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The desire for land: Strategic lending with adverse selection

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Abstract

This paper deals with a setting in which borrowers and lenders place different values on an asset that can be used as collateral. Under adverse selection, lenders may rationally choose credit contracts with the object of attracting a relatively risky group of clients, so raising their chances of gaining possession of the asset through default. Contracts of differing attractiveness to borrowers can also coexist in equilibrium. When an 'inside' and an 'outside' lender compete, the latter placing a lower value on the collateral, and their loanable funds are sufficiently limited, a separating equilibrium may exist in which the insider offers a contract which attracts risky borrowers, whereas the outsider's contract is aimed at a safer group. If loanable funds are ample, the only equilibrium will involve pooling contracts, but the insider may still offer more attractive contracts in an entry game.

JEL classification: C7; D8; O1; Q1
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1. Introduction

This paper deals with a setting in which borrowers and lenders place different values on an asset that can be used as collateral, with particular reference to land in rural societies. The fact that those lenders who put a high value on a collateral asset will be readier to offer credit contracts that involve a higher probability of default than those who place little or no

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value on it raises a central question: Are there circumstances in which it is optimal for a lender of the first sort to offer contracts that are attractive to a set of ‘risky’ borrowers, even in the presence of a lender of the second kind? It will be established that under adverse selection, this is indeed so, a result which runs exactly counter to the standard argument (Stiglitz and Weiss, 1981; Clemenz, 1986). The existence of such a separating equilibrium is an explanation of the empirically important phenomenon whereby some lenders offer credit contracts that are evidently less attractive to borrowers than those offered by other lenders and still stay in business (see, for example, Hoff et al., 1993). Even if such an equilibrium is not sustainable, it will be shown that heterogeneity of contractual terms can also arise in a pooling equilibrium when lenders’ valuations of collateral are heterogeneous.

That an asset should have different values to different agents when trading is possible needs a brief commentary. The peasant’s attachment to his land is legendary, for not only does it produce a stream of income, but its ownership also confers social prestige in his community. The moneylender and trader, who are often one and the same, also value land for the same reasons, but arguably less highly. Although their own shortcomings as cultivators need be no bar to profitable ownership if there is an ample supply of capable tenants, getting the best out of a holding or enterprise usually requires some special knowledge of it. More importantly, they are less likely to be swayed by considerations of social prestige, and if the lender is an institution, such considerations do not come into play at all. The problem for moneylenders and traders who want to acquire land, then, is that the peasant is extremely reluctant to sell—at a price they find acceptable. Hence, the market for land as an asset is often very thin (see, for example, Binswanger and Rosenzweig, 1986).

Yet land does change hands, often in times of distress, when crops have failed or commodity prices have collapsed. In such cases, much of the land in question had been pledged as collateral to secure a loan, or mortgaged outright. The lender therefore achieved indirectly through a loan what he was unable to do profitably through a straight purchase. There were several episodes in South Asia in the late 19th and early 20th centuries in which many peasants lost their land to moneylenders in this way (Gupta, 1987; Rothermund, 1993, pp. 46–48). Some of these episodes followed changes in the law that effectively transformed land into a commercial commodity. It might be argued, therefore, that such alienation on a large scale was simply the result of the peasants’ failure to understand that, by pledging their land as collateral, they had put it at risk.

That is not, however, the whole story. In his classic study of the Punjabi peasantry, Darling (1925) demonstrated that the peasants responded to good times by going into debt, using their land as security. When bad times followed, many of them lost their land. Darling took pains to understand what motivated peasants and lenders to enter into such contracts. For the peasant, a loan secured by land meant that he was still the owner and would remain so if all turned out as he hoped. As for the moneylender, he advanced credit not only for the interest it would yield, but also with an eye to acquiring the land itself. That is to say, he lent with a strategic aim.[1] This suggests that a further consequence of such an attachment to land is the resort to debt contracts.

[1] Gupta (1987) provides an interesting account of the land market in Maharashtra between 1820 and 1960, in which most of the considerations discussed above are nicely illustrated. Particularly telling for present purposes is the example of a prosperous cultivator and moneylender whose loanable funds and landholdings grew rapidly during the 1920s (p. 140).