

Asymmetric Information and the Housing Rental Market

Context and problem:

This issue talks the rental market in Spain from the perspective of landlords' lack of information regarding tenant reliability. The inability to accurately distinguish between low- and high-risk profiles creates an information asymmetry that influences landlords' decisions and impacts rent levels and access to housing.

This phenomenon unfolds within a context marked by the economic vulnerability of renters: their income is, on average, 28% lower than that of landlords, nearly half of all tenants in the market are at risk of poverty, and a significant proportion dedicate more than 40% of their income to rent. This reality increases landlords' perception of insecurity, leading them to resort to measures such as security deposits and other contractual requirements to screen tenants.

Furthermore, the legal framework and social norms influence how contracts are structured and the final market outcomes. Overall, the text analyses how this dynamic affects the functioning of the rental market, its efficiency, the degree of accessibility to housing, and the implications for public policies.

QUESTION 1

i) Landlord
Tenant (safe, risk-chosen by N)

$N \in \{S, R\} \quad P(S) = 1/2; P(R) = 1/2$

Landlord does not know the type, offers a price (r) \rightarrow tenant either accept or reject

- Utility tenant
 $A: M_T = V - r$
Tenant accept

Rej: $\Pi_T = 0$
tenant reject

Tenant will accept always that $r \leq V$

- Utility landlord
if landlord does not rent $\rightarrow \Pi_L = \bar{U}$
if landlord does rent $\rightarrow \Pi_L = E[\Pi_L(r)] = \underbrace{1/2 \cdot r}_{N(S)} + \underbrace{[p \cdot 0 + (1-p) \cdot r]}_{N(R)} \cdot 1/2 = r \left(1 - \frac{p}{2}\right)$

If we assume that the housing market is competitive, we should assume that the landlord will participate if $E[M_L(r)] = \bar{U}$

$$r^* \cdot (1 - p/2) = \bar{U} \rightarrow r^* = \frac{\bar{U}}{1 - \frac{p}{2}}$$

in order that the tenant accepts:

$$r^* \leq V \rightarrow \frac{\bar{U}}{1 - p/2} \leq V \quad \text{all tenants should accept.}$$

if the risk of unpayment (p) increases, the landlord will require higher r^*
 if the reserve utility of the landlord is higher, the rent price required is higher.

QUESTION 2

ii) the same environment than before

but now there is collateral K . (if there is no unpayment it will be pay back)

- utility tenant

Accept \rightarrow safe type does not change $r \leq V$; Risk type: $E(M_{TR}) = (1-p) \cdot r + p \cdot K$

Reject: $M_T = 0$

- utility landlord

$M_L = \bar{U} \rightarrow \times$ rent

$$\text{if rent: } E(M_L) = \frac{1}{2} \cdot r + \frac{1}{2} [p \cdot K + (1-p) \cdot r]$$

[eq. condition]

$$E(M_L) = \bar{U} \rightarrow r^* \cdot \left(1 - \frac{p}{2}\right) + \frac{p}{2} \cdot K = \bar{U}$$

$$r^*(K) = \frac{\bar{U} - \frac{p}{2}K}{1 - \frac{p}{2}}; \quad \frac{\partial r^*(K)}{\partial K} = - \frac{\frac{p}{2}}{1 - p/2} < 0$$

if the collateral K increase, the rent price required will reduce
 (incentive for protection landlord)

for the tenant:

$$\text{safe} \rightarrow r^*(K) \leq V$$

$$\text{risk} \rightarrow (1-p)r^*(K) + pK \leq V$$

there is a value of K where risk type will not enter

ADVERSE SELECTION

for the safe type $\uparrow U$ as $r^* \downarrow$, but risk types are ~~loosened~~ tightened.

Landlord Behaviour and Rental Pricing Under Incomplete Information

It is characterized by the high sensitivity of Spanish landlords to default risk, particularly among those who own one or only a few properties and depend on rental income as their main source of return. The uncertainty about a tenant's true risk profile leads landlords to add a risk-premium on rents, increasing prices to compensate for potential losses due to non-payment or property damage. In equilibrium, this results in higher gross rental yields in lower-income rental areas, where tenants have less financial security and default risk is perceived to be greater.

This situation produces pooling equilibria, where even low-risk tenants end up paying inflated rents to offset the risk created by others. When rents rise too much, safer tenants may leave the market, which adversely selects the remaining pool toward riskier profiles and reinforces the cycle of high rents and high uncertainty.

Landlords also respond by tightening their screening criteria, meaning they become more selective and impose stricter conditions to evaluate potential tenants. This includes requesting extensive documentation such as employment contracts, payslips and bank statements, and favouring applicants with stable, long-term jobs, sufficient income and a strong credit history. Many adopt rigid rules of thumb, such as requiring income to be at least three times the rent and often exclude those who do not meet these standards. As a result, groups like young and foreign-born households, temporary workers or people without local credit records face significant barriers to access. These practices strengthen adverse selection and lead to reduced access for tenants perceived as "risky," even when they may be reliable.

Furthermore, well-intentioned tenant protections, such as eviction moratoria for those who might be 'vulnerable', increase landlords' caution. This causes them to further raise rents or avoid renting to higher-risk profiles altogether, ultimately restricting access for poorer households and narrowing the rental market.

