THE FINANCIAL CRISIS
A DICTIONARY OF TERMS

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Foreword

Anyone trying to understand the financial crisis is probably grappling with the bewildering number of esoteric terms that bankers and government regulators are using to explain it.

What is a credit default swap or LIBOR or a tranche? What makes a loan subprime? What is a basis point, and how is it calculated?

The good news is you don't need to be chairman of the Federal Reserve to make sense of these terms; just use this guide, put together by the Business Law Solutions Experts at Thomson Reuters.

The Financial Crisis
A Dictionary of Terms

Across the board
Widespread stock market activity that affects most stocks in all sectors is said to be "across the board." The term comes from the large boards that stock exchanges once used to post share prices.

Adjustable-rate mortgage
A mortgage with an interest rate that changes over time. Initially the rate is fixed, but after a predetermined time the interest rate paid by the borrower adjusts in an effort to bring the rate on the borrower's mortgage in line with changing market forces.

Asset
Any item or possession that has value in a trade or exchange. The raw materials, buildings, finished goods, services and labor force owned or employed by a company or business.

Asset-backed securities
A type of security that bundles loans, credit cards, leases and other receivables. An asset-backed security is similar to a mortgage-backed security except that the assets providing the collateral are loans or receivables other than real estate or mortgages.

Auction-rate securities
Debt instruments sold through a kind of reverse auction, known as a "Dutch auction," in which the interest rate is set at the lowest rate bid by competing buyers. The interest rate may be reset every month, quarter or six months. *See Dutch auction*.

Balance sheet
Detailed list of a company's assets and liabilities and owners of shares. A balance sheet in essence showcases a company's financial position.

Balloon payment
Large additional payment of the balance due at the end of a loan or lease or at set intervals during the life of the loan. Balloon payments are most commonly used in mortgage lending and allow the borrower to pay a lower interest rate at the beginning of the loan period.

Bank holding company
A bank holding company does not actually engage in banking directly but owns banks and other affiliates that are involved in non-banking transactions such as mortgage lending and credit card operations.

Basis point
A unit of measurement equal to one-hundredth of a percentage point, used to measure very small differences in yields or interest rates. For example, the Federal Reserve Board may approve a 25-basis-point decrease in the federal funds rate to slow inflation.
See federal funds.

Bear market
Market climate in which prices decline and investor confidence falls.

Blue-chip stock
Shares or stocks of well-established companies that have a steady track record of profits, strength in management and the payment of dividends to shareholders.

Bond markets
Capital market upon which debt securities are purchased and sold.

Bond rating
Methodology used to establish the quality and level of risk associated with a bond offered by a company or government agency. Ratings range from AAA, the best possible rating, to D, representing the greatest risk.

Bull market
Market climate of rising prices and high investor confidence.

Bundling
Investment strategy that involves the grouping of various financial products or services together to sell them as a single investment unit. A mortgage-backed security is an example of bundling in which several mortgage loans have been assembled into one investment unit.

CAMELS rating system
International rating system that labels banks as high-quality institutions or less than satisfactory. The CAMELS rating system allows regulators to identify banks in need of support. The rating system reviews six factors: capital adequacy, asset quality, management quality, earnings, liquidity and sensitivity to market risk.

Capital markets
Markets in which companies and governments offer stocks or bonds for sale to raise money. The stock market and the bond market are the most widely used capital markets.

Capital Purchase Program (CPP)
Voluntary program promoted by the U.S. Treasury Department to encourage financial institutions to increase the flow of credit to consumers and businesses. Under the program, the Treasury could purchase qualifying preferred shares in financial institutions to provide them with capital to make loans.

Collateralized debt obligation (CDO)
Financial instrument that pools loans, bonds or assets into a single portfolio to be traded. An investment in a CDO is an investment in the cash flows of the pooled assets rather than a direct investment in the underlying collateral.

Collateralized mortgage obligation (CMO)
A type of collateralized debt obligation in which the pooled assets are mortgages. The mortgages are used as collateral for bonds grouped into "tranches," or slices of the pool of assets. The pools of mortgages are divided into short-, medium- and long-term portions. *See tranche*.

Commercial bank
A bank that deals in deposits and loans by large businesses and corporations. Also known as "business banking." Investment banks that deal primarily in large-scale capital market activities were once distinct from commercial banks but no longer are. Commercial banks are distinct from retail banks that mainly serve individual consumers. *See investment bank*.

Commercial paper
Short-term loans that companies take out to support their day-to-day operations and meet their liquidity needs.

Commodity Futures Trading Commission (CFTC)
Federal agency established by Congress in 1975 to monitor and regulate the trading of futures, which are bets on whether the prices of specific commodities, such as oil or corn, will go up or down at some point in the future. The CFTC in recent years has worked closely with the Securities and Exchange Commission. There is speculation the two agencies will merge into a single regulatory body.

