Glossary of Financial Crisis Terms

(Revised April 2011)

A

Adjustable-rate mortgage (ARM)

A mortgage that permits the lender to periodically adjust the interest rate on the basis of changes in a specified index.

Agency debt or agency security

A bond or other debt obligation that is issued or guaranteed by a federal agency or ***government sponsored enterprise,*** (government sponsored enterprises include Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Federal Farm Credit Banks). Federal agencies and GSEs are chartered by Congress and are subject to close supervision by a U.S. government entity, but their debt is generally *not* backed by the U.S. government. Two exceptions are Government National Mortgage Association (GNMA) debt and Small Business Administration (SBA) debt, both of which *are* backed by the full faith and credit of the U.S. government.

Alt-A (Alternative A) mortgage

A mortgage granted with liberal underwriting criteria. The liberal criteria may include reduced documentation, a low down payment, or non-owner occupied property as the security for the loan.

Asset-backed commercial paper (ABCP)

Short-term debt that has a fixed maturity of less than 270 days. The debt is backed by some financial asset, such as trade receivables, consumer debt receivables, or auto and equipment loans or leases. A firm that wants to issue ABCP may sell some of its assets to a ***special purpose vehicle (SPV)*** to issue the ABCP. The SPV, which is typically created by a bank or other financial company, is a legally separate entity from the firm.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)

One of the special lending facilities set up by the Federal Reserve in 2008. The AMLF was established at the Boston Fed to assist money funds to meet the demand for redemptions and to foster liquidity in the ABCP market and money markets generally. The facility provided funding to U.S. depository institutions and bank holding companies to finance their purchase of high-quality ABCP from money market mutual funds. The AMLF was closed on February 1, 2010.

Asset-backed security (ABS)

A debt instrument that is collateralized by specific financial assets that generate the cash flow used to service the debt instrument. Asset-backed securities are normally marketable – that is, transferable to third parties in market transactions.

B

Bank holding company

A company that has control over any bank, or over any company that becomes a bank, as “bank” and “control” are defined in the Bank Holding Company Act of 1956. The Federal Reserve is responsible for supervising bank holding companies even if the bank that the company controls is under the primary supervision of a different federal agency.

Bankruptcy

A statutory procedure, usually triggered by ***insolvency***, by which a person is relieved of most debts and undergoes a judicially supervised reorganization or liquidation for the benefit of that person's creditors. Chapter 11 of the Bankruptcy Code provides for debtor rehabilitation – the court approves a plan of reorganization to keep the debtor's business alive and pay creditors over time.

Board of Governors of the Federal Reserve System (Board)

Federal government agency that is the governing body of the Federal Reserve System. Supported by a staff of about 2,000, the Board is composed of seven members ("Governors"), who are appointed by the President and confirmed by the Senate. Board members have responsibility for the conduct of U.S. monetary policy, a responsibility they carry out as members of the ***Federal Open Market Committee***. The Board also supervises the Federal Reserve Banks. In addition, the Board shares with the Reserve Banks responsibility for supervising and regulating certain financial institutions and activities, has broad responsibilities in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection.

C

Capital (banking)

The money that a bank "owns" as opposed to money that the bank has borrowed and has to pay back. Capital represents the funds invested in a bank that are available to absorb loan losses or other problems and therefore protect the bank's depositors and debt holders. Capital includes all equity and some debt that may be very long term or convertible to equity. Bank regulators generally classify capital into two tiers according to the potential ability for loss absorption: Tier 1 capital, which can absorb losses while a bank continues operating, and Tier 2 capital, which may be of limited life and require payment of interest or have other characteristics of borrowed money.

Capital ratio (banking)

Total assets minus total liabilities as a percentage of total assets. This ratio can be defined in various ways depending on what is counted as capital, assets, and liabilities.

Capital Purchase Program

A program established by the U.S. Treasury Department in October 2008 to purchase up to $250 billion in capital stock in eligible financial institutions as part of the $700 billion Troubled Asset Relief Program (TARP). Some 52 institutions participated in the program.

Certificate of deposit (CD)

A time deposit in a financial institution with a specific maturity date. The deposit is "small" if it is less than $100,000 and "large" if it is over this amount (until October 3, 2008, $100,000 was the maximum insured amount for federal deposit insurance). A separate category of CDs is large-denomination CDs ("negotiable CDs"). These are typically issued in amounts of $1 million to $5 million and can be sold but not redeemed before maturity.

Collateral

An asset that is pledged as security against an obligation, such as a loan of money or an insurance guarantee. The property is subject to a security interest under Article 9 of the Uniform Commercial Code. The borrower risks losing the asset if the terms of the security agreement are not met.

Collateralized debt obligation (CDO)

A ***special purpose entity*** set up to own a pool of securities or loans, divide the pool's cash flows into ***tranches*** based on risk, and sell investors bonds that represent an interest in a particular tranche. The securities may be mortgage-backed securities or other similar securities. The tranches are designed to redistribute the risk of ***default.*** "Senior" tranches are considered the safest. Interest and principal payments are generally made in order of seniority, so that junior tranches offer higher coupon payments to compensate for additional default risk. CDOs are a type of ***structured debt*****.**

CDO squared or CDO^2

A collateralized debt obligation that is collateralized by other CDOs.

