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.

Mario B. Lamberte is director of research at the Asian Development Bank Institute.
Fig. 3C.1 Model of lender and developer behavior

Fig. 3C.2 Lender and developer behavior: Asian context
Interlocking directorates among these institutions also abound, facilitating access of real estate companies to bank loans. Thus, the problem that arises in the Asian banking system is quite different from that described by the model. Imprudent lending to subsidiaries, affiliates, and bank directors and officers appears to be a serious problem. The solution, therefore, which many countries in the region have attempted to do in the aftermath of the financial crisis, is to strengthen banking regulations including capacities of regulators and corporate governance of banks. A strong banking sector closely monitored by regulators can fare better in times of real estate market downturn.

There are some nuances in developing mortgage securitization in Asia. In the model, $P$ denotes the price of land for development. However, valuation of real estate properties is still a big problem in Asia. It is not unusual to find two significantly different valuations of the same property given by two real estate appraisers. Also, benchmark yield curve is not yet firmly established in Asia, making it difficult to develop the securities market rapidly.

Turning to the empirical analysis made by the authors, the sample appears to be too small to generate enough confidence in the results. More studies of this nature using a larger sample are, therefore, called for.