

Inside Job – Vocabulary

Asset Backed Security (ABS)

An asset-backed security is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt. An ABS is essentially the same thing as a mortgage-backed security, except that the securities backing it are assets such as loans, leases, credit card debt, a company's receivables, royalties and so on, and not mortgage-based securities.

Bank Holding Company

Bank holding company is broadly defined as any company that controls one or more banks. Becoming a bank holding company makes it easier for the firm to raise capital than as a traditional bank. The holding company can assume debt of shareholders on a tax free basis, borrow money, acquire other banks and non-bank entities more easily, and issue stock with greater regulatory ease. It also has a greater legal authority to conduct share repurchases of its own stock. The downside includes responding to additional regulatory authorities, such as the Federal Reserve and the Securities and Exchange Commission.

NOTE: Goldman, Sachs and Morgan Stanley became Bank Holding Companies during the 2008 crisis in order to benefit from the federal government's Troubled Assets Relief Program (TARP).

Capital Structure

This refers to the way a company finances its assets and operations through a combination of equity (stock), debt (loans), or hybrid securities. A company's capital structure is then the composition or 'structure' of its risks and liabilities. The company's ratio of debt to total financing is referred to as its leverage.

Collateralized Debt Obligation (CDO)

CDOs are a type of structured asset-backed security whose value and payments are derived from a portfolio of fixed-income underlying assets. CDOs are split into different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.

NOTE: Each CDO is made up of hundreds of individual residential mortgages. CDOs that contained subprime mortgages or mortgages underwritten because of predatory lending were at greatest risk of default. They are blamed for precipitating the global crisis and have been called "weapons of mass destruction."

Commercial mortgage-backed security (CMBS)

CMBS are a type of asset-backed security that is secured by commercial and multifamily properties (such as apartment buildings, retail or office properties, hotels, schools, industrial properties and other commercial sites). The properties of these loans vary, with longer-term loans (5 years or longer) often being at fixed interest rates and having restrictions on prepayment, while shorter-term loans (1–3 years) are usually at variable rates and freely pre-payable.

NOTE: Commercial loans are often predicted as the next security class to default. Fitch, one of the three largest ratings agencies, estimates that defaults on the loans behind U.S. CMBS will continue to rise through 2010 and the overall rate of default for deals it has rated to exceed 11 percent by year-end.

Credit Default Swap (CDS)

A CDS is an insurance contract in which the buyer of the CDS makes a series of payments to the protection seller and, in exchange, receives a payoff if a security (typically a bond or loan or a collection of loans such as a CDO) goes into default.

NOTE: CDOs are widely thought to have exacerbated the financial crisis, by allowing investors who did not own a security to purchase insurance in case of its default. AIG almost collapsed because of these bets, as it was left on the hook for tens of billions of dollars in collateral payouts to some of the biggest U.S. and European financial institutions. AIG paid Goldman Sachs \$13 billion in taxpayer money as a result of the CDSs it sold to Goldman Sachs.

Credit Rating Agency (CRA)

A CRA is a company which assigns credit ratings for issuers of certain types of debt securities (such as bonds, ABS and CDOs) as well as the debt instruments themselves. In most cases, the issuers of the debt securities are companies, special purpose entities, state and local governments, non-profit organizations, or national governments issuing debt-like securities (i.e., bonds) that can be traded on a secondary market. A credit rating for an issuer includes the CRA's opinion of the issuer's ability to pay back the loan. (In contrast to CRAs, a company that issues credit scores for individual credit-worthiness is generally called a credit bureau or consumer credit reporting agency.)

NOTE: The three largest and most influential credit ratings agencies are Moody's, Standard & Poor's and Fitch. The 2008 crisis highlighted the inadequacies of the ratings agencies when troubled companies retained their investment grade ratings until days before their collapse.

Deposit Taking Institution

Banks, building societies, credit unions and other organizations which accept customers' funds, either at call or for fixed periods, and pay interest on the amounts. Deposit-taking institutions are identified with 'savings' and differ in purpose from investment institutions which actively manage their customers' funds in the pursuit of profits, or from corporations which 'borrow' money from the public by issuing debentures or bonds.

Deregulation

Deregulation is the removal or simplification of government rules and regulations that constrain the operation of market forces. Deregulation does not mean elimination of laws against fraud, but eliminating or reducing government control of how business is done and securities are regulated. Tools of deregulation include the reduction of laws and regulations pertaining to taxation of securities transactions and removing restrictions around mergers and acquisitions within industries. Deregulation supports the efficient market theory in economics that states that financial markets are "informationally efficient" with prices accurately reflecting the value of a company of stock, the less taxes and regulation the more accurately price reflects value.