Collateralized mortgage obligation (CMO)

A ***special purpose entity*** set up to own a pool of mortgage-backed securities (whole mortgages are sometimes used), divide the pool's cash flows into ***tranches*** based on risk, and sell investors bonds that represent an interest in a particular tranche. The tranches are designed to redistribute prepayment risk – the risk that the bond holder will find principal being paid back as interest rates fall and mortgage holders choose to refinance into lower rates. Other types of risk, such as the credit risk in non-agency securities, may also be addressed. CMOs are a type of ***structured debt***.

Commercial paper

A short-term, unsecured promissory note issued by a large bank or corporation or a foreign government. For commercial paper issued in the United States, maturities range up to 270 days, but the average maturity is much shorter. European commercial paper may be issued for up to one year, but again, the average maturity is much shorter. As the note is backed only by the issuer's promise to pay, only firms with good credit ratings are able to issue unsecured commercial paper. (See also ***asset-backed commercial paper***.)

Commercial Paper Funding Facility (CPFF)

One of the special lending facilities set up by the Federal Reserve in 2008. The CPFF was created to provide funding for the purchase of unsecured and asset-backed commercial paper directly from eligible issuers. The CPFF was closed on February 1, 2010.

Conforming loan

Loan eligible for sale to Freddie Mac or Fannie Mae because the original mortgage amount does not exceed a dollar threshold that is adjusted annually. In 2010, for example, the conforming-loan limit for a one-family home is $417,000. Higher limits apply in high-cost areas and to multi-unit properties.

Conservatorship

The legal process (for entities that are not eligible for bankruptcy court reorganization) in which a person or entity is appointed to establish control and oversight of a company to run the company as a going concern and put it in a sound and solvent condition or ultimately manage it to receivership. The powers of the company's directors, officers, and shareholders are transferred to the designated conservator.

Credit default swap (CDS)
In effect, an insurance contract. The buyer of the swap makes periodic payments to the seller of the swap in return for protection against a possible "credit event" affecting the value of a specified asset. The seller agrees to buy the specified asset from the buyer at par in the event of a credit default. The asset is typically some type of security, such as a corporate bond, CDO, or mortgage-backed security. Neither the buyer nor the seller typically owns the security – i.e., credit default swaps are ***derivatives***. (Sometimes the buyer may own the security as part of other activities and may therefore enter into the CDS as a ***hedge***.) Various "credit events" might trigger the buyer's protection: missed payments to owners of the security, a downgrading of the security's credit rating, a downgrading of the seller's own credit rating. When the protection is triggered, the seller compensates the buyer. To compensate for a decline in the security's market value, the seller may deliver collateral to the buyer in the amount of the decline. The seller may also close out the swap by paying full par value to buy the reduced-value security (or its equivalent) from the buyer. Parties and counterparties can disagree as to the amount of the decline in the value of the security and the compensation that is due.

Credit rating agency
A company that rates the quality of bonds and other financial securities. The rating gives a lender or investor an indication of the probability that the issuer of the bond or other security will be able to pay back the borrowed funds – that is, the rating assesses the probability of ***default***. A poor credit rating indicates a high risk of default, thus leading the lender or investor to charge a higher interest rate or refuse to make the transaction. Well-known rating agencies include Moody's, Standard & Poor's, and Fitch Ratings. Credit rating agencies must meet standards established by the Securities and Exchange Commission.

D

Default
The omission or failure to perform a legal or contractual duty such as to satisfy the terms of a loan agreement.

Derivatives
A way of investing in a particular product or security without having to own it. The investment is a financial contract that derives its value from an underlying product or security, but the investor does not actually own the linked asset. The value of the derivative depends on what happens to some attribute of the linked asset: the price of a commodity, the interest rate on a security, the price of a stock, the amount of rain in some location, the risk that a borrower will default on a loan. Futures, options, and credit default swaps are examples of derivatives.

Discount rate
The interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's "discount window." There are three discount window programs: primary credit, secondary credit, and seasonal credit, each with its own interest rate. Because primary credit is the main program, the term "discount rate" is often used to mean the primary credit rate. Discount rates are established by each Reserve Bank's board of directors, subject to the review and determination of the Board of Governors. The rates for the three lending programs are the same across all Reserve Banks except on days around a change in the rate. All discount window loans are fully secured.

E

Excess reserves

Funds held by a depository institution in its account at a Federal Reserve Bank in excess of its required reserve balance and its contractual clearing balance.

F

Fannie Mae

A ***government sponsored enterprise*** (GSE) chartered by Congress in 1938 to improve the availability and cost of funds for housing. Like Freddie Mac, Fannie Mae buys mortgages in the ***secondary mortgage market***, pools them, and sells them as mortgage-backed securities to investors. Fannie Mae and Freddie Mac also own large portfolios of their own of mortgages and mortgage-backed securities. Initially chartered as a federal agency, Fannie Mae was re-chartered in 1968 as a private company with shareholders. In September 2008, facing ***insolvency***, it was taken over by the federal government and placed into ***conservatorship***. The original legal name for Fannie Mae was Federal National Mortgage Association.

