The US Subprime Lending Crisis

Explaining the financial turmoil

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NOTE: The meanings of the words underlined below can be found under the Glossary section.

Preface

Everyone has been constantly reading in almost all newspapers about the US subprime mortgage crisis which has been said to have the potential to bring the US economy to a brink of a recession. It has led to the ouster of top executives of Merrill Lynch, Citibank etc to name a few because of exposure to the subprime mortgage turmoil. Ironically, the same crisis has led to an Indian born banker- Vikram S Pandit being put at the helm of the world's largest bank – Citigroup. So what is exactly the subprime crisis all about?

The following extract seeks to explain what we mean by the term "subprime lending". Then we decipher what is the subprime mortgage lending crisis all about and what led to its happening. Lastly, we seek to find its potential impact on the US and Indian economy.

"Subprime" means what

It refers to the category of borrowers with weak credit history. These borrowers usually find it tough to land mortgage-backed loans. Subprime lending is a general term that refers to the practice of making loans to borrowers who do not qualify for loans at market interest rates because of problems with their credit history or the lacking of their ability to prove that they have enough income to support the monthly payment on the loan for which they are applying. Thus, a subprime loan is one that is offered at an interest rate higher than A-paper (Prime) loans due to the increased risk.

Background to the crisis

The easy liquidity policy in the US led to the U S Fed rates touching about 40-plus year lows about four years ago. The low-interest rate policy led to a boom in mortgage financing. As lenders exhausted high quality clients, they gradually started moving down the credit curve of borrowers towards the subprime category.

This gave rise to sizeable loans to borrowers who figured low on credit quality. The boom in these loans has been on an unprecedented scale *(as shown in the adjacent diagram)*. This home buying spurred by low interest led to realty prices going way of out of line with realistic levels. It made homeowners believed that the realty prices will continue to grow and make future refinance and second mortgages quite profitable. At the same time eased lending standards allowed them to buy more expensive homes than they could afford.

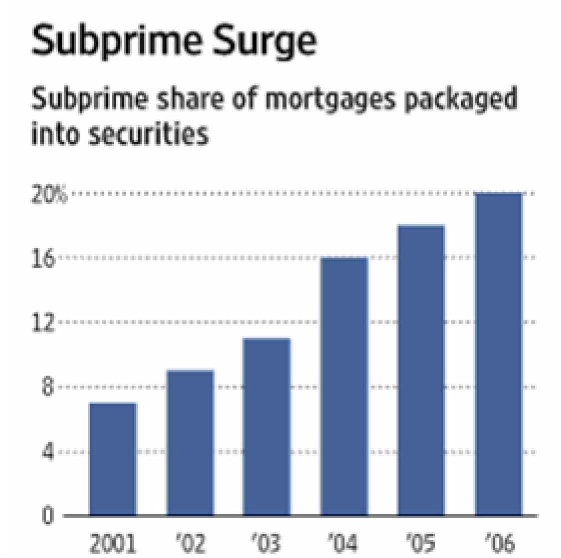

Fig1. Source: Credit Suisse, Mortgage Bankers Association

Lenders were prompt to offer riskier loans Adjustable Rate Mortgages (ARMs) *(which have a floating interest clause)* to subprime borrowers as loan products with such adjustable rates, transferred great part of a risk from the lender to the borrower. This risk transfer was also main reason why they often offered greater commission to Mortgage Brokers if they sold adjustable rate loan. Probably some of the brokers were overtaken by greed and were offering and suggesting adjustable mortgages even to borrowers who would qualify for prime loans.

