GLOSSARY

Asset-Backed Security (ABS)
A type of debt security whose yield is secured with cash flows from a set of underlying assets (mortgage loans, income from payment cards issued, car purchase loans, etc.). ABSs backed by payments from mortgage loans on residential property are called Residential Mortgage-Backed Securities (RMBS). Asset-Backed Commercial Papers (ABCP), which are issued to obtain short-term credit, are a variant of ABSs.

Balance-sheet liquidity
The ability of an institution to meet its obligations in a corresponding volume and term structure.

Capital adequacy ratio
The ratio of regulatory capital to total risk-weighted assets. Tier 1 capital adequacy is the ratio of Tier 1 capital to total risk-weighted assets (see also *Tier 1*).

Carry trade
A speculative strategy on the financial markets where an investor borrows money in a currency with a lower interest rate and invests it in a currency with a higher interest rate in order to realise the profit arising from the interest rate differential (a similar transaction can be carried out using financial derivatives). However, this profit can only be realised on the assumption that any movement of the exchange rate between the financing currency and the investment currency does not eliminate the gain from the interest rate differential.

Collateralised debt obligation (CDO)
A security backed by debt, with various debt receivables serving as the underlying portfolio. By contrast with traditional debt-backed securities, several risk variants (tranches) of debt securities, characterised by specific risk profiles and yields, are issued against a single underlying portfolio. Riskier tranches offer higher yields but also result in higher losses in the case of default in the underlying portfolio. CDSs can also be used as underlying assets; such obligations are called synthetic CDOs.

Conduits
Special-purpose vehicles established by banks. Like SIVs, they sell short-term liabilities (commercial papers) and use the funds raised to buy long-term asset-backed assets (mortgage loans, car purchase loans, income from payment cards issued, etc.). Banks use them to securitise loans provided and to a large extent guarantee their operations.

Credit default swap (CDS)
A credit derivative in which the buyer of the collateral undertakes to pay the seller periodical fixed payments ("swap premium") for the duration of the contract in exchange for a conditional payment of the counterparty in the case of default of the "reference entity" to which the agreement refers. If default does not occur, the contract terminates at a specified time and the seller only gains a premium for taking on the potential credit risk.

Default
Default is defined as a breach of the debtor's payment discipline. The debtor is in default at the moment when it is probable that he will not be able to repay his obligations in a proper and timely manner, without recourse by the creditor to settlement of the claim from the security, or when at least one repayment (the amount of which deemed by the creditor to be significant) is more than 90 days past due.

Default rate
The 12-month default rate is the number of new defaulters over a 12-month reference period as a proportion of the total number of entities existing in that period. The default rate can also be defined analogously in terms of volume based on the obligations assumed by debtors.

Equalisation provision The equalisation provision is set aside for individual areas of non-life insurance and is intended to equalise increased insurance claim costs arising due to fluctuations in loss ratios as a result of facts independent of the will of the insurance company.

Flight to quality A situation on the financial markets where investors sell en masse all risky assets and buy only high-quality government bonds of advanced countries with very low risk.

Herfindahl index (HI) The sum of the squares of the market shares of all entities operating on a given market. It expresses the level of concentration in the market. It takes values between 0 and 10,000. The lower the HI, the less concentrated the market.

Interest rate spread Also interest rate differential; the spread between the interest rate on a contract (deposit, security) and a reference interest rate.

IRB approach Internal Rating Based Approach – an approach to the calculation of the capital requirement in relation to the credit risk of the investment portfolio and the risk of diffusion of the portfolio, based on internal ratings. It is one of the most important innovations under the new capital framework. The IRB approach is laid down in CNB Decree No. 123/2007 Coll., on prudential rules for banks, credit unions and investment firms.

Leveraged loans Loans with a high degree of leverage, granted to companies whose external debt exceeds a level that is considered normal. These loans have a higher probability of default and banks charge relatively high interest rates on them. They are often used for a specific purpose – typically to acquire a controlling interest in a corporation using borrowed money (leveraged buy-out, LBO).

Liquidity Money in the broader sense (cash, short-term assets quickly exchangeable for cash, etc.).

Loan-to-value (LTV) ratio The ratio of a loan to the value of pledged property.

Market liquidity The ability of market participants to carry out financial transactions in assets of a given volume without causing a pronounced change in their prices.

Monoline insurers Specialised institutions insuring against the risk of default on bond issues and securing high ratings for them (originated primarily to insure municipal bond issues). This relatively small sector attracted increased attention during the credit crisis in 2008, as it also started insuring credit derivatives, including those created through the securitisation of subprime mortgages, in a search for yield.

Natural population increase
The difference between the number of live births and the number of deaths in the same period of time in a given area. See also *Total population increase*.