Federal Deposit Insurance Corporation (FDIC)

An independent federal agency created in 1933 to provide federal insurance of bank deposits. When a bank or thrift institution fails, the FDIC steps in to give insured depositors access to their money and to limit spillover effects on the economy and financial system. The FDIC is funded by the premiums that banks and thrift institutions pay for deposit insurance coverage and by earnings on its investments in U.S. Treasury securities. Besides its insurance responsibilities, the FDIC is the primary federal regulator of state-chartered banks that are not members of the Federal Reserve. The FDIC regularly monitors the potential risks at all insured institutions, not just those for which it is the primary federal regulator.

Federal deposit insurance

Federal insurance of deposits at an insured bank or thrift. The insurance is provided by the Federal Deposit Insurance Corporation (FDIC) and is backed by the full faith and credit of the U.S. government. Currently, the standard maximum deposit insurance amount (SMDIA) is $250,000 per depositor. The maximum was raised to this level on October 3, 2008. It is scheduled to revert to $100,000 on January 1, 2014. FDIC insurance does not cover other financial products and services that a bank may offer, such as stocks, bonds, mutual fund shares, and life insurance policies.

Federal funds rate

The interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions, usually overnight. Depository institutions are required by law to maintain a certain level of vault cash and reserves with the Fed. They sometimes borrow from each other to maintain the required level of reserves. The interest rate that a borrowing bank pays to a lending bank is negotiated between the two banks; the weighted average of this rate across all such transactions is the *federal funds effective rate*. In its monetary policy deliberations, the ***Federal Open Market Committee*** sets a *federal funds target rate* that it believes will result in the money supply and credit conditions that it wants to achieve for the economy. The FOMC then uses ***open market operations*** to inject or pull out reserve balances as needed to achieve the target rate and the monetary and credit conditions that are desired.

Federal Home Loan Banks
A system of 12 regional banks chartered by Congress in 1932 to promote a healthy home finance system. As ***government sponsored enterprises*** (GSEs), the banks borrow on a joint basis in the nation's credit markets and in turn lend to their member institutions to help members meet liquidity needs and have funds to lend in their communities. The Federal Home Loan Banks are owned by their member institutions, which today include commercial banks and credit unions, as well as thrift institutions, the original category of members. Thrift institutions include S&Ls, savings banks, and cooperative banks.

Federal Housing Administration (FHA)
An agency within the U.S. Department of Housing and Urban Development (HUD) that insures mortgages and loans made by private lenders.

Federal Housing Finance Agency (FHFA)
An independent federal agency that regulates the 12 Federal Home Loan Banks, Fannie Mae, and Freddie Mac. It is the successor to the Federal Housing Finance Board (itself the successor to the Federal Home Loan Bank Board) and the Office of Federal Housing Enterprise Oversight (OFHEO). FHFA is the agency that put Fannie Mae and Freddie Mac into conservatorship in October 2008.

Federal Open Market Committee (FOMC)
The entity within the Federal Reserve System responsible for directing U.S. monetary policy. Created pursuant to the Banking Acts of 1933 and 1935, the FOMC consists of 12 voting members: the seven Governors of the Federal Reserve Board; the president of the Federal Reserve Bank of New York; and, on a rotating basis, the presidents of four other Reserve Banks. Nonvoting Reserve Bank presidents also participate in FOMC discussions. The FOMC generally meets eight times per year to set the nation's monetary policy. It also establishes policy relating to System operations in the foreign exchange markets.

Federal Reserve Act
Federal legislation, enacted in 1913, that established the Federal Reserve System.

Federal Trade Commission (FTC)
Independent federal agency established in 1914 to promote consumer protection and prevent harmful anti-competitive business practices. The FTC is charged with (1) protecting consumers against unfair or deceptive acts or practices in commerce, and (2) eliminating and preventing "anticompetitive" business practices. Along with the Federal Reserve, the FTC is the primary rule writer for federal consumer protection legislation.

FICO credit score
A number representing the likelihood that a person will pay his or her debts. FICO stands for Fair Isaac Corporation, the company that developed the most widely used credit scoring model. The three major U.S. consumer credit report agencies, Equifax, Experian, and TransUnion, collect data about consumers' payment practices when paying on credit. The agencies then use the FICO modeling software to assess credit worthiness and derive a credit, or FICO, score. Each individual actually has three credit scores at any given time because the three credit agencies have their own databases, gather reports from different creditors, and receive information from creditors at different times. The agencies sell the FICO scores to lenders. FICO scores vary, but are generally between 500 and 850. FICO scores between 700 and 850 indicate that a borrower is very likely to repay loans and other debts. FICO scores lower than 600 indicate that a borrower may not be a good credit risk. Lenders may deny credit, charge a higher interest rate, demand more collateral, or require extensive income and asset verification if an applicant's FICO score is low. Better terms may be offered to applicants with higher FICO scores.

Fixed-rate mortgage (FRM)
A mortgage loan in which the interest rate does not change during the entire term of the loan.

Foreclosure
The legal process by which a property that is mortgaged as security for a loan may be sold and the proceeds of the sale applied to the mortgage debt. A foreclosure can occur when the borrower fails to comply with the terms of the loan; typically, the borrower fails to make timely loan payments.

