

EUROMONEY

financial terminology from A-Z

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Allianz 

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A-Z of financial terms

Introduction: Towards a Common Risk Management Language

In recent years, the worlds of banking, insurance and investment management have become increasingly intermingled, and for good reason – investment is, after all, a form of insurance, albeit one in which the parameters of risk and reward are generally broader.

That process of convergence has been visible at a regulatory and corporate level, with the passage of a series of financial reforms – such as the Gramm-Leach-Bliley Act in the US in 1990 – opening the way for consolidation between banks, insurance companies and investment management firms. The consequence has been a number of high profile mergers within the financial services sector – many of them negotiated on a cross-border basis – that have created global groups whose fields of expertise extend across all areas of business.

This is a logical development, given that one of the most important disciplines common to all three businesses is risk management: the proactive identification and measurement of financial risks and the timely implementation of measures designed to minimize or eliminate those risks. Over the past two decades, the risk management capabilities of the financial services sector have taken giant strides towards ensuring that the chances of a system-wide failure are minimized.

As risk management techniques have become more sophisticated and more efficient, innovations developed in banking and investment management have increasingly used the nomenclature of the insurance industry to describe the processes used to address the issue of risk.

An obvious example of this process has been the contribution made to the evolution of the structured finance market by monoline insurance companies, the specialists that started out by providing insurance in the market for municipal bonds, but that now also play a key role in providing protection for investors in

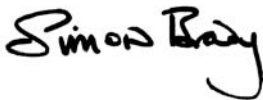
areas ranging from project finance to the market for collateralized debt obligations (CDOs). Less obvious but equally important examples are to be observed in the growing importance of capital market products that go by different names, but which also effectively act as insurance policies.

Credit default swaps (CDS), for example, have been a key building block in the development of a new class of hedging and investment products that have transformed the fixed-income markets, although CDS themselves are essentially just insurance policies allowing for credit protection to be bought and sold among participants in the capital market.

In other words, the cross-fertilization of banking and insurance products and their closer integration with investment management is bringing with it a range of by-products from new hedging mechanisms to entirely new asset classes. These products allow investment managers to better manage their portfolios by enabling them to customize risk/return payoffs in a way that was, until recently, impossible.

On one level, this process has underpinned the development of a number of innovations that have improved efficiencies for retail and institutional investors alike – with the emergence of capital-guaranteed products such as constant proportion portfolio insurance (CPPI) one notable example. At another, it has helped in the evolution of products insuring a range of risks that were previously thought of as uninsurable, with the growing popularity of catastrophe bonds (or cat-bonds) one example of an innovation that will become more important as weather patterns become increasingly unpredictable.

Against this background, a degree of blurring and overlapping in the terminology of the banking, insurance and investment management industries has been inevitable. This guide aims to demystify many of those terms, bringing some of the more frequently used technical expressions in all three disciplines into a concise, single volume. We hope it will serve as a useful guide for market participants in all three areas of the financial services sector.

A handwritten signature in black ink that reads "Simon Brady". The signature is written in a cursive, slightly slanted style with a long, sweeping tail on the letter 'y'.

Simon Brady
managing director, Euromoney magazine

A

Accrued Interest & Accrued Interest Bonds

Accrued interest refers to interest accumulated but not paid to the investor during the life of a security. Instead, the interest accrued is added to the principal at maturity.

Actuary

An individual qualified to calculate commercial risks and probabilities arising from uncertain future events – such as those impacting on insurance policies.

Algorithmic Trading

Algorithmic trading, 'algo',

'black box' or 'autodealing' are terms generally used in the equity and foreign exchange markets to describe the use of computer programmes to determine and implement trading strategies – theoretically improving the efficiency and reducing the costs associated with frequent trading.

Alpha (see also 'Greeks')

Alpha is a measure of risk-adjusted performance relative to 'beta'. In portfolio management, a 'portable alpha' strategy refers to the combination of the returns provided by a passive exposure to a market

index or asset class with an independent 'alpha' strategy, with the aim of achieving attractive 'alpha' or risk-adjusted return.

Alternative Assets

In the institutional investor market, asset classes that fall outside the mainstream securities of bonds and equities. Private equity, hedge funds and real estate are all examples of assets sometimes referred to as 'alternative'.

Alternative Risk Transfer

A term that refers to any non-traditional form of insurance risk transfer. Catastrophe bonds and

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Asset-Liability Management (ALM)

The process by which a financial institution aims to ensure that its assets generate an adequate return and are able to meet all the institution's liabilities. The decline in recent years of yields available on risk-free assets has made this issue especially relevant for pension funds in markets such as the UK that have been left with widening asset-liability gaps as a result. A number of modern ALM techniques based on liability-driven investments (LDI) are available to reduce or eliminate these exposures.

credit derivatives are two forms of ART.

