

UNDERSTANDING THE CURRENT ECONOMIC CRISIS

Glossary



Term	Explanation
ABCP	See <i>Asset-backed commercial paper</i> .
ABX Indexes	Indices of values of asset-backed securities, based on credit quality and other characteristics.
Adjustable rate mortgage (ARM)	A loan secured by a home, with an interest rate that adjusts according to some specified benchmark, such as the prime lending rate, the rate on a U.S. Treasury security, or the LIBOR. The rate on an ARM typically adjusts to the benchmark after some specified period of time; until such adjustment, the rate may be low (hence, referred to as “teaser” rates).
Alt-A	See <i>Alternative-documentation loan</i> .
Alternative documentation loan	Alternative-documentation loan, which is a mortgage classified between sub-prime and prime, generally with missing documentation with respect to income and/or assets.
ARM	See <i>Adjustable rate mortgage</i> .
Asset backed security	A security that is created, and hence derives its value from, the value of another asset, in which investors receive a claim on income and / or principal of the underlying asset. A mortgage-backed security is type of asset-backed security in which the underlying is a pool of mortgage loans.
Asset-backed commercial paper (ABCP)	Commercial paper issued by a special purpose vehicle.
Bond insurance	A type of insurance that protects the investor in the event of a default on an investment.
Breaking the buck	The situation in which the net asset value of a money market fund is less than \$1 per \$1 invested. This situation arises if the fund has large investment losses or if investment income is less than the fund’s operating expenses.
Buy and bail	A strategy in which the homeowner who is unable or unwilling to pay the mortgage on his/her present home buys another, possibly more-affordable home, and then fails to pay the mortgage on the first home, resulting in foreclosure of the first home.
CDO	See <i>collateralized debt obligation</i> .
Collateralized debt obligation (CDO)	An asset-backed security in which the underlying asset for the security is some form of fixed income asset, such as a mortgage loan or commercial paper. Generally, this security is structured by creating a special purpose entity that owns the underlying assets and then interests in this entity are sold to investors.
Commercial paper	An unsecured promissory note with a maturity of less than 270 days.
Counterparty risk	The uncertainty pertaining to the possibility that a party to a transaction will not uphold their contractual obligations.
Credit default swap	A form of insurance against the event that the party to a debt instrument does not pay the promised interest and principal as contracted. Though not referred to as insurance – to avoid the regulatory scrutiny of insurance – this is essentially credit insurance.
Credit enhancement	A transaction that reduces the risk of a security. These enhancements may include collateralization, third party guarantees, and credit insurance.
Credit rating	An evaluation of the likelihood that a party to a debt will be able to pay the promised interest and principal as promised in the future.
Derivative	A security whose value is determined by that of another, underlying security. The value of an option on a stock, for example, depends, in part, on the value of the underlying stock.
Discount rate	The interest rates on short-term loans made by the Federal Reserve to banks.
Discount window	The short-term loans made by the Federal Reserve to banks.

Term	Explanation
Equity	The difference between the value of assets and the amount borrowed; if the loan exceeds the value of the asset, the equity is zero.
Equity stripping	The repeated refinancing of a loan resulting in low or non-existent equity; the equity diminished from some combination of fees or from the borrower using the funds for other purposes.
Exploding ARM	An adjustable rate mortgage for which the interest rate increases quickly from the initial rate or rates, such that the homeowner can no longer afford the mortgage payments.
Fair value	Under FAS 157, the price that would be received in a sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If available, a quoted market price in an active market is the best evidence of fair value; if a quoted market price is not available, an estimate, using the assumptions market participants would use in pricing the asset or liability, is made.
FAS 157	Financial Accounting Standard number 157, which took effect beginning with fiscal years ending after November 15, 2007, defines and establishes an approach for measuring fair value in financial reports. It does not extend fair value measurement beyond what is already required under other accounting pronouncements.
Federal funds rate	The interest rate for interbank lending.
FICO score	A specific credit score – determined by the Fair Isaac Corporation -- that reflects a borrower’s credit worthiness. The score ranges from 300 to 850, with the higher score indicating more creditworthiness.
Fiduciary responsibility	The legal duty of responsibility of one party (the agent) to another party (the principal).
Flipping	The practice of buying real estate as a short-term investment, with the expectation of selling property at ever-increasing prices.
Glass-Steagall Act	The 1933 law, and its subsequent amendments, that prohibited commercial banks, insurance companies, and investment banks from entering in to each others’ line of business. Repealed in 1999.
Government sponsored entity (GSE)	An entity that is neither part of the private or public sector, but rather is a quasi-governmental entity that has capital stock, privately held, but has the ability to make loans and have an implicit federal guarantee for its borrowing. Examples: Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Agricultural Mortgage Corporation (Farmer Mac), Federal Home Loan Bank System, and the Farm Credit System.
GSE	See <i>Government sponsored entity</i>
Hedge fund	A private investment fund, accessible to only those individuals who qualify as accredited investors, that may or may not participate in hedging activities to modify its risk. In general, hedge funds tend not to hedge but rather take on excessive risk (a.k.a. bets) regarding both liquid and illiquid investments. Hedge fund managers typically earn performance fees in the range of 35%-50%.
Hedging	An investment intended to reduce or eliminate the risk associated with another investment.
HEL	See <i>Home equity loan</i> .
Home equity loan (HEL)	A loan for which the collateral of the loan is a home.
Investment banker	An intermediary that facilitates the raising of funds by companies and government entities.
Jingle mail	House keys left by homeowners who “walk away” (that is, default) from a home and its mortgage.
Level III assets	Investments for which there are no readily available market values and whose fair values are estimated using a majority of inputs which cannot be observed in the market (e.g., default assumptions, prepayment assumptions, and expected cash flows.) At the present time, the majority of, if not all, subprime mortgage backed securities fall in to this category.
Leverage	In the context of capital structure, the use of borrowed funds to finance an investment.
Liar loans	Loans made to borrowers who self-report inflated income in order to qualify for the loan. Also includes loans in which the lender inflated the borrower’s income.