Freddie Mac
A ***government sponsored enterprise*** (GSE) chartered by Congress in 1970 to provide competition for the newly privatized Fannie Mae. Like Fannie Mae, Freddie Mac buys mortgages in the ***secondary mortgage market***, pools them, and sells them as mortgage-backed securities to investors. Freddie Mac and Fannie Mae also own large portfolios of their own of mortgages and mortgage-backed securities. Initially owned by the Federal Home Loan Banks and their member institutions, Freddie Mac was made a listed public company in 1989. Facing ***insolvency***, Freddie Mac was put into ***conservatorship*** by the U.S. government in September 2008. The original legal name for Freddie Mac was Federal Home Loan Mortgage Corporation.

G

Government-sponsored enterprise (GSE)
A financial services corporation chartered by Congress for the public policy purpose of improving the availability of, and reducing the cost of, credit to a specific borrowing sector of the economy. GSEs targeting home finance include the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. The Federal Farm Credit Banks target agriculture. Sallie Mae was set up as a GSE to target education, although it became fully privatized and gave up its government sponsorship in 2004. The GSEs are private companies with a limited charter of activities mandated by Congress. Their securities are not backed by the full faith and credit of the federal government, although investors have always assumed there was an implicit guarantee that the government would not allow a GSE to default on its debt. In September 2008, this implicit guarantee was recognized, when Fannie Mae and Freddie Mac were taken over and put into ***conservatorship***.

H

Haircut
The difference between the market value of a security and the amount of money a lender will advance against it. The haircut serves as the borrower's equity in the transaction and acts as a buffer for absorbing any decline in the collateral's value in the event the loan is not repaid. (See also ***margin***.)

Hedge fund
Generally, any private investment fund with a large, unregulated pool of capital and very experienced investors. There is no precise legal definition of "hedge fund." Hedge funds solicit investors privately and are not widely available to the public. They pursue a variety of sophisticated investment strategies to maximize returns, which may include ***hedging***, ***leveraging***, and ***derivatives*** trading.

Hedging
Making an investment or entering into a contractual arrangement to reduce the risk of price fluctuations in the value of an asset or assets. For example, the owner of a stock might agree to sell the stock at a particular price on a particular future date. This agreement protects the owner against a future decline in the stock's price: if the price declines to below the agreed-upon price, the owner will still get the agreed-upon price; the owner does, however, give up the opportunity to gain if there is instead a rise in the stock's price.

Home Mortgage Disclosure Act (HMDA)
A 1975 law that requires mortgage lenders to disclose information about the mortgage applications they receive. They are required to report information about both successful and unsuccessful mortgage applications. HMDA applies to all mortgage lenders with the exception of those not based in metropolitan statistical areas (MSAs), those with no branches or offices in MSAs, and very small lenders.

Home Owners Equity Protection Act (HOEPA)
A 1994 amendment to the Truth in Lending Act that provides certain protections to mortgage borrowers. These include protecting consumers from unfair, abusive, or deceptive mortgage lending and servicing practices, ensuring that mortgage advertisements provide accurate and balanced information, and providing consumers with transaction-specific disclosures early enough to use while shopping for a mortgage.

Homeowner's equity
The owner's interest in a property, calculated as the current fair market value of the property less the amount of existing liens.

I

Insolvency
Incapacity to pay debts upon the date they become due in the ordinary course of business.

Investment bank
A financial institution that assists corporations and governments in raising capital by underwriting and acting as the agent in the issuance of securities. Investment banks also advise companies regarding mergers, acquisitions, and divestitures. They typically also provide services involving the buying and selling of securities, commodities, and foreign exchange and may engage in "market making" in particular financial instruments, currencies, and commodities. Investment banks may make trades for their own account and on behalf of their customers. Investment banks do not take insured deposits, but may be part of a bank holding company that also owns a depository institution.

Investment grade security
A security that has been deemed by one or more of the ***credit rating agencies*** to have a relatively low probability of default. The security has likely been assigned a rating of Baa3 (or BBB-) or above.

J

Jumbo loan
A loan that exceeds the mortgage amount eligible for purchase by Fannie Mae or Freddie Mac. Jumbo loans are also called "nonconforming" loans.

L

Leveraging

The use of borrowed funds to supplement ownership equity in making an investment or other purchase.

Leverage ratio

A measure of the extent to which a firm's creditors are financing the firm's investments, rather than the firm itself. The ratio is expressed in different ways. For investment firms, a common expression is total long-term debt divided by total shareholders' equity. For commercial banks and thrifts, the numerator and denominator are reversed, and the ratio is expressed as capital divided by total assets. Regulators establish minimum leverage ratios.

Liar loan

An industry term for a low- or no-documentation loan, typically ***Alt-A*** or ***subprime*****.** The term comes from the suspicion that the borrower, mortgage broker, or loan officer may have fraudulently overstated the borrower's income and/or assets to qualify for a larger loan. Liar loans are typically "stated income" or "stated asset" loans, where the lender does not verify the information but instead records it based on the borrower's verbal statement.

LIBOR (London InterBank Offered Rate)

The average interest rate at which international banks borrow funds from each other in the London interbank market. (LIBOR is actually computed as a trimmed mean, where the top and bottom 25 percent of the rates surveyed are thrown out to calculate the average rate.) LIBOR, typically the three-month or six-month LIBOR, may be used as the index to determine periodic interest rate changes on an adjustable rate mortgage or as the index for determining a variable interest rate on credit card balances.

