# Finance Capital and the Global Economic Crisis

## Glossary of Some Technical terms

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**401(K) plan**: Savings plan in the United States that allows an employee to save for retirement without having to pay taxes on investment-earnings until the withdrawal of funds from the plan. Savings may be channelled into a range of different types of investment, including *mutual funds* investing into *equity, bonds* and money-market investments.

**Adjustable-Rate Mortgage (ARM)**: Broadly, any mortgage-loan with changing interest rates. In many economies, such as Britain, most mortgages have rates that vary according to market interest-rates. The recent real-estate bubble and subprime frenzy in the United States saw very different types of ARM develop. Mortgages with '*teaser rates*' offered borrowers temporarily low initial rates and monthly payments, which would automatically increase a couple of years into the loan. As with *negative amortisation-mortgages*, this type of ARM sought to exploit the widely documented tendency of ordinary borrowers to focus exclusively on monthly repayments when considering a loan.

**Arbitrage**: The practice of seeking to make a profit by taking advantage of price-misalignments across a number of markets. If the dollar is trading for 100 yen in Tokyo, while the pound sells for 150 yen in London and 1.48 dollars in New York, there is an arbitrage opportunity. An *arbitrageur* can make a profit by spending 1.48 dollars to buy a pound in New York, selling it in London for 150 yen, and then selling the yen for 1.50 in New York. The actions of the *arbitrageur* will help change market-prices to eliminate both the price misalignment and the profit-opportunity. According to mainstream financial theory, *arbitrageurs* fulfil a socially valuable function in capital-markets as their actions help to ensure that asset-prices take into account all relevant information. This view neglects the fact that only investors who are well informed, funded and connected can make such profits in most markets. It also ignores the possibility that profits may be made through deliberate manipulation of prices by influential groups of investors.

**Basle II capital-adequacy framework**: Framework developed by the Basle Committee on Banking Supervision aimed at creating a new single international standard for the amount of capital that banks must set aside to guard against unforeseen asset-losses. The central innovations of the new framework include making mandatory capital-reserves highly sensitive to the estimates of asset-risk by a range of financial firms. This allows some of the more 'sophisticated' international banks to use their own internal 'risk-management' systems to calculate their minimum levels of capital-reserves.

**Bond**: A form of debt where the terms of repayment by the borrower are specified in a standardised financial contract that can be bought and sold in capital-markets. Lending through bonds allows lenders to get their money back at short notice (by selling the bond) without having to call in the borrower's loan. **Brokerage**: The financial function of mediating between sellers and buyers of securities. For its services, a broking firm charges fees. When a broking firm buys or sells securities for itself and not a client, it is said to be undertaking principal or *proprietary* trade.

**Capital gain:** A gain made by an investor in a financial asset when its current price exceeds the price at which it was bought. The investor may choose to realise the gain by trading the asset, or keep the gains unrealised by holding on to the asset, typically in the hope of further price-increases. Capital-losses are defined in equivalent fashion.

**Capital markets**: Markets where *equities* as well as private and public *bonds* are traded.

**Capitalisation** or **market cap**: refers to the total value of a corporation's outstanding *equity*.

**Collateralised Debt-Obligation (CDO)**: A structured financial asset promising holders a series of payments that are funded from a bundle of debt-instruments, such as *bonds* or mortgages. The CDO's structure takes the repayments on the bundled bonds or mortgages (or other debt-service payments) and forwards them to its holders according to a prioritised ranking. Holders of more *senior tranches* of the CDO are paid first, followed by holders of *mezzanine-tranches*, and finally *equity-tranches*. As a result, holders of equity tranches suffer the first losses arising from defaults, followed by mezzanine-holders and senior holders. Originally devised for the junkbond market in the United States in the late 1980s, CDOs became widespread in US secondary-mortgage markets in the first half of this decade.

**Commercial banking**: The type of banking that involves raising funds through current, savings, or time-deposits, subsequently to allocate them into loans as well as public and *corporate securities*. Commercial banking is distinct from *investment-banking*, which involves *brokerage* and other direct participation in the trading of *corporate securities* in *capital-markets*, as well as the raising of funds not from depositors but also directly from capital-markets.

**Corporate securities**: Fungible and tradable financial claims on a corporation. They include corporate *equity* and *bonds.*

**Credit-Default Swap (CDS)**: A contract between two parties in which the buyer makes regular payments to the seller in exchange for a payoff in the event that an underlying credit instrument (such as a bond) defaults. In essence, it is a form of insurance against default on debt, except that the holder is not required to own the insured asset. CDSs were introduced by JP Morgan Chase in the late 1990s as a vehicle to shift the risks of holding credit instruments, such as bonds, onto other parties.

**Credit-scoring**: A quantitative estimate of a borrower's creditworthiness. It is calculated by lenders on the basis of proprietary models, developed through statistical inference, that estimate the relationship between a range of borrower-characteristics and the likelihood they will make debt-repayments on time. Credit scoring has been an instrumental technology in the recent rise of mass lending to individuals, as it allows lenders to obtain quick and cheap estimates of the creditworthiness of a borrower.

