

Weekly Post Series **Products** 2024 #12

Weekly Post Series topics include **Research, Strategies, Products**

Bonds and Loans for Liquidity Portfolio

This week, my *research* uncovered a concerning oversight in liquidity management—the Liquidity Gap Report. Yesterday, I proposed a *strategy* for leveraging the Contingency Funding Plan report to enhance liquidity management. Today, in this *products* post, I will delve into the crucial role of the Liquidity Gap Report in identifying the sources of buyers for the Liquidity Portfolio bonds and loans.

Challenge

My previous post advocated for a proactive approach to liquidity management. This involves carefully selecting a liquidity bond or loan pool using the Liquidity Access Optimizer. This pool can then be used as collateral for FHLB Advances funding or sold to correspondent bankers. Alternatively, the Liquidity Pool values can be monitored in preparation for sale to potential buyers. This process differs from traditional loan transactions, as the Bank seeking liquidity is not simply posting assets for sale. Instead, the Liquidity Pool seeks out potential buyers by leveraging our extensive network and market insights. But how does this process work?

Products: MBS and Residential Mortgages

I first discuss the analytics of MBS and residential mortgages, which can constitute a Liquidity Portfolio. The analytics of bonds and loans can assist in selecting the pool's constituents.

Mortgage-backed Securities (MBS)

Analyzing candidates for the Liquidity Pool requires understanding the MBS regarding prepayment behavior, conditional prepayment spread, the mortgagors' prepayment option, and market pricing. Our MBS analytics report provides a comprehensive analysis.

CPR SCENARIO ANALYSIS					
Speeds(CPR)	25	20	15	10	5
Yield to Maturity(%)	5.356	5.477	5.591	5.698	5.794

INTEREST RISK RELATED						
CPR(%)	Duration	Convexity	OAS(%)	OAS Duration	WAL	Yield(%)
14.065	1.788	-2.649	0.302	3.208	4.525	5.506

KRD							
3M	1Y	3Y	5Y	7Y	10Y	20Y	30Y
0.073	0.580	0.621	0.335	0.283	-0.107	0.006	0.020

GAP							
0 to 3mos	3 to 6mos	6 to 1yr	1 to 2yrs	2 to 3yrs	3 to 5yrs	5 to 10yrs	10yrs+
43,639	93,518	259,544	505,919	343,789	491,653	416,998	253,384

This live bond was selected from the Thomas Ho Platform Capital Market Inventory. The bond is a 30-year fixed-rate MBS priced at 101.558. It has a WAL of 4.525 years, a yield of 5.506%, and an OAS of 30 BP. As an MBS, there is no credit risk. With a 1.5% premium, the bond does not have excessive prepayment and price risk. The choice of the Liquidity Pool should be such that the sale would not adversely affect the balance sheet profile. This means that the bonds should be generic to be more easily sold, and their sale should not significantly impact the bank's financial position. At the same time, the bonds should be generic to be more easily sold.

Loan Central and Potential Buyers

The following Platform transactional partners provide our clients with daily indicative prices so that the bank can analyze their Liquidity Portfolio risk exposure and valuation. Furthermore, these transactional partners' asset analytics are consistent with those of the platform facilitating the transaction.

Mortgage Backed Securities and Collateralized Mortgage Obligations

MBS Source (MBSS) is a transactional partner of the Platform for MBS and related structured products. MBSS provides intraday updates on over 15,000 MBS inventory items, including descriptive data and prices. MBS Source is a financial technology company that provides an electronic trading solution for securitized products, including non-agency CMOs, Spec Pools, CMBS, ABS, CDOs, and CLOs.

Thomas Ho Company's reverse engineering team also updates the CMOs available in the Capital Market Inventory. It is important to note that CMOs are diverse in their risk characteristics. Some are often protected from prepayments, such as the PACs, and others, such as the Support Tranches, are sensitive to prepayment risk. For this reason, some CMOs are more liquid than others. The Capital Market Inventory provides analytics, indicated price, and outstanding amount. The CMOs enable the banks to select the tranches targeted to the balance sheet needs.

Ask Price	Ask Size	Sub Sector	Desc ↑	Maturity	CP...	Eff.Dur	WAL	Yield(%)
▼	▼	▼	pac ▼	▼	▼	▼	▼	▼
102.154	52,520	Agency CMO	1987F PE PAC	09/01/2027	7.50	0.76	1.14	5.537
101.526	1,375,132	Agency CMO	3472B PL PAC	07/15/2038	6.50	1.45	2.73	5.815
100.036	51	Agency CMO	96-028I PK PAC	07/25/2025	6.50	0.13	0.13	6.239
101.792	71,141	Agency CMO	97-018A PE PAC	04/18/2027	7.50	0.70	0.97	5.602
101.954	157,457	Agency CMO	97-022A PA PAC	04/18/2027	8.00	0.61	0.85	5.654
102.000	66,872	Agency CMO	97-028A PG PAC	05/18/2027	7.50	0.74	1.07	5.561
102.058	120,785	Agency CMO	97-029A PG PAC	05/18/2027	7.50	0.75	1.09	5.551
101.673	113,280	Agency CMO	97-037B PB PAC	06/18/2027	8.00	0.55	0.75	5.719
102.157	211,676	Agency CMO	97-050H PA PAC	08/18/2027	7.50	0.77	1.14	5.536
101.937	96,659	Agency CMO	97-051A PB PAC	08/18/2027	7.50	0.72	1.04	5.574