Amortization

In the bond and loan market, the continuous repayment of principal over a period of time until the debt is entirely repaid.

Annuity (see also 'Deferred Annuity')

The sum payable by an insurance company to policyholders at regular, specified intervals. When this sum is predetermined, the arrangement is known as a 'fixed annuity'.

Apportionment

The dividing of a loss proportionately between two or more insurers covering the same risk.

Arbitrage & Arbitrage Pricing

In its most basic form, arbitrage refers to the simultaneous buying and selling of the same security

or contract in two separate markets at different prices resulting, in theory, in a risk-free profit for the arbitrageur.

Asset-Backed Security (ABS)

A security in which payments to investors are collateralized by cash flows generated by specified assets, such as auto loans or credit card receivables.

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(LDI) are available to reduce or eliminate these exposures.

B

Barbell Investment Strategy

A semi-active fixed income investment strategy in which portfolio managers go long or short at either extreme of the yield curve – for example, taking long positions in two-year and 30-year Treasuries. In general, barbell strategies outperform when the yield curve flattens.

Basel I & Basel II (see also 'Capital Adequacy')

The series of accords originally issued in 1988 by the Basel Committee on Banking Supervision on banks' minimum capital.

Basis Point

The most commonly used

measure of yields in the bond market, where one percent equals 100 basis points (bp).

Basis Risk

The risk that the price of an underlying asset and its derivative are imperfectly correlated, leaving a hedger exposed to potential losses (or gains) on a position comprised of being long one element and short the other.

Basis Trading

A strategy aimed at arbitraging the perceived mispricing of two similar securities by selling one and buying the other. An example would be the simultaneous sale and purchase of cash and futures, or of a cash bond and the same issuer's credit default swap.

Bell Curve (see also 'Normal Distribution')

Also known as 'normal

distribution' or 'Gaussian distribution', the bell curve refers to a family of continuous probability distributions. The standard normal distribution has a mean of zero and variance of one. It is called 'bell curve' because the graph of its probability density is shaped like a church bell. This shape means that there is a high probability of being close to the mean and a lower probability of being far from it.

Beta (see also 'Greeks')

A measure of performance relative to a benchmark. If the Standard & Poor's (S&P) Index rises by 10%, a stock rising over the same period by 15% is said to have a 'beta' of 1.5 times.

Binary Options

Binary or Digital Options are option contracts in which only two outcomes are possible – either a fixed payout or a zero return.

Black-Scholes

Most commonly, the term given by Robert Merton to describe the options pricing model he developed based on research by Fischer Black and Myron Scholes.

Bootstrapping

A process of creating a theoretical spot rate curve using one yield projection as the basis for the yield of the next maturity.

Bullet Bond

A bond in which the capital is redeemed in its entirety on the last day of the security's life.

C**Callable Security**

A security in which the issuer has the option to redeem the bond prior to maturity.

Capital – Economic & Regulatory

Total assets less total liabilities. In banking and insurance, economic capital refers to the total capital that entities determine they need in order to cover their risks; regulatory capital, meanwhile, refers to the total mandatory capital that firms are required by regulators to hold.

Capital Adequacy (see also 'Basel I & Basel II')

The minimum required ratio of a bank's capital to its total assets; under the Basel I guidelines, capital adequacy was defined as a minimum ratio of capital to assets of 8%.

Capital Asset Pricing Model (CAPM)

A pricing model that assumes that the return of an asset is equal to the risk-free return, plus a beta, multiplied by a market-wide premium. It is used to determine an asset's theoretically appropriate required rate of return.

Captive Insurance

The arrangement whereby



a subsidiary company provides insurance or reinsurance for its parent.

Catastrophe Bond

Often abbreviated to cat-bond, a catastrophe bond is a high-yielding, insurance-backed security providing for payment of interest and/or principal to be suspended or cancelled in the event of a specified catastrophe such as an earthquake.

Catastrophe Model

A computerized model generating a set of simulated events to calculate insured losses arising from a catastrophe.

Collateral (see also 'Asset-Backed Security')

The cash flow generated by assets used to pay interest to holders of asset-backed securities.

Collateralized Obligations

(CDOs, CLOs, CBOs and CDOs)

Securities backed by a diversified pool of assets. Now often generically referred to as Collateralized Debt Obligations (CDOs), these pools can be loans (in collateralized loan obligations or CLOs), bonds (CBOs), commodities (CCOs) and even other CDOs (CDOs Squared).

Combined Ratio

Represents the total

of acquisition and administrative expenses (net) and claims and insurance benefits incurred (net) divided by premiums earned (net).

Commercial Paper

Short-term instruments issued by banks and large corporates with maturities of up to nine months generally used to cover working capital requirements.

