

Bank Management



7e

Timothy W. Koch
S. Scott MacDonald

SEVENTH EDITION

BANK MANAGEMENT

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Bank Management, Seventh Edition
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Library of Congress Control Number: 2009930687

ISBN-13: 978-0-324-65578-0

ISBN-10: 0-324-65578-9

South-Western Cengage Learning

5191 Natorp Boulevard
Mason, OH 45040
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Preface

The Glass-Steagall Act of 1933 created three separate lines of business within the financial services industry—commercial banking, investment banking, and insurance. The primary purpose was to separate commerce from banking in order to reduce conflicts of interest among business managers and encourage the smooth functioning of financial and product markets. At that time, commercial banks accepted demand deposits and made loans to businesses. Investment banks were largely involved in underwriting securities, which helped governments and businesses sell newly issued bonds and stocks to the public and helped individuals buy and sell securities. Insurance companies accepted premiums and underwrote insurance policies for individuals and businesses.

Over time, U.S. firms dominated global finance and economic activity. Large U.S. financial firms aggressively expanded into new lines of business with new products offering financial innovations, for example the use of derivatives, which allowed firms to dramatically alter their risk management practices. Many firms expanded their operations throughout the world far beyond traditional lending and deposit gathering. Concurrently with the growing economic power of the U.S., the U.S. dollar served as the currency of choice for global transactions and central bank reserves. Economic policymakers, politicians, and regulators followed three basic tenets to achieve sustained economic growth: the pursuit of free trade, deregulation of financial services, and macroeconomic stability. U.S. firms grew accordingly.

Other countries followed suit. In October 1986, the United Kingdom deregulated its financial institutions and markets. London subsequently became a booming financial center where many of the world's largest institutions, such as HSBC and the Royal Bank of Scotland RBS, were headquartered. Japan, China, Singapore, Russia, and many emerging-market countries developed their own successful stock exchanges. These actions produced long periods of sustained economic growth. But things changed.

Beginning in mid-2007, the U.S. economy began to weaken following a series of crises related to problem financial institutions. Several large investment banks, commercial banks, and insurance companies suffered losses due to falling real estate values, particularly home prices, and excessive financial leverage. Lehman Brothers failed and many large financial institutions effectively failed as they were collapsed into stronger surviving institutions. Thus, Bank of America acquired Countrywide and Merrill Lynch. J.P. Morgan Chase acquired Bear Stearns and Washington Mutual. Wells Fargo acquired Wachovia. Goldman Sachs and Morgan Stanley converted to bank holding companies, as did several other noncommercial bank financial companies such as American Express, The Hartford, and General Motors Acceptance Company, to name a few.

As large financial institutions suffered significant losses all over the globe, credit availability lessened and the terms of borrowing became extraordinarily restrictive. In December 2007, the United States fell into recession. The global

economy followed. In 2008, the U.S. lost over 2.5 million jobs. By 2009, the Obama administration and Congress had approved a massive stimulus plan involving tax cuts and increased government spending in an effort to jump-start consumer and business spending. Importantly, the policies were designed to raise consumer and business confidence, which had eroded with recent events.

Clearly, the banking world has permanently changed. Investment banks, as traditionally structured, no longer exist as independent organizations. Given excessive financial leverage, bank regulators pursued policies to reduce leverage at banks. As such, the nature of bank risk taking changed. Lending refocused on borrowers' ability and willingness to repay because the model of originating and distributing loans broke down. The tight credit markets of 2008 and 2009 forced the American consumer to reduce their total borrowings and de-leverage, as well. Banks focused on capital adequacy, the quality of assets (reduced loan losses), and the availability of adequate liquidity. The financial industry again consolidated.

This book examines the impacts of the changing competitive environment on commercial banks, banking services, and to a lesser degree the entire financial services industry. Upon completing the book, the reader will better understand the risks associated with loans and securities, the process of securitization, excessive leverage, and inadequate liquidity. The reader will also appreciate the value of core business models that value core operating earnings versus trading, or price and volume driven profits. The analysis provides a framework for developing effective strategies to ensure the proper balance between management's profit targets and allowable risk taking.

Audience

Bank Management is designed for use in upper division undergraduate or master's level banking and financial institutions courses at universities as well as professional banking programs. As prerequisites, students should be familiar with elementary accounting, basic interest rate and bond pricing concepts, and basic macroeconomics. The book is also well suited for broad-based instructional purposes in bank training programs. For someone new to banking, the book describes the range of banking activities and demonstrates how bank managers make financial decisions. For practitioners, it presents traditional decision models and explains how decisions in one area affect performance and opportunities in other areas. This book therefore provides a comprehensive view of balance sheet management with an emphasis on the trade-offs between profitability and risk.

About Bank Management

The book focuses on decision making and offers a unique approach to understanding commercial bank management. Key chapters address the specific aspects of an issue or problem, explain how a financial model or decision framework applies, and then demonstrate the application of the model

or framework using sample data. The reader not only observes how certain factors influence credit, investment, funding, and pricing decisions, but also develops an appreciation of the trade-offs between return and risk. Several Microsoft Excel templates, which include various models and applications using sample data, are available to users. End-of-chapter cases, questions, and problems provide an opportunity to test the reader's understanding of important issues and data analysis.

After reading *Bank Management*, the reader should have a solid foundation in the key issues confronting managers today, a familiarization with the basic financial models that are used to formulate decisions, and an understanding of the strengths and weaknesses of data analysis. The text and numerous applications help the reader to recognize the trade-offs involved in making financial decisions and to develop the logical thought processes needed to reach reasonable conclusions.

New Features of This Edition

The seventh edition of the book builds on the topics and features of earlier editions, with several important changes:

- A complete regulatory update has been applied throughout the book. In particular, the book examines the many programs evolving from the financial crisis that focus on providing liquidity to the banking system. Included are discussions of the Troubled Asset Relief Program (TARP), the Term Securities Lending Facility (TSLF), and related programs, as well as recent regulatory actions.
- A complete discussion of the changing landscape of the financial services industry—including the evolution of investment banks into bank holding companies.
- An analysis of the subprime mortgage crisis, its impact on financial institutions and the economy, and regulatory responses.
- An updated and comprehensive evaluation of commercial bank performance and the impact this has on the analyst's job in evaluating performance. A direct comparison of PNC Bank's financial performance in 2007 versus peer institutions as well as important contrasts with the performance of community banks.
- An analysis of the most current data from the Uniform Bank Performance Report (UBPR), the FDIC, and the Federal Reserve Bank, including discussion of key performance ratios, an explanation of alternative performance measures, and strengths and weaknesses of the traditional analysis.

- A critique of different funding options, including the various government liquidity facilities, and descriptions of the structure of contingency funding plans.
- A discussion of the current developments in credit scoring, credit reports, bankruptcy reform, check truncation, and applications to consumer lending.
- Extensive use of new tools and examples such as total return analysis and option-adjusted spread analysis are introduced to assist in the evaluation of alternative investment instruments.
- New data and analysis on international banking and the role and size of U.S. banking institutions abroad as well as the ownership and composition of foreign banking institutions in the U.S.
- This book remains the only text that focuses on cash flow analysis as part of the lending decision. It introduces a comprehensive procedure for generating cash-based income statements, explains how to interpret the results, and provides an approach to forecasting a potential borrower's future performance. An Excel template is provided to conduct the comprehensive analysis.

Organization of The Book

The unifying theme of the book is risk management. As a lead-in to each chapter, the text will describe a current issue or provide an example of a key topic discussed in the chapter. This introduction reinforces the risk focus by emphasizing that although managers make both good and bad decisions, the consistent application of finance theory and models should lead to a better understanding of the trade-off between risk and return.

The first two chapters address an overview of the banking industry and regulation, and provide background information related to bank management and current banking trends. They start with an overview of how global financial institutions led the U.S. and other economies into recession in 2007. These chapters also document how large investment banks and commercial banks have effectively merged, examine the organizational structure of small banks and large bank holding companies, describe the regulatory environment, and explain the impact of key banking legislation. They also describe the universal banking model and its recent problems with this organizational structure and strategy.

The chapters that evaluate bank performance examine the basic risk and return features of commercial banks and how analysts evaluate performance. Chapter 3 introduces bank financial statements and presents the traditional DuPont model for evaluating bank performance using financial ratios from the Uniform Bank Performance Report (UBPR) to analyze the strengths and weaknesses of bank performance over time and versus peer institutions. It provides the foundation and building blocks for understanding how banks

make a profit and the trade-offs involved in balancing credit risk, liquidity risk, market risk, operational risk, reputational risk, legal risk, and solvency risk. Chapter 4 documents recent strategies and trends in controlling noninterest expense relative to noninterest income to help meet efficiency objectives. Chapter 5 documents differences in nontraditional banking organizations by focusing on the performance of Goldman Sachs, Mutual of Omaha Bank, and BMW Bank, organizations that were once purely an investment bank, insurance company, and automobile manufacturer/finance company, respectively.

The next four chapters demonstrate how banks measure and manage interest rate risk. Chapter 6 provides background information on the pricing of securities, total return analysis to investors, and the determinants of interest rates. Chapter 7 introduces GAP analysis and the use of earnings sensitivity analysis to assess the potential impact of interest rate and balance sheet changes on net interest income. Chapter 8 describes duration gap analysis and the use of sensitivity analysis to assess the potential impact of interest rate and balance sheet changes on the economic value of stockholders' equity. The discussion emphasizes the impact of embedded options and the necessity behind incorporating sensitivity analysis to assess the impact of such options on profits and risk. Chapter 9 describes the basic features of financial futures, forward contracts, interest rate swaps, and interest rate caps and floors and explains how banks use them to both hedge and speculate. Emphasis is directed toward understanding the models, data output, and strategies to improve performance.

Chapters 10 through 12 describe the features of bank liabilities, regulatory capital requirements, and overall liquidity analysis. They present a procedure for estimating the marginal cost of funds that is used in making investment decisions and pricing assets. They also explain how banks meet legal reserve requirements and manage cash assets, and develop a model for estimating liquidity needs and planning for temporary cash deficiencies and longer-term liquidity needs. Special attention is focused on the nature of Federal Home Loan Bank advances and other sources of funding from government entities and their use in liquidity management. A new section describes the importance and nature of contingency funding plans at banks. Chapter 12 documents risk-based capital requirements and outlines strategies for obtaining new external capital.

Chapters 13, 14, and 15 address how banks manage credit risk, beginning with basic credit analysis principles and the characteristics of different types of loans. Subsequent chapters present a procedure for estimating a business borrower's cash flow from operations and the basic credit scoring models applied to individual borrowers. Considerable emphasis is placed on interpreting financial statements and generating cash flow estimates to determine repayment prospects. Given the recessionary environment of 2008 and beyond, many of the discussions focus on the deterioration of asset quality at banks and the consequent potential impacts on loan workouts.

The last two chapters, 16 and 17, describe the role of fixed-income securities in helping a bank meet profit and risk objectives. Chapter 16 identifies the basic objectives of a bank's investment portfolio and the nature of investment policy guidelines, and explains the basic features of taxable and tax-exempt securities

that banks buy. It then introduces various strategies related to choosing security maturities, the composition between taxable and tax-exempt securities, and purchases or sales timed to take advantage of the business cycle. It explains the impact of embedded options on security pricing and the risk-return trade-off to investors of callable bonds and mortgage-backed securities with significant prepayment risk. The final chapter describes recent trends in global banking activities and the management of foreign exchange risk.

Each chapter of *Bank Management* concludes with a series of discussion questions and problems that require the student to apply the decision models introduced in the chapter. Excel templates can be used to generate and address additional problems as well as provide a useful tool for future analysis.

The seventh edition contains 17 chapters, three chapters more than in the sixth edition. Additional material has been added to address the changing financial services industry landscape, and other chapters have been restructured to streamline and improve the presentation of material. Chapter 1 is a new chapter that specifically addresses the change in the financial landscape that resulted from the financial crisis of 2008–2009. Chapter 5 is also a new chapter that addresses the differences in the business models of nontraditional banking organizations.

Ancillary Package

INSTRUCTOR'S MANUAL AND TEST BANK

A comprehensive Instructor's Manual and Test Bank (provided on CD-ROM) accompanies *Bank Management*. The CD provides teaching objectives and outlines for each chapter. It further offers detailed answers to end-of-chapter questions and problems. Finally, multiple choice questions are provided, with answers on disk.

LECTURE PRESENTATION SOFTWARE

Microsoft PowerPoint™ presentations are available to those professors who wish to incorporate multimedia in the classroom. This multimedia presentation allows the student to explore the almost unlimited number of different financial situations that banks face on a daily basis. Furthermore, it provides the instructor a method by which he or she can integrate a financial analysis spreadsheet template directly into the class presentation. Many tables and diagrams are featured in the lecture software package.

PREFACE SPREADSHEET TEMPLATE

Microsoft Excel templates are available for those who wish to use microcomputers to perform and extend the data analysis presented in the book. The templates provide a generic decision model for applications related to analyzing bank performance and key financial ratios, and cash flow from operations for nonfinancial firms. The templates also provide a full range of decision models with data for key problems and cases in the text. Students can use the templates to analyze historical balance sheet and income statement data

and conduct “what if” analysis. This allows the user to quickly examine a range of outcomes rather than just simple, static solutions. The templates cover topics including bank performance analysis, duration analysis, risk-based capital requirements and planning, credit analysis, and customer profitability analysis.

WEB SITE

The product-support Web site, located at www.cengage.com/finance/koch, contains the PowerPoint slide presentation, Instructor’s Manual, and Spreadsheet Templates.

ACKNOWLEDGMENTS

Throughout the writing of the seventh edition, we have relied on the assistance and expertise of many friends in the banking industry and academic community. This revision has benefited from ongoing discussions with the following individuals and former students. We especially thank John Barrickman, David Chappell, William Chittenden, Steve Christensen, Ken Cyree, David Davis, Charles Funk, Jeff Gerrish, Scott Hein, Jeff Judy, Ira Kawaller, Randy King, Ed Krei, Charles Moyer, Don Mullineaux, Don Musso, James Pappas, Ramesh Rao, Merrill Reynolds, Robert Schweitzer, Mike Stevens, Lynda Swenson, Ernie Swift and Randy Woodward.

We would also like to thank the reviewers who contributed invaluable comments and suggestions. These individuals are:

Ronnie Clayton, Jacksonville State University
 Robert Kunkel, University of Wisconsin, OshKosh
 James McNulty, Florida Atlantic University
 Chien-Chih Peng, Morehead State University
 Dean S. Sommers, University of Delaware

Also, we appreciate the guidance and assistance of the staff at South-Western/Cengage Learning, especially Mike Reynolds, Maggie Kubale, Michelle Gaudreau, and Lysa Kosins. It was a pleasure working with them.

Finally, we want to thank our families—Susan, Michala, and Andy; and Becky, Cassy, and Erin—for their encouragement, support, and insights in seeing this project through to completion.

