Discussion:
Covenant Violations and Dynamic Loan Contracting

Felix Freudenberg, Björn Imbierowicz,
Anthony Saunders, Sascha Steffen

Discussant: Magdalena Pisa, University of Luxembourg

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Introduction

- *Objective* is to analyze the dynamic allocation of control rights in private debt contracts.

  Do lenders choose:

  1) covenants to *monitor* covenant violating borrowers?
  2) to *shift the control rights* in case of a recidivist?
  3) to insure against possible recidivists by *more and stricter* covenants?

- *Challenge* is the complexity of loans contracts with covenants. A simplification is needed to compare those contracts in a meaningful way.

- *Relevant* for uninformed lenders who may choose to monitor via covenants to reduce the agency cost/monitoring cost.

  Also relevant for borrowers who can select loans based on the “covenant looseness index”.

Contributions

- *Big question*: How do lenders react to covenant violation in subsequent loans?
- Why is it *interesting*:
  1) unique *data* that match:

     SEC filins

     LPC DealScan

     CRSP/COMPUSTAT

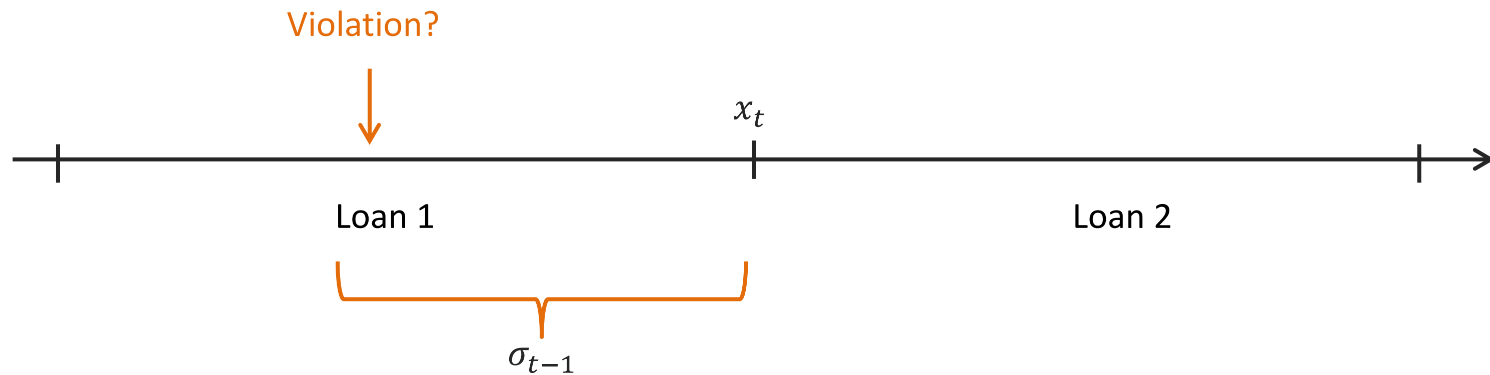
  2) novel measure of *covenant looseness*.
  3) *55% of loans* are affected by covenant violation. Relevant for a large share of the syndicated loan market.

Comments (1/6)

1) The authors propose a measure of *looseness*:

- $Looseness = \frac{c - x_t}{\sigma_{t-1}}$

  where *c* is the covenant threshold



Comments (2/6)

1) The authors propose a measure of *looseness*:

- Is it an appropriate measure of covenant looseness?

