G. Gorton and G. Ordonez, "Collateral Crisis"

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1) Short-term collateralized debt (money instruments, say repo) was central in the recent crisis. This observation made in the introduction is in line with Gorton and Metrick (2010).

However, the current model is on physical collateral (land) whose quality is measured by the ability to produce a good used by firms and consumers.

It can be argued that securities used as collateral in repo result from securitization of mortgages. So this model can be seen as a first step.

2) The opacity of collateral quality in the case of asset-backed securities seemed to have played an important role in the pre-2007 boom, as was already pointed out in Gorton (2010) and Gorton and Metrick (2010).

So the information-insensitive debt modeled in the current paper seems to be motivated by ABSs, particularly by CDOs.

3) The lenders are in this model the agents that can acquire information on collateral quality and the lenders would tend to reject land of bad quality as collateral.

In repo, lenders could fear that collateral prices decreases lead to borrowers' default or that insolvency on the part of the borrowers would make them default.

So it is not only the collateral quality per se that worries the lenders.

This may explain why repo markets almost stopped working for all sorts of collateral, not just on collateral related to subprime mortgages or even mortgages in general.

4) A high interest spread can be due to the possibility of bankruptcy of the holder of securities (and not because of default of the security itself).

Importance of a GE approach - see Bottazi, Luque, Pascoa, JET 2012, On GE repo.

Say I know Lehman Brothers has posted a lot of ABS, then ABS have a higher spread because the funder may have to liquidate the collateral post default.

The counterparty insolvency risk can be very high due to leverage allowed by repo.

In the paper there is no counterparty risk and positions are not being leveraged.

5) The authors want to depart from models of the crisis driven by bubbles and their bursting.

The authors want to focus instead on the role of information-insensitive debt during the boom.

I think it is hard to dismiss the bubble approach and to put all the emphasis on lack of information.

6) Even if it is consensual that the collateral has a bubble it is difficult to fight the bubble in the securities market by shorting rather than issuing.

As uniform impatience does not need to be assumed to avoid Ponzi schemes in secondary markets, shorting the bubble may not be optimal, it is better to hold on to positions on the security

- see Leverage and Bubbles by Bottazzi, Luque and Pascoa

7) I think the model is coherent and helps to understand crises where borrowing was mainly done using physical collateral (relevance for the Thai crisis of the nineties and to Kyiotaki-Moore model).

It is also a good step in the direction of understanding modern crisis, being motivated by the information-insensitive ABS borrowing.

But a better model for the recent crisis could be done along the lines of a repo run, as suggested by Gorton and Metrick (2010) and, in my opinion, without departing from the bubble approach and taking into account the leverage allowed by re-hypothecation.

This is important for policy purposes. How to deal with future collateral cycles?

If there is no opacity on the quality of the collateral per se, would the boom be not so long and magnified (and the crash not so deep)?

Or should we be still worried given the leverage allowed by repo in modern credit markets.

Possible additional minor points:

Risk-free debt: with many states having positive collateral values we would need to post enough so that the collateral value is never below the promise. This may be too demanding, why not allow for default in equilibrium?

OLG versus infinite-lived agents: the infinite lived planner considers information-sensitive debt to be optimal for a wider collateral quality interval.

Why not allow for individual agents to be infinite lived (dynasties) choosing whether to borrow or lend at each date. It can be shown that Ponzi schemes are ruled out by the same restrictions that bound leverage.