Conservatorship
In a conservatorship, the government takes control of a bankrupt or financially troubled entity with the intention of restructuring and streamlining it. The intent is to return the entity to private ownership once improvements have been made.

Corporation
A business organization that is treated as a legal entity separate from its members and owned by shareholders. The level of ownership depends on the amount of shares owned. Shareholders elect a board of directors that in turn directs corporate affairs.

Counterparty risk
A measure of risk factored into financial arrangements that the other party (counter-party) may not meet agreed-upon obligations.

Credit crunch
Lending crisis in which banks reduce the amount of credit they will extend to each other and consumers, caused in part by concern over the availability of capital.

Credit default swap (CDS)
A contract, similar to an insurance policy, in which the buyer of the CDS makes a series of payments, like insurance premiums, to the seller and, in exchange, receives a payoff if a credit instrument, such as a bond or loan, goes into default. It is not necessary for the buyer to own the underlying credit instrument. Credit default swaps enable investors to bet on the probability that an entity will be unable to meet its financial obligations.

Credit-loss ratio
A comparison of losses associated with delinquencies and foreclosures to the overall scale of a mortgage business. The credit-loss ratio is similar to the profit-loss ratio that other business entities use to measure the health of their enterprises.

Depositary institution
A financial institution that pulls in funds through deposits by the public. Credit unions and banks are examples of depositary institutions.

Depression
Severe and prolonged economic downturn that includes high levels of unemployment, low investor confidence and slow economic activity. There is no universally accepted way to determine when a depression is occurring. Some define it as a long recessionary period in which people are forced to sell their assets to meet their day-to-day expenses.

Derivatives
Derivatives are financial contracts whose value derives from the performance of assets, interest rates, currency exchange rates or financial indexes. They include collateralized debt obligations, collateralized mortgage obligations and mortgage-backed securities and other types of asset-backed securities.

Distressed assets
Assets or financial instruments belonging to a company that is unable to meet its financial obligations. The financial instruments or assets are called "distressed" because they have suffered a substantial loss in value.

Dutch auction
An auction of an initial public offering in which the price of the offering is lowered until it receives a bid. Investors place a bid at the price they are willing to purchase a specific quantity of shares. The purchase price for all bidders on that quantity of shares is then set at the lowest successful bid above the reserve price, the price below which the IPO will not be sold.

Emergency Economic Stabilization Act of 2008
Law authorizing the U.S. Treasury to spend up to $700 billion to buy up distressed assets or purchase preferred stock in distressed companies; also referred to as the "bailout."

Equity
Shares or stock that represent ownership in a company. In relation to real estate, equity represents the difference between the existing market value of the property and the amount the owner owes on the mortgage.

Exchange-traded funds
A bundled security that tracks the performance of a specific index. Spider (SPDR) is a well-known ETF that tracks the performance of the S&P 500 index.

Fannie Mae
Created as a government entity in 1938, Fannie Mae (formally called the Federal National Mortgage Association) operates to increase the availability and affordability of home ownership to those with low to middle income. In 1968, it was rechartered by Congress as a publicly traded corporation to buy mortgages from lending institutions to hold as investments or to resell to other investors. Battered by the financial crisis, Fannie Mae was placed into federal conservatorship in September 2008.

Federal Deposit Insurance Corp. (FDIC)
Government agency responsible for insuring accounts at commercial and mutual savings banks. Traditionally the FDIC has insured accounts up to $100,000, although there is speculation that this level may increase to protect deposits by small businesses that commonly deposit more than $100,000 in one bank account to meet payrolls and other business expenses.

Federal funds
Federal funds are loans that banks borrow from other banks overnight to maintain the levels of reserves required by the Federal Reserve. A bank whose reserves have fallen below its required level of reserve may borrow from a bank that has a surplus balance. The interest rate on these one-day-only loans is called the federal funds rate.

Federal Reserve System
Regulating the U.S. monetary and financial systems, the Federal Reserve System, or "the Fed," is considered the central bank of the United States. It consists of 12 regional reserve banks governed by a seven-member board of directors that formulates banking regulations and sets monetary policy.

Financial crisis of 2008
A global economic downturn consisting of numerous elements, including a high rate of home foreclosures due to the issuance of large numbers of subprime mortgages, a slowing of credit, inflation due to high oil and food prices, and the failure of large and well-established investment and commercial banks on a global level.

Financial institution
An organization that channels its own funds toward the purchase of financial assets instead of tangible property.

