

# The Role of Collateral in Credit Markets

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## Abstract

The author examines the role of collateral in an environment where lenders and borrowers possess identical information and similar beliefs about its future value. Using option-pricing techniques, he shows that a secured loan contract is equivalent to a regular bond and an embedded option to the borrower to default. The author finds that the lender will not advance to the borrower, a loan that exceeds the market value of the collateral, and that the supply of loans increases with a rise in the market value of the collateral. Increases in the volatility of the value of the collateral, interest rate, and dividend rate of the collateral independently depress the loan supply. The author also derives the cost of a third-party guarantee of a loan and an implied risk premium.

## Keywords

Collateral, Credit, Credit Aggregates, Option Pricing, Risk Premium

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## 1. Introduction

Loan contracts generally require that the borrowers post assets which can be taken over by lenders if the borrowers default on the promised payments. An explanation for such contractual arrangements is that borrowers and lenders have asymmetric information about the project which the loan is financing; because the borrowers appear to know more about the project than the lender, and the borrowers' evaluation of the project tends to be higher than that of the lenders. According to a strand of the literature, collateral in loan agreements in this environment acts as a disincentive for borrowers to default.

Another strand of the literature argues that collateral plays an important role in loan negotiations even when borrowers and lenders have the same information but differ in beliefs. In this environment, the collateral signals information to the lender about the riskiness and/or prospects of the project that the loan is needed to finance. The borrowers provide collateral as a way of sorting themselves out by risk class if lenders believe that the level of secured loan indicates the project's profitability. Lenders may have such beliefs because the secured debt is costly for borrowers whose projects are of low quality.

The focus of this paper is to re-examine the role of collateral in a loan contract. Our approach differs from the

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