**Derivatives**: Financial assets whose value directly depends (or derives) from the value of another asset (referred to as the underlying asset). A basic insurance-contract (for instance, homeowners' insurance) can be understood as a derivative, as the value of the contract depends on whether or not a house becomes damaged. The recent explosion in derivatives markets has involved derivatives linked to financial assets and payments, such as stock options or swaps.

**Equity**: An ownership-claim on a corporation that can be traded in *capital-markets*. Holders of the most general forms of corporate equity own a share of the corporation and are entitled to propotional shares of dividend payments made by the corporation to equity holders.

**Equity-buyback**: *Capital-market* operation through which a corporation buys back some of its own shares from shareholders, leaving fewer shares outstanding. Corporate managers may buy back shares of their corporations if they believe shares are currently undervalued, if they wish to signal such a belief to other capital-market players, or if their salaries and bonuses depend on the corporation's earnings per outstanding share.

**Fictitious capital**: Marxist term used most generally in relation to all tradable paper claims to future wealth. In relation to *capital markets*, the term refers to corporate *equity*, market-*capitalisation*, and their attendant social relations. A corporation's market-capitalisation corresponds neither quantitatively nor qualitatively to the value of the corporation's capital in circulation and production. Rather, it reflects the aggregate money-value that investors would presumably be willing to pay in order to secure claims to the corporation's future earnings. Its level depends on a range of factors, including the creditworthiness of the corporation, the liquidity of its securities, and the general confidence investors have in the corporation's future. This money-value takes the appearance of a capital stock because of the general capitalist tendency to conceive of every regular flow of value (in this case dividend payments) as a yield on capital. Yet, it is only the price that investors are willing to pay today for a claim on the value that will be appropriated by the corporation tomorrow. In this sense, it is a purely fictitious form of capital.

**Finance-capital**: Term advanced by Rudolph Hilferding to describe the amalgamation of industrial, merchant- and banking capital. For Hilferding, finance-capital arose as a natural result of long-run secular developments inherent to the process of capitalist competition: Competition gives rise to monopolies and to a growing reliance by industrial capital on bank credit to finance investment in fixed capital. As a result, banking and industrial capital tend to merge into finance-capital and control ever growing spheres of the economy.

**Founder's profit**: Term also advanced by Hilferding (sometimes incorrectly rendered as promoter's profit) to describe the profits realised by a corporation's founders when they first issue *equity* in an *IPO*. For Hilferding, this profit arises because competition among the buyers of *equity* ensures that the price of shares renders expected future dividend payments equivalent to a return on the share outlay that is equal to the rate of interest. However, the corporation's productive assets yield the average rate of profit, which is generally higher than the rate of interest. As a result, a firm's *market-capitalisation* at issue is higher than the net value of its assets, yielding a peculiar form of profit to the founders of a public corporation. Hilferding further argued that *founder's profit* is the future profit of enterprise that accrues as a lump-sum to the founder.

**Fund-management**: Service provided by banks and other financial intermediaries involving the management of pooled investments like *mutual* and *hedge-funds*.

**Futures-contract**: A standardised, exchange traded contract to buy or sell a specified quantity of a particular commodity or asset at a certain future date. Examples include oil futures, through which trading parties agree to buy or sell oil for delivery at future dates. Most trading in futures does not involve parties seeking to obtain or sell the actual commodity or asset in the future. They involve parties either seeking to speculate on particular price movements between the present and the contract's maturity, or to build a particular risk-profile for their asset-portfolio.

**Hedge-fund**: A particular type of investment fund open to a limited range of investors and permitted by regulators to undertake a much broader range of investments and trades than ordinary investment-funds. Notably, hedge funds are allowed to take very risky derivative positions, as well as undertake short-selling transactions through which gains can be made from falls in asset-prices. Hedge-funds generally charge high levels of fixed and 'performance' fees. They are very selective and open only to wealthy and institutional investors.

**Individual Retirement-Account (IRA)**: Private retirement-plan in the US in which contributions are often tax-deductible and all earnings are tax-exempt. Holders are liable for tax-payments on withdrawals, which are generally treated as income.

**Individual Savings Account (ISA)**: Private savings plan in Britain through which savers may undertake investments with tax-free earnings. Contributions into ISAs are subject to an annual cap.

**Investment-bank**: A financial intermediary that provides corporations with the range of services necessary to raise funds in capital markets. Investment-banking functions include underwriting the issue of *corporate securities*, *brokerage* services, and various forms of corporate advisory services. Investment-banks also raise funds directly in *capital-markets* as well as undertaking *proprietary investments* in *capital markets*.

**Initial Public Offering (IPO)**: The original sale of a corporation's shares (*equity*) to investors. It secures revenues for the corporation, which can be used for various investment projects. Th is is in contrast to the subsequent secondary transactions involving shares, in which one investor buys shares from another, with no direct effect on the corporation.

**Institutional investors**: Organisations that pool large amounts of money for investment. They include pension-funds, mutual funds, insurance-companies, and hedge-funds. They generally invest on behalf of their clients, who have claims on particular funds managed by the institutional investor.