Liquid asset

An asset that can be converted easily and rapidly into cash without a substantial loss of value. Indicators that an asset may be highly liquid include historically narrow spreads between bid and ask prices, large daily trading volumes, a large number of market participants, and prices that are insensitive to transactions of modest size. If market conditions change, an asset that was once thought to be liquid may no longer be so.

Liquidity

A firm's ability to acquire money whenever it is needed in large and highly variable sums. Firms that are "liquid" have assets on their balance sheet that can be readily converted into cash.

Loss-sharing arrangement

Loss sharing is a feature that the ***Federal Deposit Insurance Corporation (FDIC)*** introduced in 1991 into selected purchase and assumption transactions used to resolve failed insured depository institutions. The original goals of loss sharing were (1) to sell as many assets as possible to the acquiring bank and (2) to have the nonperforming assets managed by the acquiring bank in a manner that aligned the interests and incentives of the acquiring bank and the FDIC. Under loss sharing, the FDIC agrees to absorb a significant portion of the loss – typically 80 percent – on a specified pool of assets while offering even greater loss protection in the event of financial catastrophe; the acquiring bank is liable for the remaining portion of the loss.

M

Maiden Lane limited liability companies

Between June and December of 2008, the Federal Reserve created three limited liability companies to facilitate the extension of financial support for Bear Stearns and AIG. The Federal Reserve Bank of New York extended credit to the three companies under section 13(3) of the Federal Reserve Act. Section 13(3) permits the Federal Reserve to lend to corporations under "unusual and exigent" circumstances if the borrower is unable to obtain funding elsewhere. Normally, the Reserve Banks can lend only to depository institutions and primary dealers. The companies are ***Maiden Lane LLC***, ***Maiden Lane II LLC***, and ***Maiden Lane III LLC***.

Maiden Lane LLC

The first of three limited liability companies established and funded by the Federal Reserve Bank of New York (FRBNY) in 2008 pursuant to authorization by the Federal Reserve Board. Maiden Lane LLC was formed to acquire and manage certain assets of Bear Stearns in order to (1) maximize repayment of the credit extended to finance the acquisition of Bear Stearns by JPMorgan Chase and (2) minimize disruption to financial markets. Proceeds from the net portfolio holdings of Maiden Lane LLC are to be applied in the following order: operating expenses of the LLC, principal due to FRBNY, interest due to FRBNY, principal due to JPMorgan Chase, and interest due to JPMorgan Chase. Any remaining funds are to be paid to FRBNY.

Maiden Lane II LLC

The second of three limited liability companies established and funded by the Federal Reserve Bank of New York (FRBNY) in 2008 pursuant to authorization by the Federal Reserve Board. Maiden Lane II LLC was formed in order to restructure FRBNY's financial support of AIG through the purchase of residential mortgage-backed securities from some AIG subsidiaries. Proceeds from the net portfolio holdings are to be applied in the following order: operating expenses of Maiden Lane II LLC, principal due to FRBNY, interest due to FRBNY, and deferred payment and interest due to AIG subsidiaries. Any remaining funds are to be shared by FRBNY and the AIG subsidiaries.

Maiden Lane III LLC

The third of three limited liability companies established and funded by the Federal Reserve Bank of New York (FRBNY) in 2008 pursuant to authorization by the Federal Reserve Board. Maiden Lane III LLC was formed to help restructure FRBNY's financial support of AIG by purchasing the collateralized debt obligations (CDOs) on which a division of AIG had written credit default swaps. Concurrent with the purchase of the CDOs, AIG's counterparties to the CDS contracts were paid off in full. Proceeds from the net portfolio holdings of Maiden Lane III LLC are to be applied in the following order: operating expenses of Maiden Lane III LLC, principal due to FRBNY, interest due to FRBNY, principal due to AIG, and interest due to AIG. Any remaining funds are to be shared by FRBNY and AIG.

Margin

The collateral value that must be maintained when borrowing money using securities or some other asset that fluctuates in value as ***collateral*** for the loan. If the value of the collateral falls below the lender's margin requirement, the borrower will generally be required to provide additional collateral. When the margin is low relative to the size of the borrowing, the borrower is said to be highly leveraged. (See ***leveraging***.)

Mark-to-market

An accounting rule (FASB 157) that requires companies to value assets at prices determined in the marketplace – so-called "fair value" prices. In practice, a variety of issues surround the application of mark-to-market accounting, such as what to do when the market is inactive, unstable, or nonexistent.

MBS Purchase Program
Federal Reserve program announced in November 2008 to purchase mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae as well as direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The purchases were intended to reduce the cost and increase the availability of credit for housing and, in turn, foster improved conditions in financial markets more generally. The FOMC has announced that the MBS purchases would total $1.25 trillion, with all purchases likely completed by March 31, 2010.

Money Market Investor Funding Facility (MMIFF)
One of the special lending facilities set up by the Federal Reserve in 2008. The MMIFF was created to help the private sector provide liquidity to U.S. money market mutual funds and certain other money market investors to increase their ability to meet redemption requests. The MMIFF expired on October 30, 2009.

