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Abstract


The failure and near-collapse of some of the largest dealer banks on Wall Street in 2008 highlighted the profound complexity of the industry. Dealer banks are financial intermediaries that make markets for many securities and derivatives. Like standard banks, funding for a loan made by a dealer bank may come from the bank's own equity or from external sources, such as depositors or creditors. Unlike standard banks, however, dealer banks rely heavily upon collateralized borrowing and lending, which give rise to "internal" sources of financing. This article provides a descriptive and analytical perspective of dealer banks and their sources of financing, both internal and external. The authors conclude that "internal" sources of financing, relative to external sources of financing, yield high levels of efficiency in normal times, but can experience significant and abrupt reductions in stressful times. Their results suggest that accounting netting for collateralized transactions may not reflect a true netting of economic exposures, and that a prudent risk management framework should acknowledge the risks inherent in collateralized finance.

Keywords: dealer banks, collateral

JEL Classification: G00, G20, G32

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