

Exam 2 Study Guide  
Fall 2015

What is the underinvestment/debt overhang problem  
How can the debt overhang problem be resolved  
What is the asset substitution problem  
What is the basic credit risk equation? Define each of the terms.  
What are typical recovery rates?  
How is exposure measured (there are several ways to measure exposure).  
What are the “Five Cs” of credit analysis? How are each measured?  
What is the YT/credit spread approach to measuring default risk?  
What is the CDS approach to measuring default risk?  
What is the Merton model approach to measuring default risk?  
What is Altman’s Z-score?  
How can customer credit risk be mitigated?  
What is factoring?  
What is sovereign credit risk?  
What is funding risk? And how can it be managed?  
What is securitization  
What cash flows have been securitized, which are the most common  
What is an SPV  
What are the motives for securitization  
What is a pass-through security  
What is a collateralized debt obligation (CDO)  
How does a CDO achieve credit enhancement  
What is a tranche  
What is “toxic waste” (and why is it called that)  
What is a CDO<sup>2</sup>  
What is the effect of default risk correlation on the default risk of different CDO tranches  
What are the problems applying standard bond ratings to CDOs  
What is the systematic risk of the different CDO tranches  
Define *insurance* can be defined in legal terms. In financial terms. How do these definitions differ?  
How does insurance redistribute the costs of losses?  
Describe the difference between a named-perils policy and an open-perils policy.  
What is the difference between a hazard and a peril? Give examples of each.  
Why is it the chance of loss, and not the loss itself, that creates the need for insurance?  
How does a moral hazard differ from a physical hazard? Give examples of each.  
Define the law of large numbers. What are its implications for an insurance system?  
Explain the differences between social insurance and private insurance programs.  
Describe the characteristics of an ideally insurable loss exposure  
Explain why a broad group of is needed to assure affordable premiums  
Describe how risk classification systems operate and how they can result in subsidization in insurance markets  
Describe how risk classification can create a competitive advantage for an insurance company  
Describe the causes of adverse selection in insurance markets  
Describe the characteristics of a well designed risk classification system  
Describe the different types of private insurance companies in the U.S.