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Good Developers - Bad Developers: A Risk Resolution and Transformation Plan for Real Estate Enterprises

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Abstract: *In the process of resolving of risks associated with real estate enterprises, the "Project-based resolution" approach has certain limitations. Firstly, it may lead to the preferential resolution of high-quality assets at lower prices, increasing the proportion of non-performing assets in the remaining assets and the difficulty of subsequent resolution. Secondly, while prioritizing the resolution of some project assets, it also prioritizes the settlement of some related debts, raising issues of fairness. Thirdly, "Bao Jiao Lou" policy implies the completion of buildings that have already been pre-sold. If there is no distinction made between regions and markets, this approach may lead to significant waste of resources. Fourthly, it does not assist existing real estate developers in transitioning to a new real estate development model.*

We propose a real estate enterprise risk resolution plan that is more improved than the current practices. Considering that real estate enterprises in China are more akin to shadow banks, we can draw on the experience of risk resolution and transformation in the banking industry, and follow the "good developer - bad developer" model. This involves stripping the non-performing assets held by real estate companies to a "bad developer" at a certain consideration, while all liabilities remain with the "good developer." Concurrently, a comprehensive debt restructuring and recapitalization of the "good developer" should be undertaken. This model aims to ensure the fair treatment of creditors' rights, avoid selective biases brought about by project-based resolution. Moreover, with

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the government's preferred stock investment, the "good developer" can transition to a new real estate model, reduce leverage, and break free from reliance on pre-sale funds. The subsequent asset resolution of the "bad developer" can be integrated with affordable housing construction, and the government can gradually exit its equity in the "good developer" once the real estate market returns to normal. The resolution cost of this plan will be primarily borne by creditors, achieving minimal resolution costs and effective resource utilization, and it also helps to quickly break the self-fulfilling pessimistic expectations in the new housing market.

I. Limitations of "Project-Based Resolution"

For a long time, real estate enterprises have generally adopted a model characterized by "high debt, high leverage, and high turnover" to achieve rapid expansion and efficient operations. This model relies on the pre-sale of residential properties to generate funds for subsequent project development. When housing prices are on the rise and financing channels are accessible, companies can maintain normal cash flow by continuously securing new financing, with high revenue from pre-sales and turnover facilitating rapid growth.

In our CF40 Research Briefing "*Shadow Banking" Nature of Real Estate Enterprises*, we pointed out that this business model has made many Chinese real estate enterprises resemble shadow banks. The leverage ratios of these enterprises are comparable to those of banks and insurance institutions, with the average asset-liability ratio of the top 20 real estate companies reaching 82.3%. Similar to shadow banks, if financing channels for real estate enterprises become restricted, they will encounter cash flow tensions and further fall into a liquidity crisis.

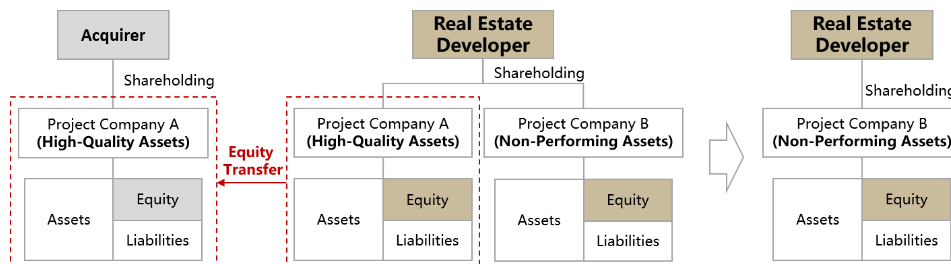
Due to the shortage of funds, the development and construction of the company's existing projects have to be suspended or even completely halted, failing to deliver the pre-sold housing on time. These stagnant projects become "non-performing assets," which severely affects homebuyers' confidence in pre-sold housing and makes potential buyers more resistant to purchasing pre-sale homes. This further weakens the company's sales and cash recovery ability, forming a vicious cycle.

In China's real estate development model, developers typically establish an independent project company for each development project, responsible for the specific residential development tasks. This project-based development model ensures that each project's assets and liabilities are relatively independent. The equity of the project company is usually held by the parent company or its subsidiaries, while external investors may also be involved. The project company's assets primarily consist of the land being developed, buildings, construction equipment, and other resources directly related to the development. Its liabilities mainly originate from bank loans, bond

issuances, and other forms of financing, which support various stages of the project's development.

