Glossary of Terms

Appreciation. Increase in the value of a property or other asset.

Arrearage. Amount borrower owes to lender for missed payments and associated costs of collecting a debt.

Auto-Dialer. Automated dialing capability used by debt collectors to save on the time and expense of manually dialing phone numbers. If, after entering a phone number, the dialing system detects an answering machine, busy signal or no answer, it automatically dials the next number on a programmed list. The system's user sets calling frequencies. The call is connected to the agent only if someone answers. When the connection is made, the system also provides the agent with the account's status.

Bid Price. Specified amount a prospective buyer is ready to pay for a security, to which the seller responds by accepting, rejecting or countering the offer.

Bond. Obligation by a borrower to eventually repay money obtained from a lender. The bondholder buying the investment is entitled to receive both principal and interest payments from the borrower. A bond may be issued for $1 million or more but generally trades in smaller denominations of $1,000 increments.

Business Risk. Generic term that refers to the chance of significant loss to a company whenever the actual value of an outcome falls short of its expected value. Business-risk losses can arise from a variety of events including natural disasters, credit events–such as loan default or corporate default–or market changes in interest rates, exchange rates, commodity prices or stock prices.

Cap. Provision in a debt contract or **option** agreement that protects the owner of a variable interest-rate instrument from **interest-rate risk**. The cap locks in the maximum interest rate for which the owner is responsible, even if prevailing rates climb higher.

Capital Reserves. Difference between a firm's assets and liabilities, also known as net worth or owner's **equity**. Reserves are earmarked as a cushion against a firm's unexpected losses, as well as those anticipated in the normal course of business.

Catastrophic Risk-Transfer Bonds (CAT Bonds). Investment instrument, usually issued by an insurance company, to serve as a **hedge** against losses a client must pay out on a portfolio of property or casualty insurance contracts. The more severe the losses, the lower the return to the investor. A catastrophic loss, perhaps caused by a storm or earthquake, could result in a reduction or loss of interest payments, investor principal or both interest and principal. A lower-than-anticipated loss rate could lead to above-market interest payments.

Collateral. In mortgage finance, the property that secures or guarantees the discharge of a mortgage obligation.

Collections. Practice of referring a past-due account to an intermediary that specializes in enlisting a delinquent borrower's cooperation in bringing a debt current. In the mortgage industry, a successful intervention averts foreclosure of the collateral backing the loan while keeping to a minimum the lender's resulting expenses caused by the payment delay or foreclosure proceedings.

Conforming Mortgage. Loan eligible for sale to Freddie Mac or Fannie Mae because the original mortgage amount does not exceed a statutorily set dollar threshold that is adjusted annually. In 2000, for example, the conforming-loan limit for a one-family home is $252,700. Higher limits apply in Alaska, Hawaii, Guam and the U.S. Virgin Islands. Higher limits also apply to multiunit properties.

Conventional Mortgage. Residential loan neither insured nor guaranteed against borrower default by the federal government through one of its housing programs. See also **government-backed mortgage**.

Conventional Mortgage Home Price Index (CMHPI). Index jointly developed by Freddie Mac and Fannie Mae to track changes in the prices of detached, one-unit, single-family homes that serve as collateral for mortgages funded by the two secondary-mortgage-market firms. The index is constructed using regression techniques and observations of actual sales prices or appraised values for the same homes over time. After identifying consecutive transactions by matching street addresses, price changes are calculated for each set of consecutive events pertaining to the same property. The CMHPI data base contains records of more than 11.4 million repeat-business transactions.

Counterparty. Opposing party in a **swap** or other financial transaction.

Credit Derivative. Financial instrument with option-like characteristics designed to transfer credit-default risk from one party to another.

Credit-Rating Agency. One of four recognized firms that supports investors by analyzing, reporting and monitoring the credit risk of companies or bonds and other fixed-income investments. In the case of a bond, the agency formulates a relative credit rating for each bond **tranche** and the overall bond after collecting and analyzing relevant credit-related information. Investors use the rating to help determine whether to invest in the bond.

Credit Risk. Chance of loss to an investor arising from the loan default of a borrower who fails to make promised interest or principal payments when due or the corporate default of a business partner or other **counterparty**. Also known as default risk.

Credit Spread. Difference between the interest rate on an asset and an analogous risk-free asset, such as a Treasury security. The wider the spread, the greater the investor's return, or compensation, for taking on the higher default risk. Also considered a measure of relative credit risk.

Cure. When a borrower makes restitution for loan **arrearages** in some way, such as paying missing installments, refinancing the loan or paying off a mortgage by selling the collateral property.

