GLOSSARY

Asset-backed security (ABS)	A security that is collateralized by loans, leases, receivables, or installment contracts on personal property or on real estate. Often when the securities are collateralized by mortgages, they are called mortgage-backed securities (MBSs), although in principle MBSs are a type of ABS.
Asset allocation	The process of allocating investments among different kinds of assets, such as stocks, bonds, real estate, and cash, to optimize the risk/reward trade-off based on an individual's or institution's specific objectives and risk preferences.
Asset/liability management (ALM)	The management of assets to ensure that liabilities are sufficiently covered by suitable assets at all times.
Assets under management (AUM)	Assets managed by an investment company on behalf of investors.
Balance sheet mismatch	A balance sheet is a financial statement showing a company's assets, liabilities, and equity on a given date. Typically, a mismatch in a balance sheet implies that the maturities of the liabilities differ (are typically shorter) from those of the assets and/or that some liabilities are denominated in a foreign currency while the assets are not.
Banking soundness	The financial health of a single bank or of a country's banking system.
Brady bonds	Bonds issued by emerging market countries as part of a restructuring of defaulted commercial bank loans. These bonds are named after former U.S. Treasury Secretary Nicholas Brady and were first issued in March 1990.
Call (put) option	A financial contract that gives the buyer the right, but not the obligation, to buy (sell) a financial instrument at a set price on or before a given date.
Carry trade	A leveraged transaction in which borrowed funds are used to take a position in which the expected return exceeds the cost of the borrowed funds. The "cost of carry" or "carry" is the difference between the yield on the security and the financing cost (e.g., in a "positive carry" the yield exceeds the financing cost).
Cash securitization	The creation of securities from a pool of preexisting assets and receivables that are placed under the legal control of investors through a special intermediary created for this purpose. This compares with a "synthetic" securitization in which the generic securities are created out of derivative instruments.
CAT bonds	Catastrophe bonds (a type of insurance-linked security whereby investors bear risk if a specified catastrophic event occurs in return for an interest premium).

Collateralized debt obligations (CDOs)	A structured credit security backed by the performance of a portfolio of securities, loans, or credit default swaps, and in which securitized interests in the portfolio's performance are divided into tranches with differing repayment and interest earning streams. In the event of nonpayment or default, the higher-risk "equity" tranche absorbs the first loss from anywhere in the portfolio, up to a limit. After the equity tranche has been exhausted, the next least-secured tranche then absorbs the additional principal loss, and so on. When the tranches are backed by credit default swaps, the structure is called a "synthetic" CDO.
Corporate governance	The governing relationships between all the stakeholders in a company—including the shareholders, directors, and management—as defined by the corporate charter, bylaws, formal policy, and rule of law.
Credit default swaps (CDS)	Default-triggered credit derivatives. Most CDS default settlements are "physical," whereby the protection seller buys a defaulted reference asset from the protection buyer at its face value. "Cash" settlement involves a net payment to the protection buyer equal to the difference between the reference asset face value and the price of the defaulted asset.
Credit derivatives	A financial contract under which an agent buys or sells risk protection against the credit risk associated with a specific reference entity (or specific entities). For a periodic fee, the protection seller agrees to make a contingent payment to the buyer on the occurrence of a credit event (default in the case of a credit default swap).
Credit risk	The potential for losses on fixed-income investments and derivative contracts, caused by issue and counterparty defaults, and market value losses related to credit quality deterioration.
Credit spreads	The spread between benchmark securities and other debt securities that are comparable in all respects except for credit quality (e.g., the difference between yields on U.S. Treasuries and those on single A-rated corporate bonds of a certain term to maturity). Sometimes simply referred to as "spread."
Defined-benefit plan	Pension plan in which benefits are determined by such factors as salary history and duration of employment. The sponsor company is responsible for the investment risk and portfolio management.
Defined-contribution plan	Pension plan in which benefits are determined by returns on the plan's investments. Beneficiaries bear the investment risk.
Derivatives	Financial contracts whose value derives from underlying securities prices, interest rates, foreign exchange rates, commodity prices, and market or other indices.
Distance to default (DD)	The number of standard deviations of the value of a firm's assets from its default threshold, which is a function of the value of its liabilities. A higher distance to default is associated with a lower default probability,

