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 CDO²
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.