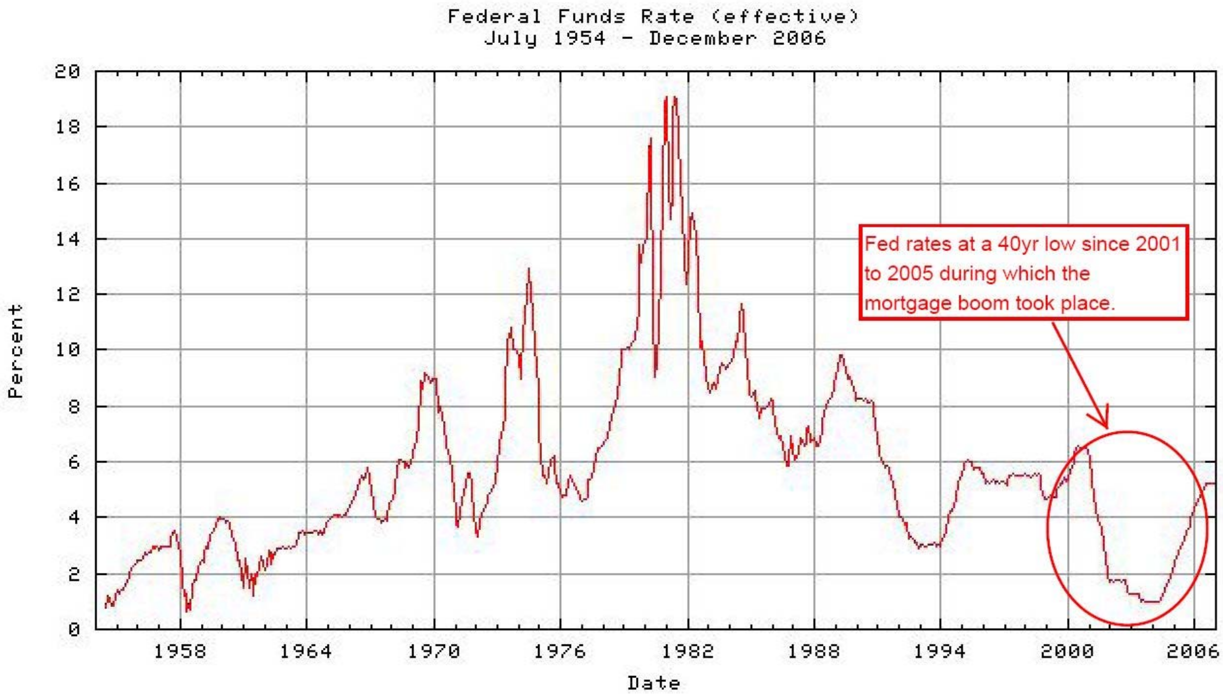

Fig2. Source: Federal Reserve

The graph clearly shows that from 2002 to 2005 the Fed rates prevailing were at a 40 year low. It was this low interest rate that was responsible for sparking the boom in mortgage financing and the subsequent boom in subprime lending and the consequential boom in the house prices.

On the advantages of Subprime lending

The obvious advantage of the expansion of subprime mortgage credit is the rise in credit opportunities and homeownership. Because of innovations in the prime and subprime mortgage market, nearly 9 million new homeowners in US are now able to live in their own homes, improve their neighbourhoods, and use their homes to build wealth.

On the challenges of Subprime lending

While the basic developments in the subprime mortgage market may seem to be positive, the relatively high default rates in the subprime market do raise issues on the viability of such lending. So there are two sides to the issue of subprime lending:

- Yes, they extend home ownership to many Americans who might not otherwise afford it.
- But they are also a contributing factor in the number of home foreclosures in the United States.

The Actual crisis

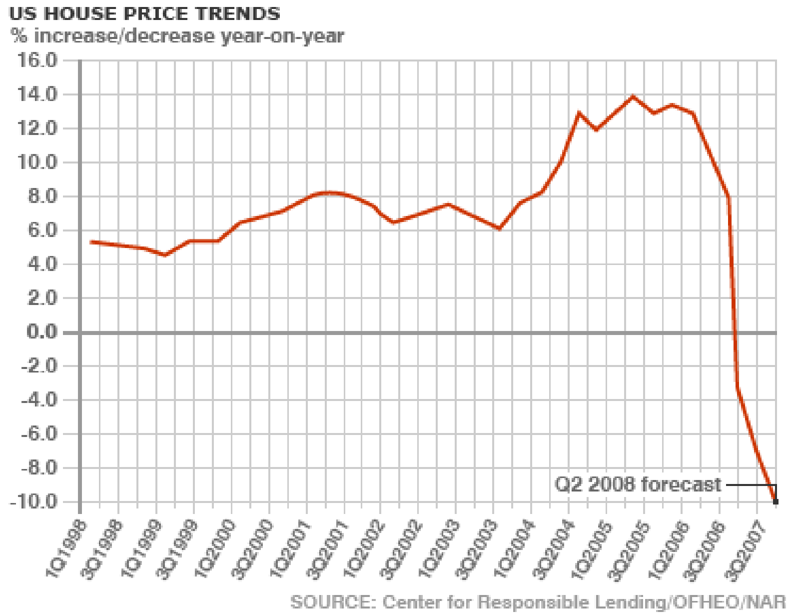

Fig3. A graph depicting the recent housing price crash in USA

Continuing from the *background to the crisis*, as mentioned earlier the home buying spurred by low interest led to real estate prices going way of out of line with realistic levels. The sharp price rise had an in-built trigger to snowball into a problem at some stage unless the period of extraordinarily low interest rates sustained. This was never going to be the case.

As the U.S Federal Reserve moved to raise rates *(there were 17 successive hikes of 25 basis points each spread from June 2004 to June 2006)* (see Fig2) leading to the Fed Rate moving from a low of 1 % to 5.25 % - the impending crisis in U.S property markets got fast tracked in terms of time.

Finally, as interest rates rose, so did payment obligations (EMIs or their equivalent in the U.S) as most of the loans were in the form of ARMs which have a floating interest rate clause. This increase in EMIs accounted for a larger proportion of income especially in the case of subprime borrowers, leaving them vulnerable. This has triggered defaults on a rising scale, especially at the lower end of the credit curve. This led to large no. of Foreclosures. Besides, declining property prices in most geography in the U.S and excess supply of homes meant that the properties under default could also not be sold. This has posed problems for borrowers and lenders alike. *This is the so called "Subprime lending crisis"*.

The Housing Price Crash

The wave of repossessions is having a dramatic effect on house prices in USA. It is reversing the housing boom seen in the last few years and is causing the first ever decline in US house prices since the 1930s.

Today there is an excess supply of four million unsold homes that is depressing prices, as builders have also been forced to lower prices to get rid of these unsold properties. The banks and other lending institutions did not expect such a large number of foreclosures and extreme decline of house prices. Now, they are paying the price as the large number of defaults resulted in great losses for those lenders offering subprime loans.

The new model of mortgage lending

The US sub-prime mortgage crisis has lead to plunging property prices, a slowdown in the US economy, and billions in losses by banks. It stems from a fundamental change in the way mortgages are funded.

