

Analysis of Real Estate Impact on Credit Risk for Financial Institutions

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Abstract. As a matter of fact, the real estate market plays a pivotal role in China's economy, directly affecting the credit risk of financial institutions. As the economy has rapidly developed, the real estate sector has become a cornerstone, significantly contributing to the Gross Domestic Product (GDP), which plays a core role in evaluating the economy. However, the rapid fluctuations in the market pose serious credit risks to financial institutions, highlighting the need for a comprehensive understanding of how these fluctuations impact borrowers' repayment capacities, collateral values, and financial institutions' lending decisions. On this basis, this research focuses on the intricate relationship between the dynamics of the real estate market and the credit risk faced by financial institutions. According to the analysis, the specific effects of real estate of China on credit risk for financial institutions are evaluated. Overall, these results shed light on guiding further exploration of various dimensions and factors that shape this relationship.

Keywords: Real estate market, credit risk, financialization.

1. Introduction

The real estate market holds a pivotal position within the Chinese economy, where its fluctuations directly impinge upon the credit risk of financial institutions. Coinciding with China's rapid economic progression, the real estate domain has emerged as a fundamental pillar, significantly bolstering the Gross Domestic Product (GDP). However, the swift oscillations of this market present substantial credit risks for financial institutions. However, its volatility poses significant risks to financial institutions, affecting borrowers' repayment capacities and collateral values, which in turn can increase the proportion of non-performing assets within banks and other financial entities.

For economic influence, the development of China's real estate market significantly affects national economic growth, acting as a major driver for GDP increase and playing a key role in urban development and residents' living standards improvement [1]. Regarding to the impact on financial stability, fluctuations in the real estate market directly affect the credit risk of financial institutions. A downturn in the market can impact borrowers' ability to repay and lead to a decline in collateral values, thereby increasing the ratio of bad assets for banks and other financial institutions [2]. Government Policy Effects: Government macro-control policies have a significant impact on the real estate market. Adjustments in land supply, mortgage rates, and purchase restrictions can control the supply-demand relationship in the real estate market to some extent, affecting housing prices and market volatility [3].

In the milieu of brisk economic development, financial institutions not only furnish financial backing to the real estate market but also confront formidable challenges related to credit risk. The way the real estate market's volatility impacts factors such as borrowers' repayment capabilities, the valuation of collateral, and the credit decisions of financial institutions, forms a critical focal point of inquiry. These market fluctuations can lead to borrowers' defaulting on timely repayments and a diminution in the value of collaterals, thereby catalyzing credit risk for financial institutions.

2. Literature Review

In the dynamic interplay between real estate and financial institutions' credit risk, the scholarly and practical realms have consistently shown keen interest. Li's pioneering research leveraged spatial

spillover effects to dissect the intricate relationship between housing vacancy rates in China and the ensuing financial risks in real estate. His insights, highlighting the tight linkage between vacancy rates and financial risk, open new avenues for a deeper understanding of the real estate market's impact on the credit framework of financial institutions [4].

In a compelling narrative, Tan in her publication for the 'China Business Journal,' addressed the synergies between financial institutions and the reformative thrust towards real estate finance's supply side. The emphasis by a tripartite symposium on hastening these reforms illuminated the government's concentrated focus on equipping financial institutions to adeptly manage real estate risks, reflecting a strategic policy engagement with real estate financial intricacies [5]. Wu brought a fresh perspective with his RBF neural network-based study, assessing the financialization levels of real estate in significant urban centers. His methodological application of neural networks to mine data across cities enriches the discourse on real estate financial risks with empirical depth. Delving into the nexus of demographic shifts, housing patterns, and financial security [6]. Huo's master's exploration unravels the nuanced impact of an aging society and the specter of empty homes on the financial health of the real estate sector. This layered analysis offers a richer, more comprehensive understanding of the ripple effects on financial institutions' credit risk [7]. Fan takes a deep dive into the evolutionary dynamics of real estate financial risk, crafting a narrative that not only deciphers these complexities but also charts a course for effective risk management [8]. Meanwhile, Lu's investigative journey into the real estate bubble's heart exposes its role in financial turbulence, laying bare the intricacies of market instability [9].

Based on these literature reviews, it can be seen that the impact of the real estate market on the credit risks of financial institutions is multifaceted and multifaceted. Factors such as policy, financialization level, demographic structure, and market bubble are intertwined, shaping the mechanism of the real estate market's impact on the credit of financial institutions [10]. Future research can further focus on the interaction between these factors to better understand the impact of the real estate market on the credit risks of financial institutions in a more comprehensive and in-depth manner.

3. The Mechanism of Real Estate Market Volatility on Credit Risks

Typically, there are three types of credit risks as given in Fig. 1. As the volatility of China's real estate market increases, the mechanism of its impact on the credit risks of financial institutions has become increasingly apparent for all the three types. The fluctuations of the real estate market are directly related to borrowers' repayment abilities.