Under this project-based development model, when real estate companies face cash flow pressure, selling equity in high-quality projects to raise funds becomes a natural choice, a practice we refer to as "project-based resolution." Real estate developers typically select projects with good qualifications and prospects, transferring the development projects by directly selling the equity of the corresponding project company, as illustrated in Figure 1. This equity transfer involves transferring both the project company's corresponding assets and liabilities to the new company. While this approach can temporarily ease the cash flow pressure on real estate developers, it also results in the loss of core assets and increases the proportion of non-performing assets among the remaining assets.

Figure 1 Diagram of Project-Based Resolution



In addition, real estate developers are also motivated to lower housing prices to attract buyers and accelerate cash flow recovery. However, this tendency to reduce prices has, in fact, reinforced market expectations of further price declines. As a result, more and more potential buyers adopt a wait-and-see attitude, anticipating further price drops, leading to a continued decline in new home sales. The ongoing decline in housing prices, on one hand, impacts the revenue and cash flow of real estate developers and, on the other hand, reduces the value of their inventory, resulting in a situation of being insolvent. Banks and other financial institutions grow increasingly concerned about the credit risk of real estate developers, reducing or even halting financing support, which further weakens the companies' cash flow and plunges them into an even more severe financial crisis.

From the above analysis, it is evident that under the current "high debt, high leverage, high turnover" model, once real estate developers fall into a liquidity crisis, they are forced to sell high-quality assets and lower housing prices to survive. This leads to a gradual increase in the proportion of non-performing assets, deterioration of their balance sheets, and a downward spiral of worsening conditions. It is difficult to break this cycle relying solely on the efforts of the real estate developers and market forces. Policy support is needed to reverse the situation.

In terms of policy responses, as the supply-demand dynamics in China's real estate market have shifted, policy orientation has also adjusted accordingly. Overall, when addressing the risks associated with real estate developers, **China adheres to the principles of rule of law and marketization, focusing on specific development projects. Currently, the primary approach to mitigating risks is through the "Bao Jiao Lou" (ensuring the completion of pre-sold housing projects) initiative.**

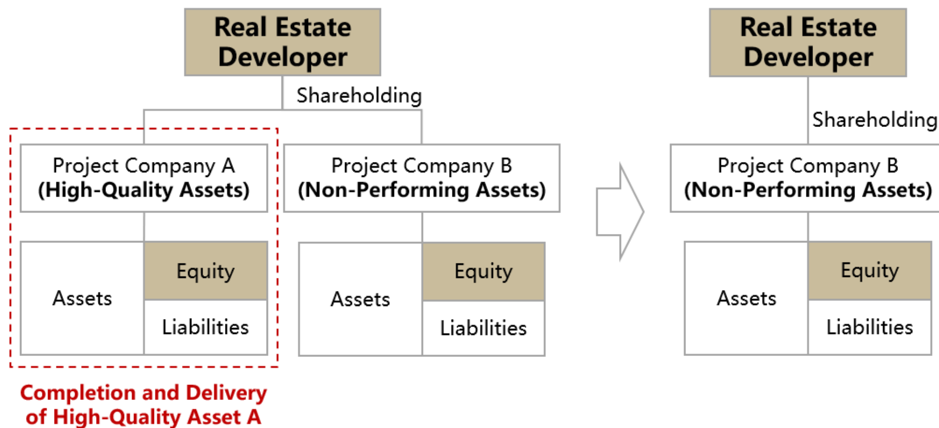
Since 2020, financing channels for real estate developers have been somewhat restricted, leading to tight cash flow for some firms. By 2021, multiple large real estate developers began to experience debt defaults. Key indicators such as new home sales, new housing construction starts, and real estate development investment have also seen significant declines since 2021 (see CF40 Research Briefing, *Long Tail II: A Cross-Country Observation of Real Estate Markets after the Bursting of the Real Estate Bubble*).

On July 28, 2022, the Political Bureau of CPC Central Committee introduced the "Bao Jiao Lou" initiative, aimed at stabilizing public welfare and the real estate market. Subsequently, various departments jointly introduced measures, including special loans from policy banks to support the construction and delivery of sold but overdue and difficult-to-deliver housing projects, addressing the issue of cash flow difficulties. In January 2024, the Ministry of Housing and Urban-Rural Development and the National Financial Regulatory Administration jointly issued a notice on establishing a coordination mechanism for urban real estate financing. This notice included a carefully selected list of high-quality projects under

a "white list," encouraging commercial banks to provide financing support for these projects. It is important to note that the special loans for "Bao Jiao Lou" are strictly limited to the construction and delivery of sold, overdue, and difficult-to-deliver residential projects, operating in a closed-loop system with funds designated for specific purposes.

