

Glossary¹

Key terms used in the financial crisis 2008

Asset-backed security (ABS): A security whose payments are backed by a pool of assets such as home loans, auto loans and credit card receivables.

Bailout: The financial rescue of a faltering business or other organization i.e. an injection of liquidity given to an insolvent or nearly insolvent entity in order for it to meet its short-term obligations.

Basel II requirements: Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision (see below). The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

Collateralized Debt Obligation (CDO): A structured debt instrument that securitizes securities such as bonds, loans, ABSs or CDSs. CDOs break up into various tranches, with senior tranches offering the least return for little risk, and the bottom tranches offering high return for taking the most risk to borrowers in the portfolio defaulting on their debt.

Credit crunch: A state in which there is a short supply of cash to lend to businesses and consumers and interest rates are high.

Credit default swaps (CDS): The most common credit derivative, which is used to protect against a borrower defaulting on its debt. A CDS is a bilateral contract under which two counterparties agree to isolate and separately trade the credit risk of at least one third-party reference entity. Under a CDS agreement, a protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a credit.

Credit rating agencies (CRA): A company that assigns credit ratings for issuers of certain types of debt obligations. In most cases, these issuers are companies, cities, non-profit organizations, or national governments issuing debt-like securities that can be traded on a secondary market. A credit rating measures credit worthiness, the ability to pay back a loan, and affects the interest rate applied to loans. (A company that issues credit scores for individual credit-worthiness is generally called a **credit bureau** or **consumer credit reporting agency**.)

Financialization: A term sometimes used in discussions of a form of capitalism which developed over several decades leading up to the 2007-2008 financial crisis, and in which financial leverage (see below) and exotic financial instruments tended to override capital (equity) and financial markets tended to dominate over the real economy.

Leveraged buyout (LBO): Occurs when a group of investors using primarily borrowed money, often raised with high yield bonds or other types of debt, takes control of a company by acquiring a majority interest in its outstanding stock. (see also leverage and leveraged effect below)

Mortgage-backed security (MBS): A type of ABS that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Off balance sheet (OBS): An asset or debt or financing activity not on the company's balance sheet
→ **Off-balance sheet entities:** Separate legal entities established so that companies could finance business ventures by transferring the risk of these ventures from the parent to the OBS subsidiary

Package loan: A real estate loan used to finance the purchase of both real property and personal property, such as in the purchase of a new home that includes carpeting, window coverings and major appliances.

¹ Most of definitions are taken from: <http://financial-dictionary.thefreedictionary.com/> and <http://derivativesdiary.com/glossary/s.html>

Subprime lending (also called B-paper, near-prime, or second chance lending): The practice of making loans to borrowers who do not qualify for the best market interest rates because of their deficient credit history. It is risky for both lenders and borrowers due to the combination of high interest rates, poor credit history, and adverse financial situations usually associated with subprime applicants. A subprime loan is offered at a rate higher than A-paper loans due to the increased risk. Subprime lending encompasses a variety of credit instruments, including subprime mortgages, subprime car loans, and subprime credit cards, among others. The term "subprime" refers to the credit status of the borrower (being less than ideal), not the interest rate on the loan itself.

Structured finance: A broad term used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities.

Other useful definitions and abbreviations²:

Absolute returns: The return that an asset achieves over a period of time. This measure simply looks at the appreciation or depreciation (expressed as a percentage) that an asset – usually a stock or a mutual fund – faces over a period of time. Absolute return differs from relative return because it is concerned with the return of the asset being looked at and does not compare it to any other measure. Absolute return funds look to make positive returns whether the overall market is up or down, while index tracking funds try to beat the index they are tracking.

Alternative investments: Usually refers to investments in hedge funds. Many hedge funds pursue strategies that are uncommon relative to mutual funds. Examples of alternative investment strategies are: long–short equity, event driven, statistical arbitrage, fixed income arbitrage, convertible arbitrage, short bias, global macro, and equity market neutral.

AMF: Autorité des marchés financiers, French Securities supervisor

Asset stripping: Asset stripping is the practice of buying a company in order to sell its assets individually at a profit.

Attrition: The reduction in staff and employees in a company through normal means, such as retirement and resignation. This is natural in any business and industry.

Bafin: German securities supervisor

Basel Committee: The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year. Its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), and representatives from Luxembourg and Spain. It usually meets at the Bank for International Settlements in Basel, where its 12 member permanent Secretariat is located. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision (see bank regulation or Basel II, for example) in the expectation that member authorities and other nation's authorities will take steps to implement them through their own national systems, whether in statutory form or otherwise.

BIS: Bank for International Settlements

Bond: A debt investment with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.

Carried interest: A bonus entitlement accruing to an investment fund manager company or individual members of the fund management team. Carried interest (typically up to 20% of the profits of the fund) are payable once the investor have achieved repayment of their original investment in the fund plus a defined hurdle rate.

