Financial constraints and collateral crises

CFM-DP2020-07

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In economies with frictions in the credit market, collateral is relevant from a liquidity perspective. In these economies, collateral circulates like money, enabling transactions. But collateral can only efficiently operate as money if it is information insensitive. This property is usually attributed to assets with well-known and easy-to-check values. However, as emphasized by Gorton and Ordonez (2014), information insensitivity might also be a feature of assets with an intrinsic value that is very costly to assess. They argue that asset-backed securities were widely used as collateral in the period leading up to the 2007-8 financial crisis because it was difficult to pin down their fundamental value.

This paper shows that in this environment, the availability of alternative ways of financing can harm the liquidity role of assets, even if these alternatives are costly and not used in equilibrium. When banks need more funding to finance their projects (either because they are short of deposits or cash, or because the demand for credit is high), the collateral value of asset-backed securities is high. In this case, banks have little incentive to invest in understanding how much those assets are worth. Hence, asset-backed securities become information-insensitive, and the market of collateralized credit works well.

However, when financial institutions have a low opportunity cost for their deposits (perhaps because the demand for loans decreased or because alternative sources of funding are available), the market of collateralized credit might break down even if it is more efficient than the available alternatives. In this case, financial institutions have more incentives to pay the costs of assessing the value of assets commonly used as collateral. This is enough to put a halt on this market. We conjecture this channel might have played a role in the onset of the 2007-8 financial crisis.