# GLOSSARY

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| Adjustable-rate mortgage (ARM) | A mortgage loan whose interest rate is periodically adjusted according to the change in a base index. The ARM rate is usually the sum of the rate in the base index and a fixed margin. |
| Alt-A mortgage | Short name for alternative-A paper, which is a U.S. mortgage loan whose credit risk is rated as being between that of a prime loan and that of a *subprime loan*. The elements of an alt-A loan that make it riskier than a prime mortgage may include weaker documentation of income and a higher loan-to-value ratio. |
| Annuity loan | A loan whose principal and interest will be fully paid with a stream of regular, fixed payments, such as monthly mortgage payments, over a specified, limited period of time. Also called an amortizing loan. |
| Asset-backed security | Any security, including commercial paper, that is collateralized by the cash flows from a pool of underlying assets, such as loans, leases, and receivables. When the cash flows are collateralized by real estate, an ABS may be called a *mortgage-backed security* (MBS); when the cash flows are divided into *tranches*, an ABS may be called a *structured credit product*. |
| Balloon mortgage | A mortgage that is not fully amortized over the life of the loan but instead requires a large payment at the end of the term. |
| Basel III | A comprehensive set of reform measures, introduced by the Basel Committee on Banking Supervision during 2009 and 2010 in response to the global financial crisis, complementing and strengthening existing Basel Committee international standards. Basel III aims to improve the banking sector's ability to absorb shocks arising from financial and economic stress; improve risk management and governance; and strengthen banks' transparency and disclosures. It includes a comprehensive revision of the Basel capital adequacy standards and also proposes, for the first time, minimum liquidity standards for banks. |
| Basis | The difference in the yields of two financial instruments that have similar risk characteristics and produce similar cash flows. Also refers to the difference between the price of a futures contract and the value of the underlying cash instrument or commodity. |
| *Bausparkassen* (*Bauspar*) | A contractual savings and loan system in Germany executed through savings banks. It provides low-cost home-construction and home-improvement loans to participants after a pre-defined period of membership. The government contributes to the system via housing benefits ("Wohnungsbauföderung") and other subsidies. See also *contractual savings systems*. |
| Building society | A financial institution, owned by its members, that offers banking and other financial services, especially mortgage lending. |

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| Bullet bond | A noncallable coupon-paying debt instrument with a single repayment of principal on the maturity date. The coupon is the annual interest rate stated on the bond when it is issued and is typically paid semiannually. |
| Callable (or redeemable) bond or loan | A bond or loan that gives the issuer the option of redeeming it on any of one or more dates before it reaches maturity. On redemption, the issuer cancels the obligation in exchange for a defined price to be paid to the bond holders. A callable loan can be prepaid in advance of maturity. |
| Cash-out refinance | A refinancing of a loan in which the borrower receives cash in excess of the existing loan balance, so that the new loan balance equals the old loan balance plus the cash-out amount. |
| Charge-off | A deduction from a bank's loan loss reserves in recognition of the outstanding balance of a loan that it deems uncollectible. See also *writedown*. |
| Claw-back | In this report, the recovery of assets or benefits deemed to have been unfairly distributed by an entity within a specific period before its insolvency. |
| Capital Requirements Directive | The Directive issued by the European Union for the financial services industry that introduced a supervisory framework reflecting the Basel II rules on capital measurement and capital standards. |
| Collateral | Assets pledged or posted to a counterparty to secure an outstanding exposure, derivative contract, or loan. |
| Conservatorship | A legal process in which an entity called a conservator is granted authority to preserve the assets of another entity. |
| Contingent claims analysis (CCA) | A methodology that combines balance sheet data and market prices of traded securities to infer the implicit value of assets and contingent liabilities of a corporation. The method has been extended to study entire economic sectors and countries. |
| Contractual savings system | A system in which a prospective borrower contractually agrees with a credit institution to save a specific amount over a prescribed period, in exchange for which the institution agrees to provide a loan, on pre-specified terms, whose amount depends on the amount saved. See also *Bausparkassen* (*Bauspar*). |
| Counterparty risk | The risk faced by one party in a contract that the other, the counterparty, will fail to meet its obligations under the contract. |
| CoVaR | "Conditional" (Co) *value at risk* (VaR) measures the VaR of a portfolio of institutions according to the stressed condition of a given institution. CoVaR is thus a measure of an institution's potential contribution to systemic risk. |
| Covered bond | Debt obligation in which the originator's or issuer's obligation to make all interest and principal payments is secured by a dedicated reference (or "cover") portfolio of assets. A covered bond is typically not *structured*. |