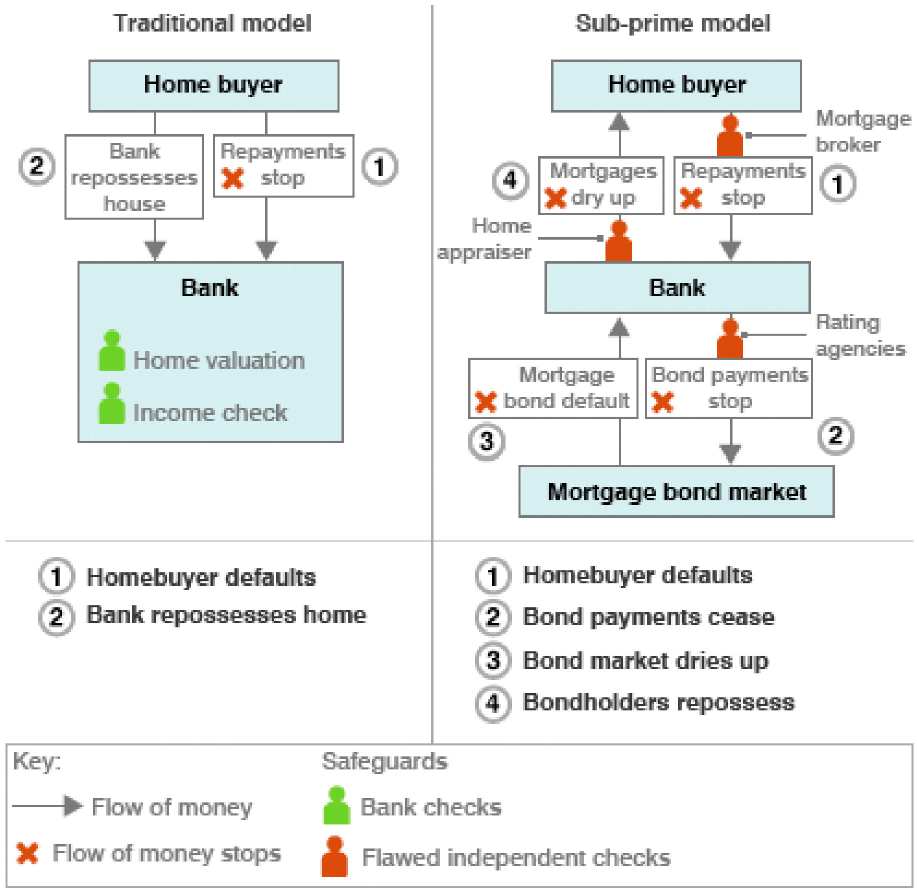

Fig4. Traditional mortgage model vs. Subprime mortgage model

Traditionally, banks have financed their mortgage lending through the deposits they receive from their customers. This has limited the amount of mortgage lending they could do. In recent years, banks have moved to a new model where they sell on the mortgages to the bond markets. This has made it much easier to fund additional borrowing, but it has also led to abuses as banks no longer have the incentive to check carefully the mortgages they issue.

Causes of the crisis

Observers of the meltdown suggest that blame needs to be shared between the Mortgage banker and the consumer i.e. the house owner/borrower. Others have charged mortgage brokers with steering borrowers to unaffordable loans, and their house appraisers with inflating housing values. The causes may be explained with the help of five points namely: Role of lenders, Role of homeowners, Role of government and regulators, Role of Credit Rating agencies & Role of Central banks.

> **“This stands to likely be the largest loss of African-American wealth that we have ever seen, wiping out a generation of home wealth building”**
>
> Mike Calhoon
> Center for Responsible Lending

Fig5. Quote

- **Role of lenders:** A variety of factors have caused lenders to offer an increasing array of higher-risk loans to higher-risk borrowers. Not only did lenders lend to higher-risk borrowers (subprime borrowers), they have also offered increasingly high risk loan options and incentives to them.

Example1: is the interest-only adjustable-rate mortgage (ARM), which allowed the homeowner to pay just the interest (not principal) during an initial period.

Example2: is a "payment option" loan, in which the homeowner could pay a variable amount, but any interest not paid would be added to the principal. Further, an estimated one-third of ARM which originated between 2004 to 2006 had "teaser" rates below 4%, which then increased significantly after some initial period, as much as doubling the monthly payment.

Example3: Lenders practised the unscrupulous method of Predatory lending.

Some subprime lending practices have raised concerns about mortgage discrimination on the basis of race because it has been found that African Americans and other minorities had been disproportionately led to sub-prime mortgages with higher interest rates than their white counterparts.

- **Role of homeowners:** Consumer-borrowers have been criticised for overstating their incomes on loan applications, which did not require verification and entering into loan agreements they could not meet or did not understand, or were motivated by greed.

  The home prices growth in US in early 2000s was completely unrealistic (that's obvious now). It made homeowners believe that the prices will continue to grow and make future refinance and second mortgages quite profitable and eased lending standards allowed them to buy more expensive homes than they could afford. Besides, they entered into riskier loan agreements like the ARMs without understanding them, and they even lied on their stated income in the loan applications.

Fig6. A foreclosure sign installed in front of a home.

- **Role of government and regulators:** Some observers claim that government policy actually encouraged the development of the subprime disaster through legislation like the Community Reinvestment Act, which they say forces banks to lend to otherwise non-creditworthy consumers. In response to a concern that lending was not properly regulated, the House and Senate are now considering bills to regulate lending practices.

- **Role of Credit Rating agencies:** Regulators have turned their attention to Rating agencies, who they think had incorrectly given investment-grade ratings to securitisation transactions holding subprime mortgages.