Conduit

Much in the news in 2007, conduits are investment vehicles, generally kept off banks' balance sheets, that fund themselves in the asset-backed commercial

Bootstrapping

A process of creating a theoretical spot rate curve using one yield projection as the basis for the yield of the next maturity.

Catastrophe Bond

Often abbreviated to Cat-Bond, a catastrophe bond is a high-yielding, insurance-backed security providing for payment of interest and/or principal to be suspended or cancelled in the event of a specified catastrophe such as an earthquake.

paper (ABCP) market and invest in longer-dated assets – typically higher-risk, structured instruments.

Constant Proportion Portfolio Insurance (CPPI)

A rules-based asset allocation strategy that creates a capital-guaranteed investment product by dynamically changing the allocation of a portfolio between risky and risk-free assets depending on their performance.

Contractual Trust Arrangement (CTA)

The placement of company pension liabilities into externally held trust solutions, thereby removing

the pension liabilities from balance sheets and therefore improving a number of key balance sheet ratios.

Convertible Bond

A fixed-income security that can be exchanged into the issuer's shares at a predetermined conversion premium. A variant on the convertible is the exchangeable bond, which can be exchanged into shares of companies other than the issuer. Allianz extended this concept in 2001 with an innovative Markets Index-Linked Equity Securities (MILES) issue, convertible into shares

of one of three different companies.

Convexity

A means of measuring how a bond's price changes as interest rates change. Convexity is said to be positive if yields rise as duration falls; negative convexity, meanwhile, refers to a situation in which yields rise as duration rises, and falls as duration falls.

Correlation & Correlation Risk (see also 'Variance')

The degree to which the movement of two variables are related. When the prices of shares of companies in the same sector or of bonds issued by borrowers in



the same industry move in tandem, correlation is said to be high.

Cost of Carry

The costs associated with maintaining a position in a security. Cost of carry is said to be negative when those costs are greater than the return on the security.

Cost-to-Income Ratio

An important measure of the efficiency of financial institutions, this refers to their operating expenses divided by their operating revenues.

Counterparty Risk

The risk that the other party in a trade will default.

Coupon

Refers to the annualized percentage rate of interest paid by borrowers.

Covered Bond

One of the fastest growing asset classes in the world, covered bonds are securities backed by dedicated pools of mortgage or public sector loans. Although covered bonds are similar in many ways to mortgage-backed (MBS) and other asset-backed securities, a key difference is that they remain on banks' balance sheets, whereas MBS are generally off-balance-sheet instruments. Covered bonds are known as 'Pfandbriefe' in Germany, where they have

been in existence for more than 200 years; In France and Spain, Europe's two other longest-standing markets, they are 'obligations foncières' and 'cédulas hipotecarias'. Elsewhere, they are 'lettres de gage' (in Luxembourg) and 'asset-covered securities' (in Ireland).

Credit Crunch

The drying up of liquidity in the financial system, leading to a dramatic increase in the price of credit in bank and bond markets, or (in extremis) to the wholesale withdrawal of liquidity from the market.

Credit Default Swap (CDS)

Essentially an insurance policy for investors in the capital market. Swap buyers buy insurance against an issuer defaulting on a security. Swap sellers provide that insurance, taking on the risk of default..

Credit Derivatives

Synthetic (non cash-market)

contracts providing for the transfer of credit-related risks to a third party. A credit default swap is a credit derivative.

Credit Enhancement

The term applied to a range of mechanisms used to minimize risks to investors in the event of a default, including additional levels of collateral (referred to as 'over-collateralization') and insurance contracts.

Credit Rating

A measure of the probability of default (see 'Ratings Agencies').

Credit-Linked Note (CLN)

A bespoke security with an embedded credit default swap (CDS) that allows the issuer to transfer a specific credit risk to third-party investors.

Currency Overlay

In portfolio management, refers to the outsourcing

of foreign exchange risk (FX) management to a specialist 'overlay' manager who isolates and manages FX risk separately from the portfolio's other risks. Currency overlay is increasingly being used as much as a way of generating excess returns ('portable alpha') as of minimizing or eliminating currency risk.

D

Dedicated Long & Dedicated Short Investing (Long Only & Short Only strategies)

An investment strategy or mandate that allows managers to maintain exposure only to securities they physically own (long only) or where they have undertaken via a futures contract to sell positions in the future (short only).

Default & Default Rates

Default refers to a bond issuer's failure to honour an interest or principal payment on time. Default rates are therefore a measure of the underlying strength of the credit market. In the US, the default rate according to Moody's reached an all-time high of 9.29% in the middle of the Great Depression in July 1932, meaning that almost one in 10 corporate issuers rated by Moody's were unable to service their obligations in a timely manner.

Deferred Annuity (see also 'Annuity')

An annuity contract purchased either with a single or with periodic tax-deferred premiums.