Cure Rate. Of a portfolio of delinquent mortgages, the percentage brought current or repaid. In the first case, the borrower makes up missed payments, bringing the mortgage up to date. In the second instance, the borrower pays off the mortgage in full, thereby canceling the loan obligation.

Debt Restructuring. Term used in commercial real estate lending when a lender agrees to modify the terms of a loan, given the inability of the borrower to repay the debt as agreed. Often, the debt is recast to include unpaid interest, penalties and other fees, and the borrower is given an extended time to pay. Debt restructuring also can include a new mortgage rate.

Default. When a borrower is in breach of a note or a security instrument—such as a mortgage or deed of trust—thereby entitling a lender to initiate foreclosure proceedings.

Delinquency. When all or part of a mortgage borrower's monthly installment of principal and interest remains unpaid after the date due.

Depreciation. Decline in the value of a property or other asset.

Due Date. Contractually established date—often the first day of the month—at which time a mortgage borrower must make the scheduled payment. However, the loan agreement may allow for a **grace period** during which the borrower can still make payment before a late charge is assessed.

Equity. Value that an owner has in real estate over and above liens against it. Equity is measured as the difference between the property's fair-market value and current level of indebtedness.

FICO Mortgage Credit Score. Statistical credit evaluation score provided by Fair, Issac and Co., one of the country's leading scoring-system developers. The spectrum of "FICO" default values ranges from a high-risk score of around 400 to a low-risk score of around 800.

Foreclosure. When used in the mortgage business, a legal proceeding initiated by a lender to transfer ownership of the collateral property securing the note.

Futures. Financial instrument used to arrange the prospective purchase or sales of a commodity on a date and at a price agreed to in advance by the parties. Futures confer on both buyer and seller the obligation to execute the stipulated trade. Futures trade on an organized exchange and are valued daily at market prices.

Government-Backed Mortgage. Residential loan insured or guaranteed by the federal government against borrower default through programs administered by the Federal Housing Administration (FHA), Department of Veterans Affairs (VA) or Rural Housing Service (RHS).

Government-Sponsored Enterprise (GSE). Entity created by Congress that operates with private capital under a government-defined mission and charter. Housing-related GSEs include Freddie Mac and Fannie Mae.

Grace Period. In mortgage-business vernacular, a time interval specified by the lender that begins the day after the official mortgage due date and typically runs for one or two weeks. When a borrower fails to make the scheduled payment by the conclusion of the grace period, a late fee is imposed.

Guarantee. With respect to **mortgage-backed securities**, a pledge to investors that the issuing company will bear the default risk on the collateral pool of loans, thereby ensuring the timely payment of principal and interest owed to investors.

Hedge. Process by which the risk of incurring a loss on a particular asset or liability is reduced. The hedge purchaser enters into one or more financial transactions that are negatively correlated with the value of the asset or liability, thereby providing an offsetting gain when the item's value drops.

Interest-Rate Risk. Chance of loss due to fluctuating interest rates that cause a value change in a mortgage or other fixed-income instrument. Generally, a rising rate prompts a decline in the price of an existing mortgage, while a declining rate triggers an increase in its market value.

International Swaps and Derivatives Association (ISDA). Principal trade organization for the privately negotiated derivatives industry. ISDA develops and publishes master agreements for swaps and other over-the-counter derivative contracts. ISDA agreements serve as standard industry documentation for a variety of financial instruments.

Jumbo Mortgage. Loan larger than the statutory limit for purchase by Freddie Mac or Fannie Mae. Also referred to as a **nonconforming mortgage**.

Late-Fee Assessment Date. Point at which the **grace period** ends and the borrower now owes a late charge for failing to make a regular installment when due. Generally, the fee is calculated as a percentage—typically in the range of 1 percent to 5 percent—of the monthly payment. For example, if a monthly payment is due on the first of the month, but the mortgage contract allows for a 15-day grace period, the late-fee assessment date would fall on the 16th of the month.

Loan Modification. Terms under which a lender agrees to restructure a mortgage for a borrower facing a long-term financial problem but who can demonstrate the ability to meet the revised payment terms. The modification can include lowering the original interest rate or extending the loan term and calculating a new payment schedule to retire the loan.

Loan-to-Value (LTV) Ratio. Amount of a mortgage loan expressed as a percentage of the collateral property's value. This figure is inversely related to the down payment or **equity** in the property. For example, an LTV of 80 percent and a down payment of 20 percent refer to the same equity relationship. The ratio often is used in mortgage underwriting as a measure of default deterrent, based on how much equity a borrower personally stands to lose in the event of default.