- **Role of Central banks:** Central banks are primarily concerned with managing the rate of inflation and avoiding recessions. They are also the *"lenders of last resort"* to ensure liquidity. They are less concerned with avoiding asset bubbles, such as the housing bubble and dotcom bubble. Central banks have generally chosen to react after such bubbles burst to minimize collateral impact on the economy, rather than trying to avoid the bubble itself. This is because identifying an asset bubble and determining the proper monetary policy to properly deflate it are not proven concepts. There is significant debate among economists regarding whether the central banks should play an important role in avoiding such asset bubbles and whether the current strategy adopted by them of *cure rather than prevention* is the correct one or not.

The Subprime lending Impact

The sharp rise in foreclosures after the fall in housing values caused several major subprime mortgage lenders to shut down or file for bankruptcy. This activity has lead to the collapse of stock price of some of the largest lenders in US such as Countrywide Financial, Washington Mutual, the government sponsored Fannie Mae, and Citigroup *(a component of the Dow Jones Industrial Average).*

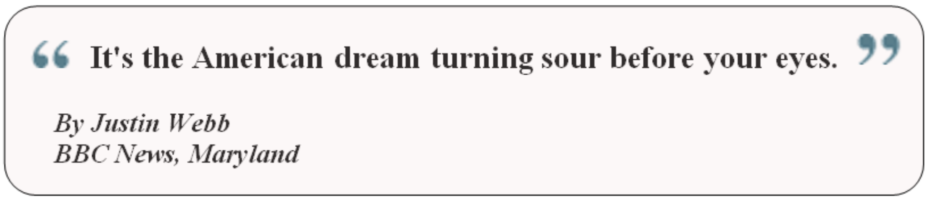

Fig7. Quote

Subprime loan packages became investment vehicles available for purchase by banks and other investment entities throughout the world, and the U.S.- created crisis is thought by many to have had its effect on stock markets globally. Several Hedge funds became worthless, and coordinated Central bank interventions became necessary.

- **Impact on the US stock markets:** Lenders who provided sub-prime loans packaged them together and sold it to investors as securitised assets *(referred to as the process of Securitisation)*. As such loans and risk appetite to buy securitised assets based on such loan pools increased, more exotic versions were added. All this led to the Dow Jones Industrial Average (DJIA) hitting a record high on July 19, 2007 by closing above 14,000 for the first time. But by August 15, the Dow had dropped below 13,000 and the S&P 500 had crossed into negative territory year-to-date. Similar drops occurred in virtually every market in the world, with Brazil and Korea being hard-hit. Year 2007's largest daily drop by the S&P 500 in the U.S. was in February, all as a result of the subprime crisis.

  Mortgage lenders and home builders fared terribly, but losses cut across sectors, with some of the worst-hit industries, such as metals & mining companies, having only the vaguest connection with lending or mortgages.

  There has been a significant decline in liquidity in the US markets. Trading levels for some asset-backed bonds have declined dramatically and these include bonds with AA or AAA ratings (high investment grade). There are few buyers even for such high quality assets. It is even harder to trade risky high-yield bonds, junk bonds and loans for borrowers with high debt. As December being the vacation season, liquidity has been further affected in these markets.

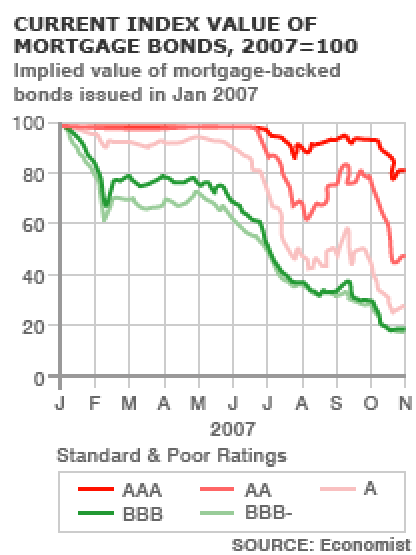

Fig8. Bond market crash

- **Impact on the US Bond Market:** Also suffering huge losses are the bondholders, such as pension funds, who bought sub-prime mortgage bonds. These have fallen sharply in value in the last few months, and are now worth between 20% and 40% of their original value for most asset classes, even those considered safe by the ratings agencies. If the banks are forced to reveal their losses based on current prices, they will be even bigger. It is estimated that ultimately losses suffered by financial institutions could be between $220bn and $450bn, as the $1 trillion in sub-prime mortgage bonds is re-valued.

- **Impact on US Housing industry:** The wave of repossessions is having a dramatic effect on house prices in USA. It is reversing the housing boom seen in the last few years and is causing the first ever decline in US house prices since the 1930s. Today there is an excess supply of four million unsold homes that is depressing prices, as builders have also been forced to lower prices to get rid of these unsold properties.

  The property crash is also affecting the broader US economy, with the building industry expected to cut its output by half, with the loss of between one to two million jobs. Many smaller builders will go out of business, and the larger firms are all suffering huge losses. The building industry makes up 15% of the US economy, but a slowdown in the property market also hits many other industries. *Example: makers of durable goods, such as washing machines, and DIY stores, such as Home Depot.*

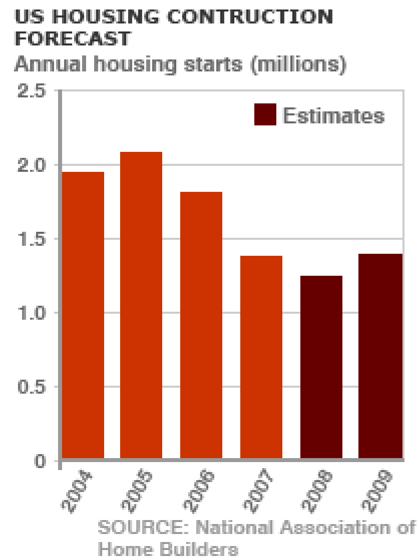

Fig9. US Housing construction forecast

- **Impact on corporations:** Many banks, mortgage lenders and hedge funds suffered significant losses as a result of mortgage payment defaults or mortgage asset devaluation. As of 21st November, 2007 banks had recognized subprime-related losses exceeding US $30 billion, with an additional US$8-$11 billion expected from Citibank.

