Econ 497   Professor Ickes

Economics of the Financial Crisis   Spring 2012

Review Questions II

1. What is performance-based arbitrage (PBA)? Why would it be used? What is an alternative? Why might PBA be important for understanding when arbitrage is not effective? Explain.

2. If stock prices are high relative to dividends this could forecast higher dividend growth in the future. Is this consistent with efficient markets? Explain. Several decades of empirical work suggest, however, that high price-earnings ratios only forecast low returns. How is this possible? Explain. What does this have to say about situations when house prices are high relative to rents? Explain.

3. What are the primary factors that led to the growth of securitization?

   (a) Why do banks engage in securitization?
   (b) What are the primary problems that securitization deals with?

4. Explain the processes of pooling and tranching? What economic problems do these deal with?

5. Is securitization consistent with the Modigliani-Miller theorem? Explain. What does this tell us about the nature of the financial transactions concerned.

6. The shift from the "originate to hold" model of mortgages to one of "originate to distribute" introduces new problems to security design. What are the key problems involved in securitizing mortgages? How do organizers deal with these problems?

7. Why are systematic risks more important for mortgage backed securities than for conventional corporate bonds? Explain.

8. What is repo? Explain how this works. Why are senior tranches of asset-backed securities likely to be used as collateral for repo transactions?

9. What is the difference between informationally sensitive and informationally insensitive assets? Why are informationally insensitive assets important? Why is debt more likely to be used as collateral than equity? Explain.

10. Describe shadow banking. In what sense is shadow banking similar to conventional banking? What are the forces that led to the growth of shadow banking?