Defined Benefit Plan

A retirement plan in which pension benefits are predetermined on the basis of a formula linked to years

Diversification

In portfolio management, refers to the variety of securities within a portfolio in terms of its geographical or sectoral spread, or in terms of its credit quality. In general, risk is reduced as portfolio diversification increases. Asset management in one sense is the science of creating portfolios in which diversification is optimized against returns.



of service multiplied by a percentage of wages.

Defined Contribution Plan

A retirement plan in which contributions are divided between employers and employees.

Delta & Delta Hedging (see also 'Greeks')

In derivatives markets, the delta ratio refers to the relationship between the price of an option and of the underlying stock. An option with a delta of 0.5 is expected to move 50 cents in value for every one euro move in the underlying. Delta hedging, meanwhile, is a dynamic hedging strategy in which the number of options is adjusted in line with the delta of the option.

Derivatives

Any security or asset in which the value is derived from the price or value of another underlying security or asset.

Dispersion

A statistical term referring to the volatility of investment strategies. The wider the dispersion from the mean, the higher the risk.

Diversification

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Dividends & Dividend Cover

Dividends are the portion of a company's profits paid to shareholders. The ratio between a company's earnings and the net dividend paid to shareholders is known as its dividend cover.

Duration Management, Duration Matching & Duration Risk

Duration management is the process by which the duration of liabilities and the maturity of assets are matched. Duration risk is said to be high when the gap between the maturity of liabilities and assets widens.

E

Efficient Frontier (see also 'Markowitz, Markowitz Diversification')

Refers to the theoretical point at which portfolios can be combined to maximize expected returns and

minimize expected risks.

Equity-Linked Annuity

An annuity paying a fixed minimum rate, qualifying for bonus payments linked to the performance of an equity benchmark such as the S&P500.

Event Risk

In credit markets, the term given to an unforeseen event such as a debt-financed acquisition, leveraged buyout or share buyback exerting pressure on a company's balance sheet, potentially leading to a widening of the spreads on its outstanding bonds.

Excess of loss (reinsurance)

A form of non-proportional reinsurance that indemnifies the ceding insurer for that portion of each loss occurrence in excess of a certain amount, called the retention or priority.

Expected Value, Expected Loss & Expected Return

Expected value, whether positive or negative, is the sum of the probabilities of each possible outcome of a situation multiplied by the outcome payoff. Expected returns, meanwhile, refer to the returns likely to be earned on risky assets calculated by the returns

Equity-Linked Annuity

An annuity paying a fixed minimum rate, qualifying for bonus payments linked to the performance of an equity benchmark such as the S&P500.

generated by a risk-free asset plus a risk premium, multiplied by the beta.

Exposure

The level of risk an investor has to a particular asset, asset class, region or derivative contract.

F

Facultative reinsurance

The reinsurance of individual risks at the option of the reinsurer and the ceding company, whether under a treaty of reinsurance or by negotiation in respect of an individual risk. The reinsurer

is free to accept or reject the offerings of the ceding company.

Financial Guarantee

Insurance (see also 'Monoline Insurance')

An arrangement whereby payment of interest and principal to bondholders is insured by a third party (generally a monoline insurance company). This will generally enhance the credit rating of the instrument and therefore make it accessible to a wider range of investors.

Financial reinsurance

A form of reinsurance that guarantees a pre-

determined profit margin for the purchasing insurance company. In life insurance, 'fin re' is usually structured as an insurance-based loan that avoids liability treatment for solvency reporting purposes.

Fixed Annuity

See 'Annuity'.

Floating Rate Note

A security in which interest payments fluctuate in line with short-term interest rates.

Forwards

 (see also 'Options')

Over-the-counter (OTC) contractual agreements to buy or sell securities or other assets at a specified future date.



Fronting

An agreement by an insurer to issue a policy on behalf of a reinsurer, captive insurer, self-insurer or another insurer. This fronting insurer assumes little or no loss exposure and is usually paid a percentage of the premium.

Futures

Exchange-traded contractual agreements to buy or sell securities or other assets for future delivery.

G

Generally Accepted Accounting Principles (GAAP)

US GAAP refers to the accounting standards used by publicly quoted companies submitting financial statements to the US Securities and Exchange Commission (SEC). GAAP is scheduled to converge with International Financial

Reporting Standards (IFRS) by 2008.

Gamma (see also 'Greeks')

Refers to the relationship between a change in the option delta and the price of the asset on which the option is written.

Gearing

Another term for financial leverage or indebtedness. A company with a high debt-to-equity ratio may be said to be highly geared.

Gramm-Leach-Bliley Act

Act passed in the US in November 1999 allowing for insurance companies, banks and securities firms to merge and to engage in each other's business.

Greeks

Letters of the Greek alphabet are used to represent the key variables that affect the price of derivative instruments. For example, theta measures

an option's sensitivity to changes in time to expiration (also known as time decay), while rho measures an option's sensitivity to interest rates.