	in which default is assumed to occur when the market value of the firm's assets becomes lower than the default threshold.
Dollarization	The widespread domestic use of another country's currency (typically the U.S. dollar) to perform the standard functions of money—that of a unit of account, medium of exchange, and store of value.
EBITDA	Earnings before interest, taxes, depreciation, and amortization.
EMBI	The JPMorgan Emerging Market Bond Index, which tracks the total returns for traded external debt instruments in emerging markets.
Emerging markets (EMs)	Developing countries' financial markets that are less than fully developed, but are nonetheless broadly accessible to foreign investors.
Extreme value theory (EVT)	A theory focusing on co-movements between extreme events ("co-exceedances")—specifically in this context, the co-movement of extreme negative (left-tail) realizations of measures of banks' soundness.
Foreign bank affiliate	A branch, subsidiary, or joint venture of a foreign bank, whose head office is located abroad.
Foreign bank claim	Foreign bank on-balance sheet financial assets including deposits and balances with domestic banks, loans, and advances to domestic nonbanks, and holdings of domestic debt securities.
Foreign direct investment (FDI)	The acquisition abroad (i.e., outside the home country) of physical assets, such as plant and equipment, or of a controlling stake in a company (usually greater than 10 percent of shareholdings).
Forward price-earnings ratio	The multiple of future expected earnings at which a stock sells. It is calculated by dividing the current stock price (adjusted for stock splits) by the estimated earnings per share for a future period (typically the next 12 months).
Funded pension plan	Pension plan that has accumulated dedicated assets to pay for the pension benefits.
Hedge funds	Investment pools, typically organized as private partnerships and often resident offshore for tax and regulatory purposes. These funds face few restrictions on their portfolios and transactions. Consequently, they are free to use a variety of investment techniques—including short positions, transactions in derivatives, and leverage—to raise returns and cushion risk.
Hedging	Offsetting an existing risk exposure by taking an opposite position in the same or a similar risk, for example, by buying derivatives contracts.
Herfindahl index	A measure of concentration—usually the sum of the squares of the market shares of firms in a particular industry. In this context, it is used to measure the degree of cross-border diversification of a bank. Calculated for each bank as the sum of the squared shares of its assets or revenues across the countries under consideration: the lower the index, the more cross-border diversified the bank.

Home-equity loan/ home-equity line of credit (HEL/HELOC)	Loans or lines of credit drawn against the equity in a home, calculated as the current market value less the value of the first mortgage. When originating a HEL or HELOC, the lending institution generally secures a second lien on the home, i.e., a claim that is subordinate to the first mortgage (if it exists).
Implied volatility	The expected volatility of a security's price as implied by the price of options or swaptions (options to enter into swaps) traded on that security. Implied volatility is computed as the expected standard deviation that must be imputed to investors to satisfy risk neutral arbitrage conditions, and is calculated with the use of an options pricing model such as Black-Scholes. A rise in implied volatility suggests the market is willing to pay more to insure against the risk of higher volatility, and hence implied volatility is sometimes used as a measure of risk appetite (with higher risk appetite being associated with lower implied volatility). One of the most widely quoted measures of implied volatility is the VIX, an index of implied volatility on the S&P 500 index of U.S. stocks.
Interest rate swaps	An agreement between counterparties to exchange periodic interest payments on some predetermined dollar principal, which is called the notional principal amount. For example, one party will make fixed-rate and receive variable-rate interest payments.
Institutional investor	A bank, insurance company, pension fund, mutual fund, hedge fund, mutual fund, brokerage, or other financial group that takes large investments from clients or invests on its own behalf.
Intermediation	The process of transferring funds from the ultimate source to the ultimate user. A financial institution, such as a bank, intermediates credit when it obtains money from depositors or other lenders and on-lends it to borrowers.
Investment-grade obligation	A bond or loan is considered investment grade if it is assigned a credit rating in the top four categories. S&P and Fitch classify investment-grade obligations as BBB- or higher, and Moody's classifies investment-grade bonds as Baa3 or higher.
Large complex financial institution (LCFI)	A major financial institution frequently operating in multiple sectors and often with an international scope.
Leverage	The proportion of debt to equity. Leverage can be built up by borrowing (on-balance-sheet leverage, commonly measured by debt-to-equity ratios) or by using off-balance-sheet transactions.
Leveraged buyout (LBO)	Acquisition of a company using a significant level of borrowing (through bonds or loans) to meet the cost of acquisition. Usually, the assets of the company being acquired are used as collateral for the loans.
Leveraged loans	Bank loans that are rated below investment grade (BB+ and lower by S&P or Fitch, and Baa1 and lower by Moody's) to firms with a sizable debt-to-EBITDA ratio, or trade at wide spreads over LIBOR (e.g., more than 150 basis points).

