The Commitment Problem of Secured Lending

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The paper challenges the argument that collateral boosts debt capacity and provides a new rationale for the use of trade credit. In a setting with uncertainty, two inputs and investment unobservability, we show that a firm-bank secured credit contract is time-inconsistent: Once credit has been granted, the entrepreneur has an ex-post incentive to alter the input combination towards the input with low collateral value, thus jeopardizing total bank revenues. Anticipating the entrepreneur's opportunism, the bank offers a non-collateralized credit contract, thereby reducing the surplus of the venture. One way for the firm to commit to the contract terms is to purchase inputs on credit and pledge them to the supplier in case of default. Observing the input investment and having a positive stake in the bad state, the supplier acts as a guarantor that the input mix specified in the bank contract will be actually purchased and that the entrepreneur will stick to the contract terms. The analysis is extended to consider the case of collusion between entrepreneur and supplier. The paper concludes that trade credit facilitates the access to collateralized bank financing and identifies new testable predictions between the degree of competition in the up-stream market and the firm financing and input choices.