

Collateralized assets and asymmetric information

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Received 1 March 2007; received in revised form 20 June 2007; accepted 25 June 2007

Available online 19 November 2007

Abstract

Introducing assets backed by physical collateral, we extend the [Cornet, B., De Boisdeffre, L., 2002. Arbitrage and price revelation with asymmetric information and incomplete markets. *Journal of Mathematical Economics* 38, 393–490.] model of asymmetric information to allow for default. We show that, independently of the financial-informational structure, equilibrium exists.

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JEL Classification: D50; D52

Keywords: Asymmetric information; Default; Collateral

1. Introduction

In a two-period incomplete markets economy with nominal assets, Cornet and De Boisdeffre (2002) contribute to the theory of asymmetric information extending the classical non-arbitrage asset pricing procedure. They propose a decentralized mechanism in which agents anticipate asset prices and make, before the trade of commodities and assets, a refinement of their signals by precluding arbitrage opportunities.

In this context, a vector of asset prices is implementable as equilibrium only if the pooling information, obtained after the exclusion of arbitrage opportunities, is non-empty (see De Boisdeffre, 2007). In particular, there are financial structures for which only asset prices that fully reveal information are equilibria.

To illustrate this point, consider a two-period economy with two states of nature in the second period, $\{u, d\}$. There is only one commodity and only one asset, an Arrow security contingent to $s = u$. There are two types of agents, $\{A, B\}$. Individuals of type A are uninformed about the realization of the uncertainty, while individuals of type B know that the state $s = d$ will occur with certainty. Then, applying the refinement mechanism of Cornet and De Boisdeffre (2002), only when the asset has zero price the pooling information (obtained by the elimination of arbitrage opportunities) will be non-empty. Furthermore, in the unique equilibrium, there is no trade and uninformed agents become fully informed.

Note that when an agent anticipates an asset price, she believes that it is a non-arbitrage price. Thus, the individual never anticipates asset prices that give unbounded gains today without any risk tomorrow. For this reason, in the preceding example, type B individuals will never anticipate a positive price for the asset.

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Moreover, the existence of a financial position that gives unbounded gains tomorrow without any cost today will be interpreted by any agent as a signal that some states of nature will not occur. This will induce agents to refine their private information. For instance, in our example, uninformed individuals will become fully informed when they anticipate a zero price.

A natural question arises: why will uninformed individuals anticipate a zero price (becoming fully informed)? For Cornet and De Boisdeffre (2002) this happens because, even without rational expectations, agents will coincide in their forecasted prices. In fact, given that credit markets are frictionless, informed individual always will anticipate a zero price.

On the other hand, when borrowers can default, financial markets need to implement mechanisms to protect lenders of excessive losses. Usually, these mechanisms will set limits on the amount of debt and, therefore, may also preclude (endogenously) the unbounded gains associated to an arbitrage opportunity. For instance, in the previous example, if we burden borrowers to constitute collateral requirements that will be seized in case of default, then a positive price for the Arrow security may emerge. In fact, the financial frictions induced by the collateral constraints will prevent type B agents from obtaining unbounded gains when the security has a positive price. Therefore, new equilibria will appear when default is allowed.

In this paper, we extend the model of Cornet and De Boisdeffre (2002) to allow for default and collateral, as in Geanakoplos and Zame (2002). We prove that equilibrium always exists, with no need to update information through a predefined (centralized or decentralized) mechanism. In this sense, the set of common non-arbitrage prices will increase when default is allowed.

Essentially, Cornet and De Boisdeffre (2002) point out that in the absence of default, a non-arbitrage price (common to every agent) may no longer exist, thus agents may need to update information to preclude arbitrage opportunities. When default is allowed and assets are collateralized, the existence of a margin between the market value of the collateral and the asset price will bound the amount of wealth that more informed borrowers extract from less informed lenders. Thus, endogenously, markets only allow for limited arbitrage opportunities and physical-financial trade becomes possible. Alternatively, from the perspective of an environment that allows agents to update information before commodities and assets can be traded, we focus on the second stage. Thus, we assure the existence of equilibrium independently of either the nature of the mechanism that was used to update information or the final distribution of information.

2. Collateralized assets in an economy with asymmetric information

2.1. Model

We consider a discrete time economy with two periods, $t \in \{0, 1\}$. There is no uncertainty at $t = 0$ and we denote by $s = 0$ the unique state of nature at this date. At $t = 1$, there is a finite set S of states of nature that can be reached. Let $\Sigma = \{0\} \cup S$.

There is a finite set of commodities, L , that can be traded at each $s \in \Sigma$. Commodities may suffer depreciation (or may appreciate) contingent on the state of nature. Thus, if one unit of good $l \in L$ is consumed in $t = 0$, an amount $Y_s(l, l')$ of the good $l' \in L$ is obtained at $s \in S$. Given $s \in S$, the matrix $Y_s = (Y_s(l, l'))_{(l, l') \in L \times L}$ has non-negative entries. Note that we allow for perishable and perfect durable goods in our economy.

As in Geanakoplos and Zame (2002), the financial sector is characterized by a finite set J of collateralized assets that can be negotiated at $t = 0$ and that make promises contingent on the states $s \in S$. More formally, each $j \in J$ is characterized by a process $(A(s, j); s \in S) \in \mathbb{R}_+^{L \times S}$ of state contingent real promises, and by its physical unitary collateral requirements, $C_j \in \mathbb{R}_+^L$. Collateral guarantees are always held by the borrowers.

Following Cornet and De Boisdeffre (2002), there is a finite number of agents, $h \in H$, that have a private information $S_h \subset S$ about the states of nature that will occur in $t = 1$. This private information is correct in the sense that the true state will belong to S_h . Therefore, the state of nature that actually will occur in $t = 1$ will belong into the *pooled information set*: $\underline{S} := \bigcap_h S_h$.

Each $h \in H$ may trade commodity and assets at $t = 0$, and make plans for consumption at each $s \in S_h$. Let $\Sigma_h = \{0\} \cup S_h$. We assume that consumer $h \in H$ is also characterized by his endowments, $w^h = (w_s^h; s \in \Sigma_h) \in \mathbb{R}_+^{\Sigma_h \times L}$, and by his preferences over consumption, that are represented by a function $U^h : \mathbb{R}_+^{\Sigma_h \times L} \rightarrow \mathbb{R}_+$.

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