- Firm receives a shock in a Loan 1

  => variable is forced out from the normal behavior

  => covenant is violated

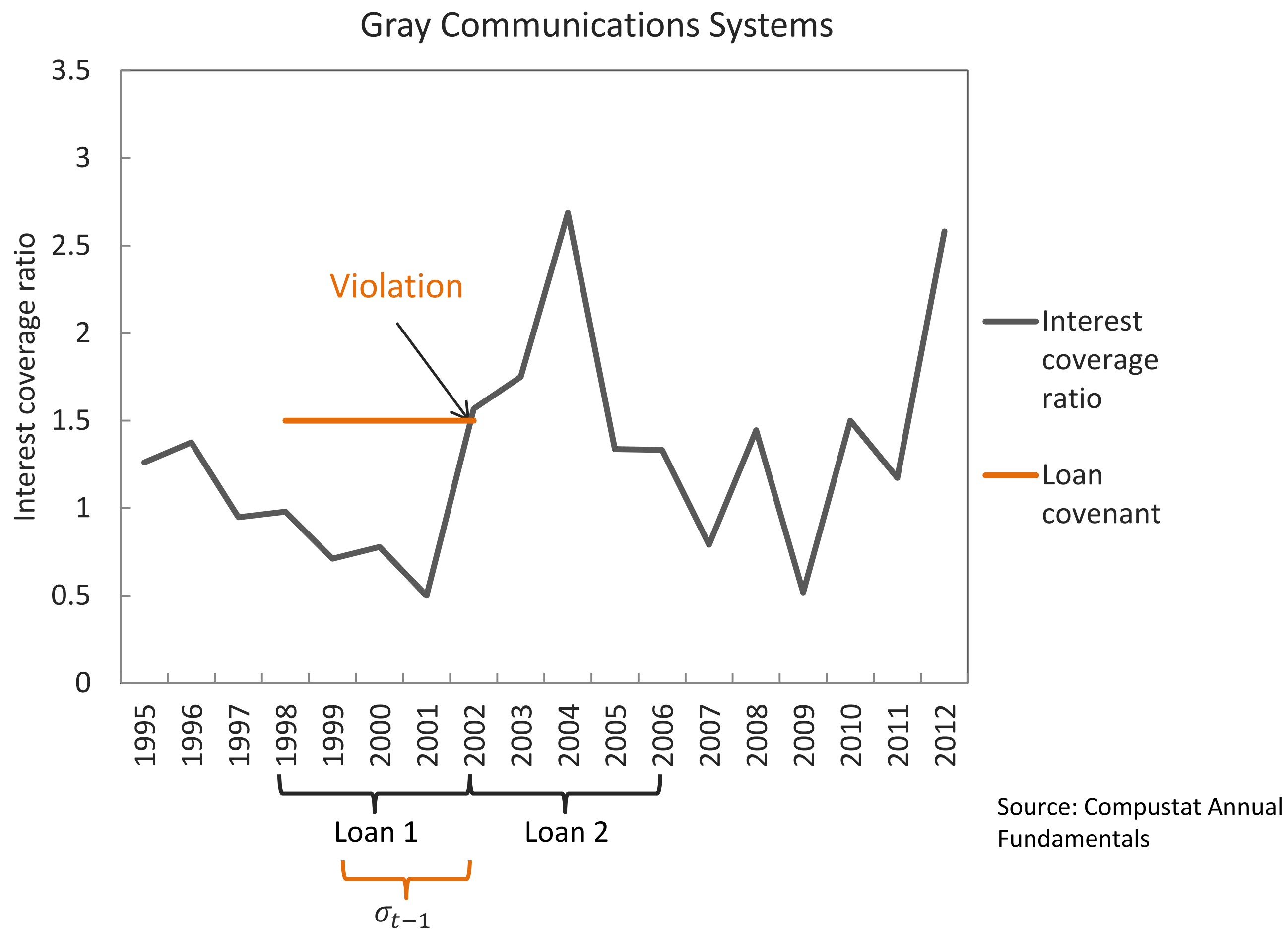
  => its σ_{t-1} ↗

  => looseness index (Loan 2) ↘

- By design *looseness* takes lower values after violation.

