Appendix 2: The Credit Intermediation Process of Bank Holding Companies

The credit intermediation process of Financial Holding Companies flows through a chain of subsidiaries and off-balance sheet activities, and is facilitated by capital markets. This intermediation chain enhances the efficiency of bank equity for various reasons. If markets freeze and the FHC’s subsidiaries have to “onboard” their normally off-balance sheet assets and activities, capital efficiency can quickly become capital deficiency, with systemic consequences. The process described here is an originate-to-distribute model of non-conforming mortgages, where the originating banks and the broker-dealers that slice and dice mortgages into ABS and ABS CDOs do not retain any first loss piece along the intermediation chain.

The credit intermediation process of Diversified Broker-Dealers (DBD) is similar to that of FHC’s (see Figure XX), with only a few differences: First, DBDs originate loans out of financed company subsidiaries, not commercial bank subsidiaries. Second, DBDs warehouse loans not in conduits, but in industrial loan company subsidiaries; alternatively, DBDs can outsource loan warehousing to an multi-seller conduit run by an FHC. Third, ABS warehousing is also not conducted from conduits, but from trading books. Finally, ABS intermediation is not conducted through SIVs, but through internal credit hedge funds. On a funding level, DBD’s intermediation process is more reliant on brokered deposits and repos, compared to the FHC process, which is more reliant on branch deposits, CP and ABCP.