Discussion
of
Residential Mortgage Credit Derivatives
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Paper Summary

- Examine the hedging effectiveness of hypothetical credit derivates
- How?
  - Create pools of mortgage loans that mimic those of depositories
  - Create 2 synthetic indices: 1) credit-loss and 2)house price
  - Use adjusted R-squared method to assess effectiveness
  - Do simulations and use actual data

Policy Issues

- Highlights nicely some of the institutional structures of the `regional` mortgage market in U.S.
  - Need to mitigate regional bank exposure to regional economic fluctuations
  - How regional banks tend to hold on to ARMs

- Completion markets pareto improve

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Comments: Hedging effectiveness measure

- Accounting standard should not drive choice: Should not be constrained to OLS-based R-squared measure
- Examine other hedge ratio specification based on Error correction models, time varying GARCH models
  - Paper does allow for dynamic or time varying via dummy in OLS
- R squared measure: Problems related to potential structural breaks not handled

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Comments: Hedging effectiveness measure

- However, Don Lien (Journal of Futures Markets, 2005) argues at conditional (model-based) measures are biased relative to true unconditional effectivenss

- Bottom line: Paper could do a more in terms of hedge effectiveness.

Comments: Thresholds and non-linearities

- More robustness around use of threshold
- House price threshold : c = -1; why not c = xx; c > 0?
  - House price appreciation slowdown might be sufficient

- Simulation: what is sensitivity of results to different specifications of house price dynamics (equ 9-10)?
  - Non-linear or jumps

Comments: Loss portfolio and Index data

- A So What Result
- Hedge effectiveness high because measure the same thing
- Although created differently, dependent and independent variable drawn from the same data set

- Need much more clarity on differences
- Maybe more structure

Comments: Other Data and Hedge instruments

- Comparisons to ABX data would be helpful
- ABX index track prices of credit default swaps on a basked of subprime tranched RMBs.
  - New vintage every 6 months
  - Different ratings
  - But not regional

- BIS study found house price indicators important for ABX return (Home builder returns)