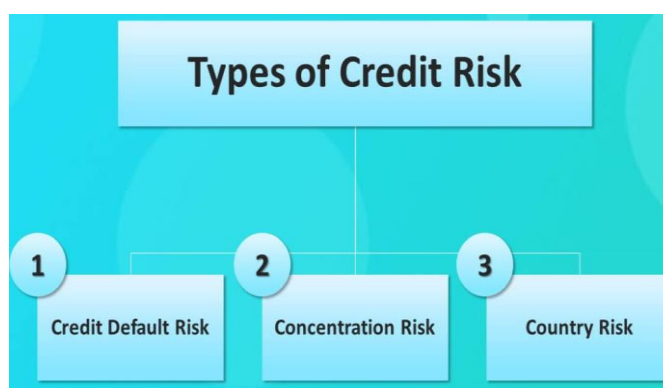


Figure 1. Three types of credit

When housing prices rise, borrowers tend to use their mortgaged properties as loan collateral, thereby decreasing their repayment risks. Conversely, a decline in house prices can lead to a reduction in the value of collaterals, increasing the possibility of borrowers defaulting on timely repayments and triggering credit risks for financial institutions. The fluctuation of collateral value is a critical factor influencing credit risks. Financial institutions often take real estate as their main collateral, and

changes in house prices directly determine the value of collateral. In situations where market fluctuations are significant, the instability of collateral value increases the risk of financial institutions being unable to recover debts, thus exacerbating credit risks. Real estate market fluctuations also significantly impact financial institutions' credit decisions. In situations of high market uncertainty, financial institutions may become more cautious, leading to stricter loan approval standards. This may affect the development of the real economy by denying financing to some projects that would otherwise be eligible for loan support.

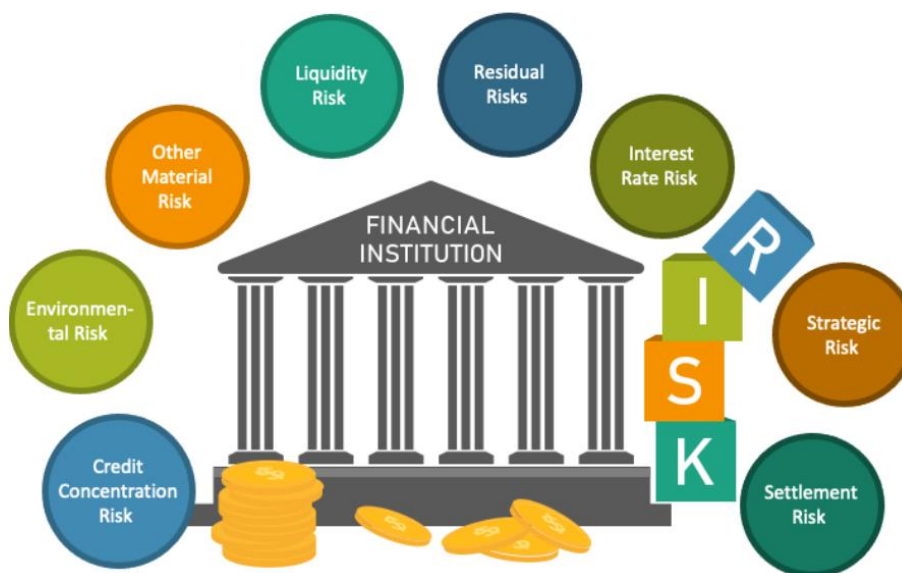


Figure 2. Risks for financial institution

4. Types and Characteristics of Credit Risks Confronting Financial Institutions

The typical risks for financial institutions are shown in Fig. 2. In the ebb and flow of the real estate market, different financial entities grapple with their own set of credit risks. For commercial banks, the principal players in lending, this could mean navigating through the treacherous waters of loan defaults and surging non-performing assets. Insurance companies, on the other hand, might wrestle with the devaluation of their real estate investment portfolios, a scenario that could tighten their liquidity screws. Securities firms face their own battle with fluctuating investment portfolio values, often a casualty of less-than-stellar asset-liability management strategies.

5. Strategies and Tools for Credit Risk Management

Some typical risk management process is shown in Fig. 3. To navigate the choppy waters of real estate market volatility, financial institutions employ a suite of savvy strategies and tools tailored to manage credit risk adeptly. At the forefront is the art of diversification, i.e., a strategic maneuver that spreads investments over a broad spectrum of regions and asset categories, diluting the impact of any single market's downturn. Hedging, too, plays a pivotal role, with financial derivatives acting as a financial bulwark against unforeseen losses. Not to be overlooked, the strategic reallocation of risk, exemplified by the procurement of insurance, further fortifies these institutions against the vagaries of credit risk.

In the future, while pursuing operating profits, real estate enterprises with the background of central and state-owned enterprises should shoulder more responsibilities related to public interests, including the construction of indemnitee housing and old-age housing, etc., so as to promote the real estate industry to return to social attributes to a certain extent. This can not only effectively reduce the housing pressure of the people, especially new citizens, young people, and other groups, but also implement the policy requirements of "housing without speculation". At the same time, today, credit

risks broke out in many private real estate enterprises, and the "loan suspension storm" spread throughout the country. Central and state-owned enterprises should make full use of their advantages in capital and resources, more involved in the revitalization of non-performing assets, and strive to shoulder the social responsibility of "guarantee and delivery". This can reduce the problem of delayed delivery and protect the vital interests of the people. It can also improve the current situation of unreasonable resource allocation, promote the real estate industry in the "post-debt crisis" period, and realize long-term, healthy, and stable development.



Figure 3. Risk management process

6. Conclusion

To sum up, in-depth analyses underscore a primary insight: the swings in the real estate market wield a substantial influence over the credit risk confronting financial institutions. This matter gains its significance from the reality that the ensuing credit risks, birthed from market fluctuations, have the potential to disrupt the financial system's equilibrium and its journey towards sustainable growth. As one looks ahead, it's imperative that scholarly inquiries delve deeper into the strategies financial entities employ to navigate credit risk across diverse market landscapes. Equally important is a thorough examination of policy and regulatory frameworks, aiming to soften the blow dealt by real estate market turbulence to these institutions. Pursuing such avenues of research paves the way for the establishment of a financial ecosystem that's not only resilient and stable but also a pillar for the economy's enduring expansion.

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