction of a factory that, while unsuccessful overall, employs numerous local residents and reduces the local government's burden of supporting them. If the lender that holds a loan to that company that has become non-performing opts to sell this loan to an asset-management company rather than seeking to enforce it, the state-supported lender and the state-supported asset-management company share the ultimate loss, while the municipal government entity continues to enjoy the benefit.

China's lenders might suffer even more than they already have, because of their earlier failures to make credit decisions based on a mortgagor's actual capacity to repay. Such a development, however painful in the short term, might eventually lead to the growth of a more mature residential lending industry, with loan decisions based on an applicant's actual salary, job history, and credit record.

The true sources of the banks' bad loans, according to these experts, are state-owned enterprises, foreign joint ventures, and wholly foreign-owned enterprises.⁹⁰ While the gargantuan non-real-estate problems facing China's banking system are well beyond the scope of this Article, it is worth noting that the Chinese government has significant reasons to ensure that many of these loans continue to be repaid, even if it means using general tax revenues for the repayments. Some of the companies that might otherwise collapse are high-profile Chinese brand names, and it could shatter confidence in the emerging Chinese market, both at home and abroad, if the government were to allow a well-known company to fail. China has at least as much interest in ensuring the survival of some of its banner companies as the United States had in bailing out Chrysler or United Airlines.

More critically, some of China's state-owned companies provide thousands of their workers with housing, education, health care, a reliable retirement income, and all the other benefits that used to be known as the "iron rice bowl." If too many of these companies were to close their doors, "chaos in the countryside" might threaten the viability of China's government and the supremacy of the Chinese Communist Party.⁹¹ China's government probably is more concerned about avoiding problems that could lead to its own downfall than it is about any of the other issues it faces today.

Some of the nonperforming loans in sectors other than real estate are relatively recent in origin, and certainly were made after the international community began to focus on the fragility of the Chinese financial sector. To some extent, this likely reflects the continued importance of personal connections in obtaining loans, particularly those loans that might not be forthcoming based solely on the underlying quality of a project. Even without the persistence of the *guanxi* problem, however, it is clear that the government wants the banks it controls to keep antiquated factories afloat even if the resulting loans worsen the health of the banks themselves.

By rescuing companies that cannot pay their debts, China is indirectly supporting more than just its banking industry: it truly is keeping its entire social welfare system afloat. China's leaders seem to recognize this fact

90. One expert argued that nonperforming automobile loans account for a growing part of this problem as well. *See supra* note 40.

91. A Western lawyer informed me that some of these outdated factories are diversifying by investing in real estate, trying to offset losses from their outdated but essential manufacturing operations with investments in the hottest sector of the twenty-first century. *See also supra* note 76.

clearly, and the real question is what might happen if China's economy slows down to the point that the government simply is unable to keep these enterprises alive any longer. One real estate developer's answer to my question of whether China's banks are stable – "They must be!" – succinctly captures the combination of hope and faith that so many Chinese appear to feel.

VIII. CONCLUSION

China's real estate sector still is in an early stage of development, but it nonetheless is more mature than China's real estate law. Despite its youth, and despite the fact that it developed in the absence of a formal real estate code, the Chinese real estate industry has fared remarkably well since market concepts were re-introduced in the 1980s.

This Article has examined some of the most important features of China's young real estate system. By examining the types of loans and lenders that are present in China and the types of assets that a borrower can mortgage as security, it has drawn parallels with the American system while highlighting notable differences. By discussing lending standards, the ultimate source of loan funds, and the fragility of the Chinese banking industry, it has noted some critical policy questions that investors must consider in the future.

To many Western observers, it would appear that the Chinese real estate market should have collapsed years ago. Yet this market seems to be thriving, and the level of confidence within China in the stability of real estate as an investment is extremely high. Western observers and participants are sure to follow China's real estate markets with great interest in the coming years, as the Chinese economy continues to grow and become more integrated with the economies of other nations.⁹² An improved understanding of China's legal and business systems will benefit real estate market observers and participants within China and elsewhere.

92. "China's construction industry is a mainstay of the Chinese economy and is projected to become the largest construction market in the world by 2010." Ashley Howlett, *PRC CONSTRUCTION LAW – A GUIDE FOR FOREIGN COMPANIES* 3 (2006).