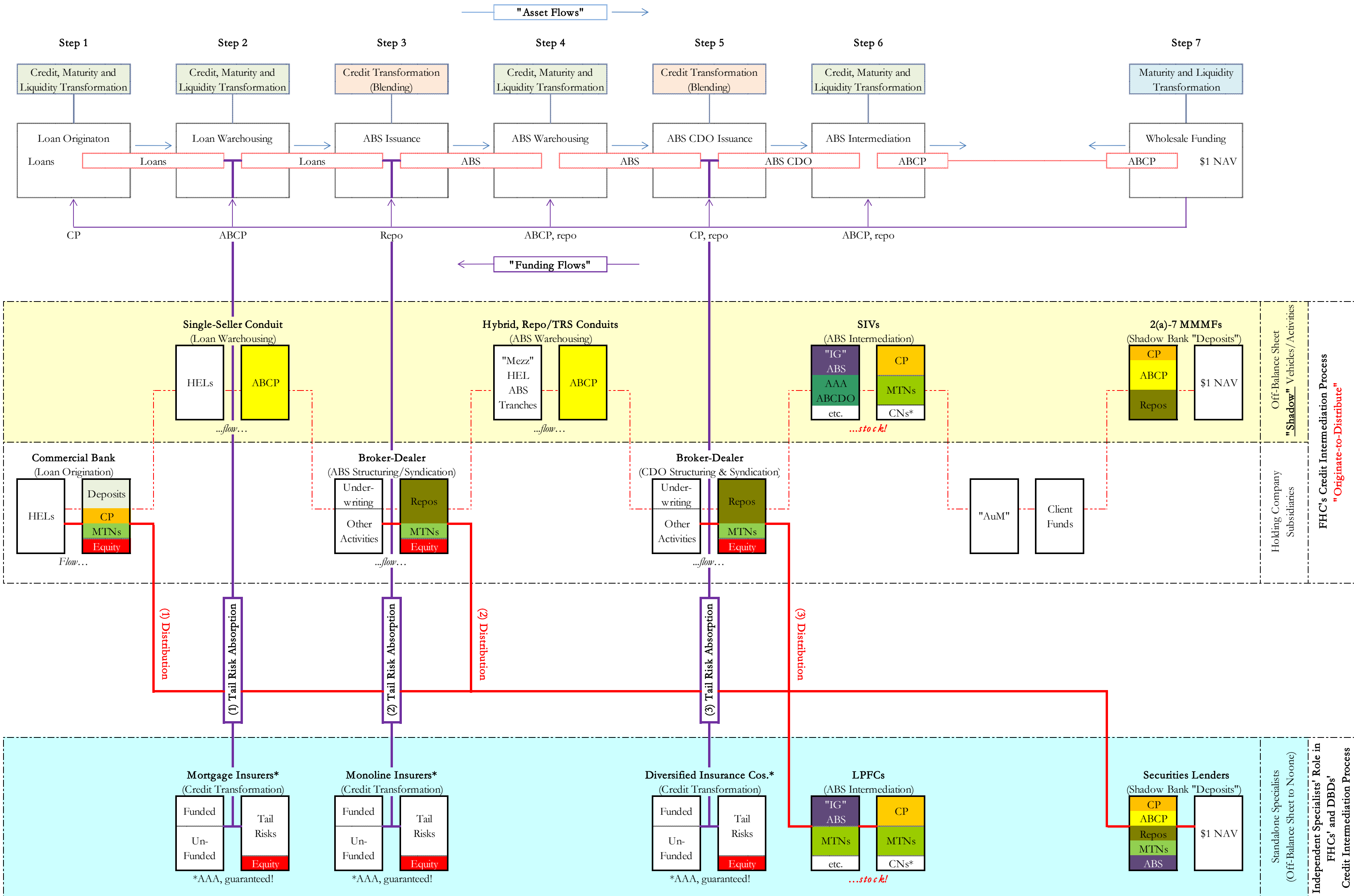
Appendix 5: The Independent Specialists-Based Credit Intermediation Process – FHCs' and DBDs' Reliance on Independent Specialists

The "internal" and "external" shadow banking sub-systems are symbiotic. Not only is the independent specialists-based credit intermediation process dependent on FHCs and DBDs as warehouse providers and gatekeepers to capital markets, but FHCs and DBDs also relied on members of the "external" shadow banking system for funding and other functions. As such, independent specialists like LPFCs and securities lenders, for example, are instrumental in funding commercial banks and broker-dealers by buying their term debt. Furthermore, entities called private risk repositories were turning loan pools into AAA-rated, informationally insensitive securities, which in turn served as collateral in secured funding transactions. An example of such a transaction would be a repo collateralized by monoline-wrapped AAA-rated subprime RMBS, where a broker-dealer pledges the RMBS collateral for an overnight cash loan from a 2(a)-7 MMMF. Credit risk repositories were present in both **originate-to-distribute** and **originate-to-fund** securitization chains, and each type of risk repository corresponded to specific stages of the shadow credit intermediation process. As such, mortgage insurers wrapped unsecuritized mortgage pools, monoline insurers wrapped ABS (on either the loan pool or the tranche side of deals) while entities like AIG-Financial Products (as well as credit hedge funds, and German Landesbanks' SIVs and conduits (famously IKB's Rhineland by investing in the infamous ABACUS 2007-AC1 deal)) were selling CDS on ABS CDOs. Credit risk repositories made the originate-to-distribute process seem riskless and essentially played the role of private-sector versions of the FDIC in the system.



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