  The losses could be much greater, as many banks have concealed their holdings of sub-prime mortgages in exotic, off-balance sheet instruments such as "Structured Investment Vehicles" or SIVs. Although the banks say they do not own these SIVs, and therefore are not liable for their losses, they may be forced to cover any bad debts that they accrue.

  Other companies around the world have also suffered significant losses, from Europe to China. A number of mortgage lenders have filed for bankruptcy or are expected to do so during 2007.

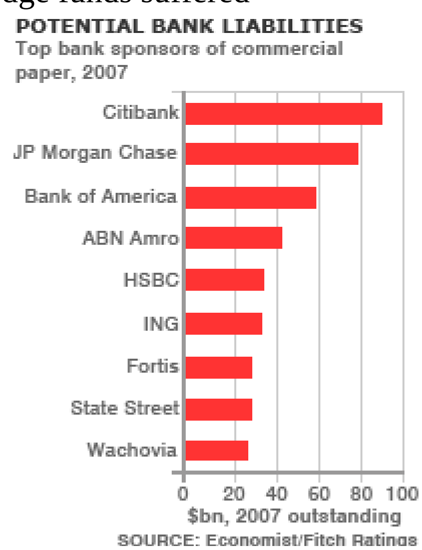

Fig10. Bank liabilities due to subprime exposure

  Top management has not escaped unscathed. The CEOs of Merrill Lynch and Citigroup were forced to resign within a week of each other due to exposure to subprime turmoil. The irony is that the same crisis has led to the rise of an Indian – Vikram Pandit to the post of CEO at Citigroup.

Losses of major banks due to subprime lending

Business	Type	Loss
Citigroup	Investment bank	$11,000,000,000
Merrill Lynch	Investment bank	$8,400,000,000
Barclays Capital	Investment bank	£1,300,000,000
HSBC	Bank	$3,400,000,000
Swiss Re	Re-insurance	$ 1,070,000,000
UBS AG	Investment bank	$3,600,000,000
Deutsche Bank	Bank	€2,200,000,000
Bear Stearns	Investment bank	$1,200,000,000
Morgan Stanley	Investment bank	$3,700,000,000
Lehman Brothers	Investment bank	$700,000,000
Freddie Mac	Mortgage Govt. Sponsored enterprise	$3,600,000,000

Source: Wikipedia

Certain businesses filing for bankruptcy

Business	Type	Date
New Century Financial	Subprime lender	April 2, 2007
American Home Mortgage	Mortgage lender	August 6, 2007
Ameriquest	Subprime lender	August 31, 2007
NetBank	On-line bank	September 30, 2007
Sentinel Management Group	NA	NA

Source: Wikipedia

- **Impact on global stock markets:** At the global level, especially in advanced markets such as U.S, U.K, France, Germany and Japan, to name a few, as interest rates have risen and sub-prime has affected risk appetite (investors are now showing appetite for lower risk) hence the equity markets have been impacted.

  As FII flows and hedge fund investments have been significant factors in emerging markets, the developments in the U.S have spread the low risk appetite to other emerging markets and leading to FIIs becoming net sellers which is leading to high degree of volatility in prices and price weakness. Large daily drops became common with for example, the KOSPI (Korean Stock Price Index) dropping about 7% in one day.

- **Impact on India:** The sub-prime and credit market crisis is not likely to have an impact on the fundamental story in India. However, it may have an impact on sentiment and liquidity flows in the short term. This could lead to high volatility in the short term and some corrective phases. However, it does not change the long-term outlook and positive view on our Indian markets. *(Source: BNP Paribas)*

How Sub-prime lending affected one city – Cleveland (The sub-prime capital of America.)

The adjacent figure shows the high level of concentration of subprime lending in Cleveland.

Cleveland was the sub-prime capital of America. It was a poor, working class city, hit hard by the decline of manufacturing and was sharply divided along racial lines. Mortgage brokers focused their efforts in selling sub-prime mortgages in working class black areas where many people had achieved home ownership. They told them that they could get cash by refinancing their homes, but often neglected to properly explain that the new sub-prime mortgages (ARMs) would "reset" after 2 years at double the interest rate.

