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**Comment** Michael Davies

The development of bond markets (including asset-backed securities [ABS] markets) has been a key focus of Asian central banks and government agencies over the past decade (see Gyntelberg, Ma, and Remolona 2006; Gyntelberg 2007). The push to build ABS markets makes this chapter particularly relevant as it seeks to provide a robust theoretical justification for their development.

The chapter offers a theoretical model that explains how bank employees' misaligned incentives cause them to extend too much finance to the real estate sector, which destabilizes real estate prices and the broader economy. It then shows how securitization better aligns bank employees' and investors' incentives. The chapter also provides evidence from twelve countries that have experienced real estate market declines of at least 20 percent at some point during the past two decades, which shows that banks' excessive lending has a detrimental impact on real estate markets. Last, the chapter provides a discussion of current developments in ABS markets in Asia.

Overall, I thought that the chapter was good, but I have a few suggestions that might improve it.

**General Comments**

- The chapter argues that securitization is particularly important in Asia because it improves the transparency of the financial sector and helps lenders manage their interest rate risk and duration risk. An additional benefit of securitization is that it improves financial stability by removing risk from lenders' balance sheets and dispersing it more widely among a large number of less-leveraged domestic and nonresident institutional investors.
- The chapter discusses both residential mortgage-backed securities (RMBS) markets and commercial mortgage-backed securities (CMBS) markets and sometimes does not make a clear distinction between the two markets. It might be worth focusing on CMBS markets as this is the market for which the theoretical model and the real estate data appear best suited.
- Excess liquidity and banks' unwillingness to securitize loans are cited as reasons for why ABS markets have not developed in Asia. It might also be worth discussing how governments and market participants in

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The chapter was interesting, and I am grateful for the opportunity to discuss it. The views expressed in the following are my own and do not necessarily reflect those of the Reserve Bank of Australia.

several Asia-Pacific countries have tried to overcome these constraints and build their ABS markets:

- In Hong Kong, Japan, Korea, and Malaysia, the government-supported housing finance agencies have been issuing mortgage backed securities (MBSs) to develop a market (see Davies, Gyntelberg, and Chan 2007).
- In Singapore and Korea, government agencies have bought some of the riskier ABS tranches to help bridge the gap between the credit quality of the bonds that investors in the region would like to hold and the actual credit quality of potential corporate borrowers (see Gyntelberg and Remolona 2006)
- In Australia, new specialist mortgage lenders, that relied solely on RMBS for funding, quickly built a presence in the mortgage market and the RMBS market in the mid-1990s (see Gizycki and Lowe 2000).

### Comments on the Theoretical Model

- The chapter argues that bank employees can hide losses from investors and analysts because the bank has a large, diversified loan book. I am not an expert in bank agency problems, but I have three concerns about this argument. Banks often report separate results for each division. Banks that make underpriced real estate loans would also likely underprice loans to borrowers in other industries, maybe undermining the argument that losses can be hidden in the banks' diversified loan book. Even if the additional losses on real estate loans were within the standard errors of aggregate loan losses across the whole loan book, over time, the bank's aggregate losses would always be biased upward, and eventually shareholders would realize that losses were too high.
- I agree that securitization improves the transparency of lenders' loan books, but I am not sure that it eliminates agency problems. The ability to securitize loans was an important factor in the decline in lending standards in the U.S. subprime loan market, as the companies that originated the loans did not bear the credit risk.
- The disaster scenario does not appear to impact on the profitability of safe developers. This implies that safe developers do not invest any equity in their real estate projects. If this is the case, how are safe developers different from risky developers?

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## Comment Mario B. Lamberte

The authors have developed a model to explain why underpricing of risk is not detected by bank shareholders and that its persistence results in compression in the spread between lending and deposit rates, lending booms, inflated asset prices, excess building, and real estate crashes. The model may be described in figure 3C.1. There are five major players in the real estate market, namely, the bank regulator; bank shareholders; bank management; real estate developers, consisting of both risky and safe borrowers; and households who have demand for real estate, which can assume three states with associated probabilities. In this model, a principal-agent problem exists. Managers' objective function is to maximize compensation. It is assumed that managers can hide bank losses. Thus, they engage in underpricing risk, that is, lend to risky borrowers at safe rates. As the authors have pointed out, "[S]uch underpricing behavior forces a race to the bottom across lending institutions, with marketwide consequences." Under this situation, real estate markets decline more during market downturn in economies where risk is underpriced but reported bank losses are expected to be lower than real estate losses. To mitigate the principal-agent problem, the authors have offered a solution: introduce mortgage securitization that will discourage lenders from underpricing risk.

Given the title of the chapter, it is worthwhile to describe the banking system and real estate markets in Asia to see if the model and its policy implications are applicable to the region. As many analysts have observed, figure 3C.2 more accurately describes the banking system in Asia than figure 3C.1. In figure 3C.2, bank ownership is highly concentrated, and bank owners are greatly involved in the management of their banks. Thus, the principal-agent problem that exists under figure 3C.1 does not either exist or is less pronounced in Asia. Even though a number of banks are publicly listed, the listed shares as a percent of their total outstanding shares are significantly small compared to what can be found in more-developed economies. Moreover, many banks in Asia are either majority or minority shareholders of real estate companies and mortgage redemption insurance companies.

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