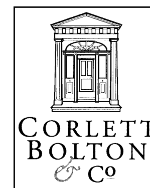


Credit Crunch Glossary

Here you will find a short list of commonly used terms in the credit crunch and what they mean.

Administration

Administration is a rescue procedure designed to assist companies in severe financial trouble. It is granted by order of court and allows a company to continue operating as a going concern but only under the administration of specialist administrators. The process allows a company although it is indebted is still considered worth saving so it is granted the opportunity to try to trade out of it's difficulties by continuing in business. While in administration the company cannot be wound up without permission from the court, so creditors are obliged to wait while rescue of the company is attempted.

Bank bailout

Taxpayer money has been used by most governments in the developed world to capitalise their banks, where the banks financial stability is considered to be in doubt. The British government while injecting vast sums of taxpayer money into the banking system said the idea was "designed to put the British banking system on a sounder footing".

Bear market

In a "bear" market, prices of shares are falling. Consequently investors, anticipating losses, tend to sell.

Bull market

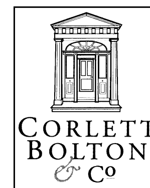
A "bull market" is the opposite wherein prices are seen to be rising and everyone wants to buy and see the value of their contract increase.

Bond

Is simply an IOU given by a Corporation or Government or other institution (bond issuer) to the bond purchaser (holder). The bond (IOU) states when the loan must be repaid and what interest the borrower must pay to the holder. Banks and investors buy and trade bonds. When they consider the Government or institution may not be as readily able to repay the loan they will look for higher interest rates to compensate for additional risk, and so make it even more expensive for the borrower to borrow

Collateralised debt obligations

A collateralised debt obligation is a financial instrument which parcels individual loans, bonds or other assets in a portfolio, which can then be traded. CDOs were said to have a stronger credit rating than individual assets due to the risk being more diversified, but as events have shown where the value of



assets has fallen such as house prices or commercial property, the value of many CDOs have also fallen and may indeed even be worthless commonly referred to “toxic waste”.

Credit crunch

The situation created when banks are reluctant to lend to each other because they were uncertain about how much money they or the other banks really had. This meant that individuals and small businesses could not get financing.

Credit default swap

A swap designed to transfer credit risk from one party to another. The buyer of the swap makes periodic payments as a form of insurance against default on the obligation to the seller in return for protection in the event of a default. Insurer AIG “bailed out” by the US Government had insured many such arrangements.

Derivatives

Derivatives are a way of investing in a particular product without having to own it. Derivatives can be used as insurance to limit the risk of a particular investment. Derivatives for accounting purposes are carried off-balance sheet which often makes it impossible to know how much exposure to derivatives any particular institution has.

Equity

In a business, equity is how much all of the shares put together are worth. In a house, your equity is the amount your house is worth minus the amount of mortgage debt that is outstanding on it.

Fundamentals

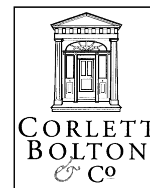
Fundamentals determine a company, a currency or a security's value. A company's fundamentals include its assets, debts, income, earnings and expected growth.

Futures

A futures contract is an agreement to buy or sell a commodity at a predetermined date and price. It could be used to hedge or to speculate on the price whether it is expected to go up or down.

Hedge fund

A private investment fund into which investments are made by wealthy individuals or pension funds and banks creating a large, unregulated pool of capital for investment by very experienced and shrewd investors.



Hedging

Hedging is making a particular investment in order to reduce the risk of price fluctuations in the value of another asset you already own such as oil. For example, if you owned oil and then sold a futures contract agreeing to sell your oil on a particular date at a set price any fall in the oil price would not harm you - but nor would you benefit from any rise.

Investment bank

Investment banks provide sophisticated financial services for governments, companies or extremely rich individuals. They differ from **commercial banks** where you might typically have your savings invested or who advanced your property mortgage to enable you to buy a house.

Leveraging

Leveraging, or gearing, means using additional debt to supplement the value or size of an investment. The more you borrow on top of what you already have, the more highly "leveraged" you are. Leveraging potentially maximises both gains and losses and explains the vast sums of money we hear about.

Deleveraging

Deleveraging means reducing the amount you are borrowing.

Libor

London Inter Bank Offered Rate. The rate at which banks lend money to each other.

Liquidity

The liquidity of something is how easy it is to convert it into cash. Your current account, for example, is more liquid than your house as if you needed funds in a hurry to sell your house quickly you would probably drop the price substantially in order to get a quick sale.

Loans to deposit ratio

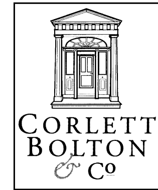
For financial institutions this is the sum total of their loans divided by the sum total of their deposits.

Mark-to-market

Recording the value of an asset on a daily basis according to the prevailing market price of that asset.

Mortgage-backed securities

These are securities made up of a parcel of mortgages. Banks package debt from a number of mortgages



into a parcel (a security) which can be traded. Selling these mortgage packages off is intended to free up bank funds to be able to make more loans.

Negative equity

Refers to a situation in which the value of your home is currently below the amount of the mortgage still outstanding on it.

Rating

Bonds are rated according to their perceived safety from an investment point of view and are based on the perceived ability of the company or government that has issued it to repay it's debt. Ratings range from AAA referred to as "triple A" being the safest, down to D where the entity has already defaulted.

Securities lending

Security lending is when one broker or dealer lends a **security** to another for a fee. This is the process that allows **short selling**. Mortgage-backed securities were often "shorted" as the homeowners were not expected to be able to repay.

Securitisation

The process of turning something into a **security**. For example, taking a number of mortgages and combining them in a parcel such as a mortgage-backed security to make a financial product which can then be traded.

Security

Essentially, a contract that can be assigned a value and traded such as a stock on a stock exchange or a bond in the bond market.

Short selling

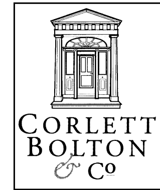
A technique used by investors who think the price of an asset, such as shares, currencies or oil contracts, will fall. They borrow the particular asset from another investor and then sell it in the relevant market with a view to buying back the asset at a lower price to return it to it's owner, pocketing the difference.

Stagflation

The dreaded combination of inflation and stagnation where an economy is not growing while prices continue to rise.

Sub-prime mortgages

These are home mortgages offered to people who have had financial problems in the past or who have



low or unpredictable incomes.

Toxic waste

This is a casual description for an overvalued or otherwise unattractive security. The term is used most often in the context of "bank bailouts" where the banks are suspected to be holding a lot of collateralized debt obligations on their balance sheets which they have not recognised as potentially problematic, but in fact only the most risky of mortgage bonds make up the underlying assets.

Write-down

Reducing the book value of an asset to reflect a fall in its market value. An example would be to write-down a company's value after a big fall in it's share prices.

For further information on these or any other personal law matters, please contact us on (01624) 676868

This publication is intended only to provide a brief guide. It does not purport to be comprehensive or to provide legal advice.

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