Gross Redemption Yield (see also 'Delta', 'Gamma')

The total return on a bond taking into account coupon payments and capital gains (or losses).

H

Hedge Funds

Broadly, funds that generate returns by adopting more aggressive strategies than most retail-targeted investment schemes. Hedge funds aim to outperform conventional funds by, for example, selling short, trading in derivatives and taking on leverage. Hedge fund managers' compensation is generally performance-related.

Hedging & Dynamic Hedging

Hedging is the process of offsetting risk by simultaneously taking two or more positions that are negatively correlated. Dynamic hedging, which is used by derivatives dealers, is duplicating the payout of an option or option portfolio by constantly buying and selling the underlying or futures contracts.

High-Yield Bond

Also known as 'junk bonds', high yield or sub-investment grade bonds are those issued by lesser-rated borrowers paying high rates of interest but exposing investors to a higher risk.

Hurdle Rates

The minimum rate of return demanded by an investor before making a commitment to an investment. Can also refer to the rate of return that an investment manager is required to generate before earning his fee or commission.

Hybrid Security

A security that combines the features of debt and equity, or a security whose value is linked to the price of more than one asset class – for example, a bond whose redemption price is linked to the price of a commodity and an exchange rate.

**IFRS**

See 'GAAP'.

Illiquidity Premium

The additional yield demanded by holders of securities with limited liquidity.

Immediate Annuity (see also 'Annuity')

An annuity purchased with a lump sum, usually at retirement. So-called because payment to the annuity-holder usually begins within a year of the purchase.

Gearing

Another term for financial leverage or indebtedness. A company with a high debt-to-equity ratio may be said to be highly geared.



Immunitization

A means of protecting a portfolio against interest rate risk by holding assets and liabilities with the same duration.

Implied Volatility

Asset volatility derived from the market price of an option using an option pricing model rather than the observed or historical volatility of the asset.

Incurred but not reported (IBNR)

Insured losses that have occurred but have not been reported to a primary insurance company. Reinsurers must establish

an adequate reserve for IBNR claims to make a correct analysis of their business.

Inflation-Linked Bonds

Securities paying interest indexed to the rate of consumer or retail price inflation (CPI or RPI).

Internal Rate of Return (IRR)

The rate at which a security's future cash flows, discounted back to the present, equals its price.

Internal Ratings-Based Approach (IRB)

Under the Basel guidelines (see 'Basel I & Basel II'), the IRB approach allows

financial institutions to use their own internal assessments of key risk drivers when weighting their assets. The IRB Foundation approach uses formulas developed by the Basel Committee to determine the weightings while the IRB Advanced approach gives financial institutions more freedom to apply their own formulas (see also 'Standardized Approach')

Investment Income

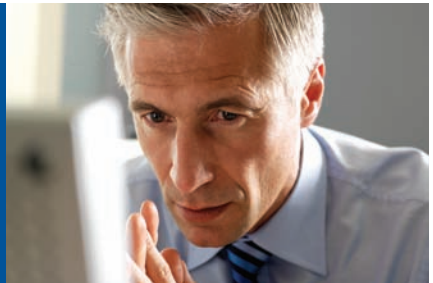
Income generated by a portfolio of invested securities.

iTraxx

The brand name for a suite

Leverage & Leveraged Loan

Broadly, leverage is an alternative term for indebtedness or gearing. In the context of a leveraged loan, however, it refers to loans made to sub-investment or less creditworthy borrowers – measured either by credit ratings or by the loan's spread.



of credit default swap (CDS) index products covering a range of geographical regions and credit ratings. For example, iTraxx Europe is an index made up of the 125 most liquid CDS in Europe.

J

Junior debt (see also 'Subordinated Debt')

Usually unsecured debt that has a lower priority than other (senior) debt claims on the same issuer.

Junk bond

See 'High-Yield Bond'.

K

Knockout Options

Options that expire with no value when the underlying asset reaches a certain predetermined price (also

known as barrier options).

Kurtosis

A measure of the 'peakedness' of a probability distribution. High kurtosis means a higher likelihood of extreme observations or events.

L

Layer

Any segment of a reinsured liability – for example, the first €100,000 of a €500,000 claim.

Leverage & Leveraged Loan

Broadly, leverage is an alternative term for indebtedness or gearing. In the context of a leveraged loan, however, it refers to loans made to sub-investment or less creditworthy borrowers – measured either by credit ratings or by spread.

Liquidity, Liquidity Risk & Liquidity Premium

Liquidity generally refers to the ease and efficiency with which a security can be bought or sold. A security that can be converted into cash quickly and at no discount (irrespective of the size of the transaction) is generally said to be highly liquid. As a consequence, they may attract a liquidity premium, while those that are illiquid may attract an illiquidity discount or be said to incur a liquidity risk.