In practice, the "Bao Jiao Lou" policy is also a form of "project-based resolution." The goal of "Bao Jiao Lou" is to secure funding for projects with a solid foundation, ensuring that the funds raised are solely used for the construction of these associated projects. As shown in Figure 2, with the delivery of one batch of high-quality projects after another, the remaining "bad assets" in the hands of real estate enterprises become increasingly difficult to resolve.

Figure 2: Diagram of the "Bao Jiao Lou" Policy



In summary, we believe that the current "project-based resolution" approach has the following issues:

First, under the "project-based resolution" model, quality assets of real estate enterprises are often prioritized for resolution or completion and delivery at lower prices. This, however, increases the proportion of non-performing assets within the remaining portfolio and complicates their subsequent resolution. While this selective resolution approach can mitigate risks for certain projects in the short term, it exacerbates the buildup of non-performing assets in the long term, making future resolutions more

difficult and potentially pushing real estate companies into deeper financial distress.

Second, “project-based resolution “ prioritizes the resolution of certain project assets while also preferentially settling related debts, raising concerns about fairness. The current approach treats homebuyers as priority creditors, yet lacks a clear plan for handling the claims of other creditors, such as financial institutions. By failing to view the entire portfolio of a real estate company’s assets and liabilities as a whole, this method leads to inconsistent treatment between different projects and creditors. Creditors of the same type may be treated differently depending on the project, raising issues of fairness. This resolution method is essentially a form of debt restructuring, but its lack of systemic and holistic consideration risks leading to a chaotic debt restructuring process.

Third, the “Bao Jiao Lou” policy requires the completion of already pre-sold developments, but without differentiating between regions and markets, this approach could lead to significant resource waste. According to our research in the CF40 Research Briefing *Long Tail IV - No Oversupply but Misallocation in Real Estate Market*, there is a degree of housing “oversupply” in third-tier cities, while first- and second-tier cities still face a substantial housing “shortage.” If the “ Bao Jiao Lou “ policy guarantees the completion of all pre-sold developments, it may further exacerbate the spatial mismatch of resources. From a broader perspective, not all projects need to be fully completed. Allocating construction resources to first- and second-tier cities with housing shortages, while considering flexible options for unused properties in third-tier cities, could improve resource efficiency.

Fourth, this approach fails to help existing real estate companies transition to a new development model. For real estate companies, “project-based resolution “ does not alter their existing asset structure or reduce their debt levels; they remain in a state of high debt, high leverage, and lack of liquidity. Currently, real estate companies are primarily focused on delivering high-quality projects, leaving insufficient funds and energy

to pursue a shift in their business model. This could result in missed opportunities to transition to a new real estate development model during the adjustment period. If real estate companies fail to successfully transition, their future survival prospects will be extremely bleak.

II. Drawing Lessons from the Banking Sector's Approach to Resolving Distressed Financial Institutions

In the CF40 Research Briefing *How to Resolve Financial Institutions at Risk (Real Estate Companies)*, we emphasize that, given the strong financial characteristics of real estate companies in China, the resolution of distressed real estate companies should draw on the methods used to resolve distressed financial institutions

In the banking sector, a relatively comprehensive mechanism has been developed for resolving troubled banks. This often involves single-point resolution, whereby quality assets and non-performing assets are separated for different management and resolution, thereby mitigating risks. The basic logic behind the separation of non-performing assets is that the government, either by authorization or through the establishment of specialized asset management companies, purchases the non-performing assets from the banks. In turn, the banks receive liquidity and reduce their non-performing loan ratio, improving their asset structure and debt-to-asset ratios, thus restoring their normal lending and financing operations.

We believe that the current real estate enterprises still possess significant value, such as brand equity, extensive operational experience, strong market influence, and exceptional human resources. These core competencies are crucial to the industry's development and should be preserved. In this context, we propose adopting a **"Good Bank - Bad Bank"** model to facilitate the resolution of real estate enterprises' non-performing assets. Although this method may not be the optimal solution, it can, to some extent, avoid the issues encountered in the current project-based resolution approach.