² Mainly from *Hedge Funds and Private Equity. A Critical Analysis*. Party of European Socialists: Van den Burg, Ieke; Rasmussen, Poul Nystrup; Brussels, 2007: 243-248

CESR: Committee of European Securities Regulators

Derivatives: Security, such as an option or futures contract, whose value depends on the performance of an underlying security or asset. Futures contracts, forward contracts, options, and swaps are the most common types of derivatives. Derivatives are generally used by institutional investors to increase overall portfolio return or to hedge portfolio risk.

Dividend: Distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. The amount of a dividend is quoted in the amount each share receives or in other words dividends per share.

EBITDA: Earnings Before Interest, Taxes, Depreciation, and Amortization. An indicator of a company's financial performance calculated as: Revenue – Expenses (excluding tax, interest, depreciation, and amortization). EBITDA can be used to analyze the profitability between companies and industries, because it eliminates the effects of financing and accounting decisions.

ECB: European Central Bank

Emerging markets: The financial markets of developing economies or industries.

Equities: A type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. There are two main types of stock: common and preferred. Common stock usually entitles the owner the right to vote at shareholder meetings and to receive dividends that the company has declared. Preferred stock generally does not have voting rights, but has a higher claim on assets and earnings than the common shares. For example, owners of preferred stock receive dividends before common shareholders and have priority in the event a company goes bankrupt and is liquidated.

FED (also the Federal Reserve; informally The Fed): The FED is the central banking system of the United States. The Federal Reserve System is a quasi-governmental banking system composed of (1) a presidentially-appointed Board of Governors of the Federal Reserve System in Washington, D.C.; (2) the Federal Open Market Committee; (3) twelve regional Federal Reserve Banks located in major cities throughout the nation; and (4) numerous private member banks, which own varying amounts of stock in the regional Federal Reserve Banks.

Foreign exchange (FOREX): Any type of financial instrument that is used to make payments between countries is considered foreign exchange. The list of instruments includes electronic transactions, paper currency, checks, and signed, written orders called bills of exchange.

Futures: A financial contract that obligates the buyer (seller) to purchase (sell and deliver) financial instruments or physical commodities at a future date, unless the holder's position is closed prior to expiration. Futures are often used by mutual funds and large institutions to hedge their positions when the markets are rocky, preventing large losses in value. The primary difference between options and futures is that options provide the holder the right to buy or sell the underlying asset at expiration, while futures contracts holders are obligated to fulfil the terms of their contract.

FSA: Financial Services Authority, UK

Hedge fund: Fund whose manager receive performance-related fees and can freely use various active investment strategies to achieve positive absolute returns, involving any combination of leverage, long and short positions in securities or any other assets in a wide range of markets.

Hurdle rate: A rate of return that must be achieved before the manager becomes entitled to carried interest payments from a fund.

Hostile takeover: A takeover attempt that is strongly resisted by the target firm.

Info ratio statistics: The Information Ratio is a commonly used statistic by the long only industry's (UCITS) practitioners in order to measure the efficiency of an investment policy, considering not only the excess of return versus the adopted benchmark, but also the risk assumed against it. Under a purely technical viewpoint the Information Ratio is the ratio between the annualized excess of return over the benchmark attained by the manager along a given timeframe and the fund's Tracking Error.

IMF: International Monetary Fund

Institutional investors: A non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions. Institutional investors face less protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves.

Investment vehicle: This term is used very broadly. It refers to anyplace you can put your money. For example: stocks, bonds, mutual funds, options, futures, etc. You'll often hear it used in sentences like this: Mutual funds are a good investment vehicle for beginning investors who aren't confident enough to pick stocks themselves.

IOSCO: The International Organization of Securities Commissions

IPO (initial public offering): A company's first sale of stock to the public. Securities offered in an IPO are often, but not always, those of young, small companies seeking outside equity capital and a public market for their stock. Investors purchasing stock in IPOs generally must be prepared to accept considerable risks for the possibility of large gains. IPOs by investment companies (closed-end funds) usually include underwriting fees that represent a load to buyers.

Leverage: Leverage is generally considered to exist when: (a) an institution's financial assets exceed its capital; (b) an institution is exposed to the change in value of a position beyond the amount, if any, initially paid for the position; (c) an institution owns a position with "embedded leverage", i.e. a position with a price volatility exceeding that of the underlying market factor.