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Dr. Koch's research and writing focuses on bank risk management, performance analysis and improvement, the pricing of financial futures and fixed-income securities, and public finance. He has published in a wide range of academic journals, including the *Journal of Finance*, *Journal of Financial & Quantitative Analysis*, *Journal of Futures Markets*, *National Tax Journal*, *Journal of Banking and Finance*, *Journal of Fixed Income*, *Journal of Financial Research*, *Journal of Macroeconomics*, *Journal of Portfolio Management*, *Municipal Finance Journal*, and the *Journal of Money, Credit and Banking*. He has served as Treasurer of the Financial Management Association and President of the Eastern Finance Association and Southern Finance Association. He also authors the *General Banking* curriculum materials used at many state-sponsored banking schools and is a frequent seminar leader for the banking industry.

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Dr. MacDonald is the author of articles in academic journals such as the Journal of Financial Economics, the Journal of Business, the Journal of Futures Markets, the Review of Futures Markets, Quarterly Journal of Business and Economics, and the Journal of Money, Credit and Banking. He is also the author of professional curriculum materials for industry-sponsored seminars and schools in the financial services industry, as well as the recipient of numerous teaching and research awards.

Dedication

*To my parents, Lowell and Marilyn Koch, who always
encouraged and supported me.*
Timothy W. Koch

*To my family, Becky, Cassy, and Erin for their never-ending
support and encouragement.*
S. Scott MacDonald

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GLOSSARY

1-4 FAMILY RESIDENTIAL MORTGAGE LOANS Mortgage loans secured by 1-4 family residential properties.

A

ACCELERATED DEPRECIATION A method of computing depreciation deductions for income taxes that permits deductions in early years greater than those under straight line depreciation.

ACCEPTANCES, SEE BANKERS ACCEPTANCE.

ACCOUNT ACTIVITY Transactions associated with a deposit account, including home debits, transit checks, deposits, and account maintenance.

ACCOUNT ANALYSIS An analytical procedure for determining whether a customer's deposit account or entire credit-deposit relationship with a bank is profitable. The procedure compares revenues from the account with the cost of providing services.

ACCOUNT EXECUTIVE A representative of a brokerage firm who processes orders to buy and sell stocks, options, etc., for a customer's account.

ACCOUNT FEE-ONLY NONINTEREST CHECKING ACCOUNT Incurs a monthly fee (regardless of the account balance) as well as a possible per-check charge.

ACCOUNT MAINTENANCE The overhead cost associated with collecting information and mailing periodic statements to depositors.

ACCOUNTS PAYABLE Funds owed to a firm's suppliers.

ACCOUNTS RECEIVABLE Funds owed a firm by customers to whom the firm sells goods and services.

ACCOUNTS RECEIVABLE AGING SCHEDULE A list of accounts receivable segregated according to the month in which the invoice is dated (invoice aging) or in which the invoice is payable (due date aging).

ACCOUNTS RECEIVABLE TURNOVER Credit sales divided by average accounts receivable outstanding.

ACCRUAL The accumulation of income earned or expense incurred, regardless of when the underlying cash flow is actually received or paid.

ACCRUAL BOND A bond that accrues interest but does not pay interest to the investor until maturity when accrued interest is paid with the principal outstanding.

ACCRUED INTEREST Interest income that is earned but not yet received.

ACID-TEST RATIO A measure of liquidity from reported balance sheet figures with a targeted minimum value of 1. Calculated as the sum of cash and marketable securities divided by current liabilities.

ACTIVE PORTFOLIO MANAGEMENT An investment policy whereby managers buy and sell securities prior to final maturity to speculate on future interest rate movements.

ACTIVITY CHARGE A service charge based on the number of checks written by a depositor.

ADD-ON RATE A method of calculating interest charges by applying the quoted rate to the entire amount advanced to a borrower times the number of financing periods. An 8 percent add-on rate indicates \$80 interest per \$1,000 for 1 year, \$160 for 2 years, and so forth. The effective interest rate is higher than the add-on rate because the borrower makes installment payments and cannot use the entire loan proceeds for the full maturity.

ADEQUATELY CAPITALIZED BANK FDIC definition of a bank with capital levels that meet or exceed all applicable Federal regulatory capital standards--but one that is restricted from obtaining brokered deposits without FDIC approval.

ADJUSTABLE-RATE MORTGAGE A mortgage with an interest rate that can be adjusted with changes in a base rate or reference index. The index generally varies with market interest rates.

ADR American Depository Receipt: A certificate issued by a U.S. bank that evidences ownership in foreign shares of stock held by the bank.

ADVANCE A payment to a borrower under a loan agreement.

ADVANCE COMMITMENT An agreement to sell an asset prior to the seller holding a commitment to purchase the asset.

AFFILIATE Any organization owned or controlled by a bank or bank holding company, the stockholders, or executive officers.

AFFINITY CARD A credit card that is offered to all individuals who are part of a common group or who share a common bond.

AFTER-TAX REAL RETURN The after-tax rate of return on an asset minus the rate of inflation.

AGENCY A trust account in which title to property remains in the owner's name.

AGENCY SECURITIES Fixed-income securities issued by agencies owned or sponsored by the federal government. The most common securities are issued by the Federal Home Loan Bank, Federal National Mortgage Association, Government National Mortgage Association, and Farm Credit System.

AGING ACCOUNTS RECEIVABLE A procedure for analyzing a firm's accounts receivable by dividing them into groups according to whether they are current or 30, 60, or over 90 days past due.

ALCO Acronym for asset and liability management committee.

ALL-IN-COST The weighted average cost of funds for a bank calculated by making adjustments for required reserves and deposit insurance costs. The sum of explicit and implicit costs.

ALLOWANCE FOR LOAN LOSSES A balance sheet account representing a contra-asset, or reduction in gross loans. It is established in recognition that some loans will not be repaid. Also called a loan loss reserve.

ALTERNATIVE MINIMUM TAX (AMT) A federal tax against income intended to ensure that taxpayers pay some tax even when they use tax shelters to shield income.

AMORTIZE To reduce a debt gradually by making equal periodic payments that cover interest and principal owed.

AMORTIZING SWAP An interest rate swap in which the outstanding notional principal amount declines over time.

ANNUAL PERCENTAGE RATE The effective annual cost of credit expressed as a percentage inclusive of the amount financed, the loan maturity, and the finance charge.

ANNUITY A constant payment made for multiple periods of time.

ANTICIPATED INCOME THEORY A theory that the timing of loan payments should be tied to the timing of a borrower's expected income.

APPLICABLE INCOME TAXES Estimated taxes to be paid over time, not actual tax payments.

APPRECIATION An increase in the market value of an asset.

ARBITRAGE The simultaneous trading (purchase and sale) of assets to take advantage of price differentials.

ARBITRAGEUR OR SPREADER Speculators who take relatively low-risk positions.

ARM (ADJUSTABLE-RATE MORTGAGE) A mortgage in which the contractual interest rate is tied to some index of interest rates and changes when supply and demand conditions change the underlying index.

ARREARS An overdue outstanding debt.

ASK PRICE The price at which an asset is offered for sale.

ASSET AND LIABILITY MANAGEMENT (ALM) The management of a bank's entire balance sheet to achieve desired risk-return objectives and to maximize the market value of stockholders' equity.

ASSET LIQUIDITY The ease of converting an asset to cash with a minimum of loss.

ASSET SENSITIVE A bank is classified as asset sensitive if its GAP is positive.

ASSET UTILIZATION (AU) Ratio of total operating income to total assets; a measure of the gross yield earned on assets.

ASSET-BACKED SECURITY A security with promised principal and interest payments backed or collateralized by cash flows originating from a portfolio of assets that generate the cash flows.

ASSET-BASED FINANCING Financing in which the lender relies primarily on cash flows generated by the asset financed to repay the loan.

ASSIGNMENT The transfer of the legal right or interest on an asset to another party.

AT THE MONEY An option where the price of the underlying instrument or contract is approximately equal to the option's exercise price.

ATS ACCOUNT A checking account that pays interest, similar to a NOW account, but the customer has both a DDA and savings account. The bank forces a zero balance in the DDA at the close of each day after transferring just enough funds from savings to cover checks presented for payment.

AUCTION-RATE SECURITIES Are usually long-term bonds with interest rates that reset periodically, often once a month through an auction process. Since the auction resets their rates often, they act similarly to short-term bonds.

AUTOMATED CLEARINGHOUSE (ACH) A facility that processes interbank debits and credits electronically.

AUTOMATED LOAN MACHINE A machine that serves as a computer terminal and allows a customer to apply for a loan and, if approved, automatically deposits proceeds into an account designated by the customer.

AUTOMATED TELLER MACHINE (ATM) A machine that serves as a computer terminal and allows a customer to access account balances and information at a bank.

AUTOMATIC TRANSFERS FROM SAVINGS (ATS) Transactions accounts that pay interest set by each bank without federal restrictions.

AVAILABLE-FOR-SALE Securities reported at market value.

AVERAGE HISTORICAL COST OF FUNDS Measure of average unit borrowing costs for existing funds.

B

BACKWARDIZATION The situation in which futures prices on futures contracts that expire farther in the future are below prices of nearby futures contracts.

BAD DEBTS Loans that are due but are uncollectible.

BALANCE INQUIRY A request by a depositor or borrower to obtain the current balance on his or her account.

BALANCE SHEET A financial statement that indicates the type and amount of assets, liabilities, and net worth of a firm or individual at a point in time.

BALANCE SHEET GAP The effective amount of assets that reprice by the full assumed rate change minus the effective amount of liabilities that reprice by the full assumed rate change.

BALLOON LOAN A loan that requires small payments that are insufficient to pay off the entire loan so that a large final payment is necessary at termination.

BANK HOLDING COMPANY (BHC) Any firm that owns or controls at least one commercial bank.

BANK HOLDING COMPANY ACT OF 1956 The act placed the Federal Reserve in charge of determining what activities holding companies could engage in and prohibited bank holding companies from acquiring a bank in another state. Banks were generally restricted to operating within very narrow geographic markets.

BANK LIQUIDITY A bank's capacity to acquire immediately available funds at a reasonable price.

BANKERS ACCEPTANCE A draft drawn on a bank and accepted, which makes it a negotiable instrument.

BANKERS' BANK A firm that provides correspondent banking services to commercial banks and not to commercial or retail deposit and loan customers.

BANKRUPT The situation in which a borrower is unable to pay obligated debts.

BARBELL STRATEGY An investment portfolio in which a large fraction of securities mature near term and another large fraction of securities mature longer term.

BASE COMPUTATION PERIOD The 14-day period during which a bank's outstanding liabilities determine the amount of required reserves to be held during the reserve maintenance period.

BASE RATE An interest rate used as an index to price loans; typically associated with a bank's weighted marginal cost of funds.

BASIC SWAP A plain vanilla interest rate swap in which one party pays a fixed interest rate and receives a floating rate, while the other party pays a floating rate and receives a fixed rate, with all rates applied to the same, constant notional principal amount.

BASIS With financial futures contracts, the futures rate minus the cash rate.

BASIS POINT 1/100th of 1 percent, or 0.0001; 100 basis points equal 1 percent.

BASIS RISK The uncertainty that the futures rate minus the cash rate will vary from that expected.

BEARER BONDS Bonds held by the investor (owner) in physical form. The investor receives interest payments by submitting coupons from the bond to the paying agent.

BENCHMARK RATE The key driver rate used in sensitivity analysis or simulation models to assess interest rate risk. Other model rates are linked to the benchmark rate in terms of how they change when the benchmark rate changes.

BENEFICIARY The recipient of the balance in a trust account upon termination of the trust.

BEST EFFORTS UNDERWRITING The underwriter of securities commits to selling as many securities as possible and returns all unsold shares or units to the issuer.

BETA An estimate of the systematic or market risk of an asset within the capital asset pricing model (CAPM) framework.

BETA GAP The adjusted GAP figure in a basic earnings sensitivity analysis derived from multiplying the amount of rate-sensitive assets by the associated beta factors and summing across all rate-sensitive assets, and subtracting the amount of rate-sensitive liabilities multiplied by the associated beta factors summed across all rate-sensitive liabilities.

BID PRICE The price at which someone has offered to buy an asset.

BIF Bank Insurance Fund that insures deposits at commercial banks.

BLANK CHECK A signed check with no amount indicated.

BOARD OF DIRECTORS Individuals elected by stockholders to manage and oversee a firm's operations.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM The policy-setting representatives of the Federal Reserve System in charge of setting the discount rate, required reserves, and general policies designed to affect growth in the banking system's reserves and U.S. money supply.

BOND An interest-bearing security representing a debt obligation of the issuer.

BOND ANTICIPATION NOTES These provide interim financing for capital projects that will ultimately be financed with long-term bonds.

BOND BROKER A broker who trades bonds on an exchange.

BOND EQUIVALENT RATE Also known as the coupon-equivalent rate, is the annual percentage yield quoted for most Treasury and corporate bonds. Does not equal the effective annual compounded rate of interest.

BOND FUND A mutual fund that invests in debt instruments.

BOND RATING The subjective assessment of the likelihood that a borrower will make timely interest and principal payments as scheduled. Letters are assigned to a security by rating agencies to reflect estimated creditworthiness.

BOOK VALUE Accounting value typically measured as historical cost minus depreciation.

BOOK VALUE OF EQUITY Total assets minus total liabilities reported on the balance sheet.

BORROWED FUNDING Federal funds purchased, repurchase agreements, Federal Home Loan Bank (FHLB) borrowings, and other borrowings.

BORROWING BASE An estimate of the available collateral on a company's current assets

BOUNCE A CHECK A depositor writes a check that is returned to the bank and by the bank to the depositor because of insufficient funds.

BRANCH BANKING An organizational structure in which a bank maintains facilities that are part of the bank in offices different from its home office. Some states allow banks to set up branches through the state, county, or city. Others prohibit branches.

BRIDGE LOAN A loan issued to fund a temporary need from the time a security is redeemed to the time another security is issued.

BROKER An individual who executes orders for customers for which he/she receives a commission.

BROKERED DEPOSITS Deposits acquired through a money broker (typically an investment bank) in the national markets.

BULGE BRACKET FIRMS Firms in an underwriting syndicate that have the highest commitment to assist in placing the underlying securities.

BULLET LOAN A loan that requires payment of the entire principal at maturity.

BURDEN Noninterest expense minus noninterest income.

BURDEN RATIO Measures the amount of noninterest expense covered by fees, service charges, securities gains, and other income as a fraction of average total assets.

BUSINESS RISK EXPENSE Represents both actual cash expense (losses) as well as noncash expense, or allocations for potential losses.

C

CALL FEATURE Bonds with call features give the right, but not the obligation, to the issuer to redeem the bond at a date prior to the original maturity date. Usually have a deferral period as well as a call premium to the face value.

CALL LOAN A loan that is callable on 24 hours' notice.

CALL OPTION An agreement in which the buyer has the right to buy a fixed amount of the underlying asset at a set price for a specified period of time.

CALL PROTECTION The feature that does not allow a bond to be called for some (deferral) period.

CALL PROVISION A provision in a bond that allows the issuer to redeem the bond, typically at a premium over par, prior to maturity.

CALLABLE BOND A bond in which the issuer has the option to call the bond from the investor; that is, to prepay the outstanding principal prior to maturity.

CALLABLE CD Certificate of deposit that typically carries a two-year deferral period, meaning it cannot be called for two years after issue. Afterward, the bank can call the CD, meaning that it could repay the depositor's principal, at its discretion.