Money market mutual fund
A mutual fund (SEC-registered investment fund) that is registered under Rule2a-7 of the Investment Company Act of 1940. Money market mutual funds invest in short-term debt instruments that must have a weighted average maturity of no more than 60 days.

Monoline bond insurer
A financial guaranty (insurance) company that guarantees all scheduled interest and principal payments on the bonds or asset-backed securities that it insures and writes no other line of insurance.

Moral hazard
The tendency of individuals, firms, and governments, once insured against some contingency, to behave so as to make that contingency more likely. "Moral hazard" has been said to arise when the government steps in to prevent a firm from failing. The rescue is seen as encouraging the firm (and others like it) to engage in risky behavior in the future since the firm (and others like it) expect to earn a handsome profit if a loan or investment turns out well, but to be bailed out by the government (taxpayers) if the initiative turns out badly. Government rescue does not protect the firm's shareholders, who may see their investment wiped out, but it does protect the firm's creditors and some or all of management. Moral hazard has also been said to arise in the case of mortgage securitization. When the originator sells the loan for securitization, the originator passes on the risk associated with the loan. If the loan goes bad, there is no loss to the originator, so that the originator has no stake in underwriting sound loans. (See also ***too-big-to-fail***.)

Mortgage backed security (MBS)
A security backed by a pool of mortgages. Investors in the security receive payments derived from interest and principal on the underlying mortgages.

N

Negative amortization
An increase in the principal amount of a mortgage that occurs when the monthly payment is not large enough to cover the entire principal and interest due. The amount of the shortfall is added to the unpaid principal balance to create "negative" amortization.

Negative equity
A situation in which a borrower's mortgage principal is greater than the value of the property that is securing the mortgage. The borrower owes more than the property is worth.

Non-recourse loan

A loan that is secured by a pledge of collateral (such as the borrower's house), for which the lender agrees to rely solely on the collateral if the borrower fails to make the required payments of principal and interest. The lender has no recourse to other assets of the borrower. The borrower can fulfill the obligation to repay the loan by surrendering the collateral.

O

Office of the Comptroller of the Currency (OCC)

The authority within the U.S. Department of the Treasury that charters, regulates, and supervises all national banks (i.e., all banks that are federally rather than state-chartered). It also supervises the federal branches and agencies of foreign banks.

Office of Thrift Supervision (OTS)

The authority within the U.S. Department of the Treasury that charters, supervises, and regulates thrift institutions (savings banks and savings and loan associations) and also oversees domestic and international activities of thrift-institution holding companies and thrift-institution affiliates.

Open market operations

The purchase and sale of government securities or other financial instruments by a central bank, such as the Federal Reserve, in order to control a nation's money supply. In the United States, depository institutions must maintain a required level of reserve balances at their regional Federal Reserve Bank. The Fed controls the nation's money supply through open market operations that affect these reserves. The Fed's purchases and sales of securities inject or pull out reserve balances as needed to achieve the monetary and credit conditions that are desired. (See also ***federal funds rate***.)

Option ARM

An adjustable-rate mortgage that allows the borrower to choose from a set of choices regarding how much interest and principal to pay each month. The borrower's choices may result in ***negative amortization***. The option period is typically limited – for example, to five years.

Originate-to-distribute model

A business model for mortgage lending in which the lender finances the loan by selling it to an investor. This model contrasts with portfolio lending, a model in which the lender holds in portfolio the loans that are originated and receives income from payments made by the borrowers.

P

Preferred stock (preferred equity)

Ownership shares in a firm that have a senior claim over common shareholders in the event of the firm's bankruptcy. A firm must pay preferred dividends on these shares, according to a contractually specified schedule, before it can pay dividends to common shareholders.

Primary credit rate
The interest rate charged by the Federal Reserve for primary credit loans to depository institutions. Because primary credit is the Federal Reserve's main discount window program, the term "discount rate" is sometimes used to mean the primary credit rate. Discount rates are recommended by each Reserve Bank's board of directors, subject to the review and determination of the Board of Governors.

Primary Dealer Credit Facility (PDCF)
One of the special lending facilities set up by the Federal Reserve in 2008. The PDCF was created to provide overnight funding to ***primary dealers*** in exchange for specified eligible collateral. Similar funding was subsequently made available to a set of additional securities dealers. The PDCF was closed on February 1, 2010.

Primary dealers
Banks and securities broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York.

Private label security
A mortgage-backed security or other bond created and sold by a company other than a government agency or ***government sponsored enterprise*. Private label securities are frequently collateralized by loans that are ineligible for purchase by Fannie Mae or Freddie Mac. Also called non-agency securities, private label securities contrast with ***agency debt***.

Q

Quantitative easing
The purchase of financial assets by a central bank using money it has created in order to stimulate the economy when interest-rate easing does not provide enough stimulus. Since December 2008, with the ***federal funds rate*** at or close to zero, the Federal Reserve has undertaken purchases of a variety of securities, providing banks with significant ***excess reserves*** in order to promote economic activity and encourage further lending.