Loan Loss Provision

An expense set aside by a financial institution as an allowance for a non-performing loan (NPL).

Long Tail Event

In a 'bell curve', the longer the tail becomes, the less likely an event is to happen, meaning that risk models become increasingly incapable of evaluating their likely impact. An earthquake



Mark-to-Market

Recording the price of an asset on a regular (usually daily) basis to reflect its current market value.

in the UK, for example, would be a long tail event.

Long/Short Positions & Long/Short Strategies

A hedging strategy involving simultaneously adopting long and short positions.

Loss Given Default (LGD)

The size of the loss incurred to a lender in the event of a borrower defaulting.

Loss Portfolio Transfer

A buyout of retained insurance liabilities. In exchange for relief of obligations to pay these losses over time, a client agrees to a fixed premium. There are usually tax, administrative and balance sheet benefits to the seller.

M

Mark-to-Market

Recording the price of an asset on a regular (usually

daily) basis to reflect its current market value.

Markets in Financial Instruments Directive (MiFID)

Due to replace the Investment Services Directive (ISD) in November 2007, MiFID will introduce a single market and regulatory regime for investment services across the EU.

Markowitz, Markowitz Diversification

Harry Markowitz, winner of the Nobel Prize for Economics in 1990, is best known for his pioneering research into the impact of correlation and diversification on a portfolio's returns. Markowitz Diversification is a strategy that aims to reduce portfolio risk by combining imperfectly correlated assets.

Mezzanine

In debt markets, mezzanine generally refers to debt

ranking below the senior level, but above the junior level, that can incorporate equity-like features.

Minimum Variance Frontier

Graph of the lowest possible portfolio variance that is attainable for a given expected return.

Monoline Insurance (see also 'Wraps')

A guarantee to issuers in the bond market, provided by specialist insurance companies, that protects investors' principal and interest payments in the event of a default.

Monte Carlo & Monte Carlo Simulation

A mechanism for assessing the probability distribution of possible outcomes by aggregating a large number of simulations.

Moral Hazard

In insurance, the risk that the existence of a contract will

cause one or both parties to change their behaviour.

Mortgage-Backed Securities

Securities in which interest payments are collateralized by pools of mortgage loans. The backbone of securitization markets around the world, the most common form of these bonds are backed by residential mortgages (RMBS), although commercial mortgage-backed securities (CMBS) are becoming increasingly common.

N

Net Asset Value (NAV)

The 'true' value of a fund's investments based on the quoted prices of its components.

Normal Probability Distribution

See 'Bell Curve'.

O

Option

The right, but not the obligation, to buy or sell a security or asset at a predetermined price. In an American-style option, the holder has the right to exercise at any time up to and including the expiry date. In a European-style option, exercise can only take place on the expiry date.

Over-the-Counter

Refers to securities not listed on a recognized exchange that are therefore generally less liquid than listed securities.

P

Pairs Trading (see also

'Correlation and Correlation Risk')

In a pairs trade, an investor

or dealer will simultaneously take a long position in one security and a short position in another correlated security as a means of establishing a market-neutral position.

Political Risk Insurance

An insurance policy taken out by companies against political-related risks ranging from revolution to expropriation of assets by a government.

Portable Alpha

See 'Alpha'.

Present Value

The value on a specified date of a stream of cashflows discounted – the

opposite of compounded – at a specified rate chosen to reflect the appropriate time value of money.

Price to Earnings (P/E) Ratio

A simple way of providing a snapshot of the value that equity investors place on a listed company, the P/E ratio (or 'earnings multiple') is calculated by dividing a company's share price by its earnings per share (EPS).

Primary Market (see also 'Secondary Market')

The market in which new securities are priced, issued and distributed – hence also known as the new issue market.

Prime Broker & Prime Brokerage

A broker who provides a range of services – most importantly credit lines – to professional investors such as hedge funds.

Private Placement

The sale of securities direct to investors without the requirement for their registration with national regulators. The US Private Placement (USPP) market is a well-developed, liquid funding source for local and overseas borrowers looking for more flexibility than the public market provides.

Product recall (insurance)



Price to Earnings (P/E) Ratio

A simple way of providing a snapshot of the value that equity investors place on a listed company, the P/E ratio (or 'earnings multiple') is calculated by dividing a company's share price by its earnings per share (EPS).

insurance for manufacturers against accidental and/or malicious damage or contamination that may lead to a product recall.

Probability of Default (PD)

Used by banks for the purposes of calculating economic or regulatory capital under the Basel II guidelines, PD is a measure of the likelihood that a borrower will default on a loan.



Qualified Institutional Buyer (QIB)

In the US, large institutional

investors (generally defined as those with a minimum of \$100 million of assets) deemed qualified to buy and trade securities issued under Rule 144(a), which gives issuers safe harbour from registration with the SEC.