CAMELS An acronym that refers to the regulatory rating system for bank performance: C—capital adequacy; A—asset quality; M—management quality; E—earnings quality; L—liquidity; and S—sensitivity to market risk.

CAP Use of options to place a ceiling on a firm's borrowing costs.

CAPITAL Funds subscribed and paid by stockholders representing ownership in a bank. Regulatory capital also includes debt components and loss reserves.

CAPITAL GAIN (LOSS) Profit (loss) resulting from the sale of an asset for more (less) than its purchase price.

CAPITAL MARKET Market for securities with maturities beyond one year.

CAPITAL RESERVES FOR CONTINGENCIES The value of cumulative reserves established for deferred taxes or contingencies.

CAPITAL RISK Potential decrease in the market value of assets below the market value of liabilities, indicating economic net worth is zero or less.

CAPTIVE FINANCE COMPANY A finance company owned by a manufacturer that provides financing to buyers of the firm's products.

CARD BANK Bank that administers its own credit card plan or serves as a primary regional agent of a national credit card operation.

CARS (COLLATERALIZED AUTOMOBILE RECEIVABLES) A form of asset-backed security in which the collateral is automobile receivables.

CASH ASSETS Assets held to satisfy customer withdrawal needs, meet legal reserve requirements, or purchase services from other financial institutions--but that do not pay interest.

CASH BASIS The accounting procedure that recognizes revenues when cash is actually received and expenses when cash is actually paid.

CASH BUDGET A comparison of cash receipts and cash expenditures over a period of time.

CASH FLOW FROM OPERATIONS A firm's net cash flow from normal business operating activities used to assess the firm's ability to service existing and new debt and other fixed-payment obligations.

CASH LETTER Transit letter on tape that lists items submitted between banks for collection.

CASH MARKET The spot market for the immediate exchange of goods and services for immediate payment.

CASH SETTLEMENT The form for settling futures contracts where the parties exchange cash rather than have one party deliver the underlying asset.

CASH-BASED INCOME STATEMENT A modified form of a direct statement of cash flows. It is essentially a statement of changes reconciled to cash, which combines elements of the income statement and balance sheet.

CASHIER'S CHECK A bank check that is drawn on the bank issuing the check and signed by a bank officer.

CASH-TO-CASH ASSET CYCLE The time it takes to accumulate cash, purchase inventory, produce a finished good, sell it, and collect on the sale.

CASH-TO-CASH LIABILITY CYCLE The length of time it takes to obtain interest-free financing from suppliers in the form of accounts payable and accrued expenses.

CASH-TO-CASH WORKING CAPITAL CYCLE The timing difference between the cash-to-cash asset cycle and the cash-to-cash liability cycle.

CD SPECIALS CDs with higher rates offered to attract new customers. CD specials are typically offered with nonstandard maturity dates such as 7 or 13

months rather than 6 months or one year; intent is to attract new funds and not cannibalize deposits from current customers in traditional CDs.

CEASE AND DESIST ORDER (C&D) A legal document that orders a firm to stop an unfair practice under full penalty of law. Only the cease and desist order has legal standing, but other types of recommendations serve the purpose of notifying a bank as to whether its house is in order.

CENTRAL BANK The main bank in a country responsible for issuing currency and setting and managing monetary policy.

CERTIFICATE OF DEPOSIT (CD) A large-denomination time deposit representing the receipt of funds for deposit at a bank.

CERTIFIED CHECK A check guaranteed by a bank where funds are immediately withdrawn.

CERTIFIED FINANCIAL PLANNER (CFP) A designation earned by individuals who have passed the examination sponsored by the Certified Financial Planner Board. Such individuals have studied banking, investment, insurance, estate planning, and tax planning to assist in managing client financial needs.

CHANGES IN RESERVE REQUIREMENTS Changes that directly affect the amount of legal required reserves that banks are required to hold as an asset and thus change the amount of funds a bank can lend out.

CHANGES IN THE DISCOUNT RATE Changes that directly affect the cost of reserve borrowing. When the Fed raises the discount rate, it discourages borrowing by making it more expensive. Fed decreases in the discount rate make borrowing less expensive.

CHARGE-OFF The act of writing off a loan to its present value in recognition that the asset has decreased in value.

CHARTER A document that authorizes a bank to conduct business.

CHARTERED FINANCIAL ANALYST (CFA) A designation earned by individuals who have passed a three-part examination sponsored by the Institute of Chartered Financial Analysts. Topics include economics, finance, security analysis, and financial accounting to assist in security analysis and portfolio management.

CHECK 21 The process that facilitates check truncation by creating a new negotiable instrument called a substitute check, which permits banks to truncate original checks, process check information electronically, and deliver substitute checks to banks that want to continue receiving paper checks.

CHECK KITING The process of writing checks against uncollected deposits while checks are in the process of collection, thereby using funds (float) not actually available.

CHECK TRUNCATION The conversion of a paper check into an electronic debit or image of the check by a third party in the payment system other than the paying bank

CHINESE WALL The imaginary barrier that ensures a trust department will manage trust assets for the benefit of the trust beneficiaries, not for other departments in the bank.

CLASSIFIED LOAN A loan for which regulators have forced management to set aside reserves for clearly recognized losses.

CLEAN UP THE LINE OF CREDIT To bring the balance to zero at least once during the year.

CLEARINGHOUSE ASSOCIATION A voluntary association of banks formed to assist the daily exchange of checks among member institutions.

CMO (COLLATERALIZED MORTGAGE OBLIGATION) A security backed by a pool of mortgages that is structured to fall within an estimated maturity range (tranche), based on the timing of allocated interest and principal payments on the underlying mortgages.

COLLAR Use of options to place a cap and floor on a firm's borrowing costs.

COLLATERAL Property a borrower pledges as security against a loan for repayment if the borrower defaults.

COLLATERALIZED BOND OBLIGATION (CBO) A security backed by a pool of noninvestment grade (junk) bonds.

COLLECTED BALANCES Ledger balances minus float.

COMMERCIAL BANK A bank that mostly specializes in short-term business credit, but also makes consumer loans and mortgages, and has a broad range of financial powers. Commercial banks are stock corporations whose primary purpose is to maximize shareholder wealth.

COMMERCIAL LOAN THEORY A theory suggesting that banks make only short-term, self-liquidating loans that match the maturity of bank deposits.

COMMERCIAL PAPER A short-term unsecured promissory note of a prime corporation.

COMMERCIAL REAL ESTATE LOANS These are generally short-term loans consisting of construction and real estate development loans, land development loans, and commercial properties loans such as shopping centers and office buildings.

COMMISSION BROKER A trader operating on the floor of an exchange who executes trades for other parties.

COMMITMENT FEE Fee charged for making a line of credit available to a borrower.

COMMON STOCK Securities (equities) that evidence ownership in a company for which the holder received discretionary dividends and realizes price appreciation/depreciation.

COMMUNITY BANK A bank that operates primarily in, or has ties to, one community.

COMPENSATING BALANCE A deposit balance required as compensation for services provided by a lender or correspondent bank.

COMPETITIVE EQUALITY BANKING ACT OF 1987 The act recapitalized the Federal Savings and Loan Insurance Corporation (FSLIC) and expanded the FDIC's authority for open bank assistance transactions.

COMPOSITION (MIX) EFFECTS Suggest that the mix of liabilities may differ.

COMPOUND INTEREST Interest paid on outstanding principal plus any interest that has been earned but not paid out.

COMPOUNDING Earning interest on interest.

COMPUTATION PERIOD Consists of two 1-week reporting periods and, therefore, consists of 14 consecutive days beginning on a Tuesday and ending on the second Monday thereafter.

CONCENTRATION RISK Risk of making investments (loans) into a particular geographic area or certain industry; such risk is not measured by the total dollar amount of assets.

CONSERVATOR An individual or trust department appointed by a court to manage the property of an incapacitated individual.

CONSOLIDATED BALANCE SHEET A balance sheet showing the aggregate financial condition of a firm and its subsidiaries, netting out all intracompany transactions.

CONSTRUCTION LOANS Represent interim financing on commercial, industrial, and multifamily residential property. Construction loans are *interim loans*.

CONSUMER BANK A bank that does not make commercial loans.

CONTEMPORANEOUS RESERVE ACCOUNTING (CRA) During the period from 1984 until 1998, open market operations affected both the current deposit levels and required reserves coincidentally.

CONTINGENT LIABILITIES Items, such as guarantees or related contracts, that may become liabilities if certain developments arise.

CONTRACTUAL REPRICING A variable-rate loan or deposit for which the applicable interest changes at a predetermined time for a predetermined amount on the basis of movements in a base rate or the simple passage of time

CONVENTIONAL MORTGAGE A mortgage, deed, or trust that is not obtained under a government-insured program.

CONVERSION FEE Fee charged for converting a loan commitment to a term loan.

CONVERTIBLE DEBT A bond that may be exchanged for common stock in the same firm.

CONVEXITY Characterizes the rate of change in duration when yields change. It attempts to improve upon duration as an approximation of price volatility.

CORE CAPITAL Tier 1 capital consisting primarily of stockholder's equity.

CORE DEPOSITS A base level of deposits a bank expects to remain on deposit, regardless of the economic environment.

CORRESPONDENT BANK A bank that provides services, typically check clearing, to other banks.

CORRESPONDENT BANKING System of interbank relationships in which one bank sells services to other financial institutions.

COST OF FUNDS Interest expense divided by the dollar volume of interest-bearing liabilities.

COST OF FUNDS ESTIMATE May be a bank's weighted marginal cost of pooled debt or its weighted marginal cost of capital at the time the loan was made.

COUNTRY RISK The credit risk that government or private borrowers in a specific country will refuse to repay their debts as obligated for other than purely economic reasons.

COUPON RATE The ratio of the dollar-valued coupon payment to a security's par value.

COVENANT An element of a loan agreement whereby the borrower agrees to meet specific performance requirements or refrain from certain behavior.

COVERED INTEREST ARBITRAGE A trader borrows in one currency yet covers the transaction by selling the expected foreign exchange after investment for the original currency in the forward market. A profit is available because the interest rate differential between securities in the two countries is out of line with the spot-to-forward exchange rate differential.

CREDIT BUREAU An association that collects and provides information on the credit (payment) histories of borrowers.

CREDIT CHECK Efforts by a lender to verify the accuracy of information provided by potential borrowers.

CREDIT CULTURE Refers to the fundamental principles that drive lending activity and how management analyzes risk.

CREDIT DEPARTMENT The bank department where credit information is collected and analyzed to make credit decisions.

CREDIT ENHANCEMENT A guarantee or letter of credit backing for a loan, which improves the creditworthiness of the contract.

CREDIT FILE Information related to a borrower's loan request, including application, record of past performance, loan documentation, and analyst opinions.

CREDIT LIMIT The maximum amount that a borrower is allowed to borrow against a loan commitment or credit line.

CREDIT PHILOSOPHY Determines how much risk the bank will take and in what form.

CREDIT RISK Potential variation in net income and market value of equity resulting from the nonpayment of interest and principal.

CREDIT SCORING The use of a statistical model based on applicant attributes to assess whether a loan automatically meets minimum credit standards. The model assigns values to potential borrowers' attributes, with the sum of the values compared to a threshold.

CREDIT SERVICES The types of products offered by financial institutions related to lending activities.

CREDIT UNION A nonprofit organization that offers financial services to qualifying members. Credit unions do not pay state and federal income taxes and thus operate at a competitive advantage to other depository institutions.

CRITICALLY UNDERCAPITALIZED BANK An institution that does not meet minimum threshold levels for the three capital ratios.

CROSS HEDGE Use of a futures contract for a specific asset that differs from the cash asset being hedged.

CUMULATIVE GAP A measure of interest rate risk that is the sum of the periodic GAPS through the longest time frame considered. A measure of the bank's aggregate interest rate risk exposure.

CURRENCY SWAP An agreement to exchange payments denominated in one currency for payments denominated in a different currency.

CURRENT RATIO The ratio of current liabilities that indicates a firm's ability to pay current debts when they come due.

CURRENT TAX EQUIVALENT ADJUSTMENT Reverses the current part of the tax benefit included in interest income on loan and lease financing, as well as the estimated tax benefit from municipal securities.

CURRENT YIELD The coupon rate on a bond divided by the current market price of the bond.

CUSTOMER INFORMATION FILE A record of the services used by each customer.

CUSTOMER PROFITABILITY ANALYSIS A procedure that compares revenues with expenses and the bank's target profit from a customer's total account relationship.

CYCLICAL LIQUIDITY NEEDS An estimate of liquid funds needed to cover deposit outflows or loan demand in excess of trend or seasonal factors.

D

DAY TRADER A trader who tries to profit from short-term price movements during trading hours in any day, but offsets the initial position before market closing so that no position remains outstanding overnight.

DAYLIGHT OVERDRAFTS Bank payments from deposits held at a Federal Reserve bank or correspondent bank in excess of actual collected balances during a day.

DAYS ACCOUNTS PAYABLE OUTSTANDING Accounts payable divided by average daily purchases; measures the firm's efficiency in using trade credit to finance its working capital needs.

DAYS ACCOUNTS RECEIVABLE COLLECTION PERIOD Accounts receivable divided by average daily credit sales; indicates the average number of days required to convert accounts receivable into cash.

DAYS INVENTORY ON HAND Inventory divided by average daily cost of goods sold; measures the efficiency of the firm in managing its inventory.

DE NOVO BRANCH A newly opened branch.

DEALER A trader who sets bid and ask prices for every security traded.

DEALER RESERVE An account established by a bank and dealer used to assign the interest that accrues to dealers as they sell loans to a bank.

DEBENTURE A long-term bond that is secured by the general performance of the issuer.

DEBIT CARD A plastic card that, when used, immediately reduces the balance in a customer's transactions deposit.

DEBT SERVICE The amount needed to pay principal and interest on a loan.

DEBTOR-IN-POSSESSION FINANCING A loan made to a firm that has filed for Chapter 11 bankruptcy protection.

DEBT-TO-TOTAL-ASSETS RATIO Total liabilities divided by total assets.

DEFALCATION The misappropriation of funds or property by an individual.

DEFAULT The failure to make obligated interest and principal payments on a loan.

DEFAULT RISK With respect to credit services, the largest single risk.

DEFERRED AVAILABILITY CREDIT ITEMS Checks received for collection for which a bank has not provided credit to the depositor.

DELINQUENT ACCOUNT An account that is past due because the account holder has not made the obligated payment on time.

DELIVERY DATE Specific day that a futures contract expires.

DELTA The change in an option's price divided by the change in the price of the underlying instrument or contract.

DEMAND DEPOSIT Transactions account, payable on demand, that pays no interest to the depositor.

DEPOSIT INSURANCE REFORM ACT OF 2005 The act merges the old Bank Insurance Fund (BIF) and the old Savings Association Insurance Fund (SAIF) into one new fund, the Deposit Insurance Fund (DIF) and increases deposit insurance on retirement accounts to \$250,000.

DEPOSIT SERVICE CHARGES Income from checking account fees, which generally constitute the bulk of noninterest income.

