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Abstract

This paper develops a model of collateralized lending where the main source of asymmetric information between counterparties is the borrower's ability to make whole on his promise to pay.

In the model, borrowers finance the purchase of an asset by obtaining a collateralized loan from a monopolist lending sector, which uses the margin (a.k.a. haircut) on the loan to infer how well capitalized the borrower may be. Borrowers are able to credibly reveal this information since well capitalized borrowers are less exposed to liquidity shocks between loan issuance and repayment that could potentially force the borrower to default. Losses stem from a deadweight illiquidity cost that affects collateral in case of default.

Profits stem from the borrower’s ability to use his own unencumbered capital to finance the margin payment, which comes at the expense of un-modeled existing claimants. The monopolist balances the trade off between these two frictions and offers contracts to infer the borrower’s type. The main motivation behind this line of work is to understand the factors that drive haircuts in the repo market.