Freddie Mac
Congress created Freddie Mac (formally called the Federal Home Loan Mortgage Corp.) as a private corporation in 1970 to compete with Fannie Mae as a way to make more mortgage money available for low- and moderate-income earners. Freddie Mac purchases qualified mortgages, guaranteeing their credit and offer them for sale as bonds. Like Fannie Mae, Freddie Mac was placed into conservatorship in September 2008.

Hedge fund
An unregulated investment fund catering to sophisticated investors with very large sums of money to invest. Hedge funds are known for their use of aggressive investment strategies involving short selling, derivatives and swaps.

Hedging
An investment strategy intended to reduce risk associated with pricing fluctuations. Hedging means to strategically use financial instruments in the market to minimize risk, for example, by buying two stocks, one of which will perform well when the other declines, or by offering a futures contract for the sale or purchase of commodities in the future at a set price.

Hope Now Alliance
A federation made up of the U.S. Department of Housing and Urban Development, mortgage lenders, counseling services and trade associations established in August 2007 to help homeowners avoid foreclosure. The alliance operates a 24-hour hotline where volunteers offer free counseling to homeowners.

Illiquid assets
Securities or commodities that are not easily converted into cash.

IMF
See International Monetary Fund.

Inflation
An economic climate in which the prices of goods and services rise, causing a decrease in consumers' purchasing power.

Insolvency
A situation in which a company is no longer able to meet its financial obligations to creditors or lenders.

International Monetary Fund (IMF)
An international organization of member nations that lends funds to member countries to expand international trade growth and create greater monetary cooperation among nations.

Investment bank
A financial institution involved in raising capital, facilitating merger and acquisition transactions, and trading securities.

Leverage
The ratio of debt to a company's equity. A "highly leveraged" bank or company is one that has borrowed a great deal more money than it can offset by the sale of all its assets. Buying on margin, or borrowing to invest in stocks, is a common form of leverage in the financial markets.

LIBOR
The London Interbank Offered Rate is the interest rate at which banks lend to each other. The rate is a daily reference point based on the interest rates at which banks borrow unsecured funds from banks in the London wholesale money market.

LIBOR-OIS spread
The difference obtained by subtracting the Overnight Index Swap rate from the LIBOR. The spread indicates the amount of perceived risk in the interbank lending market. Normally the two rates move up or down at the same time. A widening spread between them indicates that cash is becoming scarcer. The Fed uses the measure to assess the health of the credit market. *See Overnight Index Swap*.

Line of credit
A covenant entered into between a bank and a borrower in which the bank agrees to provide a certain amount of cash over a predetermined period. The borrower may then use the cash as needed and repay the amount borrowed at an agreed-upon interest rate.

Listed
The status of being traded on an exchange. Companies generally strive to be listed on recognized global exchanges such as the New York Stock Exchange and NASDAQ. Each exchange maintains its own listing standards. If requirements are not met, companies can be delisted. Once a company's securities are listed on an exchange, they may be purchased or traded.

Liquidity
The flow of money or capital; the degree to which an asset can be converted into cash by being bought and sold on the financial markets.

Member bank
A bank or depositary entity that is a member of the Federal Reserve. National banks are required to be members of the Federal Reserve while mutual savings banks may elect to become members.

Mortgage-backed security
A form of asset-backed security that involves the bundling of mortgage loans, which then serve as collateral and the source of dividends for the security holder.

Nationalization
The process by which a government acquires ownership of a company, industry or other privately held assets.

Office of Financial Stability
Federal office established by the Emergency Economic Stabilization Act of 2008 to oversee the government bailout of troubled financial institutions. *See Troubled Asset Relief Program (TARP)*.

Overnight Index Swap
An instrument that allows financial institutions to manage interest rate risk by swapping the interest rates they are paying on loans. The OIS rate is based on the average overnight interest institutions have paid on any given day.

Preferred stock
A class of securities offered to investors that pay dividends at a predetermined rate. Dividends on preferred stock are paid before any dividends are paid to common-stock holders. Preferred stock also takes precedence over common stock in the event of a bankruptcy or insolvency. Preferred-stock holders do not have voting rights in their shares while common-stock holders do.

Profit warning
A statement issued by a company ahead of its earnings announcement indicating that profits will not meet analysts' expectations.

Qualifying financial institution (QFI)
An institution that may participate in the Troubled Asset Relief Program (TARP). QFIs are any U.S. banks or savings associations that are not controlled by a bank holding company or a savings and loan holding company under Section 4(k) of the Bank Holding Company Act.

Recession
Large-scale decline in economic activity. Adverse drops in sales, income, production and employment levels are seen as indicators of recession. Economists commonly declare a recession when production has slowed and unemployment has risen for two consecutive quarters or six months.