DEPOSITORY INSTITUTIONS ACT OF 1982 The act, also known as Garn-St Germain, expanded FDIC powers to assist troubled banks and established the Net Worth Certificate program for savings and loans to assist these institutions in acquiring needed capital. The act authorized money market deposit accounts

to allow banks and thrifts to compete with products offered by brokerage firms. It also expanded the powers of thrift institutions in a misguided attempt at allowing these institutions to “earn” their way out of their financial problems.

DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT (DIDMCA) OF 1980 The act removed interest rate ceilings and authorized banks and savings institutions to pay interest on checking accounts through the use of negotiable orders of withdrawal (NOW) accounts.

DEPOSITS HELD IN FOREIGN OFFICES Dollar-denominated demand and time deposits, but balances are issued by a bank subsidiary (owned by the bank holding company) located outside the United States.

DEPRECIATION Writing down the value of a capital asset, reported as an expense. Also, a decrease in the market value of a financial asset.

DEREGULATION The process of eliminating existing regulations.

DERIVATIVE A financial instrument whose value is determined by the specific features of the underlying asset or instrument.

DIRECT LOAN Loan with terms negotiated directly between the lender and actual user of the funds.

DISCOUNT BROKER A brokerage firm that offers a limited range of retail services and charges lower fees than full-service brokers.

DISCOUNT RATE Interest rate charged by Federal Reserve banks for borrowing from the discount window.

DISCOUNT WINDOW The process of Federal Reserve banks lending to member institutions.

DIVIDEND A payment made to holders of a firm’s common stock and/or preferred stock. Cash dividends are paid in cash, while stock dividends are paid in stock.

DIVIDEND PAYOUT RATIO Cash dividends divided by net income; measures the fraction of earnings a firm pays out in cash to stockholders and thus is not retained.

DRAFT A written order requesting one party to make payment to another party at a specified point in time.

DUAL BANKING SYSTEM System in the U.S. in which a group trying to obtain a charter to open a bank can apply to the state banking department or the Office of the Comptroller of the Currency—the national banking agency.

DURATION The weighted average of time until cash flows generated by an asset are expected to be received (paid). The weights are the present value of each cash flow as a fraction of the asset’s current price.

DURATION GAP The weighted duration of assets minus the product of the weighted duration of liabilities and the ratio of total liabilities to total assets.

DURATION GAP ANALYSIS Compares the price sensitivity of a bank’s total assets with the price sensitivity of its total liabilities to assess whether the market value of assets or liabilities changes more when rates change.

E

EARLY WITHDRAWAL PENALTY An interest penalty a depositor pays for withdrawing funds from a deposit account prior to maturity.

EARNING ASSET RATIO The dollar volume of a bank's earning assets divided by the dollar volume of total assets.

EARNING ASSETS Income-earning assets held by a bank; typically include interest-bearing balances, investment securities, and loans.

EARNINGS BASE (EB) Compares the proportionate investment in average earning assets to average total assets and, thus, indicates whether one bank has more or fewer assets earning interest versus peers.

EARNINGS CHANGE RATIO (ECR) A ratio calculated for each asset or liability that estimates how the yield on assets or rate paid on liabilities is assumed to change relative to a 1 percent change in the base rate.

EARNINGS COVERAGE OF NET LOSSES A measure of net operating income before taxes, securities gains (losses), extraordinary items, and the provision for loan losses divided by net loan and lease losses.

EARNINGS CREDIT Interest rate applied to investable balances.

EARNINGS DILUTION A decrease in earnings per share after one bank acquires another.

EARNINGS PER SHARE Net income divided by the number of outstanding shares of common stock.

EARNINGS SENSITIVITY ANALYSIS Takes into account shifts in asset and liability composition and embedded options in a bank's assets and liabilities and off-balance sheet activities. It provides a better understanding of potential changes in earnings than does simple static models.

EARNINGS-AT-RISK (OR NET INTEREST MARGIN) SIMULATION Summary results of a bank's earnings sensitivity.

EBIT Earnings before interest and taxes.

EBITDA Earnings before interest, taxes, depreciation, and amortization.

ECONOMIC RISK The risk to a company's earnings or processes derived from economic events.

ECONOMIC VALUE ADDED (EVA) A measure of financial performance trademarked by Stern, Stewart & Co. that is equal to a firm's net operating profit after tax (NOPAT) minus a capital charge representing the required return to shareholders.

ECONOMIC VALUE OF EQUITY SENSITIVITY ANALYSIS Sensitivity analysis framework that extends the static duration gap analysis by making it dynamic using a simulation procedure incorporating a "what if" analysis of all the factors that affect EVE across a wide range of interest rate environments.

ECONOMIES OF SCALE Cost efficiencies evidenced by low operating costs per unit of output.

ECONOMIES OF SCOPE Focus on how the joint costs of providing several products change as new products are added or existing product output is enhanced.

ECU European Currency Unit.

EDGE ACT CORPORATION A bank subsidiary that engages in international banking activities.

EFFECTIVE ANNUAL COMPOUNDED RATE OF INTEREST The compounded rate of interest assuming the investor reinvests all periodic cash flows received at the same rate of interest.

EFFECTIVE CONVEXITY The value for convexity that reflects the price impact of embedded options in different interest rate environments.

EFFECTIVE DURATION The value for duration reflecting the price impact of embedded options when interest rates rise versus fall.

EFFECTIVE GAP The “true” measure of GAP that takes into account a specific interest rate forecast and when embedded options will either be exercised or will affect the actual repricing of an asset or liability.

EFFICIENCY RATIO Noninterest expense divided by the sum of net interest income and noninterest income.

ELASTICITY A measure of the relative quantity response to a change in price, income, interest rate, or other variable.

ELECTRONIC FUNDS TRANSFER (EFT) Electronic movement of financial data, designed to eliminate the paper instruments normally associated with such funds movement.

ELECTRONIC TRANSACTIONS Transactions that occur through automatic deposits, Internet and telephone bill payment, ATMs, and ACH transactions.

EMBEDDED OPTION A specific feature of a bank’s asset, liability, or off-balance sheet contract that potentially changes the cash flows of the item when interest rates vary. Examples include early prepayment of principal on loans, issuers calling outstanding bonds, and depositors withdrawing funds prior to maturity.

EMERGENCY CREDIT May be authorized in unusual and exigent circumstances by the Board of Governors to individuals, partnerships, and corporations that are not depository institutions.

EMU European Monetary Union.

ENTERPRISE VALUE The value of a firm equal to the market capitalization (number of shares of stock times the current stock price) plus the market value of outstanding debt.

EQUITY Ownership interest in a firm represented by common and preferred stockholders.

EQUITY AND SECURITY PRICE RISK Potential risk of loss associated with a bank’s trading account portfolios.

EQUITY MULTIPLIER (EM) Ratio of total assets to equity; a measure of financial leverage.

ESTIMATED TAX BENEFIT Estimated dollar tax benefit from not paying taxes on loan and lease financing and tax-exempt securities income.

EURO (EUROPEAN UNIFIED CURRENCY) The European currency unit introduced in January 1999.

EUROCREDITS Term loans priced at a premium over LIBOR.

EUROCURRENCY A financial claim denominated in a currency other than the one where the issuing institution is located.

EURODOLLAR A dollar-denominated financial claim at a bank outside the United States.

EURODOLLAR DEPOSITS Dollar-denominated deposits at banks located outside the United States.

EUROPEAN COMMUNITY (EC) A confederation of countries that have negotiated the removal of trade barriers to enhance competition.

EXCHANGE RATE Price of one currency in terms of another.

EXECUTOR An individual or trust department responsible for handling a settlement.

EXPEDITED FUNDS AVAILABILITY ACT The act stipulated maximum time limits under Regulation CC for banks to make funds available on deposited checks; effective September 1990.

EXPENSE RATIO (ER) The sum of all expense components (interest, noninterest, and provisions for loan losses) divided by average total assets.

EXTENSION RISK The risk that the holder of a mortgage-backed security will receive outstanding principal payments later than originally anticipated. Later principal payments result from interest rates rising and prepayments occurring slower than expected.

EXTRAORDINARY ITEMS An unusual nonrecurring event, a cost or expense such as expenses related to acquisitions or plant shutdowns, results of legal proceedings, or unanticipated tax benefits

F

FACILITY FEE Fee imposed for making a line of credit available.

FACTORING An advance of credit whereby one party purchases the accounts receivable of another party at a discount, without recourse.

FAIR AND ACCURATE CREDIT TRANSACTIONS ACT (FACT) OF 2003 Enhances consumer rights in situations involving identity theft, credit scoring, and claims of inaccurate credit information.

FANNIE MAE Name referring to the Federal National Mortgage Association.

FASB 115 Issued by the Financial Accounting Standards Board in 1993 to addresses the market value accounting of all investments in equity securities that have readily determinable fair values, and all investments in debt securities.

FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991 The act greatly increased the powers and authority of the FDIC, recapitalized the Bank Insurance Fund, and allowed the FDIC to borrow from the Treasury. The act mandated a least-cost method and prompt corrective action for dealing with failing banks, and established new capital requirements for banks.

FEDERAL FINANCING BANK A federal agency that borrows from the U.S. Treasury and lends funds to various federal agencies.

FEDERAL FUNDS Unsecured short-term loans that are settled in immediately available funds.

FEDERAL HOME LOAN BANK (FHLB) BORROWINGS Direct loans from the Federal Home Loan Bank with original maturities ranging from one week to over 20 years. FHLB borrowings have seen extraordinary growth since the passage of the Gramm-Leach-Bliley Act of 1999.

FEDERAL HOUSING FINANCE AGENCY (FHFA) The new regulator for Fannie Mae, Freddie Mac, and the 12 FHLBs, created by the Housing and Economic Recovery Act (HERA) of 2008. The act merged the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board (FHFB), and the U.S. Department of Housing and Urban Development (HUD).

FEDERAL HOUSING FINANCE REGULATORY REFORM ACT OF 2008 Designed to address problems related to certain government-sponsored enterprises (GSEs).

FEDERAL RESERVE BANK One of the 12 district Federal Reserve banks that make up the Federal Reserve System.

FEE INCOME Noninterest income.

FHA (FEDERAL HOUSING ADMINISTRATION) A federal agency that insures mortgages.

FHA MODERNIZATION ACT OF 2008 Created by HERA in conjunction with the Foreclosure Prevention Act of 2008. It expanded the benefits of the FHA loan limit, established minimum down payments for FHA loans (3.5 percent), made changes to FHA insurance for manufactured housing, and increased consumer protections.

FHLMC (FEDERAL HOME LOAN MORTGAGE CORPORATION, OR FREDDIE MAC) A private corporation operating with an implicit federal guarantee; buys mortgages financed largely by mortgage-backed securities.

FHLMC COLLATERALIZED MORTGAGE OBLIGATIONS Are debt issues originated by FHLMC that are secured by a pool of mortgages in which payments are grouped into classes, or tranches, according to their estimated maturities.

FHLMC GUARANTEED MORTGAGE CERTIFICATES Mortgage-backed securities issued by FHLMC that are similar to bonds. Interest and principal payments on the certificates are backed by a pool of mortgages, but interest is paid just semiannually and principal is repaid annually.

FHLMC PARTICIPATION CERTIFICATES Pass-through securities issued by FHLMC that are secured by conventional residential mortgages.

FIDELITY BOND A contract that covers losses associated with employee dishonesty, typically embezzlement and forgery at banks.

FIDUCIARY An individual or trust department responsible for acting in the best interests of a designated third party.

FIDUCIARY ACTIVITIES Income from the institution's trust department.

FINANCE CHARGE Under Regulation Z, the sum of "all charges payable directly or indirectly by the borrower and imposed directly or indirectly by the lender as an incident to or as an extension of credit."

FINANCE COMPANY A firm that borrows from the money and capital markets to make loans to individuals and commercial enterprises.

FINANCIAL FUTURES CONTRACT A commitment between two parties to exchange a standardized financial asset through an organized exchange at a specified price for future delivery. The price of futures contracts changes prior to delivery, and participants must settle daily changes in contract value.

FINANCIAL HOLDING COMPANY (FHC) A specific type of bank holding company created by the Gramm-Leach-Bliley Act of 1999 that allows banks, securities firms, and insurance companies to affiliate within the FHC structure.

FINANCIAL INNOVATION The continuous development of new products, services, and technology to deliver products and services.

FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989 The act abolished the FSLIC and placed the FDIC in charge of insurance of the industry and created two insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The act also abolished the Federal Home Loan Bank Board and created the Office of Thrift Supervision (OTS) and the Resolution Trust Corporation (RTC), which was to manage and dispose of the assets of failed institutions. The act further established severe penalties for bank boards and management for their actions or failure of action.

FINANCIAL LEVERAGE Relationship between the amount of debt versus equity financing.

FINANCIAL RISK Potential variation in income before interest and taxes associated with fixed interest payments on debt and lease payments.

FINANCIAL SERVICES HOLDING COMPANY A parent company that owns a bank holding company plus other subsidiaries, such as a thrift holding company and insurance subsidiary.

FIXED CHARGE COVERAGE RATIO Earnings before interest and taxes (EBIT) plus lease payments divided by interest expense plus lease payments; measures the number of times the firm can pay interest and other fixed charges (such as lease payments) with current earnings.

FIXED RATE An interest rate that does not change during a specified period of time.

FIXED-RATE CD Fixed-rate contract renegotiated at various maturities.

FLIPPER REPO Type of repurchase agreement in which the rate paid by the borrower changes, or “flips,” from a floating rate to a fixed rate after a prespecified lockout period. The parties agree to terms when the RP is originated.

FLOAT Dollar amount of checks in process of collection, net of deferred availability amounts, to depositors.

FLOATING RATE An interest rate tied to a base rate that changes over time as market conditions dictate.

FLOATING-RATE NOTE (FRN) A short-term note whose interest payment varies with a short-term interest rate.

FLOOR Use of options to establish a minimum borrowing cost.

FNMA (FEDERAL NATIONAL MORTGAGE ASSOCIATION, OR FANNIE MAE) A private corporation operating with an implicit federal guarantee; buys mortgages financed by mortgage-backed securities.

FORECLOSURE Selling property in order to apply the proceeds in payment of a debt.

FORECLOSURE PREVENTION ACT OF 2008 Created by HERA and in conjunction with the FHA Modernization Act of 2008; expands the benefits of the FHA loan limit, establishes minimum down payments for FHA loans (3.5 percent), makes changes to FHA insurance for manufactured housing, and increases consumer protections.

FOREIGN EXCHANGE Currency of a foreign country acceptable as a medium of exchange.

FOREIGN EXCHANGE RISK The risk that the value of a position denominated in a foreign currency may decline due to a change in exchange rates.

FOREIGN TAX CREDIT Income taxes paid to a foreign country that can be claimed as a tax credit against a domestic tax liability.

FORWARD CONTRACT A commitment between two parties to exchange a nonstandardized asset at a fixed price for future delivery. The price of the contract does not change prior to delivery, and no interim payments are required.

FORWARD MARKET Comprises transactions that represent a commitment to exchange currencies at a specified time in the future, at an exchange rate determined at the time the contract is signed.

FORWARD RATE Yield on a forward contract. Also, break-even yield calculated under pure expectations theory according to prevailing interest rates.

FORWARD RATE AGREEMENT A forward contract in which the two parties establish an interest rate to be paid by one party to the other at a set date in the future. If the actual rate on that date differs from the predetermined rate, one party makes a cash payment to the other party.