The “Good Bank - Bad Bank” model is a classic strategy for resolving distressed financial institutions. A Bad Bank is specifically established to purchase and manage the non-performing loans and other illiquid assets of one or more financial institutions, allowing these institutions to retain their quality assets and become a Good Bank. The task of managing and liquidating non-performing assets is left to the Bad Bank, while the Good Bank can refocus on its normal business activities. This resolution method essentially separates and rescues the institution from the asset side.

The advantage of this strategy lies in its direct containment of systemic risk, helping to restore market confidence (by improving the bank’s credit rating) and maintaining financial stability. Additionally, the bank’s original brand value and other strengths can be maximally preserved within the Good Bank. On the other hand, by concentrating non-performing assets within the Bad Bank, these assets can be managed in a more specialized manner and resolved flexibly over time, improving recovery rates and overall operational efficiency, thus minimizing the cost of asset resolution. The downside is that the scale of funding required for such a rescue can be enormous, asset valuation is difficult, leading to a lack of standardized policy, and the approach may create moral hazard for banks.

China used the “good bank-bad bank” model to restructure the four major state-owned commercial banks. In the late 1990s, China’s four large state-owned banks faced a severe non-performing loan problem. To address this, China established four asset management companies in 1999, each responsible for handling one bank’s non-performing assets, essentially functioning as Bad Banks. These Bad Banks acquired a large volume of non-performing loans through policy-driven transfers and market-based purchases. Meanwhile, the People’s Bank of China used the country’s foreign exchange reserves to inject capital into the Good Banks after the non-performing assets had been removed, replenishing the banks’ capital. At the same time, China actively promoted the corporatization of state-owned commercial banks, reforming their operational and internal management systems to align with modern banking standards. After the asset separation and restructuring, the non-performing loan ratio of the four major state-

owned banks declined significantly, and they eventually went public on capital markets.

Compared to real estate enterprises, there are two key differences in the resolution of distressed banks. First, banks' deposits and loans do not have a one-to-one correspondence, whereas the debt and pre-sale funds of real estate companies correspond to specific projects and housing units. This makes it relatively easier for banks to separate their non-performing assets. Banks can package and sell non-performing assets while maintaining their existing liability structure, leaving all liabilities with the Good Bank. Second, deposits, as the core liability of banks, (almost) cannot be discounted. Therefore, when banks sell assets at a discount to remove non-performing loans, the resulting losses cannot be offset by simple debt restructuring or discounting; they must be covered by additional capital injections. In contrast, the liabilities of real estate companies are not entirely non-discountable, so the cost of resolution does not necessarily require complete reliance on capital injections.

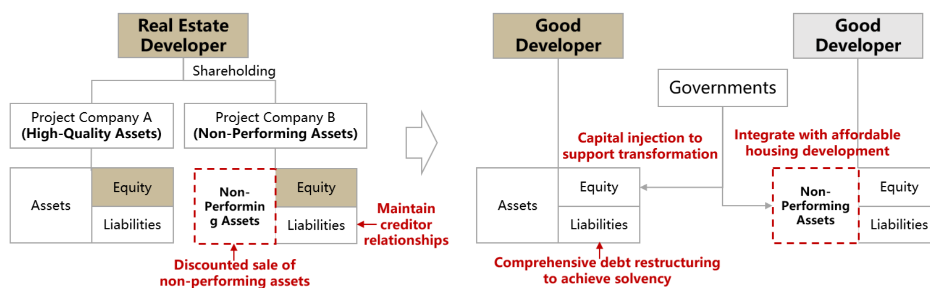
III. "Good Developer - Bad Developer": A Conceptual Plan

We aim to propose a plan superior to the "project-based resolution" approach, seeking to minimize resolution costs while ensuring fairness for all types of creditors when resolving distressed real estate firms. The goal is to ensure that the rights and interests of all stakeholders are reasonably and fairly addressed during asset separation and debt restructuring. Additionally, we hope to preserve the valuable parts of real estate companies, such as their brand, operational experience, and market influence, while promoting a shift from the traditional high-leverage, high-turnover model to a more sustainable business model.

Our overall concept is to draw on the "good bank-bad bank" model by stripping the non-performing assets held by real estate companies at a discounted price to another "bad developer," while keeping all liabilities within the "good developer." At the same time, a comprehensive debt

restructuring of the "good developer" should be carried out to achieve a insolvent status. Finally, the government could take the lead in recapitalizing the "good developer" to assist it in transitioning to a new real estate development model. The subsequent asset resolution of the "bad developer" can be integrated with affordable housing construction, and the government can gradually exit its equity in the "good developer" once the real estate market returns to normal. The resolution cost of this plan will be primarily borne by creditors, achieving minimal resolution costs and effective resource utilization. The specific resolution plan is illustrated in Figure 3.