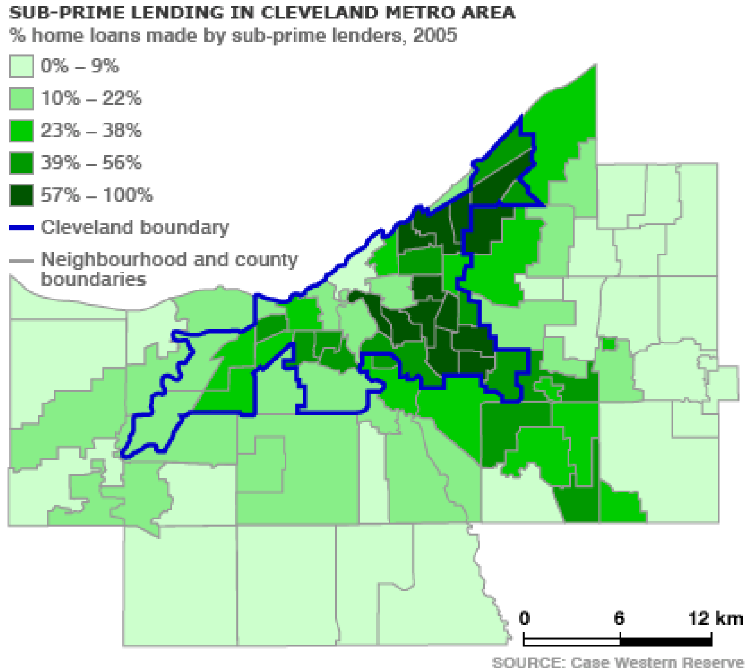

Fig11. Sub-prime lending in Cleveland
Source: Case Western Reserve

The result of the "reset" was a wave of repossessions that wrecked neighbourhoods across the city and the inner suburbs. Today, one in ten homes in Cleveland has been repossessed and Deutsche Bank Trust, acting on behalf of bondholders, was the largest property owner in the city.

The adjacent figure shows the sub sequential foreclosure concentration in precisely these same areas when the crisis broke out.

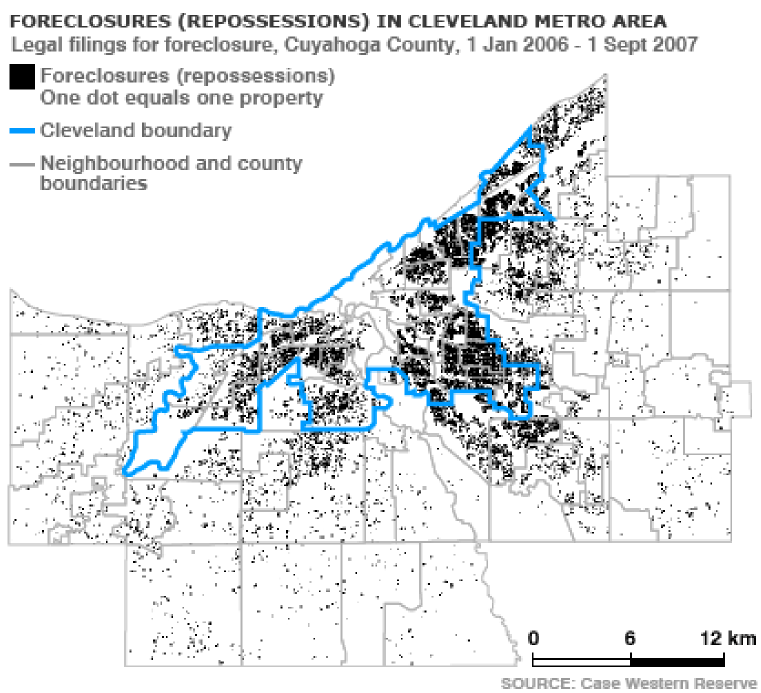

Fig12. Foreclosures in areas of sub-prime lending in Cleveland
Source: Case Western Reserve

Actions to manage the crisis *(Source: Wikipedia)*

The following parties have taken or begin taking the following actions to manage the crisis.

- ✓ **Central banks** have conducted open market operations to ensure member banks have access to funds (i.e. liquidity). These are effectively short-term loans to member banks collateralised by government securities. Central banks have also lowered the interest rates charged to member banks (called the discount rate in the U.S.) for short-term loans.

  Central banks around the world have begun coordinated efforts of their own to increase liquidity in their own currencies to stabilize foreign exchange rates (thus reducing a further fall in the American dollar and diminishing any incentive to sell them off) and prevent the probable significant global consequences a run on the American dollar would cause. It marks the first time the American, European, and Japanese central banks have taken such actions together since the aftermath of the September 11, 2001 terrorist attacks.

  As of August 10, 2007, the United States Federal Reserve (Fed) has injected a combined 43 billion USD, the European Central Bank (ECB) 156 billion euros (214.6 billion USD), and the Bank of Japan 1 trillion Yen (8.4 billion USD). Smaller amounts have come from the central banks of Australia, and Canada.

Fig13. Concerned customers of Northern Rock Bank queuing to withdraw savings from the bank due to fallout from the subprime crisis

- ✓ **Lenders and homeowners** both may benefit from avoiding foreclosure, which is a costly and lengthy process. Some lenders have taken action to reach out to homeowners to provide more favourable mortgage terms (i.e., loan modification or refinancing). Homeowners have also been encouraged to contact their lenders to discuss alternatives.

- ✓ **Credit rating agencies** help evaluate and report on the risk involved with various investment alternatives. The rating processes can be re-examined and improved to encourage greater transparency to the risks involved with complex mortgage-backed securities and the entities that provide them. Rating agencies have recently begun to aggressively downgrade large amounts of mortgage-backed debt.

- ✓ **Regulators and legislators** can take action regarding lending practices, bankruptcy protection, tax policies, affordable housing, credit counselling, education, and the licensing and qualifications of lenders. On December 6 , 2007, President George W. Bush announced a plan to voluntarily and temporarily freeze the mortgages of a limited number of mortgage debtors holding ARMs, declaring "I have a message for every homeowner worried about rising mortgage payments: The best you can do for your family is to call 1-800-995-HOPE". *(Source: TOI dated 7th Dec, 2007)*

- ✓ **Media** can help educate the public and parties involved. It can also ensure the top subject material experts are engaged and have a voice to ensure a reasoned debate about the pros and cons of various solutions.

Conclusion

The most important question to be resolved now is: What will be done to minimize effects of crisis on the overall US economy and what will be done to enable defaulted homeowners keep their homes? We all expect major players in this game to show now their skills and efforts so that American dream about owning a home could turn again into pleasant dream, achievable to those US citizens who are facing the worst homeowner's nightmare ever - eviction from home.