Risk-Mitigation Mechanisms:

Deposits, Guarantees, and Insurance shows how Spanish landlords manage rental risk by partially transferring it to tenants through collateral requirements. The main instrument is the security deposit, which guarantees compliance with tenant obligations and acts as a screening mechanism between low-risk and high-risk tenants. Traditionally, this was supplemented with additional guarantees such as guarantors, advance rent payments, or bank guarantees to reduce exposure to default.

The 2019 legal reform capped these additional guarantees, limiting landlords' ability to cover and filter risk, which has led to stricter tenant selection or higher rents as a compensatory response.

At the same time, the use of rent non-payment insurance has expanded, transferring risk to insurance companies and operating as an external screening mechanism through the assessment of solvency, income and credit history. Its growing adoption, already present in a significant share of new contracts, helps mitigate asymmetric information and improve risk management in a market dominated by small landlords.

Institutional Context: Legal Protections, Credit Information, and Equilibrium Outcomes

Spain's legal-institutional environment heavily influences how asymmetric information plays out in the rental market. On the one hand, Spanish tenancy law offers strong protections for tenants with more home's security but increases landlord fears.

If a tenant stops paying rent, eviction isn't immediate; legal process is required. All the process can last many months. Indeed, there are some cases of non-paying tenant for a year, but he stays inside the house, while the landlord continues paying the expenses (water, electricity...

. Statistics show that rental payment delinquency is the main cause of residential evictions in Spain. Recent emergency measures provoke more protection to tenants, for example with the restrictions of COVID 19, which cannot allow to go out of our houses.

Based on what we have explain before asymmetric information says that the landlord cannot predict if the tenant will pay or not the rent, and this possibility does that the landlords take more care when the rent their homes or floors. Economically, this shifts the equilibrium: landlords may require higher rents up (only vocational rent), higher deposits or even exit the long-term rental market.

The Bank of Spain such policies can have unintended effects of reducing supply for new rentals and raising rents if landlords demand a risk premium for the added uncertainty.

Another crucial institutional factor is the lack of transparent credit information on tenants in Spain. We don't have a public credit check system for landlords. Therefore, the landlords are contracting "blind". The only way of have the security of payment is if the tenant gives documents, receipts, reports but the landlord cannot verify if it is true. This informational opacity provokes additional guarantees as a form of self-protection. Furthermore, the legal and honest tenants cannot signal their true reliability.

The absence of a trusted credit-quality signal is a market failure that keeps transactions informal and cautious. It contributes to inefficient outcomes. Overall, Spain's credit information gap reinforces the asymmetry: landlords feel insecure and tenants face onerous requirements to demonstrate solvency and security.

Market Efficiency, Accessibility, and Policy Implications

The presence of asymmetric information in Spain's rental market has efficiency costs and equity implications. From an efficiency point of view, there is some cases in which the properties are under-utilized because of mistrust and overestimated risk. The market may equilibrium at a higher rent level than socially optimal and a lower quantity of rentals supplied. Safe tenants subsidize risky tenants in pooled contracts or exit the market which further concentrates risk among remaining renters. From an accessibility perspective, lower-income and otherwise marginalized renters suffer more because they have to pay more if they get a contract which is complicated in their conditions. Actually in Spain, the renter household are in poverty, and this sector is financially vulnerable which increases the landlords' guarantees.

This tension between tenant protection and landlord assurance is at the heart of the policy debate. The Spanish government's recent housing law reforms seek to protect tenants (like rent control) as a control of social policy. But if the landlord continues with asymmetric risk, we will keep watching the same problems of rising rents or less landlords. Indeed, some landlords only use his rent homes to short-term tourist rentals which is harmful to residents.

Policy Recommendations: To improve market efficiency and rental accessibility in Spain, a multifaceted approach is needed to mitigate the effects of asymmetric information:

- **Enhance Risk Mitigation and Information Sharing:** Encourage the expansion of rent default insurance and consider mechanisms for better credit information sharing in the rental process. Policy makers could help tenants to certificate their solvency to landlords. The Bank de Spain suggests incentivizing a broader rental insurance as a public-private collaboration to protect landlords. This would group the risk and manage this more efficiently.

- **Strengthen Legal Certainty and Speed of Enforcement:** Streamline and expedite eviction procedures for clear-cut cases of non-payment, while maintaining support for vulnerable families. If we combine the faster judicial process with less cost to the landlord, with compensation mechanisms to them it increases their confidence. Essentially, the goal is that landlords can rent under regulated terms reducing uncertainty and delays which provokes more supply and temper the need for excessive screening.
- **Promote Professional Landlords and Affordable Supply:** The market would benefit from a larger role of professional and institutional landlords who can diversify risk and operate at large scale. Nowadays, in Spain most of the rent homes are of small owners. If we apply those policies, the supply will increase and there would be a better control of the risk for landlords. Furthermore, the expansion of social housing and affordable rental sector helps to the segment of tenants with less sources. In addition, it helps to landlords because they cannot support these social rents and this risk would diminish in the private market. The last point is that Public-private partnerships help landlords to rent for low-income tenants by effectively underwriting part of the risk.

CONCLUSION

In conclusion, asymmetric information in Spain's rental housing market leads to cautious landlord strategies: higher rents, strict screening, and reliance on collateral. Security deposits and guarantees serve as imperfect solutions to bridge the information gap, and legal constraints on these tools seek to balance power between landlords and tenants. By aligning incentives and reducing uncertainty for instance through insurance, faster dispute resolution, and supportive housing policies. Ultimately, mitigating the information asymmetry will help unlock additional supply and trust in the rental sector, easing Spain's housing affordability challenges while safeguarding both tenant rights and landlord interests.

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