Residential Mortgage Loans Prepayment Risk

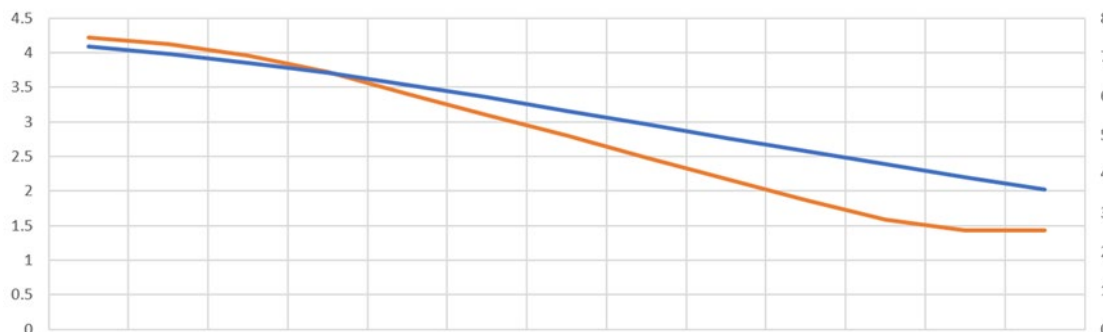
As noted above, conforming fixed-rate residential mortgages (FRM) tend to be more liquid. However, the prepayment risk affects the pricing and liquidity. Then, the market rate falls, mortgagors will be more likely to prepay and the prepayment risk increases. Conversely, mortgagors will be less likely to prepay the extension risk. As of 3 – 27-2023, the current loan rate is 7.18%¹.

The chart below depicts the impact of prepayment on the FRM². When loan rates are below the current rate, the loan behaves similarly to a loan without an option. When rates drop, the option lowers the duration until the FRM becomes similar to a short-term loan with significant price risk. The prepayment option impacts the loan's risk characteristics, pricing, and credit risk. It also determines the CMO tranche behavior in either mitigating or becoming more sensitive to the prepayment risk.

[1] Source: US mortgage national average

[2] Data source from Futurewave Financial

Duration and WAL



The red line is the duration and the blue line is the WAL. The y-axes are in Years. The X-axis is the loan rate stack.

While Loan Central lets sellers publicly post their offers, it also allows potential buyers to post Inquiries to Buy, which is particularly useful for the Liquidity Portfolio. The potential buyers post their “credit box” on the Platform. The table below provides a sample of the Inquiries. The credit box specifies the loan types, WAC, and credit requirements.

Loan Type	Size(MM)	WAC(%)	FICO	LTV(%)	DTI(%)
ARM 3/1,ARM 5/1,AR...	10-20	All	>680	<80	<43.00
HELOC	25-50	All	>660	<90	<50.00
HELOC	10-20	All	>680	<80	<43.00
Mult-Fix30,Mult-Fix15	>5	All	>730	<75	All

The inquiries enable a bank to decide the loan types for the Liquidity Portfolio that can access liquidity in the loan market.

Multiple correspondent bankers are ready to purchase loan pools. Thomas Ho Company's transactional partner, FutureWave Finance, provides our Platform with 1,000+ daily residential loan prices, enabling banks to benchmark the value of their Liquidity Portfolio.

Conclusions

Regulators will likely heighten their examination of the bank's liquidity management in 2024. This week, I have covered the use of the Liquidity Gap, Contingency Funding Plan, and Income Attribution reports. Banks can use these reports for their proactive liquidity management. To gain access to Market Liquidity and manage the CFP, banks can prepare their Liquidity Portfolio and establish relationships with potential buyers for the bonds and loans. The Liquidity Access Optimizer can determine the Liquidity Portfolio to offer to counterparties.

If you would like to receive Thomas Ho Company's additional analysis, learn more about Thomas Ho Company analytics, or arrange a demo of the Thomas Ho Platform, please get in touch with Megan Trillet, Director of Marketing, at megan.trillet@thomasho.com or 330-687-0608.

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Functional Groups as Integral Parts of the Ishikawa Banking



Yield Attribution | Price Attribution | Income Attribution | Performance Attribution | EVE Attribution

IncomeRisk™ Model

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