FREE CASH FLOW Typically cash flow from operations less required capital expenditures (those capital expenditures required to maintain the company's ability to produce cash flow from operations).

FREE NONINTEREST CHECKING ACCOUNT Imposes no fees of any kind.

FULL-SERVICE BROKER A brokerage that provides a full range of services to customers including advice on which securities to buy and/or sell.

FUNDING GAP, SEE GAP.

FUNDING LIQUIDITY RISK Inability to liquidate assets or obtain adequate funding from new borrowing.

FUTURES MARKETS Organized exchanges in which all contracts are subject to a daily settlement procedure.

FUTURES SPREADER Speculator who may simultaneously buy a futures contract and sell a related futures contract; tries to profit on anticipated movements in the price difference between the contracts.

G

GAAP Generally Accepted Accounting Principles representing the standard rules and procedures that accountants follow when reporting financial information.

GAP Dollar value of rate-sensitive assets minus the dollar value of rate-sensitive liabilities.

GAP RATIO The dollar volume of rate-sensitive assets divided by the dollar volume of rate-sensitive liabilities.

GARNISHMENT A court directive authorizing a bank to withhold funds from a borrower.

GENERAL MARKET RISK Refers to changes in the market value of on-balance sheet assets and off-balance sheet items resulting from broad market movements. Includes risk common to all securities, such as changes in the general level of interest rates, exchange rates, commodity prices, or stock prices.

GENERAL OBLIGATION BONDS Municipal bonds secured by the full faith, credit, and taxing power of the issuing state or local government.

GINNIE MAE Name referring to the Government National Mortgage Association.

GLASS-STEAGALL ACT The 1933 act that separated lending activities from investment banking activities at commercial banks by prohibiting commercial banks from underwriting corporate securities.

GNMA (GOVERNMENT NATIONAL MORTGAGE ASSOCIATION, OR GINNIE MAE) A government entity that buys mortgages for low-income housing and guarantees mortgage-backed securities issued by private lenders.

GOLD STANDARD A monetary system where the value of a country's currency is determined by the value of the gold content in the currency.

GOODWILL An intangible asset representing the difference between the book value of an asset or a firm and the actual sales price.

GOODWILL IMPAIRMENT Impairment losses expense for goodwill. If the value of the previously acquired asset that created goodwill is impaired or loses significant value, that value must be written off as an expense.

GOVERNMENT-SPONSORED ENTERPRISE (GSE) A quasi-public federal agency that is federally sponsored, but privately owned. Examples include the Farm Credit Bank, Federal Home Loan Banks (FHLBs), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National Mortgage Association (Fannie Mae).

GRACE PERIOD The time period for a credit card statement representing the time from when the statement is generated to the last day full payment can be made and still avoid a finance charge.

GRADUAL RATE SHOCK An assumed change in interest rates that occurs over time; a 1 percent annual increase in rates may translate into a monthly increase of 8.3 basis points.

GRAMM-LEACH-BLILEY ACT OF 1999 The act repeals the Glass-Steagall Act and modifies the Bank Holding Company Act to create a new financial holding company authorized to engage in underwriting and selling insurance and securities, conducting both commercial and merchant banking, investing in and developing real estate, and participating in other activities “complementary” to banking. The act also restricts the disclosure of nonpublic customer information, requires disclosure of a privacy policy, and provides a new funding source for some banks by easing membership and the collateral requirements that must be met to access funds from the Federal Home Loan Bank (FHLB).

GRANDFATHER CLAUSE A legislative provision that exempts parties previously engaged in activities prohibited by new legislation.

GROSS DOMESTIC PRODUCT The market value of goods and services produced over a period of time including the sum of consumer expenditures, investment expenditures, government expenditures, and net exports (exports minus imports).

GROSS LOAN LOSSES (CHARGE-OFFS) Dollar value of loans actually written off as uncollectible during a period.

GUARANTEE Make oneself liable for the debts of another.

GUARANTEED INVESTMENT CONTRACT (GIC) A financial contract in which the writer of a policy agrees to pay a fixed amount at maturity after receiving a fixed, single premium up front.

GUARDIAN An individual or a trust department appointed by a court to manage a minor’s property or personal affairs.

H

HEDGE To take a position in the forward futures, or swaps, market to offset risk associated with cash market activity.

HEDGER A trader who has an existing or anticipated position in the cash market and trades futures contracts (or some other contract) to reduce the risk associated with uncertain changes in value of the cash position.

HELD-TO-MATURITY Securities recorded at amortized cost on the balance sheet, with changes in value having no impact on the income statement.

HIGHLY LEVERAGED TRANSACTION (HLT) Transaction in which the borrower's debt increases sharply after the asset exchange, such as a leveraged buyout (LBO).

HIGH-PERFORMANCE BANK One that makes an exceptional return to shareholders while maintaining an acceptable level of risk.

HISTORICAL COST The value for certain balance sheet items reflecting the original cost or amortized cost.

HOLD ON THE CHECK When a bank holds a check until it verifies that the check writer has enough funds on deposit to cover the draft.

HOLDING PERIOD RETURN The annualized rate of return expected or realized from holding a security over a specific period of time.

HOME BANKING Actions involving the conduct of banking business taking place in customers' homes, including telephone and computer transactions.

HOME DEBIT A check drawn on a bank that is presented to the same bank for deposit or payment.

HOME EQUITY LINES OF CREDIT (HELOC) Open credit lines with a credit limit, similar to installment loans or credit card loans, that are secured by the value of the borrower's home equity.

HOME EQUITY LOAN Loan secured by an individual's equity in a home.

HOPE FOR HOMEOWNERS ACT OF 2008 Created a new discount program at the Federal Housing Administration (FHA) to back FHA-insured mortgages and to allow lenders to provide mortgage loans to distressed borrowers at a deep discount to prevent foreclosures.

HOT MONEY Funds that move between institutions quickly in search of higher yields or greater safety.

HOUSING AND ECONOMIC RECOVERY ACT (HERA) OF 2008 A package of several pieces of legislation designed to address the economic and financial crisis of 2008–2009.

HYPOTHECATION In a contract, committing property to secure a loan.

I

ILLIQUID An asset that is not easily or readily converted into cash.

IMMEDIATELY AVAILABLE FUNDS Collected deposits held at Federal Reserve banks, or certain collected liabilities or private financial institutions.

IMMUNIZE To fully hedge against interest rate risk.

IMPLIED VOLATILITY The expected volatility in return on an underlying asset or contract derived from an option pricing model.

IN THE MONEY An option that has a positive intrinsic value. A call option in which the actual price is above the exercise price; a put option in which the actual price is below the exercise price.

INCOME STATEMENT GAP An interest rate risk model which modifies the standard GAP model to incorporate the different speeds and amounts of repricing of specific assets and liabilities given an interest rate change.

INDEPENDENT BANK A bank operating in one locality that is not part of a large multibank holding company or group of banks.

INDEX RATE The rate that serves as a base rate when pricing certain mortgages and variable-rate loans.

INDIRECT LOAN Loan in which a retailer takes the credit application and negotiates terms with the actual borrower. The lender then purchases the loan from the retailer under prearranged terms.

INDIVIDUAL RETIREMENT ACCOUNT (IRA) A retirement account available to individuals to defer income taxes.

INDUSTRIAL DEVELOPMENT BOND (IDB) A municipal bond issued by a state or local government political subdivision in which the proceeds are used to finance expenditures of private corporations.

INDUSTRIAL REVENUE BOND (IRB) A bond issued by a state government, local government, or political subdivision for the express benefit of a business that will effectively use the proceeds.

INITIAL MARGIN At initiation of a futures position, traders must post a cash deposit or U.S. government securities.

INITIAL PUBLIC OFFERING (IPO) The initial offering of stock of a private company.

INSOLVENT The financial position of a firm whose market value of stockholders' equity is less than or equal to zero. A firm is technically insolvent when the book value of stockholders' equity is less than or equal to zero.

INSTALLMENT LOAN A loan that is payable in periodic, partial installments.

INSTANTANEOUS RATE SHOCK An immediate increase or decrease in all interest rates by the same amount; a parallel shift in the yield curve.

INSURANCE COMMISSION FEES AND INCOME Income from insurance underwriting and from the sale of insurance or from reinsurance; this category includes fees, commissions, and service charges.

INTANGIBLE AMORTIZATIONS Amortization expense for intangible assets.

INTELLIGENT CARD Contains a microchip with the ability to store and secure information, and makes different responses depending on the requirements of the card issuer's specific application needs.

INTER VIVOS Phrase referring to "between living persons."

INTERBANK LOAN Credit extended from one bank to another.

INTEREST EXPENSE (IE) Sum of interest paid on all interest-bearing liabilities, including transactions accounts, time and savings deposits, volatile liabilities and other borrowings, and long-term debt.

INTEREST INCOME (II) Sum of interest and fees earned on all of a bank's assets, including loans, deposits held at other institutions, municipal and taxable securities, and trading account securities.

INTEREST RATE CAP A contract in which payments are made by the seller (who receives an up-front premium) to the buyer when a reference index rate exceeds a strike rate.

INTEREST RATE COLLAR The simultaneous purchase of an interest rate cap and sale of an interest rate floor on the same index for the same maturity and notional principal amount.

INTEREST RATE FLOOR A contract in which payments are made by the seller (who receives an up-front premium) to the buyer when a reference index rate is less than a strike rate.

INTEREST RATE FUTURES When the underlying asset of a futures contract is an interest-bearing security.

INTEREST RATE RISK Potential variability in a bank's net interest income and market value of equity caused by changes in the level of interest rates.

INTEREST RATE SWAP A contract in which two parties (counterparties) agree to exchange fixed-rate interest payments for floating-rate interest payments over a specific period of time based on some notional principal amount.

INTEREST-BEARING DEBT Includes all liabilities that explicitly pay interest; these would generally include all liabilities (less demand deposits) as well as acceptances and other liabilities.

INTEREST-ON-INTEREST Interest earned on interest, or reinvestment interest income.

INTERIM LOANS Provide financing only for a limited time until permanent financing is arranged.

INTERNAL AUDIT Routine examination of a bank's accounting records.

INTRINSIC VALUE The net value obtained from exercising an option.

INVENTORY TURNOVER Cost of goods sold divided by inventory; measures the efficiency of the firm in managing its inventory.

INVERTED YIELD CURVE Yield curve with long-term rates below short-term rates.

INVESTABLE BALANCES Ledger balances minus float minus required reserves against associated deposit balances.

INVESTMENT BANKING, ADVISORY, BROKERAGE, AND UNDERWRITING FEES AND COMMISSIONS Fees and commissions from underwriting securities, private

placements of securities, investment advisory and management services, and merger and acquisition services.

INVESTMENT INCOME FROM DEPOSIT BALANCES Generated by every deposit customer's hold investment securities.

IO Interest-only security representing the interest portion of a stripped Treasury or stripped mortgage-backed security.

J

JUDGMENT Legal ruling regarding the final payment of a court-determined transfer of assets.

JUDGMENTAL CREDIT ANALYSIS Subjective assessment of a borrower's ability and willingness to repay debts.

JUMBO CDS CDs of \$100,000 or more.

JUMP-RATE CD (BUMP-UP CD) A CD that allows the rate to be changed, at the discretion of the customer, to the current rate offered by the institution at least once during the life of the CD.

JUNK BOND A bond with a credit rating below investment grade (below Baa for Moody's, and below BBB for S&P), or a bond that is not rated.

K

KEOGH PLAN A pension plan for the self-employed that allows them to make contributions and defer taxes until the funds are withdrawn.

KITE Writing checks against uncollected deposits in the process of clearing through the banking system.

L

LACK OF DIVERSIFICATION Banks that lend in a narrow geographic area or concentrate their loans to a certain industry.

LADDER STRATEGY When investing bonds, allocating roughly equivalent amounts (portions) to different maturities.

LAGGED RESERVE ACCOUNTING (LRA) System of reserve requirements based on deposits outstanding prior to the reserve maintenance period.

LAND DEVELOPMENT LOANS Finance the construction of roads and public utilities in areas where developers plan to build houses.

LARGE TIME DEPOSITS Generally referred to as large CDs or jumbo CDs, these accounts consist of large, negotiable certificates of \$100,000 or more. They are issued primarily by the largest banks and purchased by businesses and governmental units.

LBO Leveraged buyout.

LEAD BANK In loan participations, this is generally the bank that makes the original loan and sells participations. Often, the lead bank retains the largest share of the loan that is participated.

LEASE A contract in which the owner of a property allows another party to use the property if certain terms are met and lease payments (rent) are made.

LEDGER BALANCES Dollar value of deposit balances appearing on a bank's books.

LEGAL LENDING LIMIT The maximum amount that can be loaned to any one borrower or any group of related borrowers.

LEGAL RISK Risk that unenforceable contracts, lawsuits, or adverse judgments could disrupt or negatively affect the operations, profitability, condition, or solvency of the institution.

LENDER LIABILITY Circumstances in which the courts have found lenders liable to their borrowers for fraud, deception, breached fiduciary activities, broken promises, and good faith negotiations.

LESSEE The party that rents or leases an asset from another party.

LESSOR The party that owns an asset and leases or rents it to another party.

LETTER OF CREDIT A bank's guarantee of payment, indicated by a document that describes the handling of a specific transaction.

LEVERAGE CAPITAL RATIO Tier 1 capital divided by total assets net of goodwill, other disallowed intangible assets, and disallowed deferred tax assets.

LEVERAGED BUYOUT (LBO) An acquisition where the firm buying another firm contributes a small amount of equity and finances the bulk of the purchase price with debt.

LIABILITY LIQUIDITY The ease with which a bank can issue new debt to acquire clearing balances at reasonable costs.

LIABILITY MANAGEMENT THEORY A theory that focuses on banks issuing liabilities to meet liquidity needs.

LIABILITY SENSITIVE A bank is classified as liability sensitive if its GAP is negative.

LIBOR London Interbank Offer Rate, which represents a money market rate offered by banks for the placement of Eurodollars.

LIEN Legal right granted by the court to attach property until a legal claim is paid.

LIMITED BRANCHING Provisions that restrict branching to a geographic area smaller than an entire state.

LINE OF CREDIT A lending agreement between a bank and borrower in which the bank makes a fixed amount of funds available to the borrower for a specified period of time. The customer determines the timing of actual borrowing.

LIQUID ASSETS Unpledged, marketable short-term securities that are classified as available-for-sale, plus federal funds sold and securities purchased under

agreement to resell. A liquid asset can be easily and quickly converted into cash with minimum loss.

LIQUIDITY PREMIUM The premium included in longer-term interest rates to compensate investors for price risk associated with volatile interest rates.

LIQUIDITY RISK The variation in net income and market value of bank equity caused by a bank's difficulty in obtaining immediately available funds, either by borrowing or selling assets.

LOAN ADMINISTRATION EXPENSE Cost of a loan's credit analysis and execution. It includes personnel and overhead costs as well as direct costs for sending interest bills, processing payments, and maintaining collateral.

LOAN AGREEMENT Formalizes the purpose of the loan, the terms, repayment schedule, collateral required, any loan covenants, and finally, what conditions bring about default by the borrower.