Leverage effect: The leverage effect explains a company's return on equity in terms of its return on capital employed and cost of debt. The leverage effect is the difference between return on equity and return on capital employed. Leverage effect explains how it is possible for a company to deliver a return on equity exceeding the rate of return on all the capital invested in the business, i.e. its return on capital employed. When a company raises debt and invests the funds it has borrowed in its industrial and commercial activities, it generates operating profit that normally exceeds the interest expense due on its borrowings. The company generates a surplus consisting of the difference between the return on capital employed and the cost of debt related to the borrowing. This surplus is attributable to shareholders and is added to shareholders' equity. The leverage effect of debt thus increases the return on equity. If the return on capital employed falls below the cost of debt, then the leverage effect of debt shifts into reverse and reduces the return on equity, which in turn falls below return on capital employed.

Limited partners: Limited partners or investors are the private suppliers of capital for private equity or venture capital funds. Most limited partners are pension funds, banks, insurance companies, and funds of funds. A limited partner is a member of a partnership whose only financial risk is the amount he or she has invested.

Liquidity: The ability to convert an asset to cash quickly. It is safer to invest in liquid assets than illiquid ones because it is easier for you to get your money out of the investment. Examples of assets that are easily converted into cash include blue chip and money market securities. Also known as "marketability".

Management fee: Compensation received by a private equity fund manager company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.

MiFID: The Markets in Financial Instruments Directive – MiFID. With the Directives a single market and regulatory regime for investment services across the 25 member states of the European Union was introduced. The key objectives behind the Directive are threefold: 1) to complete the EU single market for investment services and 2) to respond to changes/innovations in the securities markets and 3) to protect investors.

Mutual fund: A security that gives small investors access to a well-diversified portfolio of equities, bonds and other securities. Each shareholder participates in the gain or loss of the fund. Shares are issued and can be redeemed as needed.

Merger: The combining of two or more companies, generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock.

Offshore: Located or based outside of one's national boundaries. The term offshore is used to describe foreign banks, corporations, investments, and deposits. A company may move offshore for the purpose of tax avoidance or relaxed regulations.

Prime brokerage: A special group of services that many brokerages give to special clients. The services provided under prime brokering are securities lending, leveraged trade executions, and cash management, among other things. Prime brokerage services are provided by most of the large brokers, such as Goldman Sachs, Paine Webber, and Morgan Stanley Dean Witter.

Private equity fund: A private equity investment fund is a vehicle for enabling pool investment by a number of investors in equity and equity-related securities of companies. They are generally private companies whose shares are not quoted on a stock exchange. The fund can take either the form of a company or of an unincorporated arrangement such as a Limited partnership.

Recapitalisation: Restructuring a company's debt and equity mixture often with the aim of making a company's capital structure more stable.

Ricardian equivalence (also known as Barro-Ricardo equivalence proposition or Ricardian rent): An economic theory which suggests that government budget deficits do not affect the total level of demand in an economy. It was proposed, and then rejected, by the 19th century economist David Ricardo.

Shareholder value: Refer to the concept that the primary goal for a company is to enrich its shareholders (owners) by paying dividends and/or causing the stock price to increase.

SEC (Securities & Exchange Commission): A federal agency that regulates the US financial markets. The SEC also oversees the securities industry and promotes full disclosure in order to protect the investing public against malpractice in the securities markets.

Short Selling: The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short. Selling short is the opposite of going long. That is, short sellers make money if the stock goes down in price.

Stock option: An individual's right to purchase a share at a fixed price. Stock options are a widely used form of employee incentive and compensation. The employee is given an option to purchase shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.

Stress test: A simulation technique used on asset and liability portfolios to determine their reactions to different financial situations. Stress-testing is a useful method of determining how a portfolio will fare during a period of financial crisis. The Monte Carlo simulation is one of the most widely used methods of stress testing.

Systemic risks: Risk common to a particular sector or country. Often refers to a risk resulting from a particular "system" that is in place, such as the regulator framework for monitoring of financial institutions.

Tax transparency: A fund structure or a vehicle is transparent when the fund itself is not subject to taxation and the investment in an underlying company is treated as if it would be a direct investment for the initial investor (the limited partner) who is taxed only when the investment structure distributes its gains and revenues.

Tracking error: The Tracking Error is a commonly used statistic by the long only industry's (UCITS) practitioners in order to measure the volatility of a portfolio / fund versus its benchmark. Under a purely technical viewpoint the Tracking Error is the annualized standard deviation of the difference between the periodic returns of a portfolio and those of its benchmark on a given timeframe.

UCIT: Undertakings for the Collective Investment of Transferable Securities – UCITS. A public limited company that coordinates the distribution and management of unit trusts amongst countries within the European Union.

Venture Capital: Financing for new businesses. In other words, money provided by investors to start-up firms and small businesses with perceived, long-term growth potential. This is a very important source of funding for start-ups that do not have access to capital markets and typically entails high risk for the investor but has the potential for above-average returns.

VaR model: Value at Risk model. Procedure for estimating the probability of portfolio losses exceeding some specified proportion based on a statistical analysis of historical market price trends, correlations, and volatilities.