A Theory of Eligibility

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   1. How are firm financing choices distorted by collateral-eligibility criteria?
   2. Are such distorsions quantitatively important?
   3. Given this, how should eligibility criteria be set?

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$$q(b|s) = (1 - F(b|s)) \cdot (1 + \Psi(b|s) \cdot L), \tag{1}$$

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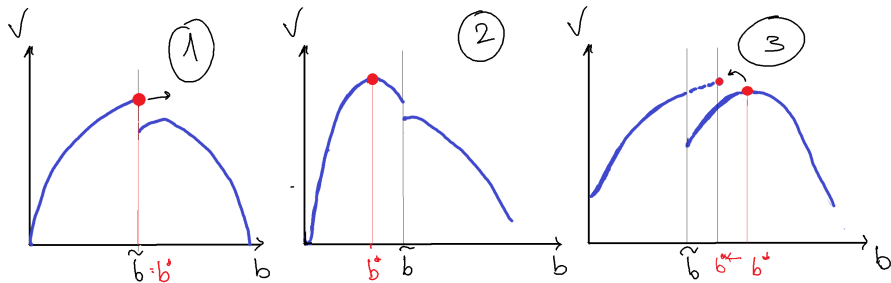where $\Psi(b|s) = 1$ if eligible, and zero otherwise.

Question: does it make sense to scale the premium by the default probability?

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Let $V(b|s) = q(b|s) \cdot b + \beta \cdot E[y - b|y \geq b]$, we have three cases:

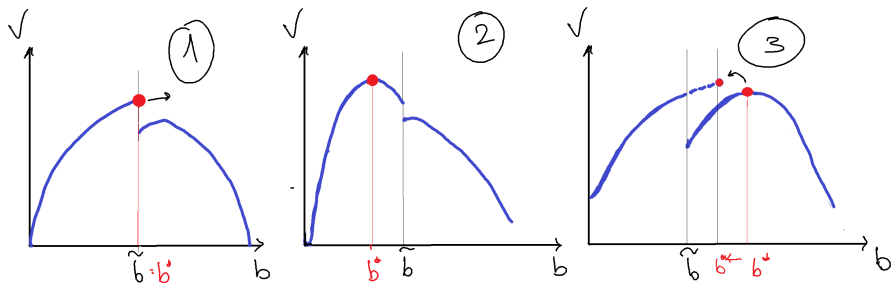# 1. How are firm choices distorted by collateral-eligibility criteria?

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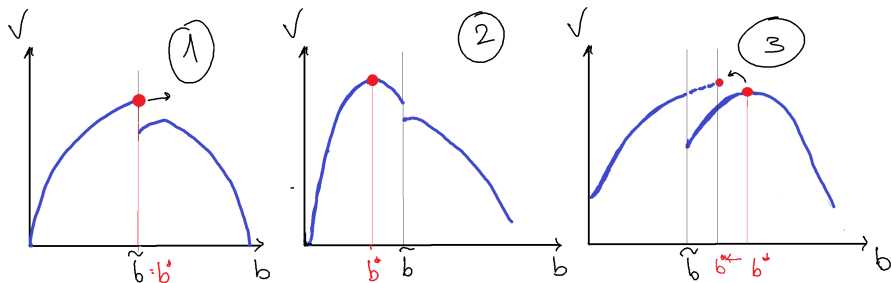# 1. How are firm choices distorted by collateral-eligibility criteria?

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2. Eligible and unconstrained: b^* does not vary when eligibility is relaxed.
3. Non-eligible: b^* can **decrease** when eligibility is relaxed.

2. Are such distorsions qualitatively important?

Take the model to the data

- ▶ When elibility criteria is relaxed, i.e. $\bar{F}$ increases, then
  - Some firms may increase debt supply: risk-taking incentive (group 1).
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  - More collateral: some eligible firms issue more + new debts become eligible.
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- ▶ Main findings: when collateral eligibility criteria is relaxed ...
    - the mechanical increase in value of collateral $>$ actual increase, and
    - default risk increases.
    - $\Rightarrow$ Firm responses dampen the effect of increasing eligibility.

Comments on the mechanism and the quantitative findings

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▶ That default increases is natural as $\sim$ risk-premia for some assets falls.

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▶ Some of the confusion I think is due to the fact that eligibility is about current default probabilities, and not future ones ... is this reasonable?

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▶ More work on modeling approach needed to have a Theory of Eligibility :)