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| Covered interest parity (CIP) | A condition in which a sum of money invested for a fixed period of time at the domestic interest rate yields the same value as a transaction in which (1) the same amount of domestic currency is exchanged at the spot rate for a foreign currency, (2) the foreign currency is invested at the foreign interest rate for the same period of time as in the domestic transaction, and (3) the foreign currency is exchanged back to the domestic currency via a forward rate that was fixed at the beginning of the transaction. |
| Credit default swap (CDS) | A derivative contract through which a protection seller provides insurance to a protection buyer against the credit risk of a "reference asset" underlying the swap. A "credit event" regarding the reference asset—a default most commonly, or other breach of specified terms—will trigger a payout to the protection buyer. CDS payouts can be either "physical," whereby the protection seller pays to the protection buyer the face value of the reference asset or delivers the asset; or in "cash," whereby the protection seller pays the protection buyer the difference between the face value and the current price of the reference asset. A "single name" CDS contract references a security of a single firm or government agency, whereas CDS index contracts reference standardized indices based on baskets of liquid single-name CDS contracts. See also *credit derivative*. |
| Credit derivative | A contract under which an agent buys or sells protection against the credit risk associated with a specific reference entity (or specified range of entities). For a periodic fee, the protection seller agrees to make a payment to the buyer on the occurrence of a credit event (usually default in the case of a *credit default swap*). |
| Credit rating | A measure of the risk that the payment terms agreed to by an entity or contained in a financial instrument will not be fulfilled. The rating is typically expressed as a letter grade issued by private sector credit rating agencies. For example, from the most creditworthy to the least, Fitch Ratings and Standard & Poor's use AAA, AA, and so on, down to D. |
| Debt-to-income (DTI) ratio | The amount of monthly debt payment obligations as a percent of monthly income. |
| Deficiency judgment | A court order against a borrower for the balance of a mortgage debt when the proceeds from the sale of the foreclosed property securing the debt are less than the outstanding loan balance. The judgment is possible only when the lender has full recourse to the borrower's income or other assets to satisfy the debt. See also *nonrecourse mortgage*. |
| Delinquency | Failure to make contractual payments on a loan. The seriousness of a delinquency is usually specified in terms of being more than a certain number of days overdue (e.g., more than 30 or 60 or 90 days overdue). Seed also *nonperforming loan*. |
| Derivative | A financial instrument (or, more simply, an agreement between two parties) whose value is derived from the price of an underlying asset to which it is linked, such as a security or currency. Examples include stock options, currency and interest rate swaps, *credit derivatives*, and *credit default swaps*. |

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| Dynamic provisioning | The build-up of loan loss reserves by a bank during an economic upturn to provide greater protection for the bank during a downturn, when loan losses rise. Under traditional provisioning, funds are added to reserves (as a charge against earnings) when a loan begins to show signs of impairment ("point in time" provisioning). Dynamic provisioning requires the bank to anticipate a certain degree of loss in advance of actual impairment ("expected loss" provisioning) as well as to extend the projection period through the full economic cycle ("through the cycle" provisioning). The bank supervisory authorities in Spain introduced dynamic provisioning in 2000. |
| European Financial Stability Facility (EFSF) | An institution set up in May 2010 by the 16 euro area member states to preserve financial stability. The EFSF can issue bonds or other debt instruments, guaranteed by all the member states, in support of member states in financial difficulty. To be replaced by the *European Stabilization Mechanism* in 2013. |
| European Stabilization Mechanism (ESM) | An emergency financing program for member states of the European Union that draws funds from the financial markets under the guarantee of the European Commission, with the budget of the European Union as collateral. The mechanism, which will replace the euro area *European Financial Stability Facility*, becomes operational in 2013. |
| Event study | A statistical method to assess the short-term impact of an event, such as a corporate announcement or a state's announcement of capital controls, by observing the change in variables of interest, such as the firm's stock price or the exchange rate of the country's currency, around the time of the announcement. |
| Excess spread | The difference between the interest received on the basis of a loan portfolio and what is paid out to bondholders, portions of which can accrue to securitizers if the performance of the loan portfolio exceeds preset levels. |
| Exchange traded fund (ETF) | An investment fund traded on stock exchanges. Many of them track an index, such as the S&P 500. ETFs feature relatively low costs and high tax efficiency. |
| Fire sale | A panic condition in which many holders of an asset or class of assets attempt a market sale simultaneously, thereby driving down the price to extremely low levels. The fire sale may also characterize the acceptance of a low price for assets by a seller facing bankruptcy or other impending distress. |
| Fixed-effects panel data estimation | An econometric technique applied to panel data (data that incorporate both cross-sectional and time series variables) to account for possible time-invariant unobserved characteristics in the underlying data. |
| Foreclosure | A legal action in which a lender takes control of assets pledged or mortgaged by a defaulted borrower, including real estate, usually with the intention of selling the assets to recover the balance owed by the borrower. |
| Funding | In this report, the process by which banks issue or assume liabilities associated with assets on their balance sheets. |