Originate-and-distribute model
A bank business model under which the bank first provides loans or funds for lending to an intermediary and subsequently sells on these loans by means of securitisation, thereby distributing the original credit risk among other entities.

Over the counter (OTC) operations
Operations not conducted on an organised market.

Present value of a basis point (PVBP)
The change in the real value of an instrument given a parallel shift in the interest rate curve of 1 basis point, i.e. 0.01%.

Price-to-income The ratio of the price of a flat (68 m^2) to the average annual wage in a given region.

Price-to-rent The ratio of the price of a flat to the annual rent. The price-to-rent ratio is the inverse of the rent return.

Property developers/developments
Companies/projects whose aim is to build a complex of residential and commercial property. Property developers' work includes choosing an appropriate site, setting up a project, obtaining the necessary permits, building the necessary infrastructure, constructing the buildings and selling the property. Developers also often organise purchase financing for clients and frequently lease or manage the property once it is built (especially in the case of commercial property). Given the combination of construction activity and speculative property purchases, developers' results are strongly dependent on movements in property prices.

Property supply prices Property sale supply prices in estate agencies. Supply prices should be higher than transfer prices. Property supply prices in the Czech Republic are published, for example, by the CZSO and the Institute for Regional Information (which also publishes data on market rent supply prices). See also *Property transfer prices*.

Property transfer prices Prices based on Ministry of Finance statistics from property transfer tax returns and published by the CZSO. These prices are the closest to actual market prices in terms of methodology, but are published with a time delay. See also *Property supply prices.*

Rent return The ratio of the annual supply rent to the supply price of the flat. It is the inverse of the price-to-rent indicator.

RMBS See Asset-Backed Security

Securitisation A credit risk transfer method creating a new marketable security from a set of illiquid assets. The cash flows from the security depend on the cash flows from the underlying assets. Securitisation takes place through an SPV (Special Purpose Vehicle). The original owner transfers the underlying assets to this company against cash payment and the SPV issues new securities based on the underlying assets (called asset-backed securities, ABSs) and sells them to investors. Credit risk is thus transferred from the original owner of the receivables to ABS holders.

Shadow banking system A relatively new term that started to be used on a larger scale in connection with the credit crisis in 2007. It is a heterogeneous group of financial institutions that enable the banking sector to provide more loans with a given level of capital or grant various forms of loans themselves. According to Wikipedia, for example, the shadow banking system or shadow financial system is largely formed by non-bank financial institutions that have short-term and liquid liabilities and long-term and less liquid assets. The system includes SIVs, conduits, money market funds, investment banks, hedge funds, monoline insurers and other non-bank entities. These institutions are subject to market risk, credit risk and especially liquidity risk in respect of the rollover of securities or the loans used to finance them. As they are not depositary institutions, they do not have access to the central bank's lender-of-last-resort support. In the event of liquidity problems, they could go bankrupt if unable to refinance their short-term liabilities.

Solvency Solvency in the insurance sector is the ability of an insurer to meet its insurance obligations, i.e. to settle eligible insurance claims arising from insured losses. Solvency II – a new regulatory framework prepared by the European Commission – is a set of rules for European insurance companies and reinsurers laying down

quantitative requirements, qualitative requirements, prudential rules, compliance with market discipline and disclosure duties.

Structured Investment Vehicles (SIVs)
Special-purpose companies acting as funds, raising money by issuing short-term securities (commercial paper), investing it by purchasing long-term securities and making profit from the difference between the interest rates on short-term liabilities (asset-backed securities or corporate bonds) and long-term assets. SIVs have an open structure, i.e. they operate continuously, buying new assets as others mature. By contrast with conduits, they cannot rely directly on obtaining liquidity from their parent banks at times of financial turbulence.

Subprime A relatively risky segment of clients with worse expected payment discipline (e.g. clients with a poor credit history, a higher risk of loss of employment, etc.).

Technical provisions Under the Act on Insurance, an insurer must set aside technical provisions to meet insurance obligations which are either likely to be incurred or certain to be incurred but uncertain as to amount or as to the date on which they will arise.

Tier 1 The highest quality and, for banks in the Czech Republic, also the most significant part of regulatory capital. The dominant components of Tier 1 are equity capital, retained earnings and mandatory reserve funds.

Total population increase The sum of the natural population increase and net migration in the same period of time in a given area. Net migration is the difference between immigration into and emigration from a given area in the same period of time. See also *Natural population increase*.

Value at risk The size of loss, with predefined probability, which a bank may suffer when holding a current portfolio for a certain period if market factors (e.g. interest rates, exchange rates) develop unfavourably.

Yield spread Also yield differential; the spread between the yield on a bond and the yield on a reference ("benchmark") bond.