London InterBank Offer Rate (LIBOR). Index used to benchmark floating-rate assets. It reflects the interest rate that the most creditworthy international banks dealing in Eurodollars would charge each other on large loans.

Loss Mitigation. Course of action agreed to by a lender and borrower to satisfy a delinquent mortgage obligation, thereby providing an alternative to foreclosure. These efforts can range from simply bringing the delinquency to the borrower's attention to working out an alternative repayment plan.

Mezzanine. In a multiclass security, the mid-range-risk **tranche**, typically split into several more credit layers of varying risk. This tranche bears less risk than the first-loss-position tranche but carries more risk than the senior-position tranche. Accordingly, the return to investors taking a mezzanine position will fall somewhere between the rates earned on investments in the first-position and senior tranches.

Mortgage-Backed Security (MBS). Financial instrument representing an interest in a pool of loans secured by mortgages. Principal and interest payments on the underlying mortgages are used to pay principal and interest on the securities. Freddie Mac and Fannie Mae **guarantee** the timely payment of principal and interest on the mortgage-backed securities they issue.

Mortgage Insurance. Financial protection paid for by a borrower with the lender as beneficiary, in which a third party—the insurer—assumes some of the default risk of the loan. In the event of foreclosure, the policy pays a set amount to the lender to cover some or all of the outstanding loan balance.

Negative Equity. Condition achieved when the market value of a property declines by more than the borrower's equity position—that is, the sum of the original down payment, any loan principal repayments and house-price **appreciation**. For example, suppose a borrower puts down $20,000 to buy a home, and the value of the property promptly declines by more than $25,000. The negative equity amounts to $5,000, meaning the borrower would have to pay $5,000 out-of-pocket to immediately refinance into a zero-equity loan at a lower interest rate.

Nonconforming Mortgage. Loan in an amount that exceeds the qualifying limits for **government-sponsored enterprise (GSE)** purchase or government insurance or warranty. See **jumbo mortgage**.

Nominal Terms. Price changes expressed in current dollars, meaning the price reflects changes, including inflation-driven contributions, in the value of a home or other object.

Notional Value. Dollar amount of the underlying assets against which derivative instrument payments are calculated.

Option. Financial agreement giving an investor the right—but not the obligation—to buy (call option) or sell (put option) a good, security or currency at a prearranged price within a specified time period.

Private-Label Security. In the housing-finance business, a mortgage-backed security or other bond created and sold by a company other than a **government-sponsored enterprise**. The security frequently is collateralized by loans that are ineligible for purchase by Freddie Mac or Fannie Mae.

Real Terms. Price changes expressed in constant purchasing-power dollars. The value of an object, such as a home, is measured relative to the value of a fixed bundle of goods and services, thus removing the contribution of inflation and isolating the real price change.

Recession. Downturn in the output of an economy. In the United States, the length of a recession is measured from the start of two consecutive quarters of negative economic growth and concludes with two consecutive quarters of positive growth.

Repayment Plan. Agreement reached between lender and borrower that increases the size of the borrower's monthly loan contributions for a period of time until **arrearages** are repaid.

Right-Party Contact. Successful effort by a loan **servicer** to speak with a mortgage borrower about resolution of a delinquency.

Risk-Transfer Bond. Debt obligation that links interest payments to losses specified in a contract between issuer and investor. **CAT bonds** are a specific example of a risk-transfer bond.

Senior-Subordinate Bond. Multiclass security commonly used in the capital markets to induce investors in **nonconforming mortagages** to accept higher levels of risk in exchange for higher returns. Risk is layered into subordinate bonds or **tranches** that pay higher returns than do the senior classes. Cash-flow losses caused by homeowner delinquencies and defaults first are allocated to and borne by the more junior classes of investors, thereby protecting the senior classes from losses.

Servicer. Company that manages the mortgage-payment process, which includes the routine collection of monthly payments from borrowers, transfer of principal and interest to investors, administration of escrow accounts and management of delinquency and foreclosure problems that may arise. Lending firms that originate mortgages occasionally run in-house servicing operations but frequently contract with outside firms.

Skip-Tracer. Investigative service hired by creditors after failing at repeated attempts to contact a delinquent borrower. A mortgage **servicer** typically waits until a borrower is at least 60 days past due to employ a skip-tracer to locate the borrower. Today's high-tech skip-tracer conducts automated searches of extensive data bases to verify or update the servicer's contact information on the borrower.

Swaption. Derivative instrument used to establish how two parties periodically exchange payments on different holdings based on the value of one or more market indexes.

Tranche. One of the bond layers issued as part of a multiclass instrument to meet different investor objectives for portfolio diversification.