LOAN AND LEASE LOSS ALLOWANCE Contra-asset (negative asset) reserve account that exists in recognition that some loans will not be repaid. The reserve's maximum size is determined by tax law but increases with the growth in problem loans and decreases with net loan charge-offs.

LOAN COMMITMENT Formal agreement between a bank and borrower to provide a fixed amount of credit for a specified period.

LOAN INTEREST Interest income on loans.

LOAN PARTICIPATION Credit extended to a borrower in which members of a group of lenders each provide a fraction of the total financing; typically arises because individual banks are limited in the amount of credit they can extend to a single customer.

LOAN POLICY Formalizes lending guidelines that employees follow to conduct bank business. It identifies preferred loan qualities and establishes procedures for granting, documenting, and reviewing loans.

LOAN PRODUCTION OFFICES (LPOS) Institutions that make commercial loans but do not accept deposits.

LOAN SYNDICATION An arrangement where several lenders make a loan jointly to a borrower.

LOAN-TO-VALUE RATIO The loan amount divided by the appraised value of the underlying collateral.

LOCAL A trader operating on the floor of an exchange who trades for his or her own account.

LOCKBOX A post office box number controlled by the bank.

LONDON INTERBANK OFFER RATE (LIBOR) Interest rate at which banks deposit Eurodollars with other banks outside the United States.

LONG HEDGE The purchase of a futures contract to reduce the risk of an increase in the price of a cash asset.

LONG POSITION Market position in which an investor actually owns an asset.

LONG-TERM INVESTMENT SECURITIES Securities with maturities in excess of one year.

M

MACAULAY'S DURATION Computed as a weighted average of the time until cash flows are received.

MACROHEDGE A hedge strategy designed to reduce risk associated with a bank's entire balance sheet position.

MAINTENANCE MARGIN The minimum amount of funds in a margin account that must be maintained at all times. When the customer's balance falls below this amount, the broker will require an additional deposit or may close the account.

MAINTENANCE PERIOD With respect to required reserve calculation, consists of 14 consecutive days beginning on a Thursday and ending on the second Wednesday thereafter.

MAKE A MARKET Stand ready to buy or sell particular assets.

MAKE-WHOLE CLAUSE A provision that requires that the borrower make a payment to a lender after a loan is called or prepaid. The amount of the payment equals the net present value of the lost interest and principal payments.

MANAGED LIABILITIES Deposits or other liabilities at banks that pay market interest rates; banks can attract additional funds by increasing rates above current quoted rates in the trade area.

MARGIN Deposit with a broker that protects the broker from losses arising from customer transactions.

MARGINAL COST OF DEBT A measure of the borrowing cost paid to acquire one additional unit of investable funds.

MARGINAL COST OF EQUITY CAPITAL A measure of the minimum acceptable rate of return required by shareholders.

MARGINAL COST OF FUNDS The incremental cost of additional funds to finance firm operations.

MARGINAL TAX RATE Tax rate applied to the last increment of taxable income.

MARKET LIQUIDITY RISK Inability of the bank to easily unwind or offset specific exposures without significant losses from inadequate market depth or market disturbances.

MARKET RISK Current and potential risk to earnings and stockholders' equity resulting from adverse movements in market rates or prices.

MARKET VALUE The actual value indicating what an asset can be currently sold for.

MARK-TO-MARKET The daily reconciliation of a future trader's margin account in which gains and losses on the position are added and subtracted, respectively.

MATURITY The date at which the principal of a note, draft, or bond becomes due and payable.

MEMORANDUM OF UNDERSTANDING (MOU) A formal regulatory document that identifies specific violations and prescribes corrective action by the problem institution.

MEMORY CARDS Cards that store information. Similar to the stored information on the back of a credit card, a memory card can contain value that the user can spend in a pay phone, retail store, or vending machine.

MERGER A combination of two firms, generally where the assets and liabilities of the seller are combined with the assets and liabilities of the buyer.

MICROHEDGE A hedge strategy designed to reduce risk associated with a specific transaction.

MODIFIED DURATION Macaulay's duration divided by 1 plus the prevailing interest rate on the underlying instrument.

MONEY MARKET DEPOSIT ACCOUNT (MMDA) Small time deposit whose holder is limited to three written checks per month.

MONEY MARKET MUTUAL FUND Mutual fund that accepts customer funds and purchases short-term marketable securities.

MONEY SUPPLY The federal government's designation of certain liquid assets as money; M1A equals currency outside banks plus demand deposits; M1B equals M1A plus other checkable deposits; M2 equals M1B plus overnight RPs, savings and small time deposits, and money market funds; M3 equals M2 plus large time deposits and term RPs; L equals M3 plus other liquid assets.

MORAL HAZARD A lack of incentives that would encourage individuals or a business to protect or mitigate against risk. In some cases of moral hazard, incentives are created that would actually increase risk-taking behavior.

MORTGAGE A contract whereby a borrower provides a lender with a lien on real property as security against a loan.

MORTGAGE BANKING The business of packaging mortgage loans for sale to investors and retaining the servicing rights to the mortgages.

MORTGAGE SERVICING The process of collecting monthly payments on mortgages, keeping records, paying the associated insurance and taxes, and making monthly payments to holders of the underlying mortgages or mortgage-backed securities.

MORTGAGE-BACKED SECURITY (MBS) A security that evidences an undivided interest in the ownership of a pool of mortgages.

MULTIBANK HOLDING COMPANY A bank holding company that owns controlling interest in at least two commercial banks.

MUNICIPAL NOTES Municipal securities with a maturity of one year or less; proceeds are used to fund operating expenses for states, local governments, and their political subdivisions.

MUNICIPAL SECURITIES (MUNICIPALS) Securities issued by states, local governments, and their political subdivisions.

MUTUAL FUND A pool of funds that is managed by an investment company. Investors in a mutual fund own shares in the fund, and the fund uses the proceeds to buy different assets.

MUTUAL SAVINGS BANKS Firms without capital stock that accept deposits and make loans.

N

NEGOTIABLE ORDER OF WITHDRAWAL (NOW) ACCOUNT Interest-bearing transactions account offered by banks.

NET CHARGE-OFFS (NET LOSSES) Difference between gross loan losses and recoveries. Net losses directly reduce loan loss reserves that a bank sets aside for potential losses.

NET FIXED ASSETS TO TANGIBLE NET WORTH An indicator of the proportion of the firm's less liquid assets financed by net worth.

NET GAINS (LOSSES) ON SALES OF LOANS Net gains (or losses) on the sales or other disposal of loans and leases.

NET GAINS (LOSSES), OTHER Income from net gains (losses) on the sales or other disposal of other real estate owned, and on sales of other assets (excluding securities) such as premises and fixed assets and personal property acquired for debts previously contracted (such as automobiles, boats, equipment, and appliances).

NET INCOME (NI) Operating profit less all federal, state, and local income taxes, plus or minus any accounting adjustments and extraordinary items.

NET INDIRECT COSTS Costs not directly related to the product, such as salaries for managing the bank or general overhead.

NET INTEREST INCOME (NII) Interest income minus interest expense.

NET INTEREST MARGIN (NIM) Ratio of net interest income to total earning assets.

NET INTEREST MARGIN SIMULATION Simulated estimates of changes in net interest margin.

NET LOSSES (NET CHARGE-OFFS) Difference between gross loan losses and recoveries. Net losses directly reduce loan loss reserves that a bank sets aside for potential losses.

NET OVERHEAD Noninterest income minus noninterest expense.

NET OVERHEAD BURDEN Difference between noninterest expense and noninterest income as a fraction of total bank assets.

NET SERVICING FEES Income from servicing real estate mortgages, credit cards, and other financial assets held by others.

NET TRANSACTIONS ACCOUNTS Base liabilities in which the holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders, and telephone and preauthorized transfers in excess of three per month.

NET WORTH Owners' (stockholders') equity in a firm.

NETTING The practice of offsetting promised interest payments with promised interest receipts and transferring the difference with an interest rate swap.

NO LOAD FUND A mutual fund that does not charge a regular sales commission. It may charge a 12b-1 fee.

NO-FEE NOW ACCOUNTS Interest-bearing checking accounts that charge no fees.

NOMINAL INTEREST RATE Market interest rate stated in current, not real, dollars.

NONACCRUAL LOAN Loan not currently accruing interest. The loan is currently—or has been habitually—past due, or has other problems, which has placed it in nonaccrual status.

NONBANK BANK A firm that either makes commercial loans or accepts deposits but does not do both. Thus, it avoids regulation as a commercial bank.

NONBANK SUBSIDIARY A subsidiary of a bank holding company that is engaged in activities closely related to banking, such as leasing, data processing, factoring, and insurance underwriting.

NONCREDIT SERVICES Non-lending-related services provided by a financial institution, for example, cash management, checking services, and ATM services.

NONCURRENT LOAN Typically a loan that is 90 days past due.

NONELECTRONIC TRANSACTIONS Transactions conducted in person or by mail.

NONINTEREST EXPENSE (OE) Composed primarily of personnel expense, which includes salaries and fringe benefits paid to bank employees; occupancy expense from rent and depreciation on equipment and premises; and other operating expenses, including technology expenditures, utilities, and deposit insurance premiums. Other noninterest expenses include goodwill impairment amortization and other intangible amortizations.

NONINTEREST INCOME (OI) Income from products and services offered by a financial institution that is not earning from lending activities.

NONPERFORMING LOAN Loan for which an obligated interest payment is past due.

NONRATE GAP Non-interest-bearing liabilities plus equity minus nonearning assets as a fraction of earning assets.

NONRATED BOND A bond that is not rated by Moody's, S&P, or other rating agency.

NONRECOURSE Stipulates that the holder of an obligation has no legal right to force payment on a claim.

NONTRANSACTIONAL ACCOUNTS Accounts that offer limited check-writing capabilities and pay higher rates.

NOTE ISSUANCE FACILITY An arrangement in which borrowers can issue short-term securities in their own names.

NOTIONAL PRINCIPAL Serves as a reference figure in determining cash flows.

NOTIONAL VALUE The face value of interest rate swap contracts; a mere reference value for computing obligated interest payments.

NOW ACCOUNT Checking account that pays interest.

NSF Not sufficient funds.

O

OFF-BALANCE SHEET ACTIVITIES Commitments, such as loan guarantees, that do not appear on a bank's balance sheet but represent actual contractual obligations.

OFF-BALANCE SHEET RISK Volatility in income and market value of bank equity that may arise from unanticipated losses due to these off-balance sheet liabilities.

OFFER PRICE The price at which a broker is willing to sell the underlying security or asset.

OFFICIAL CHECK ISSUED Bank issued check for certified funds.

"ON OTHERS" WITHDRAWAL FEES Fees charged to the institution's own customers for making withdrawals at other institutions' ATMs.

ON THE RUN The most recently issued U.S. Treasury security.

ONE-BANK HOLDING COMPANY A holding company that owns or controls only one commercial bank.

"ON-US" CHECKS CASHED Checks drawn on the bank's customer's account. Deposits represent checks or currency directly deposited in the customer's account.

"ON-US" WITHDRAWAL FEES Transaction fees for ATM withdrawals levied on the institution's depositor.

OPEN ACCOUNT Credit not supported by a note or other written record.

OPEN INTEREST Total number of outstanding unfilled futures positions measured on one side of the transaction.

OPEN MARKET OPERATIONS Conducted by the Federal Reserve Bank of New York under the direction of the Federal Open Market Committee (FOMC). The sale or purchase of U.S. government securities in the "open market," or secondary market, is the Federal Reserve's most flexible means of carrying out its policy objectives.

OPERATING INCOME Sum of interest income and noninterest income.

OPERATING LEVERAGE Ratio of fixed costs to total costs; measure of business risk that indicates the relative change in operating income that arises from a change in sales.

OPERATIONAL RISK The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events.

OPTION Right to buy or sell a specific asset at a fixed price during a specified interval of time.

OPTION CONTRACT Agreement between two parties in which one party gives the other the right, but not the obligation, to buy or sell a specific asset at a set price for a specified period of time.

OPTION ON FUTURES CONTRACT Option contract in which the underlying asset is a futures contract.

OPTION PREMIUM The price of an option.

OPTION-ADJUSTED SPREAD A procedure for valuing prepayment risk associated with mortgage-backed securities that recognizes the magnitude and timing of prepayments and required return to an investor; the corresponding yield spread over matched Treasury securities.

ORIGINATE-TO-DISTRIBUTE (OTD) The process of originating loans with the intent to sell the loans either individually or in packages of loans (securitization) and not hold the loans on the balance sheet of the originating institution. The process separates loan origination from loan ownership.

ORIGINATION FEE Fee charged by a lender for accepting the initial loan application and processing the loan.

OTHER NET GAINS (LOSSES) Income from net gains (losses) on the sales or other disposal of other real estate owned, and on sales of other assets (excluding securities) such as premises and fixed assets and personal property acquired for debts previously contracted (such as automobiles, boats, equipment, and appliances).

OTHER REAL ESTATE OWNED (OREO) Real estate owned by a bank that is acquired in settlement of debts.

OUT OF THE MONEY An option that has no intrinsic value. A call option in which the actual price is below the exercise price; a put option in which the actual price is above the exercise price.

OUTSOURCING Buying services from third-party vendors. For example, some banks might outsource their data processing.

OUTSTANDING LEASES Capitalized value of lease contracts held by the bank.

OVERDRAFT Depositor writing a check for an amount greater than the deposit balance.

OVERHEAD Expenses that generally do not vary with the level of output.

P

P/E RATIO A firm's stock price per share divided by earnings per share.

PAC (PLANNED AMORTIZATION CLASS CMO) A security that is retired according to a planned amortization schedule, while payments to other classes

of securities are slowed or accelerated. The objective is to ensure that PACs exhibit highly predictable maturities and cash flows.

PAR VALUE Dollar value of a bond's principal payment at maturity; face value printed on a security.

PARALLEL SHIFT IN THE YIELD CURVE A change in interest rates where rates at all maturities change by the same amount, in the same direction, at the same time. This never actually occurs.

PARENT COMPANY A firm that owns controlling interest in the stock of another firm.

PASSBOOK SAVINGS Nonnegotiable, small savings account evidenced by a passbook listing the account terms.

PASSIVE PORTFOLIO MANAGEMENT An investment policy whereby managers make predetermined securities purchases regardless of the level of interest rates and specific rate expectations. Examples include following a laddered maturity strategy whereby a bank continuously buys 10-year securities as previously owned securities mature.

PASS-THROUGH SECURITY Instrument secured by mortgages in which the mortgage banker passes mortgage interest and principal payments to the holder of the security minus a servicing charge.

PAST-DUE LOAN A loan with a promised principal and/or interest payment that has not been made by the scheduled payment date.

PEER GROUP Sample firms used to generate average reference data for comparison with an individual firm's performance data.

PERIODIC GAP A measure of interest rate risk calculated as the difference between rate-sensitive assets (RSAs) and rate-sensitive liabilities (RSLs) within each time bucket. A measure of the timing of the impact of interest rate changes

PERMANENT WORKING CAPITAL Minimum level of current assets minus minimum level of current liabilities net of short-term bank credit and current maturity of long-term debt; represents the amount of long-term financing required for current assets.

PERPETUAL PREFERRED STOCK Nonmaturing preferred stock.

