# Interest rate risk assignment

Business

This excess collateral backing of the bond and in addition to the priority rights f the bondholders generally ensures that the bond can be sold with a high credit rating such as AAA In contrast, the A, when evaluated as a whole, could be rated EBB or even lower. A high credit rating results in lower coupon payments than would be required if significant default risk had lowered the credit rating. Example: Consider an Fl with $20 in LET mortgages as assets. It is financing these mortgages with $mom in SST uninsured deposits (wholesale deposits) and $mom in insured deposits (retail deposits).

We ignore the issues of capital and reserve requirements. Assets LET Mortgages mom Total: Liabilities Insured deposits SST uninsured deposits $earn $ mom $mom Total: $mom Looking at this balance sheet, there are a few issues. The IF has a positive gap, which is gap exposure risk ( AD > kid ) Other is interest rate risk and the potential default and prepayment risk on the Flu's mortgage assets To counter O and lower its funding costs: Asset side: Fl will segregate $mom of the mortgages and pledge them as collateral backing of $mom LET MOB issue.

Collateral = (market value of segregated mortgages) Other mortgages $mom LET MOB issue $ mm Uninsured deposits 1 Ron Because of this oversimplification, the MOB issued by the Fl may cost less to issue, in terms of required yield, than uninsured deposits: Mobs may be well rated AAA while uninsured deposits might be rated EBB. The Fl can therefore use the proceeds of the $mom bond issue to retire the $mom of the uninsured deposits. Now looking back the balance sheet: The bond Issue has lengthened the average duration of liabilities by replacing the SST deposits with LET Mobs. T is now a better matching of AD to DEL we counter O AAA-

rated bond coupon rates are below EBB-rated uninsured deposit rates => we lowered the funding cost. However, this outcome occurs only because the insured depositors do not worry about the risk exposure since they are 100% insured by FIDE. If smaller depositors were not insured by the FIDE, they would surely demand very high risks premiums to hold these risky deposits. The implication of this is that the FI gains only because the FIDE is willing to bear enhanced credit risk through its insurance guarantees to depositors. As a result, the IF is actually gaining at the expense of the FIDE.

Other than regulatory discouragement and the risk of regulatory intervention, there are private return reasons why an IF would prefer Cosmos and pass through to issuing Mobs. Ambos tie up mortgages on the He’s balance sheet for a long time!!! (They are L T) Thus, this increases liquidity of the asset portfolio. The amount of mortgages tied up is enhanced by the need to over- collateralized to ensure a high quality credit risk rating for the bond issue. O By keeping mortgages on the balance sheet, the FI continues to be liable for capital adequacy and reserve requirement taxes.