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

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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:

\[ \Delta P = a + wX_t + \gamma S Q^*_t + \alpha S \Delta Q + \omega_t \]

where
- \( Q_t \) = trade direction indicator,
- \( Q^*_t \) = surprise in order flow
- \( \gamma S \) = informational component of the spread
- \( \alpha S \) = 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.