Reverse auction
Auction in which the government purchases illiquid mortgage-backed or other assets from financial institutions. This type of purchase has been coined a reverse auction because the government represents a single buyer whereas in traditional auctions there are numerous buyers.

Securities and Exchange Commission (SEC)
Commission created by Congress to protect the interests of U.S. investors by regulating the securities markets in the United States. The SEC is made up of five commissioners appointed by the president. Rules and regulations administered by the SEC promote the registration of securities intended to be sold to the public and the public disclosure of materially important business information.

Securitization
The conversion of credit card debt, mortgage loans and other receivables into tradable securities.

Short selling
An investment strategy in which an individual sells shares that he does not own but has merely "borrowed" with the intent of purchasing the shares later at a lower price and profiting from the difference. Short selling is the opposite of "long selling," the normal market strategy of buying shares at a lower price and selling them at a higher price.

Solvency
The ability to continue operations and pay expenses and financial obligations on a timely basis.

Stagflation
An economic climate in which there is a lack of economic growth and high unemployment but prices continue to rise; considered to be a combination of inflation and stagnation.

Subprime crisis
Financial crisis starting in 2007 in the United States stemming from high numbers of defaulting borrowers on subprime mortgage loans. The defaults caused high rates of home foreclosures, particularly in California, Nevada, Florida and Minnesota. Lenders often "bundled" high-risk subprime mortgages with low-risk mortgages and sold the investment packages to other investors, passing on the risk. The losses on these "toxic assets" led to the 2008 global financial crisis.

Subprime loan
Loan extended to a borrower who is considered high-risk, usually at a higher or variable interest rate, called an adjustable-rate mortgage. Subprime loans are given to borrowers with poor credit ratings, usually those with a credit score of 660 or less. The score is determined by the three credit rating agencies that maintain credit information on individuals in the United States.

Subprime mortgage
Mortgage extended to high-risk borrowers with lower credit ratings. Because of the higher levels of risk associated with the mortgage, the lender charges higher interest rates.

Swap
An agreement between two parties to exchange cash streams derived from other investments, such as bonds or foreign currency. For example, a currency swap involves the exchange of principal and interest in one currency for the same in another currency. The streams of cash flow are called the "legs" of the swap. Other kinds of swaps include interest rate swaps, credit swaps, commodity swaps and equity swaps.

TARP
See Troubled Asset Relief Program.

Term auction facility
Vehicle used by the Federal Reserve to bring about greater liquidity in the financial markets. The TAF allows the Fed to auction set amounts of collateral-backed short-term loans to depositary institutions that are judged to be in sound financial condition by their local reserve banks.

Toxic assets
Securities that are considered undesirable because of excessive risk or unfavorable provisions that make them illiquid.

Tranche
From the French for "slice," it refers to securities that can be sliced up and sold in smaller pieces. In a collateralized mortgage obligation or collateralized debt obligation, each tranche has a defined level of risk. A tranche consists of loans with specific characteristics, including interest rates, maturity and priority of principal repayment.

Treasuries
Securities sold by the government to investors; includes Treasury bills, Treasury bonds and Treasury notes. Treasuries are viewed as safe investments because they carry the full backing of the government.

Treasury bills
Short-term debt instruments of the U.S. government that mature, or become due for payment, in less than one year.

Treasury bonds
Long-term U.S. Treasury securities with a maturity of more than 10 years. The securities pay semiannual interest with the principal being payable at maturity.

Treasury notes
Intermediate-term U.S. Treasury securities maturing in one to 10 years. The securities pay semiannual interest with the principal being payable at maturity.

Troubled Assets Insurance Financing Fund
Fund created as part of the Emergency Economic Stabilization Act of 2008 to hold insurance premiums paid to, and fulfill claims made under, the Troubled Asset Relief Program.

Troubled Asset Relief Program (TARP)
Fundamental component of the Emergency Economic Stabilization Act of 2008 that gives the U.S. Treasury secretary the broad authority to purchase troubled assets and to make loans to, and purchase preferred stock in, foundering companies. It authorizes the secretary to carry out other kinds of financial dealings as part of the government's $700 billion bailout of the financial market.

Variable rate
An interest rate that potentially fluctuates over the life of a loan. Any fluctuations cause changes in payments of the loan or the length of the loan.

World Bank
International banking organization that aids international economic development. The bank obtains funding for operations through the sale of bonds in world financial markets. Unlike the International Monetary Fund (IMF), whose focus is on developing international trade, the World Bank seeks to build a climate of investment in developing nations by stimulating the growth of national infrastructure and establishing financial systems.

Write-down
Accounting action taken by companies when assets or securities they hold fall in value. A write-down is the reduction on the asset side of the balance sheet.

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