PERPETUITY With respect to bonds, an infinite number of payments.

PERSONAL BANKER Individual assigned to a bank customer to handle a broad range of financial services.

PLANNED AMORTIZATION CLASS A collateralized mortgage obligation (CMO) that receives principal from the underlying mortgages based on a predetermined payment schedule, where the payments vary depending on whether prepayments fall inside or outside some predetermined range.

PLEGGED SECURITIES Securities held by a third-party trustee that cannot be sold without a release from the party requiring the pledge. Pledging requirements often stipulate that depository institutions pledge either Treasury or municipal

securities as collateral against deposit liabilities such as Treasury deposits, municipal deposits, and borrowings from Federal Reserve banks.

PO Principal-only security representing the principal portion of a stripped Treasury or stripped mortgage-backed security.

POINT OF SALE (POS) Electronic terminals that enable customers to directly access deposit accounts.

POLITICAL RISK The risk of loss due to such causes as currency inconvertibility, government action preventing entry of goods, expropriation or confiscation, and war.

POOLING OF INTERESTS An accounting procedure in an acquisition where the two companies simply report financial results by combining assets, liabilities, and equity at book values.

POSITION TRADER A speculator who holds a position for a longer period in anticipation of a more significant, longer-term market move.

PREFERRED STOCK Class of stock representing ownership with a claim on firm income senior to common stock.

PREMIUM ON A BOND Difference between the price of a bond and its par value when the price is higher.

PREPAID CARDS A hybrid of the debit card in which customers prepay for services to be rendered and receive a card against which purchases are charged.

PREPAYMENT SPEED The percentage of the outstanding principal that is prepaid above and beyond normal amortization.

PRETAX NET OPERATING INCOME Tax-equivalent net interest income, plus noninterest income, minus noninterest expense, minus provision for loan losses, plus realized securities gains (or losses). It represents the bank's operating profit before taxes and extraordinary items.

PRIMARY CAPITAL The sum of common stock, perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, valuation reserves, mandatory convertible securities, and minority interest in consolidated subsidiaries at a bank.

PRIMARY CREDIT Borrowings from the Federal Reserve bank under the new primary credit program in which there are many fewer administrative requirements necessary to process the loan. Sometimes referred to as the "no questions asked" program.

PRIMARY DEALER CREDIT FACILITY (PDCF) An overnight collateralized loan facility that provides loans for up to 120 days to primary dealers in exchange for a broader range of collateral than that accepted with the Term Securities Lending Facility (TSLF).

PRIME RATE One of several base interest rates used as an index to price commercial loans.

PRO FORMA FINANCIAL STATEMENTS Projected or forecasted balance sheet and income statements.

PROBATE Legal act of submitting a will before a court to verify authenticity of the document.

PROBLEM LOANS Loans currently in default or expected to obtain default status.

PROFIT MARGIN (PM) A measure of expense control defined as net income divided by total revenue.

PROJECT NOTES A short-term security used to finance a specific project or expenditure.

PROMPT REGULATORY ACTION Divides banks into categories or zones according to their capital positions and mandates action when capital minimums are not met.

PROVISIONS FOR LOAN AND LEASE LOSSES (PLL) Management's estimate of the potential incremental lost revenue from bad loans; a deduction from income representing a bank's periodic allocation to its loan and lease loss allowance (loan loss reserve) on the balance sheet.

PRUDENT MAN RULE Requirement that a fiduciary exercise discretion, prudence, and sound judgment in managing the assets of a third party.

PURCHASE ACCOUNTING An accounting method for acquisitions in which the assets and liabilities of the combined firm reflect a revaluation of assets and liabilities of the subject firms, thus recognizing the value of goodwill and other intangibles.

PUT Option to sell an asset (security) for a fixed price during a specific interval of time.

PUTTABLE BOND A bond where the investor has the option to put the security back to the issuer after some predetermined date prior to maturity and receive the principal invested or a stated price.

Q

QUALITY SPREAD The difference in market yields between yields on risky securities and matched maturity/duration Treasury securities.

QUICK RATIO Cash plus accounts receivable divided by current liabilities.

R

RAROC Risk-adjusted return on capital; equals risk-adjusted income divided by capital.

RATE BOARDS Internet-based clearinghouses that display quotes that FDIC-insured borrowers are willing to pay for different-maturity CDs. The funds represent nonbrokered deposits; the investors are institutions, such as credit unions, banks, nonfinancial corporations and municipalities, and not individuals.

RATE EFFECTS Impact of a change in interest rates on earnings after controlling for changes due to mix and volume effects.

RATE SENSITIVE Classification of assets and liabilities that can be repriced within a specific time frame, either because they mature or carry floating or variable rates.

RATE-SENSITIVE ASSETS (RSAs) The dollar value of assets that either mature or can be repriced within a selected time period, such as 90 days.

RATE-SENSITIVE LIABILITIES (RSLs) The dollar value of liabilities that either mature or can be repriced within a selected time period, such as 90 days.

RATING System of assigning letters to security issues indicating the perceived default risks associated with that class of issues.

REAL ESTATE LOANS Loans secured by real estate.

REAL INTEREST RATE Interest rate after inflation expectations are netted from a nominal interest rate.

REALIZED COMPOUND YIELD A measure of total return calculated by comparing total future dollars equal to coupon interest or dividends plus reinvestment income and the maturity or sale value of the underlying asset, with the initial purchase price, over the appropriate number of compounding periods.

REALIZED SECURITIES GAINS OR LOSSES (SG) Arise when a bank sells securities from its investment portfolio prior to final maturity at prices above (or below) the initial or amortized cost to the bank. All such profits are reported and taxed as ordinary income.

REBATE The return of a portion of unearned interest to a borrower.

RECOURSE Legal right to enforce a claim against another party.

RECOVERIES Dollar amount of loans that were previously charged off but are now collected.

REDLINING A practice whereby lenders deny loans to residents living in predetermined geographic areas. Such a practice is illegal.

REGULATION Z Part of the Truth in Lending Act (TILA) of 1968 that requires certain disclosures to be made to consumers when they are taking out a loan.

REINVESTMENT RISK The risk that future cash flows may be reinvested at rates below those expected or available at present.

REIT (REAL ESTATE INVESTMENT TRUST) An organization that obtains funds to invest in real estate or finance construction.

RELATIONSHIP BANKING Banking strategy that emphasizes the personal relationship between the banker and customer in which the banker offers value-added services beyond the transaction itself; for example, expertise in accounting, business, tax planning, and the continuity of management.

REMIC A “real estate mortgage investment conduit” issuing securities collateralized by mortgages and passing on principal and interest payments to investors. Like CMOs, REMIC securities represent claims on the underlying cash flows that are prioritized by multiple classes or tranches.

REPORTING PERIOD The period of time covered by a particular report such as monthly, quarterly, or annual.

REPURCHASE AGREEMENTS (RPs OR REPOS) Short-term loans secured by government securities and settled in immediately available funds.

REPUTATION RISK Risk that negative publicity, either true or untrue, can adversely affect a bank's customer base or bring forth costly litigation, hence negatively affecting profitability.

REREGULATION The process of implementing new restrictions or modifying existing controls on individuals and activities associated with banking. Reregulation arises in response to market participants' efforts to circumvent existing regulations.

RESERVE BALANCE REQUIREMENT The portion of the reserve requirement that is not satisfied by vault cash holdings.

RESERVE FOR BANK DEBTS Amount appearing on a bank's balance sheet that represents the estimated value of uncollectible loans.

RESERVE MAINTENANCE PERIOD The 14-day period during which a bank must hold sufficient deposit balances at the Federal Reserve to meet its legal reserve requirement.

RESERVE REQUIREMENT RATIOS Percentages applied to transactions accounts and time deposits to determine the dollar amount of required reserve assets.

RESERVES Qualifying assets to meet reserve requirements, including vault cash and deposit balances held at Federal Reserve banks.

RESOLUTION TRUST CORPORATION (RTC) A government agency (1989–1996) that assisted in the management of savings and loans deemed to be insolvent during the thrift crisis.

RESPONDENT BANK Bank that purchases services from a correspondent bank.

RESTRUCTURED LOAN Loan for which the lender has modified the required payments on principal or interest. The lender may have lengthened maturity and/or renegotiated the interest rate.

RETAIL BANK Bank that emphasizes lending to individuals.

RETAIL FUNDING Funding the bank receives from consumers and noninstitutional depositors. Retail funding generally consist of deposits accounts such as transactions accounts, money market demand accounts (MMDAs), savings accounts, and small time deposits.

RETURN ITEMS Checks that have not been honored by the drawee bank and have been returned to the check writer.

RETURN ON ASSETS (ROA) Net income divided by average total assets.

RETURN ON EQUITY (ROE) Net income divided by average stockholders' equity.

RETURN ON EQUITY MODEL A model that relates ROE to ROA and financial leverage and then decomposes ROA into its contributing elements.

REVENUE ANTICIPATION NOTES Municipal securities that are backed by revenues from a specific project financed by the state or local government issuer.

REVENUE BOND Municipal bond issued to finance a project in which debt service payments are secured by specific revenues from the project.

REVERSE COLLAR As used in hedging by financial institutions, the simultaneous purchase of a floor and sale of a cap on interest rates; used to protect against falling rates.

REVERSE MORTGAGE A mortgage in which the owner of the property can borrow against existing equity in the property.

REVERSE REPO A contract in which a lender provides funds to a borrower for which collateral is provided in the event of nonpayment.

REVERSE REPURCHASE AGREEMENT Securities purchased under an agreement to resell them at a later date.

REVOLVER Loan commitment or line of credit that converts to a term loan.

RIDING THE YIELD CURVE An investment strategy where the investor buys a security that matures after the investor's assumed holding period. The investor plans to sell the security at the end of the holding period and earn an above-average return because interest rates are expected to remain stable or fall.

RIEGLE-NEAL INTERSTATE BANKING AND BRANCHING EFFICIENCY ACT OF 1994 Overrides state branching laws and permits nationwide interstate branching by allowing adequately capitalized bank holding companies to acquire banks or branches in any state.

RISK MANAGEMENT Process by which managers identify, assess, monitor, and control risks associated with a financial institution's activities.

RISK MANAGEMENT COMMITTEE Central committee charged with enterprise-wide risk management, measurement, monitoring, and policies. Members typically set strategy regarding market risk within the organization.

RISK-WEIGHTED ASSETS Total assets minus cash and due from balances minus U.S. government securities.

RORAC Return on risk-adjusted capital; equals income (revenue minus expense) divided by allocated risk capital.

ROTH IRA An individual retirement account introduced in 1998 that allows individuals whose wages and salaries are below a predetermined minimum to contribute after-tax income. The contributions grow on a tax-sheltered basis and thus are not taxed at withdrawal.

RULE OF 72 Divide 72 by the interest rate at which funds are invested. The value indicates how long it will take for the amount of funds invested to double in value.

RUN ON A BANK Situation in which a large number of depositors lose confidence in the safety of their deposits and attempt to withdraw their funds.

S

SAFE DEPOSIT BOX Privacy boxes for storage located in a bank vault under lock and key.

SAIF Savings Association Insurance Fund that insures deposits at thrift institutions.

SALE AND LEASE BACK Transaction in which an asset is sold, with title exchanged to a lessor who leases the asset to the original owner.

SALES GROWTH Demonstrates whether the firm is expanding or contracting and provides evidence of industry competitiveness.

SALES-TO-ASSET RATIO Total sales divided by average total assets.

SALLIE MAE Student Loan Marketing Association that guarantees student loans.

SARBANES-OXLEY ACT Passed by Congress in 2002, the act established the Public Company Oversight Board to regulate public accounting firms that audit publicly traded companies. It specifically addresses issues of conflict among company executives, accounting firms, and their affiliates; also requires CEOs and CFOs to certify the annual and quarterly reports of publicly traded companies. The act also established many required policies and procedures in the area of corporate governance for the boards of publicly traded companies.

SAVINGS ACCOUNT Small-denomination account (under \$100,000) with no fixed maturity.

SAVINGS INSTITUTIONS Institutions that are generally referred to as “thrifts” because they originally offered only savings or time deposits to attract funds.

SCALPER A trader who tries to time price movements over very short time intervals and takes positions that remain outstanding for just minutes.

SEASONAL CREDIT Designed to assist small depository institutions in managing significant seasonal swings in their loans and deposits. Seasonal credit is available to depository institutions that can demonstrate a clear pattern of recurring intrayearly swings in funding needs. Eligible institutions are usually located in agricultural or tourist areas. The interest rate applied to seasonal credit is a floating rate based on market rates.

SEASONAL LIQUIDITY NEEDS Cash-flow needs that arise from predictable seasonal loan demands and deposit outflows.

SEASONAL WORKING CAPITAL Additional working capital needs that exceed the company’s permanent working capital needs. Often a result of seasonal sales patterns in a company’s sales.

SECOND MORTGAGE Subordinate to first mortgages and usually shorter term but secured by real estate.

SECONDARY CAPITAL Limited life preferred stock, subordinated debt, and mandatory convertible securities not included as primary capital.

SECONDARY CREDIT Available to depository institutions that are not eligible for primary credit. It is extended on a very short-term basis, typically overnight, at a rate that is above the primary credit rate.

SECONDARY MORTGAGE MARKET The trading of previously originated residential mortgages. Lenders that originate mortgages can either sell them directly to interested investors or package them into mortgage pools.

SECURE AND FAIR ENFORCEMENT FOR MORTGAGE LICENSING ACT (SAFE) OF 2008 Created with HERA, the act provided for the establishment of a nationwide licensing and registry system that would establish minimum national standards for all residential mortgage brokers and lenders.

SECURED INVESTOR TRUSTS Bonds secured by the cash flow from pieces of CMOs or related securities placed in trust. In most cases, the securities are high-risk instruments subject to substantial prepayment risk. The securities are labeled “kitchen-sink bonds” because they are backed “by everything but the kitchen sink.”

SECURITIZATION Pooling loans into packages and selling the pooled assets by issuing securities collateralized by the pooled assets.

SECURITY Collateral a borrower pledges against a loan or secondary source of repayment in case of default.

SECURITY INTEREST The legal claim on property that secures a debt or the performance of an obligation.

SECURITY REPURCHASE AGREEMENTS, SEE REPURCHASE AGREEMENTS.

SERIAL BONDS A series of bonds offered by the same issuer with principal payments that are due at different maturities. Serial bonds are common for municipal bond issuers.

SERVICE CHARGES Fees imposed for bank services.

SERVICEMEMBERS CIVIL RELIEF ACT (SCRA) OF 2003 Provides specific relief to active-duty military to allow for postponement or suspension of certain civil obligations.

SHIFTABILITY THEORY An extension of the commercial loan theory recognizing that any liquid asset could be used to meet deposit withdrawals.

SHORT HEDGE Sale of a futures contract to protect against a price decline.

SHORT POSITION The sale of an asset not owned.

SHORT-TERM SECURITIES Securities that mature in one year or less.

SIGHT DRAFT A draft payable “on sight.”

SIGNIFICANTLY UNDERCAPITALIZED BANK Institution with capital that falls significantly below at least one of the three regulatory standards.

SIMPLE INTEREST Interest applied against principal only.