**Leverage**: The use of borrowed money in the pursuit of an investment. Leverage is used in attempts to augment the profitability of an investment. As long as an investor is borrowing at a rate lower than that which she is receiving on the investment, leverage can greatly increase the returns realised. Conversely, if the realised return on the investment ends up lower than the rate paid for borrowed funds, the losses facing investors are also augmented.

**Leveraged Buyout (LBO)**: A financial operation in which investors acquire a controlling stake in a corporation and a substantial part of the operation is financed through borrowing or leverage. By pledging the assets of the acquired corporation as collateral for the loans used to finance the purchase, the investors carrying out the LBO place the debt burden onto the corporation. Th is often facilitates dramatic cost-cutting measures, which become necessary to ensure that the corporation does not default on the new debt.

**London Interbank Offered Rate (LIBOR)**: A set of daily reference interest-rates at which banks are making unsecured loans to each other in the London interbank money-market. The rates are published by the British Bankers Association.

**Mortgage-backed security**: Any debt security where payments to holders originate in the repayment of mortgages. They include *CDOs*, as well as much simpler instruments that have been used in secondary US home mortgage markets since the late 1930s.

**Moral hazard**: A term originally coined in the insurance-industry to refer to a situation in which an individual protected against risk may become more likely to engage in risky behaviour. In the archetypical example, the owner of a bicycle may become more careless about taking costly measures to ensure its safety, thus making theft more likely, if she has full insurance-cover against theft. In relation to banking, the term is often used to refer to the possibility of a borrower acting against the interests of a lender, as well as the possibility that state-bailouts and other interventions to save failing banks may encourage banks to engage in high-risk behaviour in the future. **Mutual fund**: A collective investment-scheme where the funds of many investors are pooled and typically invested into *corporate securities*, short-term debt, or government-bonds. Investors become shareholders of the fund, and have a proportional claim on the value of its investments. Mutual funds are widely used by retail-investors as a means to build retirement savings.

**Negative-amortisation mortgage**: A mortgage where initial monthly repayments are lower than the interest accrued on the total loan during the month. As a result, the total amount outstanding rises over time. Clearly, monthly payments will have to rise significantly over the life of the loan if it is to be repaid. As with *teaser-rate ARMs*, these loans were used to entice borrowers into mortgages they were very unlikely to afford.

**Over-the-counter trading**: Trading of financial assets that takes place directly between two parties without use of a trading exchange that regulates, standardises, polices, and lists prices for transactions.

**Proprietary investment and gains**: Terms that refer to investment (and possible associated gains) undertaken by an investment-bank on its own behalf, as opposed to investments undertaken on behalf of client-investors. **Redlining**: The common practice by financial intermediaries and other businesses of denying (or increasing the cost of ) services or goods in certain areas, typically those with a strong presence of racial or ethnic minorities or poor residents.

**Retail-banking**: Banking that involves the provision of services directly to individuals as opposed to corporations or other businesses. This includes *commercial-banking* services such as individual savings, current or savings accounts. It may also include the provision of services more closely associated with *investment banking*, such as investment-, retirement- or related funds supplied to individual clients.

**Special Purpose Vehicle/Special Investment Vehicle** a.k.a. **'bankruptcy-remote entity'**: An autonomous organisation whose operations are limited to the acquisition and issuance of certain assets, typically a subsidiary of another corporation. They became notorious during the Enron scandal in the early 2000s because they were used to hide losses and fabricate earnings. SPVs were more recently used widely by banks to facilitate the creation and issuance of mortgage-backed CDOs. They allowed banks to devolve risks associated with CDOs away from their own balance-sheets, reducing the need to set aside capital-reserves against possible losses associated with those instruments.

**Securitisation**: Financial process of pooling and repackaging assets that produce cashflows into securities that are then sold to other investors. Th is includes CDOs and mortgageacked securities, but can also involve very different structures and underlying assets.

**Subprime mortgage**: A housing loan to borrowers who do not meet 'prime' or top level mortgage-underwriting guidelines. Subprime borrowers are generally more likely to default or fall behind in repayments than 'prime' borrowers.

**Thrifts or Savings and Loan Association**: US term for financial intermediaries specialised in taking savings deposits and making mortgage-loans. Equivalent to old British building societies.

**Treasury Bills (T-Bills)**: Short-term government- debt issued by the US Department of Treasury. T-Bills are sold in denominations of US$1,000 and have maturities from four to 52 weeks.

**Usurer's profit**: Profits realised through usury, or money-lending. The term is typically used to denote pre-capitalist lending relations, where lending was not associated with productive activity, or had very high interest-rates.

**Value at Risk**: Method prominently adopted by JP Morgan in 1994 to quantify estimates of the risk of a given portfolio position. Most commonly, it estimates the maximum possible portfolio-loss in the following 24 hours on the assumption that market-outcomes over that period will not be extreme.

**World-money**: Money that functions in world-markets as an internationally acceptable means of payment and hoarding