❖ Glossary *(Source: Investopedia)*

- ✓ **Subprime Loan:** A type of loan that is offered at a rate above Prime Lending Rate (PLR) to individuals who do not qualify for prime rate loans due to their weak credit history. Quite often, subprime borrowers are often turned away by traditional lenders because of their low credit ratings or other factors that suggest that they have a reasonable chance of defaulting on the debt repayment. So Subprime lenders lend subprime loans to such low credit rating borrowers at a higher interest rate than the prime rate offered on traditional loans. The higher interest is for the higher risk of default associated with such borrowers.

  However, getting a subprime loan could still be a good idea if the loan is meant to pay off a higher interest debt (such as credit card debt) and the borrower has no other means for payment.

  The specific amount of interest charged on a subprime loan is not set in stone. Different lenders may not value a borrower's risk in the same manner. This means that a subprime loan borrower has an opportunity to save some additional money by shopping around.

- ✓ **Mortgage:** A debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are used by individuals and businesses to make large purchases of real estate without paying the entire value of the purchase up front.

  Mortgages are also known as "liens against property", or "claims on property".

  In a residential mortgage, a homebuyer pledges his or her house to the bank. The bank has a claim on the house should the homebuyer default on paying the mortgage. In the case of a foreclosure, the bank may evict the home's tenants and sell the house, and use the income from the sale to clear the mortgage debt.

- ✓ **Subprime Mortgage:** A type of mortgage that is normally made out to borrowers with lower credit ratings. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a rate that is higher than a conventional mortgage in order to compensate themselves for carrying more risk.

- ✓ **US Fed:** The Federal Reserve System (also the Federal Reserve; informally The Fed) is the central banking system of the United States.

- ✓ **Subprime:** 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 carry more credit risk, and as such, will carry higher interest rates as well.

  Occasionally some borrowers might be classified as subprime despite having a good credit history. The reason for this is because the borrower has elected to not provide verification of income or assets in the loan application process. Thus, loans for which no income/ asset verification is provided are called no income/no asset (NINA) loans, while others are called stated income and/or stated asset (SISA) loans.

- ✓ **Subprime Lender:** A type of lender that specialises in lending to borrowers with a tainted or limited credit history. Subprime lenders use a risk-based pricing system to calculate the terms of loans, including the interest rate, which they offer to borrowers with varying credit histories.

- ✓ **Foreclosure:** A situation in which a homeowner is unable to make principal and/or interest payments on his or her mortgage, so the lender, be it a bank or any other institution, can seize and sell the property as stipulated in the terms of the mortgage contract.

  In some cases, to avoid foreclosing on a home, lenders try to make adjustments to the repayment schedule to allow the homeowner to retain ownership. This situation is known as a Special Forbearance or Mortgage Modification. Foreclosure is a last resort for lenders because it is an expensive procedure and lenders typically lose money in foreclosure proceedings.

- ✓ **Delinquency:** Failure to meet ones obligation.

- ✓ **Mortgage Banker:** A company, individual or institution that originates mortgages. Mortgage bankers use their own funds, or funds borrowed from a big lender, to fund mortgages. After a mortgage is originated, a mortgage banker might retain the mortgage in portfolio, or they might sell the mortgage to an investor *(referred to as Securitisation)*. A mortgage banker's primary business is to earn the fees associated with loan origination. Most mortgage bankers do not retain the mortgage in portfolio and they sell *(securitise)* the mortgages to free up their capacity for additional lending.

  The distinguishing feature between a mortgage banker and a mortgage broker is that mortgage bankers close mortgages in their own names, using their own funds, while mortgage brokers facilitate originations for Mortgage Bankers. Mortgage brokers do not close mortgages in their own names.

- ✓ **Mortgage Broker:** An intermediary who brings mortgage borrowers and mortgage lenders (like a mortgage banker) together, but he does not use his own funds to originate mortgages. A mortgage broker gathers paperwork from a borrower, and passes that paperwork along to a mortgage lender for underwriting and approval. The mortgage funds are then lent in the name of the mortgage lender. A mortgage broker collects an origination fee and/or a brokerage from the lender as compensation for its services.

  A mortgage broker is not to be confused with a mortgage banker, which closes and funds a mortgage with its own funds. Mortgage brokers frequently facilitate transactions for mortgage bankers.

- ✓ **Credit Rating:** It is an assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities. Credit rating is important since individuals and corporations with poor credit history will have difficulty finding financing, and will most likely have to pay more interest due to the risk of default.

- ✓ **Adjustable-Rate Mortgage (ARM):** A type of mortgage in which the interest rate paid on the outstanding balance varies according to a specific benchmark (i.e. they have a floating rate of interest). The initial interest rate is normally fixed for a period of time after which it is reset (i.e. revised) periodically, often every month. An adjustable rate mortgage is also known as a "variable-rate mortgage" or a "floating-rate mortgage"

  In US, 2/28 and 3/27 mortgages are examples of ARMs. A 2/28 mortgage's initial interest rate is fixed for a period of two years and then resets to a floating rate for the remaining 28 years of the mortgage. In a 3/27 mortgage the interest rate is fixed for three years and then floats for the remaining 27 years of the mortgage.

- ✓ **Fannie Mae (Federal National Mortgage Association (FNMA):** It is a government-sponsored enterprise (GSE) that was created in 1938 to expand the flow of mortgage money by creating a secondary mortgage market. Fannie Mae is a publicly traded company which operates under a congressional charter that directs Fannie Mae to channel its efforts into increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. Fannie Mae's "little brother" is Freddie Mac.