NOTE: This began in the Reagan Administration and it became known as Reaganomics which refers to the economic policies promoted by the U.S. President Ronald Reagan during the 1980s. The four pillars of Reagan's economic policy were to: 1. Reduce government spending, 2. Reduce income and capital gains marginal tax rates, 3. Reduce government regulation of the economy, 4. Control the money supply to reduce inflation.

Derivatives

A derivative is an agreement between two parties that is contingent on a future outcome. In finance, a derivative is a financial contract with a value linked to the expected future price movements of the asset it is linked to - such as a share, currency, commodity or even the weather. Derivatives allow risk about the price of the underlying asset to be transferred from one party to another. Options, futures and swaps, including credit default swaps, are types of derivatives.

NOTE: A common misconception is to refer to derivatives as assets. This is erroneous, since a derivative is incapable of having value of its own as its value is derived from another asset.

Fixed Income

Fixed income refers to any type of investment that makes a predetermined or "fixed" return at recurring intervals, such as bonds or annuities. Fixed income securities are a loan to the entity that issues the bond. Investors are repaid their interest through interest payments at set intervals and the face value of the loan is repaid at the maturity date. The term fixed income can be misleading because some bonds have interest rates that are linked to an index, such as inflation or the US Federal Funds Rate. Examples of bonds include simple securities such as sovereign bonds issued by national governments, municipal bonds issued by local governments and corporate bonds issued by companies. More complex fixed income securities include preferred bonds, hybrid securities, asset backed securities and collateralized debt obligations.

NOTE: Fixed-income securities can be contrasted with variable return securities such as stocks that have no guarantee of a return for the investor.

Gramm-Leach-Bliley Act (GLBA)

This has also come to be known as the Financial Services Modernization Act of 1999. This Act allowed commercial banks, investment banks, securities firms, and insurance companies to consolidate. Historically, these industries have been known collectively as the "financial services industry".

NOTE: This act repealed the Glass-Steagall Act which prohibited any one institution from acting as any combination of an investment bank, a commercial bank, and an insurance company. This Act was also known as the Citigroup Act as it allowed the merger of Citicorp, a commercial bank holding company, and Travelers Group, an insurance company, in 1998.

Hedge Fund

An aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year. Because hedge fund managers make speculative investments, these funds can carry more risk than the overall market.

NOTE: Hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors who are thought to have more resources in making investment decisions. In the U.S., laws require that the majority of investors in the fund be accredited. That is, they must earn a minimum amount of money annually and have a net worth of more than \$1 million, along with a significant amount of investment knowledge. Hedge funds are considered to be mutual funds for the super rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies.

Hedging

To hedge is to make an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

NOTE: While it is important to note that hedging is actually the practice of attempting to reduce risk, the goal of most hedge funds is to maximize return on investment. The name is mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market by shorting the stock market (mutual funds generally can't enter into short positions as one of their primary goals).

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. An investment bank also assists companies involved in mergers and acquisitions, divestitures, etc. For traditional investment banking services such as underwriting, securities issuance and mergers and acquisitions, investment banks receive a fee, usually a percentage of the transaction. They also provide ancillary services such as market making and the trading of derivatives, fixed income instruments, foreign exchange, commodity, and equity securities. The largest investment banks include Goldman Sachs, JP Morgan Chase, Bank of America, Morgan Stanley and Deutsche Bank.

NOTE: Unlike commercial banks and retail banks, investment banks do not take deposits. By 1998, the largest investment banks went public and changed from a private partnership ownership structure to an exchange traded company with thousands of shareholders. This dislocation between the firm managers and the owners of the company was one of the reasons investment banks took larger risks and exotic securities were issued without appropriate risk assessments.

Investment Grade Ratings

A bond is considered investment grade or IG if its credit rating is BBB- or higher by Standard & Poor's, Baa3 or higher by Moody's or BBB- or higher by Fitch. The credit rating agency rate the bond based upon its likelihood of meeting its payment obligations.

NOTE: Mutual funds, pension funds and sovereign funds are often limited by their prospectus to investment grade securities. When Lehman declared bankruptcy, their bonds were downgraded below investment grade causing a mass sell-off by mutual funds legally restricted to investment grade securities in their portfolio.

Leverage

Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment. Leverage is also used to describe the amount of debt used to finance a company's assets. Leverage helps both the investor and the firm to invest or operate. A company with significantly more debt than equity is considered to be highly leveraged. Leverage can be created through options, futures, margin and other financial instruments. Leverage is most commonly used in real estate transactions through the use of mortgages to purchase a home.