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| Generalized autoregressive conditional heteroskedasticity (GARCH) | A statistical technique that adjusts a model's estimates to account for the time variation in the volatility of shocks (statistical errors) derived in the model. |
| Government-sponsored enterprise (GSE) | An entity with private ownership and a public charter to support a particular sector of the economy, such as agriculture or housing, through credit insurance or by purchasing standardized loans from lenders. In the United States, the principal housing GSEs are Fannie Mae and Freddie Mac. |
| Group of Twenty (G-20) | The G-20 Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important advanced and emerging market economies to discuss key issues in the global economy. Its participants are drawn from 19 countries plus the European Union. |
| Haircut | A discount applied to the market value of collateral to reflect its market, credit, and market risk. |
| Hedge fund | An investment pool, typically organized as a private partnership or entity. It is lightly regulated and is thus free to use a variety of investment techniques—including short positions, transactions in *derivatives*, and *leverage*—to boost returns and manage risk. |
| Hedging | Offsetting an existing risk exposure by taking an opposite position in the same or a similar risk—for example, in related derivatives contracts. |
| Home Affordable Modification Program (HAMP) | A program sponsored by the U.S. Treasury in which qualifying mortgage borrowers and their servicers modify the loan payment schedule to improve affordability. |
| Imputed rent | Net value of the services rendered by a house to its owner-occupant for which rent would otherwise be paid to a landlord. |
| Interest rate derivative | A *derivative* contract that is linked to one or more reference interest rates. |
| Interest-only mortgage | A mortgage whose monthly payments consist of interest payments only; the original amount borrowed is paid back when the loan matures. |
| International Financial Reporting Standards (IFRS) | Standards, interpretations, and the framework of accounting adopted by the International Accounting Standards Board (IASB). |
| Islamic finance | Islamic finance is predicated on extending religious principles of the shari'ah to financial transactions. Since only interest-free forms of finance are permissible, any financial agreement under Islamic law is based on the idea of sharing risks (and returns) in lawful activities (halal) that require financial compensation for the temporary use of an asset. An Islamic mortgage is structured as a financing lease, in which the lessor (i.e., lender) acquires property at the request of the borrower and leases it to the borrower for an agreed sum of rent payments. The repayment might also include a portion of the agreed resale price, which allows borrowers to gradually acquire total equity ownership for a pre-determined sales price. |

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| Land registry | A system for recording ownership, possession, or other rights in land (usually operated by a government agency or department) to provide evidence of title, facilitate transactions, and prevent unlawful disposal. The information recorded and the protection provided will vary by jurisdiction. |
| Large and complex financial institution (LCFI) | A financial institution involved in a diverse range of financial activities, usually across many jurisdictions. Typically it is interconnected with other financial institutions and so is considered systemically important. |
| Leverage | The proportion of debt to equity, or assets to equity, or, in the case of banking, assets to capital. Leverage can be built up by borrowing with both on- and off-balance-sheet transactions, the latter of which are not captured by the conventional leverage measures. In this report, the term is also used to refer to the ratio of credit to GDP. |
| Leveraged buyout (LBO) | The purchase of a controlling interest in a company largely through the use of borrowed funds (see also *leverage*). |
| LIBOR (London interbank offered rate) | An index of the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market. |
| Loan-to-value (LTV) ratio | The outstanding balance on a loan as a proportion of the value of the asset (for instance, house) pledged as collateral against the loan. |
| Moral hazard | A condition in which an entity will tend to act less carefully than it otherwise would because the consequences of a bad outcome will be largely shifted to another party. For example, financial institutions have incentives to take excessive risks if they believe that governments will step in and support them in crisis periods. |
| Marginal tax rate | In a tiered income tax rate system, the rate applied to the last dollar of income earned. For instance, in a progressive tax system, the tax rate will rise on each portion of income that exceeds a threshold. In contrast, the total amount of tax paid as a percentage of the total amount of income is the average tax rate. |
| Mark-to-market valuation | The act of recording the value of an asset according to its current market price rather than its book value (which is generally the acquisition cost less any impairments). |
| Mortgage-backed security (MBS) | A security, backed by pooled mortgages on real estate assets, that derives its cash flows from principal and interest payments on those mortgages. MBS can be backed by residential mortgages (residential mortgage-backed securities, or RMBS) or mortgages on commercial properties (commercial mortgage-backed securities, or CMBS). A *private-label* MBS is typically a *structured credit product*. RMBS that are issued by a *government-sponsored enterprise* are not structured. |
| Mortgage servicer | Firm responsible for collecting and remitting loan payments, managing escrow accounts for property taxes and insurance, dealing with delinquent accounts, and supervising foreclosures and property sales. |
| Nonrecourse mortgage | A mortgage for which the lender has recourse only to the underlying property, and not to any income or other wealth of the borrower, in the event of borrower default. See also *deficiency judgment*. |