R

Reciprocal currency (swap) arrangement
Short-term reciprocal arrangements between a Federal Reserve Bank and a foreign central bank. By drawing on a swap, the foreign central bank obtains dollars that can be used to conduct foreign exchange intervention in support of its currency or to lend to its domestic banking system to satisfy temporary liquidity demands. For the duration of the swap, the Federal Reserve Bank obtains an equivalent amount of foreign currency along with a commitment from the foreign central bank to re-purchase the foreign currency at a preset exchange rate.

Required reserves
Balances that a depository institution must hold with the Federal Reserve to satisfy its reserve requirement. Depository institution can satisfy the requirement by their holdings of vault cash or a balance maintained directly with a Reserve Bank or indirectly with a pass-through correspondent bank. The required amount varies according to the required reserve ratios set by the Federal Reserve Board and the amount of reservable liabilities held by the institution.

Repurchase agreement (repo)
The sale of securities to an investor with an agreement to repurchase the securities at an agreed upon price and date. The FOMC uses repos of eligible securities to vary the quantity of banking system reserves as part of its implementation of monetary policy.

S

Second mortgage
A mortgage that has a lien position subordinate to the first mortgage.

Secondary mortgage market
The segment of the mortgage market where mortgages are resold, not where mortgages are originated. Mortgages in this market are often grouped together and sold as collateralized debt obligations, collateralized mortgage obligations, mortgage-backed securities, or other types of securities.

Section 13(3)
The section of the Federal Reserve Act that provides for the Board of Governors to authorize the Federal Reserve Banks to lend to non-depository institutions (for example, business corporations and nonbank financial institutions) if circumstances arise that are deemed "unusual and exigent" and, moreover, the borrower is unable to obtain funding elsewhere. This statute provides the legal basis for recent Federal Reserve special lending, including lending to facilitate the acquisition of Bear Stearns by JP Morgan Chase, lending to AIG, and the lending facilities set up in 2008 to lend to firms other than depository institutions and primary dealers.

Securities and Exchange Commission (SEC)
Federal regulatory agency created in 1934 to oversee key participants in the securities industry, including the securities exchanges, securities brokers and dealers, investment advisors, rating agencies, and mutual funds. The SEC is charged with enforcing securities laws, promoting stability in the markets, and protecting investors. It oversees private regulatory organizations in the securities, accounting, and auditing fields.

Securitization
A financial transaction in which assets such as mortgage loans are pooled, and securities representing interests in the pool are issued.

Senior debt
Debt that ranks before other debt in terms of claims on the debt issuer's assets if the issuer goes bankrupt. If the issuer goes bankrupt, senior debt must be repaid before other creditors receive any payment. Senior debt is often secured by collateral on which the lender has a first lien.

Shadow banking system
Intermediation between investors and borrowers that does not involve bank deposits and bank lending. Shadow banking institutions include investment banks, hedge funds, money market mutual funds, insurance companies, and complex legal entities such as ***special purpose vehicles***. It has been estimated that, as of early 2007, lending through the shadow banking system ($10.5 trillion) exceeded traditional bank lending ($10.0 trillion).

Short selling
The selling of a stock or other security that is not owned by the seller. In effect, the seller is betting that the price of the security will fall. In a "naked" short sale, the seller sells the stock or security without first borrowing it or ensuring that it can be borrowed, as is done in a conventional short sale.

Short sale in real estate

The sale of real estate in which the sale proceeds fall short of the balance owed on the property's loan. A short sale may be arranged when a borrower cannot pay the mortgage on a property, and the lender decides that selling the property at a moderate loss is better than pressing for ***foreclosure.*** Both parties must consent to the short sale. The parties may want to avoid foreclosure as it can involve delay and hefty fees for the bank and greater damage to the borrower's credit rating. A short sale does not necessarily release the borrower from the obligation to pay the remaining balance of the loan.

Special purpose vehicle (SPV) / special purpose entity (SPE)

A legal entity (usually a limited liability company) created to fulfill a narrow or temporary objective. The SPV typically holds a portfolio of assets such as mortgage-backed securities or other debt obligations. The SPV exists to hold the assets and issue a new set of claims on the assets, making the sponsor of the SPV remote from any bankruptcy associated with the SPV and from the accounting, tax, and regulatory consequences of the SPV's activities. Many SPVs are set up as "orphan" companies with professional directors provided by an administration company to ensure that there is no connection with the sponsor.

Stress test

An assessment of capital adequacy conducted by U.S. federal banking supervisors in 2009. The aim was to determine whether the largest U.S. banking organizations had sufficient capital to withstand the impact of an economic environment more challenging than anticipated at the time. (See also ***Supervisory Capital Assessment Program***.)

Structured debt

A broad term referring to debt instruments that rely on complex legal and corporate entities to transfer risk. When combined with securitization of assets, structured debt opened up new sources of financing to consumers, but the combination may also have contributed to deterioration in underwriting standards. CDOs and CMOs are examples of structured debt.

Structured investment vehicle (SIV)

A type of special purpose entity that invests in a variety of longer term financial assets and is funded by short or medium term borrowings. SIVs were typically set up by a sponsoring bank, which provided a liquidity backing for the SIV. SIVs began running into financial difficulties in 2007. Some banks brought their SIVs back onto their balance sheets. By the end of 2008, all SIVs had been shut down.

