

Probability of failure (risk),  $f$

$$f(\delta^n) = \frac{3}{4}$$

$f_e$

$f_d$

$y_1$

$y_2$

$y_3$

Iso-expected income curves

e

n

c

b

d

More expected income  
Better for borrower

Slope

$$-mrs(\delta, f) = \frac{1-f}{q(1-2f)+\delta}$$

$\delta^L$

$\delta^n$

$\delta^H$

Interest factor,  $\delta$