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| Nonperforming loans (NPL) and NPL ratio | Loans for which the contractual payments are delinquent, usually defined as being overdue for more than a certain number of days (e.g., more than 30 or 60 or 90 days). The NPL ratio is the amount of nonperforming loans as a percent of gross loans. |
| Ordinary least squares (OLS) | A method for estimating the unknown parameters in a linear regression model. The method minimizes the sum of squared distances between the observed responses in the dataset and the responses predicted by the linear approximation. Also known as linear least squares. |
| Overnight indexed swap (OIS) | An interest rate swap in which the compounded overnight rate in the specified currency is exchanged for some fixed interest rate over a specified term. |
| Over-the-counter (OTC) derivative | A financial contract whose value derives from an underlying reference value such as the price of a stock or bond, an interest rate, a foreign exchange rate, a commodity price, or some index and that is negotiated and traded bilaterally rather than through an exchange. |
| Pass-through callable mortgage bond | A *callable* security that is composed of pooled mortgages and transmits, or "passes," the mortgage payments from debtors to the investors. Not a *structured* security. |
| *Pfandbriefe* | *Covered bonds* used in Germany for mortgage funding. Created by an executive order of Frederick II of Prussia in 1769. |
| Principal component analysis (PCA) | Technique that allows researchers to summarize the information on large datasets and extract a few components that statistically explain most of the common variation in the data. |
| Private-label security | An *asset-backed security* not issued or backed by a *government-sponsored enterprise* or public sector entity. Unlike a *covered* bond or a *pass-through* bond, it is typically a *structured credit product* (divided into *tranches* of varying risk). |
| Procyclicality | The tendency of changes in asset prices and valuations to move in line with macroeconomic business and financial cycles. For example, during the recent credit cycle, the *mark-to-market* valuation of collateral in secured funding markets worked procyclically to exaggerate price movements. |
| Put option | A financial instrument that allows, but does not require, its owner to sell ("put") an asset to the option seller at a certain price (the *strike price*) at a specific future date. The option is of value to its owner if the market price of the asset drops below the strike price. |
| Quantitative easing | An expansion of a central bank's balance sheet through purchases of government securities and other assets, funded through the creation of base money (cash and bank reserve balances). |
| Regulatory arbitrage | Avoiding or reducing regulatory restrictions by taking advantage of differences in regulatory treatment across countries or across types of financial institutions, as well as by taking advantage of differences between economic risk and risk as measured by regulatory guidelines. |

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| Representation and warranties | Contractual clauses that allow investors in *securitization* vehicles to return loans to originators that do not meet pre-agreed underwriting standards; the clauses can be accompanied by disclosure of requests for such returns to reveal deficiencies in underwriting standards. |
| Repurchase transaction (repo) | A sale of a security coupled with an agreement to repurchase the security at an agreed price at a future date. This transaction occurs between a cash borrower (or securities lender), typically a fixed-income securities broker-dealer, and the cash lender (or securities borrower), such as a money market mutual fund or a custodial bank. The securities lender receives cash in return and pledges the legal title of a security as collateral. |
| Retained securitization | Assets that have been packaged into a security on a bank's balance sheet but have not been sold in the market. See also *securitization*. |
| Rights in rem | A claim directed against an asset or property, as opposed to a person. |
| Risk aversion | The degree to which an investor who, when faced with two investments with the same expected return but different risk, prefers the one with the lower risk. That is, it measures an investor's aversion to uncertain outcomes or payoffs. |
| Secondary mortgage market | The market for the sale of securities or bonds collateralized by the value of mortgage loans. |
| Securitization | The creation of securities from a portfolio of existing assets or future receivables. The securities are placed under the legal ownership or control of investors through a special intermediary created for the purpose, known as a *special purpose vehicle* (SPV) or special purpose entity (SPE). |
| Seemingly unrelated regression (SUR) | A method of estimating the parameters of a system of equations that accounts for heteroskedasticity and contemporaneous correlation in the errors across equations. Also known as Zellner's method, |
| Special-purpose vehicle or entity (SPV or SPE) | Usually a subsidiary company with a balance sheet structure and legal status that makes its obligations secure even if the parent company goes bankrupt. See also *securitization*. |
| Settlement | The act that discharges the obligation to transfer funds or securities between two or more parties. |
| Strategic default | A borrower's decision to default because the value of the underlying property is less than the outstanding mortgage balance, regardless of the borrower's ability to make the mortgage payments. |
| Stress test | A process that evaluates an institution's ability to financially withstand adverse macroeconomic and financial situations. |
| Strike price | The price at which a specific derivative contract can be exercised. In the context of a *put option*, the strike price is the contractual price at which the underlying asset can be sold. |

