

Collateral Reallocation

Jason Donaldson
Washington University in St Louis

Denis Gromb
HEC Paris

Giorgia Piacentino
Columbia University

Abstract

We develop a model in which pledging an asset as collateral allows secured creditors to block its sale unless their debt is paid in full. We find that when borrowers issue secured debt, asymmetric information about its value leads to too few asset sales in equilibrium, despite the freedom to renegotiate. Thus, debt market frictions alone cause the asset market to fail, and result in asset misallocation. We show that, nonetheless, borrowers issue secured debt in equilibrium, albeit as a last resort, when internal funds and unsecured debt capacity are low, states resembling recessions. Our theory thus explains why secured borrowing is countercyclical and asset reallocation procyclical.

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