Activity 1
Terms of Modern Financial Markets

Asset-backed security: A security whose value and income payments are derived from and backed by a specified pool of underlying assets. Pooling the assets into financial instruments allows shares to be sold to general investors and may be intended to reduce risk. The pools of underlying assets can include common payments from credit cards, auto loans, and mortgage loans.

Bank run (bank panic): A series of unexpected cash withdrawals caused by a sudden decline in confidence or fear that the bank will fail, that is, many depositors withdraw cash almost simultaneously. Because the cash reserve a bank keeps on hand is only a small fraction of its deposits, a large number of withdrawals in a short period of time can deplete available cash and force the bank to close and possibly go out of business.

Bond: A loan to a government or corporation in return for a promised repayment at a specified interest rate.

Capital: The wealth—cash or other financial assets—used to establish or maintain a business. Within companies, it is often characterized as working capital or fixed capital.

Central bank: The principal monetary authority of a nation, which performs several key functions, including issuing currency and influencing the supply of credit in the economy. The Federal Reserve is the central bank of the United States.

Commercial bank: A bank that offers a broad range of deposit accounts, including checking and savings deposits, and extends loans to individuals and businesses.

Common stock: An ownership share of a corporation. A common stock offers no guarantee that it will hold its value or pay dividends.

Credit: What individuals and institutions borrow. When you borrow money, you promise to pay in the future. A “line of credit" is permission from a bank to borrow money up to an established limit.

Credit crunch: A situation created when banks and other lenders suddenly and significantly reduce their lending to each other, to individuals, and to businesses, because they are uncertain about how much money they will have to lend and whether the borrowers will be able to pay loans back.

Credit default swap: A type of insurance against a security falling in value. For example, an owner of a mortgage-backed security pays a fee to an institution or investor in return for the promise of much larger payment if the mortgage-backed security falls in value. The risk of default has been “swapped” to the seller of the credit default swap in return for fees.

Debt: Money owed; also known as liability.

Default: Failure to meet the terms of a credit or loan agreement.

Equity: Ownership interest in an asset after liabilities are deducted. For example, the value of your house after deducting the total amount of your mortgage.

Fannie Mae and Freddie Mac: Government-created financial institutions that buy mortgages from banks and then sell those mortgages as investment products. They were created to help make more money available for banks to make more home loans. Because of the housing crisis, both independent companies were on the verge of collapse and were taken over by the federal government in September 2008. Fannie Mae was created in 1938 and Freddie Mac in 1970.

ACTIVITY 1, CONTINUED
TERMS OF MODERN FINANCIAL MARKETS

Federal Deposit Insurance Corporation (FDIC): An independent deposit insurance agency created by Congress in 1933 to maintain stability and public confidence in the nation's banking system. The FDIC protects bank accounts up to $250,000 for each individual depositor (the amount was $100,000 before October 2008).

Federal Reserve System: The central bank of the United States, created by Congress and made up of a seven-member Board of Governors in Washington, D.C., 12 regional Federal Reserve Banks, and their 25 branches.

Foreclosure: The legal process used to force the payment of debt secured by collateral (such as a house) whereby the property is sold to satisfy the debt. Usually this means a family needs to leave their house because they cannot pay their mortgage.

Futures contract: A legally binding agreement to buy or sell a commodity or security at a future date at a price that is fixed at the time of the agreement.

Hedge fund: An investment fund normally with a limited number of investors focusing on a specific type of investment strategy. Hedge funds tend to be subject to less regulation and fewer restrictions than many other investments, such as mutual funds.

Investment bank: A bank that offers financial services such as trading securities, raising capital, and managing corporate mergers and acquisitions. Examples include Goldman Sachs and the former Bear Stearns.

Leverage: Borrowing by an individual or institution to expand the size of an investment. In so doing, the potential return from the investment may increase as well as the risk of the investment.

Liquidity: The degree of difficulty in converting an asset into money.

Liquidity risk: The risk that a bank will not have sufficient cash or liquid assets to meet borrower and depositor demand.