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| Structured credit product | An *asset-backed security* in which the payouts of the underlying assets are divided into *tranches* of varying risk and sold separately. |
| Subprime loans | Loans to borrowers whose lack of creditworthiness disqualifies them for the lowest-cost (prime) loans or intermediate-cost (*alt-A*) loans. |
| Sudden stop | A sudden slowdown in the flow of private capital into emerging market economies. Sudden stops are usually followed by sharp decreases in output, private spending, and credit to the private sector and appreciation in the real (that is, adjusted for relative purchasing power) exchange value of the currency. |
| Swap | An agreement between counterparties to exchange periodic payments based on different reference financial instruments or indices on a predetermined notional amount. |
| Swap spread | The difference between the government bond yield and the fixed rate on an interest rate swap of the equivalent maturity. |
| Systemic liquidity risk | The risk that many financial intermediaries will simultaneously face severe financial difficulty—for example, through an inability to acquire funds or through a need to sell assets—and thereby incur major losses. |
| Systemic (solvency) risk | The risk that the failure of one financial institution would cause large losses to other financial institutions, thus threatening the stability of financial markets. |
| Tangible assets (TA) | Total assets less intangible assets (such as goodwill and deferred tax assets). |
| Tangible common equity (TCE) | Total balance sheet equity less preferred debt and intangible assets. See also *tangible assets* |
| Teaser rate | A low interest rate that is scheduled to increase later. Offered to attract potential borrowers. |
| Tier 1 capital | A regulatory measure of the capital supporting the lending and deposit activities of a bank. It contains the most loss-absorbing forms of regulatory capital and consists primarily of common stock, retained earnings, and perpetual preferred stock. The more loss-absorbing capital held by the bank, the greater the protection of uninsured depositors and other bank creditors in the event of a bank failure. |
| Tier 2 capital | A regulatory measure of the capital supporting the lending and deposit activities of a bank. Less loss-absorbing than *Tier 1 capital*, it includes undisclosed reserves, general loss reserves, and subordinated term debt. |
| Too important to fail (TITF) | A financial institution considered to be so large, interconnected, or critical to the workings of the wider financial system that its disorderly failure would destabilize both the financial system and the wider economy. Hence, public funds would normally be deployed to prevent such a failure. |

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| Tranches of securities | Tranches (slices) represent a hierarchy of payment and risk typically associated with an asset-backed security, and each tranche is sold separately. The claim of the "senior" tranche (least risky) on payments flowing from the security have first priority; the claim of the "mezzanine" tranche is next; and that of the "equity" tranche (most risky) is lowest. If some of the expected cash flows are not forthcoming (e.g., some of the securitized loans default), and after any cash flow buffers are depleted, the payments to the senior tranche continue in full while those to the equity tranche are reduced. If payments made to the equity tranches are completely absent, payments to the mezzanine tranche are then reduced. The senior tranche would be the last to receive a reduced or zero payment. See also *private-label security*. |
| Value at risk (VaR) | An estimate of the monetary loss over a given time period that is statistically unlikely to be exceeded at a given probability level (typically the 95 percent confidence level). See also *CoVaR*. |
| Wholesale funding | The funding of banks in private markets, which is used in addition to deposits from customers, to finance bank operations. Wholesale funding sources include, but are not limited to, debt issuance, short-term instruments such as certificates of deposit and commercial paper, repo transactions, and interbank borrowing. |
| Writedown | The recognition in a set of accounts that an asset may be worth less than earlier supposed. |
| Yield maintenance | A penalty, imposed if a borrower pays off a loan before maturity, that allows the lender to attain the same yield as if the borrower had made all scheduled mortgage payments until maturity. Also called a prepayment penalty. |