Figure 3: Diagram of Resolving Distressed Real Estate Firms under the "Good Developers - Bad Developers " Model.



In practice, the resolution of distressed real estate companies can be divided into five steps:

Step 1: Conduct stress tests to determine which distressed real estate developers are worth assisting.

By drawing on the stress-testing practices used by banks, we can conduct a thorough review of the assets and liabilities of each developer to assess which real estate companies hold significant value for assistance. First, we assume that property sales and valuations return to relatively normal levels, and assess the operational situation of developers under normal conditions. Priority should be given to assisting those companies that can operate normally under these conditions, rather than those entirely lacking prospects.

For distressed real estate companies that require assistance, it is recommended to adopt a single-point resolution strategy. A single resolution

entity should exercise resolution authority at the parent company level, with the group primarily absorbing the losses and carrying out the separation of non-performing assets, to avoid disrupting the normal operations of core institutions and businesses. Especially for large developers operating across provinces, their parent companies should coordinate nationally to ensure the proper handling of cash flows and business cooperation between subsidiaries. This method has the advantage of cleanly and thoroughly separating out the entirety of a large developer's bad assets, while preserving the company's core value.

Step 2: Identify the non-performing assets to be stripped and estimate the approximate funding gap.

When identifying and classifying non-performing assets, it is essential to comprehensively evaluate the financial condition, project progress, and pre-sale status. The non-performing assets to be stripped to the "bad developer" could primarily consist of projects with "high pre-sale ratio but low construction progress," which constitute the majority of current real estate developers' inventory. Since these projects have high pre-sale ratios and significant completion challenges, they carry substantial risks and uncertainties. Therefore, before transferring such projects, a detailed evaluation of each project's assets should be conducted to ensure fairness and transparency in the stripping process. Based on the actual situation of specific projects, different degrees of discounting should be applied, from which the overall funding gap caused by the discounted sale of assets can be calculated.

Step 3: Conduct comprehensive debt restructuring for the distressed developers to achieve solvency.

The discounted sale of assets will trigger or exacerbate the situation where the real estate company's assets are insufficient to cover its debts. A comprehensive debt restructuring should be carried out to cover the company's debts with its assets. Debt restructuring can include "haircuts" for creditors, but this is not the only way. More appropriate methods to

consider may include extending terms, reducing interest rates, and debt-to-equity swaps. It is important to note that the treatment of the same type of creditors should be essentially the same, but different types of creditors should bear losses in a certain order. Therefore, we classify the creditors of real estate companies into three categories: the first category is homebuyers who have purchased pre-sale properties; the second is construction parties and suppliers involved in project construction; and the third is bondholders or banks that have issued loans to real estate companies, or creditors who have provided financing to real estate companies through trusts, disguised equity investments, and other means, which we collectively refer to as financial institution creditors.

We believe that financial institution creditors should bear the costs of resolving distressed real estate companies, that is, the losses brought about by the discounted sale of assets. Creditors providing high-interest loans, in particular, should recognize that high-interest debt financing generally carries higher risks, and thus should have better-prepared expectations for the company's financial situation and market conditions. In resolving distressed real estate companies, institutional creditors need to bear costs in a certain order to absorb the losses from the discounted sale of assets.

The rights of homebuyers, suppliers, and construction parties should be given priority and fully honored. Homebuyers have already paid for the pre-sale properties, and their rights and interests are closely related to the delivery of real estate projects, which need to be fully protected. This is also key to reflecting the "people-oriented" nature of the real estate industry. In the process of stripping the non-performing assets of real estate companies, homebuyers will be divided into two categories. The first category of homebuyers who purchased properties as part of the high-quality projects that remain with the "good developer" can normally wait for the completion of the project and receive their homes. The second category of homebuyers who purchased properties that are identified as non-performing assets and sold to the "bad developer" still have their creditor relationships bound with the "good developer." However, due to the high risk of the projects, they face a significant risk of not receiving their homes, and therefore the "good

developer" has an obligation to compensate them, for example, through financial subsidies, residential compensation, or a combination of various methods.

Step 4: Capital injection into the "good developer" by the government through preferred shares to assist the company in its transformation.