Subordinate financing

Any mortgage or other lien with lower priority than the first mortgage.

Subprime mortgage

Generally, a lender-given designation for a mortgage extended to a borrower with some type of credit impairment, say, missed loan payments or the lack of a credit history. Even if the borrower has a high credit rating, characteristics of the mortgage loan can also lead to the loan's being classified as subprime; such characteristics include limited or no documentation about income or assets, high loan-to-value ratio, or high payment-to-income ratio. Subprime loans typically have a FICO credit score of 620 or less.

Supervisory Capital Assessment Program (SCAP)

A forward-looking exercise conducted by the federal bank regulatory agencies in February through April 2009 to estimate losses, revenues, and reserve needs of the nation's 19 largest bank holding companies under two economic scenarios, including one that was more adverse than expected. When need was shown, banks were asked to raise capital or improve the quality of their capital. (SCAP is also termed a ***stress test***.)

Supplementary Financing Program

A temporary U.S. Treasury Department program that provides cash for use in Federal Reserve initiatives. Consisting of the sale of U.S. Treasury bills, this borrowing is separate from the Treasury's regular borrowing. The value of the bills is listed as a liability on the Federal Reserve's balance sheet.

Systemic risk

Risk that a disruption at a firm, in a market segment, to a settlement system, or in a similar setting will cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole.

T

Term Asset-Backed Securities Loan Facility (TALF)

One of the special lending facilities set up by the Federal Reserve in 2008. The TALF was created to accommodate the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities (ABS) collateralized by loans such as student loans, auto loans, credit card loans, commercial mortgages, and loans guaranteed by the Small Business Administration. TALF funding is scheduled to phase out between March 31 and June 30, 2010.

Term Auction Facility (TAF)

A special lending facility set up by the Federal Reserve in late 2007 to provide term funding to depository institutions through a competitive auction process. All loans were fully collateralized with an appropriate haircut. TAF was set up at a time when the market for loans between banks was functioning poorly and institutions were reluctant to borrow at the discount window. The last TAF auction was on March 8, 2010.

Term Securities Lending Facility (TSLF)

A special lending facility set up by the Federal Reserve in 2008 to loan Treasury securities to primary dealers for 28 days (rather than overnight as in the existing program). Made against eligible general collateral, the loans were awarded based on a competitive single-price auction. At the time, market participants were reluctant to provide term funding against even high-quality collateral. The TSLF was terminated on February 1, 2010.

Term Securities Lending Facility Options Program (TOP)

A special lending facilities set up by the Federal Reserve in 2008 as a companion to the TSLF. TOP offered an option to primary dealers to draw upon short-term, fixed rate TSLF loans. It was intended to offer added liquidity over periods of heightened collateral market pressures, such as quarter-end dates. TOP auctions were suspended on July 1, 2009.

Too-big-to-fail

Implicit government backing that protects large banking organizations from the normal discipline of the marketplace because of concern that their failure would be unacceptably disruptive to the economy. Such firms may be extremely important to particular markets and may be interconnected in complex transactions with many other firms. Market participants expect that the government would rescue such a firm rather than permit it to go into bankruptcy. If a firm is considered too-big-to-fail, it may be able to borrow money at exceptionally low rates because creditors consider loans to the firm to be risk-free. Managers of a firm considered too-big-to-fail may take extra risks, knowing that, although shareholders might lose some or all of their stockholdings in the event of a failure, most managers would keep their jobs, and all creditors would be protected. (See also ***moral hazard***.)

Tranche

One of a number of related securities offered as part of the same transaction. When assets are securitized, different bonds may be created, with each bond representing a different slice (tranche) of the deal's risk. Bonds in the least risky class have first claim on the cash flow from the pool of underlying assets, then bonds in the next class are paid, and so on, up to the riskiest bonds, which have the residual claim (the equity tranche). Bonds in riskier tranches typically pay higher interest.

Tri-party repurchase agreement

A repurchase transaction involving three parties: an investor, a financial institution, and a clearing bank, which acts as an intermediary. In these transactions, which usually involve large amounts of cash and securities, the investor deposits money with the clearing bank, which then lends it to another institution.

Troubled Asset Relief Program (TARP)

A program set up by the U.S. Secretary of the Treasury, pursuant to the Emergency Economic Stabilization Act of 2008, to purchase up to $700 billion in "troubled assets" from financial institutions. "Troubled assets" include (1) residential or commercial mortgages and related instruments originated or issued on or before March 14, 2008, the purchase of which promotes financial market stability, and (2) other financial instruments, the purchase of which is deemed necessary to promote financial stability.

Truth-in-Lending Act (Regulation Z)

A federal law enacted in 1968 intended to promote the informed use of consumer credit by requiring disclosures about the terms and costs of credit. Creditors are required to disclose the cost of credit as a dollar amount (the finance charge) and as an annual percentage rate (APR).

U

Unsecured loan

A loan that is not backed by collateral.

W

Warrant

A security that entitles the holder to buy stock of the issuing company at a specified price on or after a specified date.

Workout

The process by which a lender or servicer works with a borrower to make a delinquent loan current again. It may involve everything from delaying foreclosure to allowing the borrower to repay arrears to permanent changes in the terms of the loan.