

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

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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Race and Default in Credit Markets Michael A. Stegman, 1996-07 A research commentary on the critical policy issue of whether or not racial discrimination exists in the home mortgage lending industry A collection of essays on this topic by experts such as John Yinger Stephen Ross George Galster Also includes commentaries on mortgage performance housing market discrimination default rates their place in the controversy the role of FHA data in the lending discrimination discussion Graphs charts

The Color of Credit Stephen L. Ross, John Yinger, 2002-11-08 An analysis of current findings on mortgage lending discrimination and suggestions for new procedures to improve its detection In 2000 homeownership in the United States stood at an all time high of 67.4 percent but the homeownership rate was more than 50 percent higher for non Hispanic whites than for blacks or Hispanics Homeownership is the most common method for wealth accumulation and is viewed as critical for access to the most desirable communities and most comprehensive public services Homeownership and mortgage lending are linked of course as the vast majority of home purchases are made with the help of a mortgage loan Barriers to obtaining a mortgage represent obstacles to attaining the American dream of owning one's own home These barriers take on added urgency when they are related to race or ethnicity In this book Stephen Ross and John Yinger discuss what has been learned about mortgage lending discrimination in recent years They re-analyze existing loan approval and loan performance data and devise new tests for detecting discrimination in contemporary mortgage markets They provide an in depth review of the 1996 Boston Fed Study and its critics along with new evidence that the minority white loan approval disparities in the Boston data represent discrimination not variation in underwriting standards that can be justified on business grounds Their analysis also reveals several major weaknesses in the current fair lending enforcement system namely that it entirely overlooks one of the two main types of discrimination disparate impact misses many cases of the other main type disparate treatment and insulates some discriminating lenders from investigation Ross and Yinger devise new procedures to overcome these weaknesses and show how the procedures can also be applied to discrimination in loan pricing and credit scoring

What We Know About Mortgage Lending Discrimination in America Margery Austin Turner, 2000-07 This report adds to the growing body of evidence that discrimination remains a significant problem a sizable barrier to opportunity in America It outlines how discrimination can affect minorities access to mortgage capital the key to becoming a homeowner at multiple stages of the lending process it suggests directions for further research oversight on these important The Dept of Housing Urban Develop HUD commissioned this independent study to review extend what we know about the complexities of mortgage markets nationwide HUD will use this information to further develop its policies programs aimed at ensuring equal opportunity for all

Handbook on the Economics of Discrimination William M. Rodgers, 2009-01-01 The papers contained in the first part of the book are particularly valuable as a primer for researchers interested in economic discrimination On this basis alone this book is recommended for researchers seeking an overview of

current techniques for assessing economic discrimination The final section nicely highlights both the importance in understanding the interaction of policy and economic discrimination and the difficulties in isolating policy effects Education Economics Editor Rodgers has compiled a very useful book that summarizes the current state of the literature on economic discrimination This reviewer learned something new and interesting in every chapter and particularly appreciated the clear survey of the age discrimination literature This book will be of value to academics and to those in the legal arena Highly recommended J P Jacobsen Choice Discrimination s dynamic nature means that no single theory method data or study should be relied upon to assess its magnitude causes or remedies Despite some gains in our understanding these remain active areas of debate among researchers practitioners and policymakers The specially commissioned papers in this volume all by distinguished contributors present the full range of issues related to this complex and challenging problem Part 1 explores innovations in methods and data collection that help to provide richer descriptions of inequality Part 2 reviews empirical evidence on discrimination that people with disabilities older workers and gay lesbian and bisexual individuals face Although discrimination among these groups is not new this Handbook shows that economists are beginning to more fully document their experiences Part 3 presents a balanced discussion of anti discrimination policies and the impact of affirmative action The methods and data chapters are particularly designed to encourage researchers to utilize the new approaches and develop new data sources Accessible and comprehensive the Handbook is the seminal reference on the economics of discrimination for academic and professional economists graduate students advanced undergraduates practitioners policymakers and funders of social science research

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Table of Contents Race And Default In The Credit Markets A Colloquy

1. Understanding the eBook Race And Default In The Credit Markets A Colloquy
 - The Rise of Digital Reading Race And Default In The Credit Markets A Colloquy
 - Advantages of eBooks Over Traditional Books
2. Identifying Race And Default In The Credit Markets A Colloquy
 - Exploring Different Genres
 - Considering Fiction vs. Non-Fiction
 - Determining Your Reading Goals
3. Choosing the Right eBook Platform
 - Popular eBook Platforms
 - Features to Look for in an Race And Default In The Credit Markets A Colloquy
 - User-Friendly Interface
4. Exploring eBook Recommendations from Race And Default In The Credit Markets A Colloquy
 - Personalized Recommendations
 - Race And Default In The Credit Markets A Colloquy User Reviews and Ratings
 - Race And Default In The Credit Markets A Colloquy and Bestseller Lists
5. Accessing Race And Default In The Credit Markets A Colloquy Free and Paid eBooks
 - Race And Default In The Credit Markets A Colloquy Public Domain eBooks
 - Race And Default In The Credit Markets A Colloquy eBook Subscription Services
 - Race And Default In The Credit Markets A Colloquy Budget-Friendly Options
6. Navigating Race And Default In The Credit Markets A Colloquy eBook Formats

- ePub, PDF, MOBI, and More
- Race And Default In The Credit Markets A Colloquy Compatibility with Devices
- Race And Default In The Credit Markets A Colloquy Enhanced eBook Features
- 7. Enhancing Your Reading Experience
 - Adjustable Fonts and Text Sizes of Race And Default In The Credit Markets A Colloquy
 - Highlighting and Note-Taking Race And Default In The Credit Markets A Colloquy
 - Interactive Elements Race And Default In The Credit Markets A Colloquy
- 8. Staying Engaged with Race And Default In The Credit Markets A Colloquy
 - Joining Online Reading Communities
 - Participating in Virtual Book Clubs
 - Following Authors and Publishers Race And Default In The Credit Markets A Colloquy
- 9. Balancing eBooks and Physical Books Race And Default In The Credit Markets A Colloquy
 - Benefits of a Digital Library
 - Creating a Diverse Reading Collection Race And Default In The Credit Markets A Colloquy
- 10. Overcoming Reading Challenges
 - Dealing with Digital Eye Strain
 - Minimizing Distractions
 - Managing Screen Time
- 11. Cultivating a Reading Routine Race And Default In The Credit Markets A Colloquy
 - Setting Reading Goals Race And Default In The Credit Markets A Colloquy
 - Carving Out Dedicated Reading Time
- 12. Sourcing Reliable Information of Race And Default In The Credit Markets A Colloquy
 - Fact-Checking eBook Content of Race And Default In The Credit Markets A Colloquy
 - Distinguishing Credible Sources
- 13. Promoting Lifelong Learning
 - Utilizing eBooks for Skill Development
 - Exploring Educational eBooks
- 14. Embracing eBook Trends
 - Integration of Multimedia Elements
 - Interactive and Gamified eBooks

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