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"Debt discharge in personal bankruptcy, and the signaling content of collateral"

Abstract

We analyze the effect of a bankruptcy law -- according to which some of the borrower's assets are exempt from liquidation in the event of default -- in the context of a competitive credit market characterized by adverse selection. In particular, we study how the level of such exemption affects the role of collateral as a sorting device. An increase in the level of exemption increases the role of collateral as a sorting device:

- 1) the effect of posting collateral on cost of credit is enhanced, and;
- 2) The decision to post collateral results in a lower probability to be rationed.

We exploit cross State variability in the level of asset exemption from liquidation -- according to personal bankruptcy US State laws prior to 2005 federal reform -- in order to identify the sorting role played by collateral in a sample of american small business taken from the SBF data.