Moral hazard: The phenomenon whereby an investor may take more risk if the investor does not have to bear all of the costs of that risk.

Mortgage: An agreement to pay interest and eventually to pay back a loan made on a house.

Mortgage-backed securities: Investment firms bought many mortgages on homes and put them together in a pool. The firms sold parts of the pool of mortgages to other investors. Those parts (securities) could then be bought and sold in financial markets.

Mutual fund: A group of financial investments often of a specific kind or category, managed by professionals, with many individual or institutional investors.

Nationalization: Government, normally a national government, taking ownership and/or control of a business.

Options: The right, but not the obligation, to buy or sell a specific amount of a given stock or groups of stocks, commodities, currencies, or debt, at a specified price during a specified period of time.

Private equity funds: An investment fund that purchases the majority or all of a company often with a goal of making significant changes in the company's management or operations. It is described as a private equity fund because the fund may purchase shares of stock that are currently traded on a public stock exchange and take those shares off the public market.

ACTIVITY 1, CONTINUED
TERMS OF MODERN FINANCIAL MARKETS

Regulation: A principle, rule or law designed to control or govern how a market, such as the financial system works.

Return (rate of return): Money earned from an investment. The money could be profits, interest, appreciation, or a combination of dividends and appreciation. The rate of return is the ratio of money earned to the amount invested.

Risk: The degree of uncertainty associated with the return on an asset or the value of an asset.

Securitization: The process of taking an illiquid asset, or group of assets, and transforming them into an investment to be sold or traded.

Subprime mortgages: Mortgages that are made to individuals with low incomes, few assets, and perhaps weak credit history. The risk of default on subprime loans is greater than prime loans made to individuals with higher incomes, greater assets, and better credit histories. Some subprime loans were made with very low introductory interest rates with an expectation that the interest rates would increase.

ACTIVITY 2
FINANCIAL CRISIS NEWS STORIES

News Story #1—*Small Street Journal*

(1)______ are two of the largest financial institutions in the country. They are almost exclusively focused on buying, selling, and guaranteeing single family residential mortgages. These organizations were originally U.S. government agencies, but became public companies in the 1970s. In 2008, the U.S. government (2) ________ these institutions. Dr. John C. Economist called this action "one of the most sweeping government interventions into a private financial market in decades." The overwhelming size and importance to the U.S. housing market of these institutions has resulted in what amounts to an implicit U.S. government guarantee that they will never default on their (3)_______. When the housing boom began to cool in 2006 and 2007 these institutions began to experience serious financial problems. An increasing number of home owners had fallen into (4) _________; that is, had lost ownership of their homes or been threatened with it because of a failure to keep up with their (5) ________ payments. The wave of problems has also battered cities where (6) __________ riskier loans made at higher interest rates to individuals with poor credit or other problems had been prevalent.

News Story #2—*Widget City Times*

This past weekend the (7) _________ Bear Stearns, which had specialized in trading securities and helping companies with mergers and acquisitions, went bankrupt. Bear Stearns, which was founded in 1923 and had survived the Great Depression, was destroyed by a type of investment that many Wall Street firms had been buying for years. These investments, created by bundling many home mortgages into one pool, were known as (8) __________. These investments resemble (9) ______, instruments issued by governments and corporations that promise to pay a fixed amount of interest for a defined period of time. However, these securities are created when a company such as Bear Stearns buys a bunch of (10) _________ from a lender—that is, from the bank or company that helped a person buy a home—and then uses the buyer's monthly payments, and those of thousands of others, as the revenue stream to pay investors who have bought pieces of this pool.

News Story #3—*The Young Economist*

A rash of customers withdrawing their funds from a (11) _______, commonly called a (12) _______, occurred over the weekend. In the wake of recent news about bank financial problems, customers were worried about the (13) _______, or the ability of these banks to have enough cash on hand to meet their deposit requests. The (14) ____________ quickly issued the following statement, "We stand ready to maintain public confidence in the banking system and will insure customers' deposits up to $250,000."

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