- ✓ **Predatory Lending:** It refers to unscrupulous actions carried out by a lender to entice, induce, and/or assist a borrower in taking a mortgage that carries high fees, a high interest rate, strips the borrower of equity, or places the borrower in a lower credit rated loan to the benefit of the lender. As with most things of a dishonest nature, new and different predatory lending schemes frequently arise. Becoming more financially literate helps borrowers spot red flags and avoid questionable lenders.

- ✓ **Bankruptcy:** It refers to a state of a person or firm where it is unable to repay debts. If the bankrupt entity is a firm, the ownership of the firm's assets is transferred from the stockholders to the creditors. Shareholders are the last people to get paid if a company goes bankrupt. Secured creditors always get first grabs at the proceeds from liquidation.

- ✓ **Refinance:** When a business or person revises their payment schedule for repaying debt is called refinancing. Refinancing may also involve replacing an older loan with a new loan offering better terms. When a business refinances they typically extend the maturity date. When individuals change their monthly payments, or modify the rate of interest on their loan, it usually involves a penalty fee.

- ✓ **Second Mortgage:** A type of subordinate mortgage made while an original mortgage is still in effect. In the event of default, the original mortgage would receive all proceeds from the liquidation of the property until it is all paid off. Since the second mortgage would receive repayments only when the first mortgage has been paid off, the interest rate charged for the second mortgage tends to be higher and the amount borrowed will be lower than for the first mortgage.

Since the first mortgage is used as a loan for buying the property, many people use second mortgages as loans for large expenditures that may be very difficult to finance. For example, people may take on a second mortgage to fund a child's college education, or to purchase a new vehicle. Second mortgages also can be a method to consolidate debt by using the money from the second mortgage to pay off other sources of outstanding debt, which may have carried even higher interest rates (like credit card debt).

- ✓ **House appraisal:** A home appraisal is, simply, an "opinion of value" by a professional appraiser who visits the home and inspects the size, condition, quality and function of the home. The appraiser will generate a detailed report and will generally use comparisons to the sale prices of similar homes in the area to determine a value of the home that is being appraised--known as the "subject property. Comparisons can be made to square footage, appearance, amenities and overall condition.

  A professional appraisal protects both the lender--so they don't lend more than a property is worth--as well as they buyer--so they don't PAY too much. If a buyer gets into the heat of the moment and offers a silly (too high) price on a home, the appraisal will often flush it out. The appraisal is done by a professional appraiser—called Home appraiser (in virtually all cases is selected by the lender).

- ✓ **Structured Investment Vehicle (SIV):** SIV is a fund which borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. SIVs are a type of structured credit product; they are usually from $1bn to $30bn in size and invest in a range of asset-backed securities, as well as some financial corporate bonds. A SIV has an open-ended (or evergreen) structure; it plans to stay in business indefinitely by buying new assets as the old ones mature, and the SIV manager is allowed to exchange investments without providing investors transparency / the ability to look through to the structure.

  The risk that arises from the transaction is twofold. First, the solvency of the SIV may be at risk if the value of the long term security that the SIV has bought falls below the short term securities that the SIV has sold. Second, there is a liquidity risk, as the SIV borrows short term and invests long term; i.e. out payments become due before the in payments are due. Unless the borrower can refinance short-term at favorable rates, he may be forced to sell the asset into a depressed market.

- ✓ **Dow Jones Industrial Average (DJIA):** The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. The DJIA was invented by Charles Dow back in 1896.

  Often referred to as "the Dow", the DJIA is the oldest and single most watched index in the world. The DJIA includes companies like General Electric (GE), Disney, Exxon and Microsoft.

- ✓ **Standard & Poor's 500 Index (S&P 500):** An index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe.

Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market-value weighted index i.e. each stock's weight in the index is proportionate to its market value.

The S&P 500 is one of the most commonly used benchmarks for the overall U.S. stock market. The Dow Jones Industrial Average (DJIA) was at one time the most renowned index for U.S. stocks, but because the DJIA contains only 30 companies, most people agree that the S&P 500 is a better representation of the U.S. market. In fact, many consider it to be *the* definition of the market.

Other popular Standard & Poor's indexes include the S&P 600, an index of small-cap companies with a market capitalization between $300 million and $2 billion, and the S&P 400, an index of mid-cap companies with market capitalizations of $2 billion to $10 billion.

A number of financial products based on the S&P 500 are available to investors. These include index funds and ETFs. However, it would be difficult for individual investors to buy the index, as this would entail buying 500 different stocks.

- ✓ **Hedge Fund:** An aggressively managed portfolio of investments that uses advanced investment strategies such as leverage, 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.

  For the most part, hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors. 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. Thus, one can think of hedge funds as mutual funds for the super rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ because a hedge fund has far more flexibility in its investment strategies.

  It is important to note that the term *“Hedging”* is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment. Thus the name is mostly historical, as historically hedge funds tried to hedge against the downside risk of a bear market by shorting the market (mutual funds generally can't enter into short positions as one of their primary goals). However nowadays, hedge funds use dozens of different strategies, so it is not correct to say that hedge funds just "hedge risk". In fact, because hedge fund managers make speculative investments, these funds can carry more risk than the overall market.

- ✓ **Open Market Operations:** It is the buying and selling of government securities by the central bank of a country in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite. Open market operations are the means of implementing monetary policy by which a central bank controls its national money supply by buying and selling government securities, or other instruments.

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