SIMULATION An analysis of possible outcomes for net interest margin resulting from selecting hypothetical values for key variables that influence the repricing of assets, liabilities, and off-balance sheet items; and the conducting of forecasts

to determine the effects of changes in these variables on a bank's net interest income.

SINGLE-BALANCE, SINGLE-FEE NONINTEREST ACCOUNT Incurs no fee if a minimum balance is met; otherwise, there is a single monthly fee.

SINGLE-FEE NOW ACCOUNTS Similar to noninterest accounts in that they charge no fee if the account balance remains above a minimum amount; otherwise, the institution charges a monthly fee with no check charge.

SINGLE-FEE, SINGLE-CHECK-CHARGE NOW ACCOUNTS Similar to single-fee NOW accounts in that they charge a monthly fee if the account balance falls below a minimum, but this triggers a per-check charge as well.

SMALL TIME DEPOSITS Small-denomination accounts (under \$100,000) with specified maturities ranging from seven days to any longer negotiated term, with interest penalties for early withdrawal.

SMART CARD Similar to a debit or credit card, it contains a computer memory chip that stores and manipulates information.

SOVEREIGN RISK Refers to the likelihood that foreign governments will unilaterally alter their debt service payments, regardless of the formal repayment schedule.

SPECIFIC MARKET RISKS Those risks that arise from factors other than those categorized under general market risk (e.g., risk of certain events, default risk, and other nonsystematic variations).

SPECULATION Taking a position or implementing a transaction that increases risk in hopes of earning above-average returns.

SPECULATOR A trader who takes a position to increase risk in the hope of earning extraordinary returns.

SPOT CURVE Yields on zero coupon Treasury securities that differ in terms of maturity.

SPOT MARKET Market for immediate delivery of assets.

SPOT RATE Yield on a zero coupon Treasury security.

SPREAD (SPRD) Average yield on earning assets minus the average rate paid on interest-bearing liabilities.

SPREADER A spreader is a trader who is not concerned with the direction in which the market moves, but only with the difference between the prices of each contract.

STATEWIDE BRANCHING Allowing banks to establish branches throughout an entire state.

STATIC SPREAD Yield premium, in percentage, that when added to Treasury spot rates (zero coupon Treasury rates) along the yield curve, equates the present value of the estimated cash flows for the security with options to the prevailing price of the matched-maturity Treasury.

STOCK MARKET-INDEXED CD Certificate of deposit with yields linked to a stock market index such as the S&P 500.

STOP PAYMENT Request by a depositor to stop payment on a previously issued check that has not yet cleared.

STRATEGIC PLANNING The process through which managers formulate the firm's mission and goals, and identify strengths, weaknesses, opportunities, and threats.

STRIKE PRICE Fixed price at which an asset may be purchased in a call option or sold under a put option.

STRIPPED BOND A bond in which individual coupon payments and principal payments are separated (stripped) from the bond and sold as distinct zero coupon securities.

STRIPPED SECURITIES Securities that represent just the coupon interest or principal payments on a loan. The interest-only payment is referred to as an IO, while the principal-only payment is referred to as a PO.

STRIPPING FUTURES Buying or selling equal amounts of successive futures contracts.

STRUCTURED NOTE A security that will change in value or whose cash flows will change when some underlying index or base rate changes.

SUBCHAPTER S FIRM A firm with 100 or fewer stockholders that chooses to be taxed as a partnership so as not to pay corporate income taxes.

SUBORDINATED DEBT In the case of bankruptcy, the claims of holders of subordinated debt are subordinated to the claims of other debt holders. In banks, insured depositors are paid in full before holders of subordinated debt receive anything.

SUBORDINATED NOTES AND DEBENTURES Notes and bonds with maturities in excess of one year. Most meet requirements as bank capital for regulatory purposes.

SUBSTITUTE CHECK Legal equivalent of the original check and includes all the information contained on the original.

SUPPLEMENTARY CAPITAL Also known as Tier 2 capital. See Tier 2 capital.

SUPPORT TRANCHE A class of mortgage-backed securities where the promised principal and interest payments are made after payments to holders of other classes of securities are made.

SURCHARGES Fees charged by ATM owners on users of their ATMs who are not the institution's customers.

SURPLUS (OR COMMON EQUITY SURPLUS) The excess over par value at which common stock was issued plus the value of undivided profits allocated to surplus.

SWAP Simultaneous purchase and sale of like securities to alter the portfolio composition and characteristics.

SWAPTION An option on a swap.

SYNDICATE Group of banks that jointly negotiate a contract to sell securities or make loans.

T

TAC Targeted amortization class mortgage-backed securities in which payments are guaranteed for one specific prepayment rate.

TAKEDOWN Actual borrowing against a line of credit or loan commitment.

TAKEOUT COMMITMENT An agreement whereby a different lender, such as a life insurance company or pension fund, agrees to provide long-term financing after construction is finished.

TANGIBLE EQUITY Total assets minus intangible assets minus total liabilities.

TARGETED RETURN ON EQUITY Guideline based on the cost of debt plus a premium to evaluate the cost of equity.

TARP CAPITAL PURCHASE PROGRAM (TARP-CCP) An economic recovery plan implemented in 2008 that called for direct purchases (by the U.S. Treasury) of the preferred stock of financial institutions.

TAX AND LOAN ACCOUNT A deposit account held by the U.S. Treasury at a financial institution.

TAX ANTICIPATION NOTE Short-term municipal security issued in anticipation of future tax receipts and repaid from same.

TAX CREDIT Direct reduction in tax liability arising from qualifying expenditures.

TAX-EQUIVALENT YIELD Tax-exempt interest yield converted to a pretax taxable equivalent by dividing the nominal rate by 1 minus the investor's marginal income tax rate.

TAX-EXEMPT COMMERCIAL PAPER Unsecured commercial paper that pays interest that is tax-sheltered to the investor; often the interest is exempt from federal income tax.

TED SPREAD The difference between the 3-month Eurodollar rate and 3-month Treasury rate.

TERM AUCTION FACILITIES Consist of three new programs introduced in 2007: Term Auction Facility (TAF), the Term Securities Lending Facility (TSLF), and the Primary Dealer Credit Facility (PDCF). The three facilities allow financial institutions to borrow from the Fed using various collateral sources.

TERM AUCTION FACILITY (TAF) Allows depository institutions (commercial banks and savings banks) to borrow for a fixed term, typically 28 days, against a variety of collateral that is normally accepted for discount window loans.

TERM LOAN Loan with a maturity beyond one year, typically repaid from the borrower's future cash flow.

TERM RP An RP with a maturity beyond one day.

TERM SECURITIES LENDING FACILITY (TSLF) Allows primary dealers to borrow Treasury securities against other securities (e.g., mortgage-backed securities) as

collateral for 28 days. The range of securities accepted for collateral is wider than with the TAF program. Under the TSLF, bank reserves are not altered because loans are “bond for bond.”

THRIFTS Savings and loan associations, savings banks, and mutual savings banks.

TIER 1 (OR CORE) CAPITAL Total common equity capital plus noncumulative preferred stock, plus minority interest in unconsolidated subsidiaries, less ineligible intangibles.

TIER 2 (OR SUPPLEMENTARY) CAPITAL Limited to 100 percent of Tier 1 capital and consists of cumulative perpetual preferred stock and any related surplus, long-term preferred stock, limited amounts of term-subordinated debt and intermediate-term preferred stock, and a limited amount of the allowance for loan and lease losses (up to 1.25 percent of gross risk-weighted assets).

TIME VALUE For an option, the amount by which the option premium exceeds the intrinsic value of the option.

TIMES INTEREST EARNED Earnings before interest and taxes (EBIT) divided by interest expense; measures the number of times the company can pay the interest payments on its outstanding debt.

TOO BIG TO FAIL (TBTF) Refers to large banks considered to be “too big to fail”; depositors at such banks most likely know that they have de facto 100 percent coverage and would not be as concerned about the bank’s capital cushion.

TOTAL EQUITY CAPITAL The sum of common stock, surplus, undivided profits, and capital reserves, and net unrealized holding gains (losses) on available-for-sale securities, cumulative foreign currency translation adjustments, and perpetual preferred stock.

TOTAL NONCURRENT LOANS Sum of nonperforming and nonaccrual loans.

TOTAL OPERATING EXPENSE (EXP) Sum of interest expense, noninterest expense, and provisions for loan losses.

TOTAL REVENUE (TR) (OR TOTAL OPERATING INCOME [TOI]) Total interest income plus noninterest income and realized securities gains (losses).

TRADING ACCOUNT Inventory of securities held by a bank making a market for sale and purchase.

TRADING ACCOUNT SECURITIES Defined by FASB 115 as securities that must be marked-to-market and unrealized gains and losses reported on the income statement.

TRADING REVENUE, VENTURE CAPITAL REVENUE, AND SECURITIZATION INCOME Gains (losses) from trading securities (making a market in securities) and off-balance sheet derivatives; venture capital activities; net securitization income and fees from securitization transactions; and unrealized losses (recovery of losses) on loans and leases held for sale.

TRANCHE The principal amount related to a specific class of stated maturities on a collateralized mortgage obligation.

TRANSACTION RISK Current and prospective risk inherent in transactions from fraud; theft; error; integrity of computing systems; internal controls; and delays or disruptions in processing, clearing, and settling payment transactions, which could lead to credit and liquidity problems as well as affect earnings and capital.

TRANSACTIONS ACCOUNTS (OR TRANSACTIONS BANKING DEPOSIT ACCOUNTS) Accounts on which a customer can write checks.

TRANSACTIONS BANKING The provision of transactions services such as checking accounts, credit card loans, and mortgage loans that occur with high frequency and exhibit standardized features. Because the products are highly standardized, they can be critiqued mechanically and require little human input to manage.

TRANSFER PRICING The pricing of funds transferred between organizational units of a bank, such as determining the cost of collecting deposits and borrowed funds to finance a loan.

TRANSIT CHECKS DEPOSITED Checks drawn on any bank other than the subject bank where deposits are simply deposits from checks drawn on the subject bank.

TRANSIT ITEM Checks drawn on banks located outside the community of the bank in which they are deposited.

TREASURY EMERGENCY AUTHORITY PROVISIONS Created with HERA; authorized the Treasury to purchase debt securities issued by GSEs and to purchase common stock.

TROUBLED ASSET RELIEF PROGRAM (TARP) Implemented in 2008; created \$750 billion fund originally designed to allow the U.S. Treasury to purchase distressed assets from financial institutions.

TRUNCATED ACCOUNT Checking account in which the physical check is “truncated” at the bank; that is, checks are not returned to the customer.

TRUST A property interest held by one party for the benefit of another.

TRUST PREFERRED STOCK A hybrid form of equity capital at banks that meets the requirement for Tier 1 capital.

TRUSTEE Individual or firm charged with managing trust assets.

TRUTH IN LENDING ACT (TILA) OF 1968 United States federal law designed to protect consumers in credit transactions by requiring clear disclosure of key terms of the lending arrangement and all costs.

TRUTH IN SAVINGS A part of Regulation DD (see <XR>Chapter 2), established a uniform disclosure requirement of the terms and conditions as well interest and fees on savings accounts.

U

UBPR Uniform Bank Performance Report.

UNDERCAPITALIZED BANK Institution that does not meet at least one of the three minimum capital requirements.

UNDERWRITE To purchase securities from the initial issuer and distribute them to investors.

UNDERWRITING SYNDICATES Groups of investment banks.

UNDIVIDED PROFITS Retained earnings or cumulative net income not paid out as dividends.

UNEARNED INCOME Income that has been received but not yet earned.

UNEARNED INTEREST Interest received prior to completion of the underlying contract.

UNIT BANK Single, independent bank with one home office.

UNITARY THRIFT HOLDING COMPANY A thrift holding company that owns only one thrift.

UNIVERSAL BANK A financial institution that can conduct traditional commercial banking business, such as accepting deposits and making loans, plus offer investment banking services including market making, underwriting, mergers and acquisitions advice, and asset management.

USA PATRIOT ACT (TITLE III) Passed by Congress in 2001, the act, formally known as the International Money Laundering Abatement and Financial Anti-Terrorism Act, is designed to prevent terrorists and others from using the U.S. financial system to move funds to support illegal activity. The act specifically required financial institutions to keep additional records and establish anti-money laundering programs.

USURY Interest charges in excess of that legally allowed for a specific instrument.

V

VA (VETERANS ADMINISTRATION) A federal agency that insures mortgages.

VALUATION RESERVE Loan loss reserve reported on the balance sheet; losses can be charged only against this reserve.

VALUE-AT-RISK (VAR) A procedure for estimating the maximum loss associated with a security or portfolio over a specific period of time, associated with a given confidence level.

VARIABLE RATE Automatic repricing, usually by charging the interest rate at regular intervals.

VARIABLE-RATE CD Contracts with rates renegotiated at specified intervals such as every three months. The rate paid at each interval would be equal to the average of three-month CD rates quoted by securities dealers.

VARIATION MARGIN Daily change in value.

VOLATILE (NONCORE) LIABILITIES Jumbo CDs, deposits in foreign offices, federal funds purchased, and repurchase agreements (repos or RPs), as well as Federal Home Loan Bank borrowings and other borrowings with maturities of less than one year. They are normally issued in denominations above the amount that is federally insured so the depositor bears some risk of default.

VOLATILE DEPOSITS Difference between actual outstanding deposits and core deposits; represents balances with a high probability of being withdrawn.

VOLUME EFFECTS These recognize that a bank may pay more or less in interest expense simply because it operates with different amounts of interest-bearing debt and equity and, thus, pays interest on different amounts of liabilities.

W

WEIGHTED MARGINAL COST OF FUNDS Marginal cost of pooled debt funds used in pricing decisions.

WELL-CAPITALIZED BANK A bank with a strong capital position that meets the required capital levels for well-capitalized banking companies and as a result is not subject to any regulatory directives regarding capital.

WHOLESALE BANK A bank that emphasizes business lending.

WHOLESALE FUNDING Includes borrowed funds as well as large institutional deposits such as large CDs (over \$100,000).

WINDOW DRESSING The practice in financial reporting in which a firm engages in certain transactions at the end of a reporting period (quarter or fiscal year) to make the financial results appear better or different from those prevailing at the time.

WORKING CAPITAL (or NET WORKING CAPITAL) Current assets minus current liabilities (excluding short-term debt).

X,Y,Z

YIELD CURVE Diagram relating market interest rates to term-to-maturity on securities that differ only in terms of maturity.

YIELD RATE Tax-equivalent interest income divided by earning assets.

ZERO COUPON BOND A bond that does not pay periodic interest. Because the return must come from price appreciation, the bond is sold at a discount from face value. There is no reinvestment risk of interim cash flows.

ZERO COUPON CD Certificate of deposit sold at a steep discount from par that appreciates to face value at maturity; it carries fixed rates and fixed maturities.

ZERO GAP Rate-sensitive assets equal rate-sensitive liabilities.

ZERO-BALANCE ACCOUNT A checking account with a forced zero balance due to transfers of funds from the account at the close of each business day.

Z-SCORE A statistical measure that presumably indicates the probability of bankruptcy.

Z-TRANCHE The final class of securities in a CMO exhibiting the longest maturity and greatest price volatility. These securities often accrue interest until all other classes are retired.

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