Term	Explanation
LIBOR	See <i>London Interbank Offered Rate</i>
Liquidity	The ease at which something can be bought or sold.
Loan-to-value (LTV) ratio	The ratio of the loan amount to the value of the underlying asset of the loan. In the case of a home mortgage, this is the ratio of the outstanding principal amount on the mortgage to the value of the home.
London Interbank Offered Rate (LIBOR)	A benchmark interest rate that is the rate used in inter-bank lending of unsecured funds.
LTV	See <i>Loan to value ratio</i> .
Mark to market	The accounting method in which an asset or liability is valued and reported at its current market value. This may result in unrealized gains or losses reported in earnings.
MBS	See <i>Mortgage-backed security</i> .
Moral hazard	The conflict that arises when a safety net, such as governmental backing, encourages risky behavior.
Mortgage broker	A party who sells (that is, arranges or originates) a loan secured by a home, acting as an intermediary between the borrower and the financial institution that lends the funds.
Mortgage originator	The party employed by a mortgage lender or mortgage broker, who arranges for a loan secured by a home.
Mortgage-backed security (MBS)	An asset-backed security in which the underlying is a pool of mortgage loans, and investors receive a claim on the income and /or principal repayment of these mortgages.
NINJA	A loan that does not require an income, employment, or assets: No Income, No Job, and no Assets. NINJA loans only require a credit score and a pulse; though, in some cases, the loans were made without the latter.
Off-balance sheet	Any account – asset, liability or equity – that does not appear in a company’s financial statements.
Off-balance sheet entity	An entity whose assets and liabilities are not reported on the consolidated balance sheet of its parent or sponsor. Used by Enron to hide debts; the majority of mortgage securitizations are structured so that the seller (transferor) of the mortgages does not have to record the mortgages, or the related liabilities to the investors in the securitized mortgages, on their consolidated financial statements.
Option ARM	A loan with an adjustable interest rate that provides the borrower the choice of how much of a payment to make (such as just the interest), rather than pay the amortized payment that includes both interest and principal.
Pick-a-payment mortgage	A loan secured by a home in which the borrower has the option of paying only the interest on the loan or some amount lower than the amortized payment amount. A form of option ARM.
Prepayment penalty	A fee imposed on the borrower if payments on a loan are paid ahead of schedule, such as in the case of a mortgage refinancing. Frequently found in sub-prime and exotic mortgages but rare in prime conventional mortgages.
Prime credit	A loan to a borrower with good capacity, collateral, and credit.
Rating agency	An organization that receives a fee for the services of evaluating the credit-worthiness of a security. Examples of agencies: Moody’s, Standard & Poor’s and Fitch.
Redlining	Intentionally not lending in/to specific neighborhoods or persons.
Reset	The change of an interest rate in an adjustable rate mortgage.
Reverse redlining	Arranging complex loans for less-financially savvy borrowers.
Riding the yield curve	A strategy of investing in longer-term investments, but borrowing short-term, taking advantage of an upward sloping yield curve (that is, long-term rates are higher than short-term rates).
Securitization	The process of pooling assets together and selling interests in the income and principal of these pooled assets.
SPE	See <i>Special purpose entity</i> .

Term	Explanation
Special purpose entity (SPE)	A separate legal entity (e.g., corporate, partnership, or joint venture), created to hold specified assets.
Special purpose vehicle (SPV)	See <i>Special purpose entity</i>
Structured finance	Any process of transferring the risk of an asset to another entity.
Sub-prime credit	Credit of persons with either limited credit histories or bad credit.
Target federal funds rate	The target rate for interbank lending, established by the actions of the Federal Reserve's Open Market Committee.
Teaser rate	A low rate on an adjustable rate mortgage that is intended to entice the borrower in to the loan. The rate resets, however, after a period of time to a rate generally much higher than the initial rate.
TED spread	The difference in the interest rate on interbank loans (as represented by LIBOR) and the interest rate on U.S. Treasury bills.
Tranche	A security created in securitization – when assets such as mortgages are pooled together and securities are created that represent interests in these assets -- with specified rights to income and/or principal. Within one securitization there can be many tranches; with each tranche having a different risk/reward profile and designed to appeal to different investors. Tranches are typically categorized into three broad classes based on credit risk: senior, mezzanine, and subordinated/equity.
Transparency	The degree to which activities of a business entity and values of assets are visible to investors.
Underwater	The situation in which the homeowner owes more on the home than the home's value. In other words, the LTV is greater than one.
Upside down	See <i>Underwater</i> .