Although the real estate company has removed non-performing assets and essentially achieved a balance of assets and liabilities through debt restructuring, the capital structure and business model of the real estate company also need further adjustment. The main purpose of the government's recapitalization is not to rescue the real estate company but to assist it in transforming. On the one hand, the "good developer" should no longer rely on pre-sales to indirectly finance and leverage in the future, thus requiring more of its own funds for subsequent project development. On the other hand, equity injections at this time can effectively reduce the leverage ratio of the "good developer" and promote the company to change its original high-turnover business model, allowing it to transition into a normal development company with a more reasonable capital structure and no longer dependent on pre-sale funds. In addition, when dealing with distressed companies, simultaneous asset stripping and equity injections can often more effectively help companies out of difficulty and reduce the subsequent generation of non-performing assets.

The advantage of recapitalization through investing in preferred stock is mainly threefold: First, it is simple and flexible. The government can avoid becoming a controlling shareholder, and the relatively standardized operation can be quickly extended to all risky real estate companies in crisis. Second, the government can further convert preferred shares into common shares to absorb losses according to different policy objectives and levels of crisis, playing a role as a safety cushion and retaining more policy space. Third, when the real estate market is sluggish, the government-led equity injection can also encourage other financial institutions to participate, achieving twice the result with half the effort.

Step 5: Exit of public funds and the subsequent development of developers.

After the "good developer" successfully transforms into a developer that can operate and profit normally, the government, as a preferred shareholder, can receive dividends, and the value of the preferred shares will also grow with the increase in the company's value, thus achieving the preservation and appreciation of public funds. As the "good developer" gradually matures, the government can also choose to exit its investment and recover public funds.

At the same time, the government can also use funds that would have been used for affordable housing construction to support the subsequent development and asset resolution of the "bad developer." Since the assets of the "bad developer" are acquired at a discounted price, this means that affordable housing can be constructed at a lower cost. This approach not only effectively addresses the supply of affordable housing but also fully revitalizes non-performing assets, further promoting market stability and recovery.

It should be noted that although we describe a sequence, the second, third, and fourth steps are in fact carried out simultaneously.

IV. Improvements to the Existing Plan

In the face of the current real estate risk situation, the proposal we present is not a strictly optimal solution, but rather an improvement over existing approaches to handling distressed real estate companies. We believe that handling real estate companies according to the "good developer - bad developer" model can bring more benefits to relevant parties and is a more systematic and holistic solution.

Firstly, for homebuyers and creditors. In this plan, the interests of homebuyers are better protected because the homes they purchase and receive are no longer products of a real estate company with an uncertain

future, but are products of a real estate company that can continue to operate after debt restructuring and recapitalization, which is more certain in terms of housing quality, the certainty of obtaining housing, and subsequent maintenance. Although financial institution creditors bear the losses brought about by the discounted sale of assets, these losses are significantly less than the losses and uncertainties brought about by the inability of real estate companies to continue operating or disorderly debt restructuring.

Secondly, for real estate developers. After the adjustment, a developer that was originally cash-strapped and insolvent can be effectively divided into two parts: one is a "good developer" that can obtain financing normally, and the other is a "bad developer" carrying non-performing assets. The "good developer" not only strips off non-performing assets but also gets rid of the past "high debt, high leverage, high turnover" business model, transforming into a real estate developer that sells ready-built houses and has a normal debt-to-asset ratio. Moreover, the "good developer" can retain the original company's core assets to the greatest extent, allowing the company to concentrate resources and efforts on high-quality projects and continue to use its business brand, market influence, and customer base, and other core competencies to achieve healthy operation.

Next, for the government. If all pre-sold projects were to be underwritten, the required capital investment would far exceed the current policy scale, bringing greater financial pressure. However, in the "good developer - bad developer" plan, the government does not bear the cost of resolving risky real estate companies but restructures the capital of the "good developer" in the form of preferred shares, which not only reduces the scale of capital investment but also, if the "good developer's" transformation is successful, can also obtain certain capital gains upon exit, further reducing the cost of policy funds. At the same time, the government can also integrate the subsequent development of the "bad developer" with affordable housing construction, thus achieving effective utilization of resources.

Finally, for the real estate market and the macroeconomy. Although this plan has many details that need to be improved in operation and it will take

a period of time to implement, and it will not be smooth sailing, it can send a clearer signal to the market and homebuyers. The worries of homebuyers purchasing new homes will be significantly reduced, and the concerns of financial institutions providing new financing to “good developers” will also be significantly reduced. These are important for stabilizing and restoring the real estate market and the transformation of the real estate development model. Once the real estate market can stabilize and recover, it will also have a clear supporting role for China’s consumption and investment.

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