Mark-to-market	The valuation of a position or portfolio by reference to the most recent price at which a financial instrument can be bought or sold in normal volumes. The mark-to-market value might equal the current market value—as opposed to historical accounting or book value—or the present value of expected future cash flows.
Mezzanine capital	Unsecured, high-yield, subordinated debt, or preferred stock that represents a claim on a company's assets that is senior only to that of a company's shareholders.
Mortgage-backed security (MBS)	A security that is collateralized by mortgages. MBSs can be backed by residential mortgages (RMBS) or mortgages on commercial properties (CMBS).
Mutual fund	An investment company that pools money from shareholders and invests it in a group of assets, in accordance with a stated set of objectives. Open-ended mutual funds sell and redeem shares at any time directly to shareholders. Closed-end funds generally sell a fixed number of shares, which trade on an exchange.
Nonperforming loans	Loans that are in default or close to being in default (i.e., typically past due for 90 days or more).
Occupational pension scheme	Pension plan set up and managed by a sponsor company for the benefit of its employees.
Offshore instruments	Securities issued outside of national boundaries.
(Pair-wise) correlations	A statistical measure of the degree to which the movements of two variables (e.g., asset returns) are related.
Primary market	The market in which a newly issued security is first offered/sold to investors.
Private equity	Shares in companies that are not listed on a public stock exchange.
Private equity funds	Pools of capital invested by private equity partnerships. Investments can include leveraged buyouts, as well as mezzanine and venture capital. In addition to the sponsoring private equity firm, other qualified investors can include pension funds, financial institutions, and wealthy individuals.
Private pension plan	Pension plan in which a private entity receives pension contributions and administers the payment of pension benefits.
Put (call) option	A financial contract that gives the buyer the right, but not the obligation, to sell (buy) a financial instrument at a set price on or before a given date.
Rate of return on equity (ROE)	Annual return as a percentage of equity capital.
Reinsurance	Insurance risk placed by an underwriter with another insurance company to reduce the level of the risk assumed under the original contract.

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.
Risk premium	The extra expected return on an asset that investors demand in exchange for accepting the risk associated with the asset.
Sarbanes-Oxley Act of 2002	An act passed by the U.S. Congress that established new or enhanced standards for U.S. public company boards, management, and public accounting firms. The act covers such issues as auditor independence, corporate governance, and enhanced financial disclosure, and is geared toward protecting investors from the possibility of fraudulent accounting activities by corporations.
Secondary markets	Markets in which securities are traded after they are initially offered/sold in the primary market.
Securitization	The creation of securities from a pool of preexisting assets and receivables that are placed under the legal control of investors through a special intermediary created for this purpose—a "special purpose vehicle" (SPV) or "special purpose entity" (SPE). With a "synthetic" securitization the securities are created out of a portfolio of derivative instruments.
Spread	See "credit spreads" (the word credit is sometimes omitted). Other definitions include (1) the gap between bid and ask prices of a financial instrument; and (2) the difference between the price at which an underwriter buys an issue from the issuer and the price at which the underwriter sells it to the public.
Subinvestment-grade obligation	An obligation rated below investment grade, sometimes referred to as "high-yield" or "junk."
Subprime mortgages	Mortgages to borrowers with impaired or limited credit histories, and who typically have low credit scores.
Swaps	An agreement between counterparties to exchange periodic interest payments based on different references on a predetermined notional amount. For example, in an interest rate swap, one party will make fixed-rate and receive variable-rate interest payments.
Syndicated loans	Large loans made jointly by a group of banks to one borrower. Usually, one lead bank takes a small percentage of the loan and partitions (syndicates) the rest to other banks.
Tail event	The occurrence of large or extreme security price movements that, in terms of their probability of occurring, lie within the tail region of the distribution of possible price movements.
Tobin's *q*	The ratio of the market value of a firm's assets to their replacement value.
Trustee	Private entity (person or organization) with a duty to receive, manage, and disburse the assets of a financial plan.

Value-at-risk (VaR)	An estimate of the loss, over a given horizon, that is statistically unlikely to be exceeded at a given probability level.
With-profits policies	Under this policy, an insurance company guarantees to pay an agreed amount at a specific time in the future, and may increase this guaranteed amount through bonus payments. In effect, the policyholders are participating in the profits of the life insurance company.
Yield curve	A chart that plots the yield to maturity at a specific point in time for debt securities having equal credit risk but different maturity dates.
z-score	A measure of bank soundness derived from accounting data. As used in Chapter III, it is defined as $z = (k + \mu)/\sigma$, where k is equity capital as a percent of assets, μ is the return as a percent of assets, and σ is the standard deviation of the return on assets used as a proxy for return volatility. A higher *z*-score is associated with a lower probability of default.