NOTE: Leverage comes with greater risk. If an investor uses leverage to make an investment and the investment moves against the investor, his or her loss is much greater than it would've been if the investment had not been leveraged - leverage magnifies both gains and losses. In the business world, a company can use leverage to try to generate shareholder wealth, but if it fails to do so, the interest expense and credit risk of default destroys shareholder value.

Mortgage Backed Securities (MBS)

A MBS is a type of asset-backed security 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.

NOTES: Investors in a mortgage-backed security are essentially lending money to a home buyer or business. An MBS is a way for a bank to lend mortgages to its customers without having to worry about whether the customers have the assets to cover the loan. Instead, the bank acts as a middleman between the home buyer and the investment markets.

Residential mortgage-backed securities (RMBS)

A RMBS is a type of security whose cash flows come from residential debt such as mortgages, home-equity loans and subprime mortgages. This is a type of mortgage-backed securities that focuses on residential instead of commercial debt. Holders of an RMBS receive interest and principal payments that come from the holders of the residential debt. The RMBS comprises a large amount of pooled residential mortgages.

Security

An instrument representing ownership (stocks), a debt agreement (bonds) or the rights to ownership (derivatives). A security is a negotiable instrument representing financial value. The company or other entity issuing the security is called the issuer. A country's regulatory structure determines what qualifies as a security. For example, private investment pools may have some features of securities, but they may not be registered or regulated as such if they meet various restrictions.

Securitization

Securitization is the process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promotes liquidity in the marketplace. Securitization distributes risk by aggregating debt instruments in a pool, then issues new securities backed by the pool.

Short Selling

Short selling, also known as shorting or going short, is the practice of selling assets, usually securities, that have been borrowed from a third party (usually a broker) with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the price of the assets between the sale and the repurchase, as the seller will pay less to buy the assets than the seller received on selling them. Conversely, the short seller will incur a loss if the price of the assets rises.

NOTE: Selling short is the opposite of going long. That is, short sellers make money if the stock goes down in price. In the summer of 2008, Morgan Stanley's CEO John Mack was vocal in his attack of short sellers in contributing to the fall in share prices on financial services stocks. The low market capitalization of investment banks the week of September 15, 2008, diminished their valuation in the eyes of potential investors and was a contributor to their conversion into bank holding companies.

Subprime

Subprime is a classification of borrowers with a tarnished or limited credit history. Lenders will use a credit scoring system to determine which loans a borrower may qualify for. Subprime loans are usually classified as those where the borrower has a credit score below 640. Subprime loans carry more credit risk, and as such, will carry higher interest rates as well. Approximately 25% of mortgage originations are classified as subprime. Subprime lending encompasses a variety of credit types, including mortgages, auto loans, and credit cards.

Synthetic CDO

In technical terms, the synthetic CDO is a form of collateralized debt obligation (CDO) that invests in credit default swaps (CDSs) or other non-cash assets to gain exposure to a portfolio of fixed income assets. Synthetic CDOs are a modern advance in structured finance that can offer extremely high yields to investors. Synthetic CDOs are typically divided into credit tranches based on the level of credit risk assumed. Initial investments into the CDO are made by the lower tranches, while the senior tranches may not have to make an initial investment. All tranches will receive periodic payments based on the cash flows from the credit default swaps. However, synthetic CDOs enable potentially unlimited bets on the performance of other securities, without any new real loans being created. Each synthetic CDO, unlike a real CDO, requires that one party take the "short side," i.e., must be betting that the referenced investment will fail. In the bubble preceding the financial crisis, several investment banks including Goldman Sachs and Morgan Stanley are known to have created synthetic CDOs with the explicit intention, in advance, of betting against their customers. It is also known that in at least some cases, the investment banks did not disclose this fact to the customers to whom they sold these synthetic CDOs, many of which received AAA ratings. These instruments are the focus of the SEC's fraud case against Goldman Sachs, several private lawsuits, and also, it is believed, several ongoing criminal investigations.

Tranche

A tranche is a piece, portion or slice of a deal or structured financing. This portion is one of several related securities that are offered at the same time but have different risks, rewards and/or maturities. "Tranche" is the French word for "slice". Tranche also describes a specific class of bonds within an offering wherein each tranche offers varying degrees of risk to the investor. For example, a partitioned MBS portfolio might have mortgages (tranches) that have one-year, two-year, five-year and 20-year maturities. It can also refer to segments that are offered domestically and internationally.