Quantitative Analysis & Quantitative Management

(Quant)

A form of financial analysis pioneered by Robert Merton based on mathematical and statistical modelling, measurement and research. Analysts supporting traders and risk managers by developing these models are often referred to as 'quants'.

Quota Share

A form of reinsurance in which premiums and losses are shared proportionately between the ceding insurer and the reinsurer. Under quota share, the same percentage applies to all reinsured policies in a given class of business.

Random Walk Theory

Refers to the belief, popularized by Burton Malkiel in his 1973 book, "A Random Walk down Wall Street", that no amount of technical or fundamental



Risk Management

In finance, generally refers to the process of identifying and evaluating risks; and of identifying and implementing strategies to minimize those risks.



analysis can help investors to outperform the market.

Ratings Agencies

Independent agencies, such as Fitch, Moody's and Standard & Poor's, that assess the probability (or otherwise) of default among issuers of securities.

Recovery

In reinsurance this refers to the 'mining' of old agreements and collecting uncollected claims.

Recovery Rate

In the credit market, the amount that investors are likely to be paid in the event of default. Even in the most spectacular defaults, recovery rates are seldom

lower than 10% to 20%.

Reinsurance

Insurance brought by insurance companies as a means of spreading (or 'laying off') part of the risk incurred in the primary market.

Repurchase Agreement

(Repo)

A contract under which a seller agrees to buy a security back from the purchaser at a specified price. A reverse repo refers to the same transaction from the perspective of the buyer. Repos are popular as they effectively function as collateralized loans.

Return on Assets (ROA)

Generically, companies' returns are indicators of their profitability and their relationship with a range of other indicators (such as assets, sales, capital, equity, investment) are key tools for analysing companies' financial performance.

Return on assets refers to a company's total net income divided by its total average assets and is expressed as a percentage.

Return on Invested Capital (ROIC)

Total net income divided by total invested capital.

Return on Equity (ROE)

Total net income divided by



total shareholders' equity.

Rho (see also 'Greeks')

The change in an option's price for each change of one percent in the relevant interest rate.

Risk Management

In finance, generally refers to the process of identifying and evaluating risks; and of identifying and implementing strategies to minimize those risks.

Risk Premium

The excess returns that are generated by holding risky assets such as equities or lower-rated bonds compared with risk-free benchmarks. Corporate

bonds in mature capital markets, for example, are said to pay a risk premium compared with government paper.

Risk Weightings (see also 'Basel I & Basel II')

Broadly, the amount of capital that banks are required to hold against exposures of varying degrees of credit quality. In Basel I the risk weightings were viewed as over-simplified (ranging from 0% for G-10 debt to 100% for corporate loans). Basel II has proposed substantive changes to banks' risk weightings.

Run-off

The management

of insurance claims disconnected from new policies.



Secondary Market (see also 'Primary Market')

The market in which securities are traded (bought and sold) by institutional and other investors.

Securitization

Securitization, a key component of the structured finance lexicon, describes the process whereby assets generating dependable and visible cash-flow streams

(such as mortgages and credit card loans) are pooled into a bankruptcy-remote entity to allow them to be financed at cheaper rates.

Semi-Variance

A statistical measure of downside risk calculated as the average of the squared deviations below the mean return.

Sharpe Ratio

The Sharpe Ratio, or Sharpe Index, was devised by William Forsyth Sharpe in 1966, and is a measure of a portfolio's excess return (relative to a risk-free rate) divided by the standard deviation of the portfolio's excess return.

Solvency II

Will define risk-based solvency capital calculation for regulatory purposes and will set requirements on risk management, transparency and supervisory approaches in a more principle-based

way than the current rule-based insurance supervisory rules. The current factor-based Solvency I rules have been in force since the 1980s. Solvency II is a project of the European Commission, which asks CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) for advice on the technical issues. The expected implementation date for Solvency II is 2010. A draft of the Solvency II European Framework directive was published on July 10 2007.

Special Purpose Vehicle (SPV)

In securitization, a special purpose vehicle (SPV) or special purpose entity (SPE) is a company set up to serve the sole function of holding securitized assets. An SPE or SPV is therefore generally a bankruptcy-remote entity with no employees, often located in a tax-efficient jurisdiction such as the Cayman Islands.



Sharpe Ratio
The Sharpe Ratio, or Sharpe Index, was devised by William Forsyth Sharpe in 1966, and is a measure of a portfolio's excess return (relative to a risk-free rate) divided by the standard deviation of the portfolio's excess return.

Standard Deviation

A statistical measure of volatility indicating the dispersion of returns, representing the square root of the variance of data points from the mean.

