A Discussion of
Bid-Ask Spreads and the Pricing of Securitizations: 144a vs. Registered Securitizations

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8th Annual Central Bank Workshop on the
Microstructure of Financial Markets

Overview of Paper

- Main Findings:
  - Spreads are generally tighter on 144a instruments, despite lighter trading activity.
  - Spreads on retail-size trades and CMOs are surprisingly wide.
  - Dealer connectedness matters – tighter spreads for dealers with more activity in the interdealer market.
- Important question, well-executed.
- Exciting dataset that potentially opens up new research opportunities in an economically important and understudied market (FINRA willing!)

Discussion Outline

- Some brief questions.
- A few thoughts on the spread estimation methodology.
- Potential extension: can this dataset be used to validate liquidity proxies based on observable low-frequency data in the trade-level data?

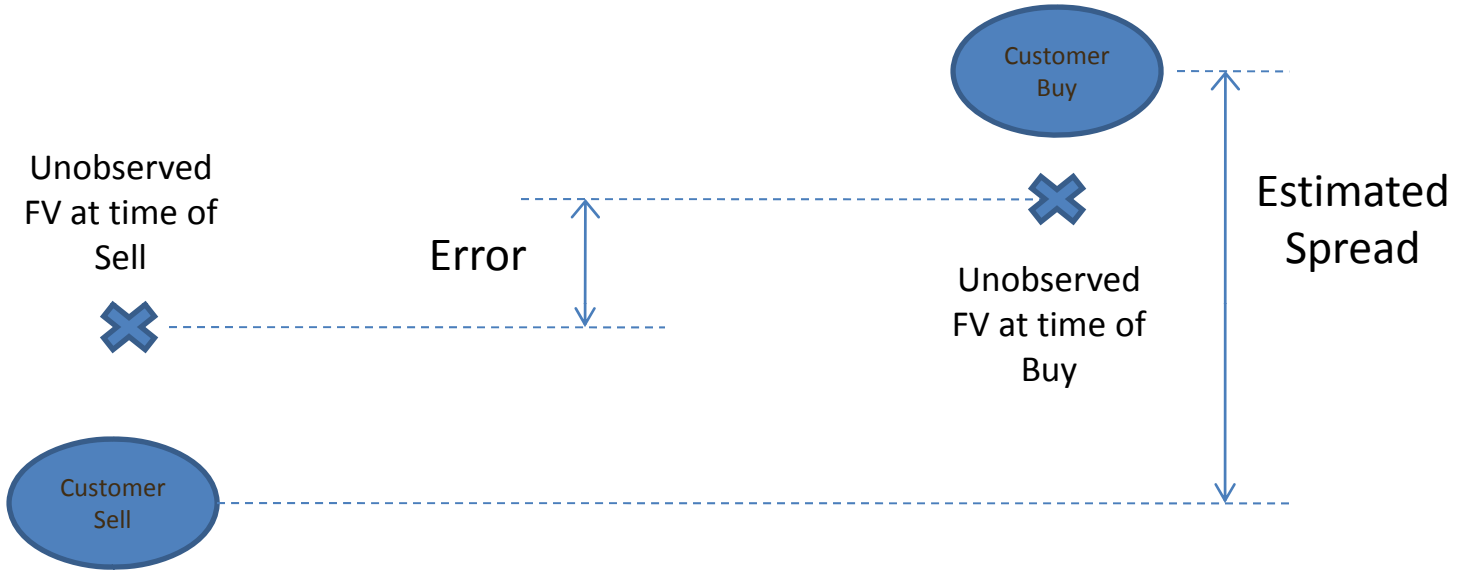
Questions

- It is somewhat surprising that there are so many retail trades in this data.
  - Can retail traders understand these bonds?
  - What securitized bond features can a retail trader want badly enough to pay these spreads?
- I would like to better understand the registration vs. 144a choice.
  - It seems like this is primarily an institutional market, can most of the major players meet QIB requirements?
  - Who does registration draw into the market?
  - Is registration primarily used for otherwise less desirable bonds?

Questions

- How do portfolio trades appear in the data?
  - Some trades in this market involve large portfolios. This was a common way for distressed banks to trade during the financial crisis, but I believe it happens in normal times as well.
  - If these can be identified, they may warrant special handling.
    - Some may be distressed trades.
    - Small trades that are part of non-distressed portfolio trades may be priced as if they were larger trades.

Spread Estimation



- Is the error large?
  - Maybe for observations with long elapsed times between trades or in volatile periods.
  - Maybe for leveraged or long duration tranches (Inverse Floaters, POs, Long Sequentials, Supports)
- Noise or bias?
  - Probably noise, but trading correlated with returns could induce bias

Regression Approach

Bessembinder, Maxwell, Venkataraman (2006) Regression:

$$\Delta P = a + wX_t + \gamma SQ_t^* + \alpha S\Delta Q + \omega_t$$

where Q_t = trade direction indicator,
Q^*_t = surprise in order flow
γS = informational component of the spread
αS = non-informational component of the spread
(inventory, order processing, MM rents)
X_t = public information variables
(changes in interest rates, credit spreads, stock returns)

- Public information variables control for market movements between trades. Could select an information set more relevant for securitized bonds.
- If this is asking too much of the data, could possibly combine spread components or pool close substitute bonds.

Confidence-weighting Approach

- Carrion (2009) introduces a technique to estimate confidence levels for trade signs in data with stale quotes using Brownian bridges.
  - Inputs are surrounding prices, volatility, and time elapsed from surrounding quotes
- Confidence levels are used as weights in WLS, and to isolate a high-confidence sample.
- This technique could be adapted to estimate a confidence level around fair value moves each bond between trades of interest.

Low-Frequency Liquidity Measures for Securitized Bond Market

- TRACE-like post-trade transparency would be valuable in this market. But will it happen?
- From a SIFMA comment letter on a related proposal:

  "the MBS-SP market [is] far more granular than corporate or agency debt markets … our buy-side and sell-side members active in the MBS-SP market are very concerned that sensitive information regarding trading strategies, volumes, identities and positions will be compromised if the proposal is implemented without amendment."
- Could this dataset be used to validate low-frequency liquidity measures derived from data observable to researchers and market participants? See Hasbrouck (2006) and Goyenko, Holden, and Trzcinka (2008).

Low-Frequency Liquidity Measures for Securitized Bond Market

- Some potential candidates for observable measures:
  - Dealer quote bid-ask spreads
  - Volumes and other measures from FINRA index disclosures
  - Non-trading/0-return days
  - Violations of no-arbitrage relationships

No-arbitrage Pricing Relationships

- This market has a lot of notorious violations of no-arbitrage relationships. Examples:
  - IO + PO ≠ collateral
  - Busted PAC ≠ collateral
- Chacko, Das and Fong (2012) use differences between bond ETF prices and NAVs to create a liquidity measure. Potential parallel here?
- Related question – are these really exploitable, or due to stale prices, wide spreads, etc.

Conclusions

- This is a very interesting paper. It is well done and we really need to know more about this market.
- I have a few questions related to retail participation, registration choice, and portfolio trades.
- I think there are potential improvements to the spread estimation methodology.
- Validation of low-frequency observable liquidity proxies would be an interesting use of this dataset.