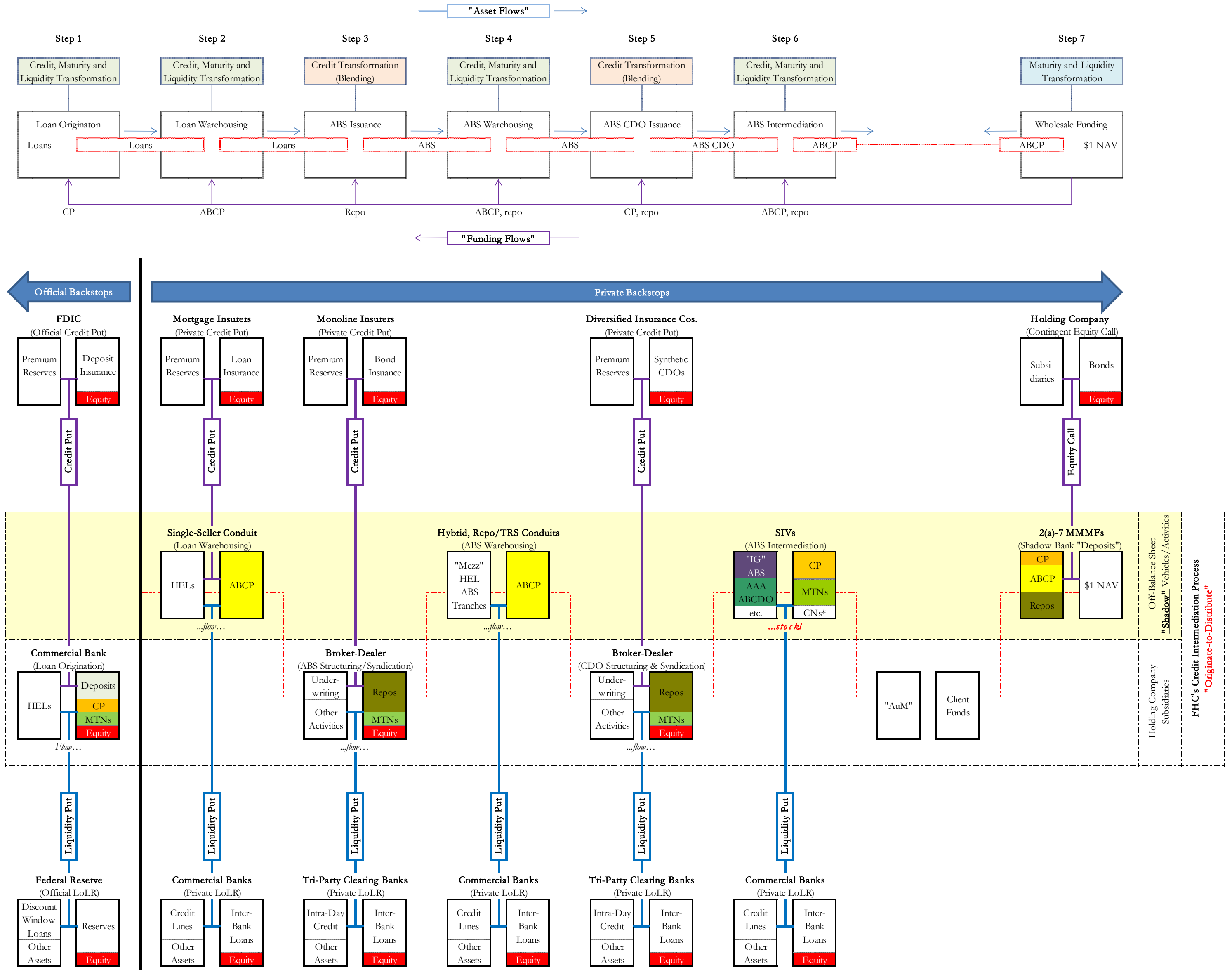
Appendix 7: The Pre-Crisis Backstop of the Shadow Credit Intermediation Process – The Case of FHCs

Prior to the financial crisis, the credit intermediation process of the shadow banking system was privately enhanced. In this figure, we examine the enhancements to a typical FHC's credit intermediation process. Of the seven steps involved in the shadow credit intermediation process, only the first step (loan origination) is officially enhanced as it is conducted from a commercial bank. The commercial bank's activities are backstoped by credit and liquidity puts provided by the FDIC and the Federal Reserve through deposit insurance and discount window lending, respectively. The remaining six steps in an FHCs credit intermediation were privately enhanced, however. Consortiums of commercial banks were providing liquidity puts through contractual credit lines to conduits and SIVs (loan and ABS warehouses, and ABS intermediaries, respectively) and the tri-party clearing banks (JPMorgan Chase and BoNY) were providing intra-day credit to broker-dealers and daytime unwinds of overnight repos to MMMFs that fund them. Private credit risk repositories were making risky assets safe by "wrapping" them with credit puts. The loans, ABS, and CDOs wrapped by mortgage insurers, monoline insurers and AIG-FP, respectively, circulated in the system as credit-risk free assets that were used for collateral for funding via ABCP and repo. When the quality of these credit puts came into question, the value of collateral fell, ABCP could not be rolled, repo haircuts rose and the private liquidity puts were triggered. To provide the funding that has been agreed to via the liquidity puts, the funding providers (commercial banks) had to tap the unsecured interbank market, where the flood of bids for funding sent Libor spreads skyward.



Source: Shadow Banking (Pozsar, Adrian, Ashcraft, Boesky (2010))