Standardized Approach (see also 'Basel I & Basel II')

Under the Basel II guidelines, the process whereby fixed risk weightings are applied to different types of assets (see also 'Risk Weightings').

Statistical Arbitrage

A quantitative trading strategy that aims to identify and profit from the statistical mispricing of one or more assets based on their expected return.

Stochastic Analysis

Refers to analysis pertaining to a series of random processes.

Structured Investment Vehicle (SIV)

An investment company

that buys highly rated debt, such as asset-backed securities (ABS), and funds itself by issuing senior debt and capital notes. A SIV generates its returns by capturing the credit spread between its longer-dated assets and its funding through shorter (and hence cheaper) maturity debt.

Subordinated Debt

Usually unsecured debt that has a lower priority than other (senior) debt claims on the same issuer.

Super Senior Tranche

In a CDO, the super senior tranche is the most senior, triple-A rated tranche of the capital structure, which is very rarely sold to investors.

Systemic Risk

Risk that impacts the entire financial system, rather than individual sectors or industries. Exposure to systemic risk cannot therefore be avoided

through diversification.

**Tier I Capital**

A key measure of capital adequacy, Tier I refers to a financial institution's core capital, including equity capital and disclosed reserves.

Tier II Capital

A measure of secondary capital, divided into Upper and Lower Tier capital. Upper Tier II generally includes perpetual subordinated debt, cumulative preference shares, general reserves and revaluation reserves; Lower Tier II includes instruments such as dated subordinated debt and perpetual subordinated debt without loss absorption features.

Tier III Capital

A less commonly observed



measure of capital which can include items such as trading book profits and certain short term subordinated debt instruments.

Tobin Q

Developed by James Tobin, the Tobin Q is an analytical measure derived from dividing the market value of a company by the replacement value of its assets.

Total Return

In fixed-income portfolio management, 'total return' refers to a core bond portfolio strategy that targets maximum current income and price appreciation consistent with

the preservation of capital and prudent risk-taking. A total return strategy aims to utilize all sectors of the bond market to add value while maintaining an overall risk level similar to the benchmark.

Total Return Swap

Similar to a credit default swap, which provides protection against a credit event, a total return swap is a contract in which one party receives interest payments on a reference asset (together with any losses or gains incurred by the asset over the payment period); the other party receives a specified fixed or floating cash flow unrelated

to the creditworthiness of the reference asset.

Tracking Error

A measure of the standard deviation of excess returns to give an indication of the volatility of a portfolio relative to its benchmark.

Tranches & Tranching

Derived from the French for a 'slice', a tranche is now used to describe a portion of a security a dual-currency bond, for example, may be said to contain 'tranches' in dollars and euros. In structured finance, tranches and the process of tranching refer to the sub-division of a security into layers of seniority for investors.

Weather Derivatives

A product serving as an insurance or hedging policy generally used by energy-related business or others whose performance is subject to weather-related risks.

U

Uninsurable Risk

Possible events deemed too uncertain or risky to be covered by an insurance policy.

V

Value at Risk (VAR)

A measure of how the market value of an asset or portfolio is likely to change over time under normal market conditions.

Vanilla

In financial markets, 'vanilla'

refers to conventional securities with no innovative embellishments – features generally referred to as 'bells and whistles'

Variable Annuity

An annuity in which the payments to holders fluctuate in line with the performance of the underlying assets selected by the annuity-holder.

Variance

A measure of a random variable's statistical dispersion, indicating how its possible values are spread around an expected value.

VIX

Sometimes referred to as

the 'fear index', the VIX is the Chicago Board Options Exchange Volatility Index, and is a measure of the market's expectations for the implied volatility over the coming 30 days of the S&P 500 Index Options.

Volatility

Refers to the intensity of fluctuations in the prices of any financial asset or security. The larger and more frequent the swings in prices, the greater the volatility.

W

Weather Derivatives

A product serving as an

insurance or hedging policy generally used by energy-related business or others whose performance is subject to weather-related risks.

Wraps

A form of credit insurance. Holders of a wrapped obligation can expect the same as they would from an irrevocable and unconditional guarantee, irrespective of the intrinsic credit quality of the obligation. See 'Monoline Insurance'.

Y

Yen Carry Trade

Seldom out of the news in 2006 and 2007, this refers to the strategy of borrowing yen at very low Japanese interest rates with a view to reinvesting the proceeds in higher-yielding currencies.

Z

Zero-Beta Portfolio

A strategy that aims to create a risk-free portfolio or one that has no beta.

Zero-Coupon Bond

A bond which pays no coupon, but which is sold at a deep discount to the face value at which it matures.

Zero-Sum Game

The theory that the gains made by a party in any financial contract can only come about as a result of another's losses.



Zero-Coupon Bond

A bond which pays no coupon, but which is sold at a deep discount to the face value at which it matures.

From Annuities to Zero-coupon bonds.

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