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Collateral in credit rationing in markets with asymmetric information

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Highlights

- The introduction of outside collateral (personal assets) may generate negative incentives.
- The borrower gambles for resurrection by continuing an inefficient bad project or by gambling with the value of the collateral asset.
- By winning the gamble the borrower can save the collateral asset.
- Moral hazard is avoided when the volume of collateral is small or large, as it occurs in the middle range of collateralization.
- The eliminate moral hazard each loan should be fully secured and the value of the collateral assets should be fixed.

Abstract: We study an incentive model of lending in which a borrower can pledge a personal asset as outside collateral. We examine how the value of the collateral affects the borrower's incentives and the lender's returns. In some scenarios moral hazard is avoided without the collateral but the introduction of the collateral may generate negative incentives. The borrower attempts to save his collateral asset by gambling for resurrection with the project output or by gambling with the value of the collateral. These negative incentives make credit rationing optimal. The findings provide recommendations on the optimal use of collateral.