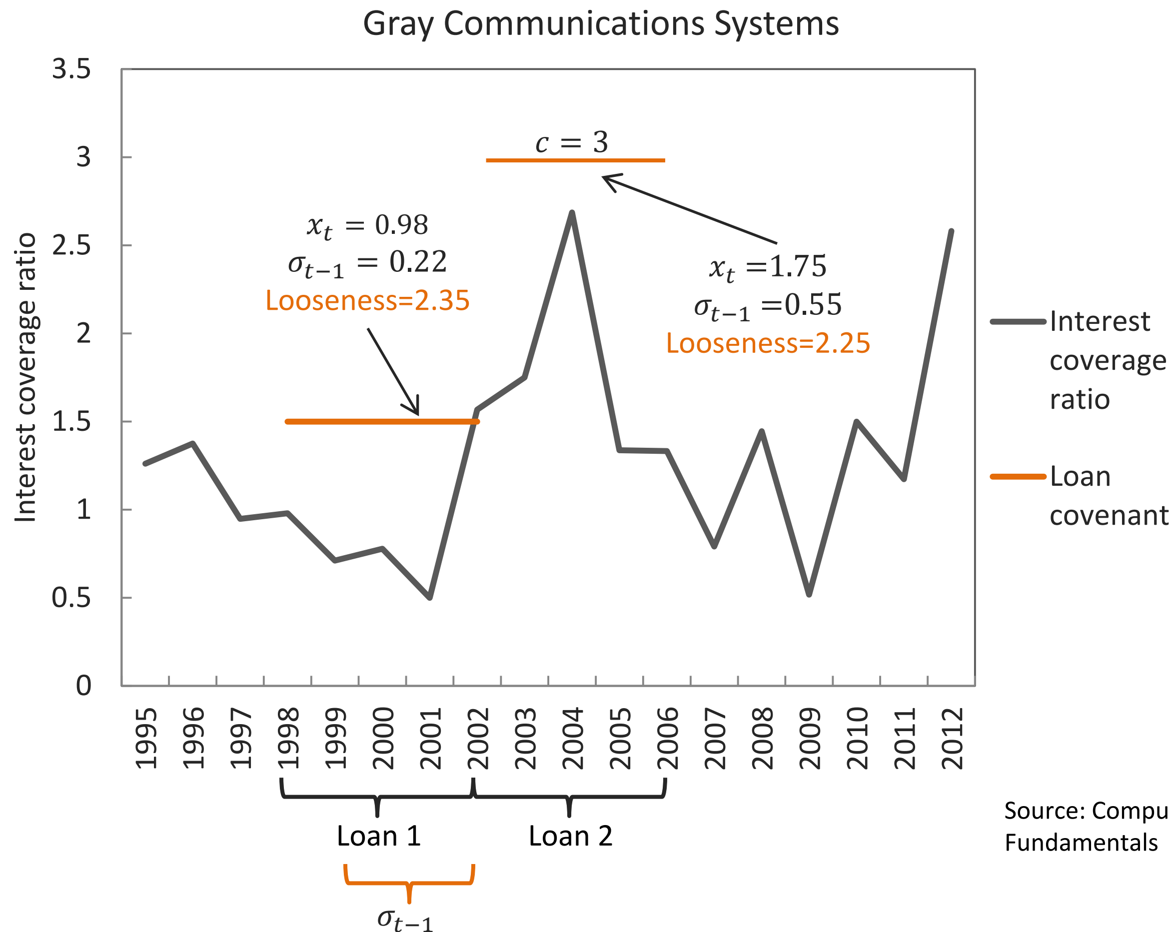
Comments (3/6)

1) The authors propose a measure of *looseness*:



Comments (4/6)

1) The authors propose a measure of *looseness*:



Comments (5/6)

2) Robustness check:

- Is a borrower *punished* for violating covenant or is it just the *deteriorated* credit quality?

  I violate a contract => conditions of my next loan become harsher due to:

  1) bad reputation
  2) higher credit risk

- Assume the covenant violation is private information:
  1) If I maintain my relationship with the old lender I can be *punished.*
  2) If I switch I have a *carte blanche* with the new lender => the *information effect* goes away (compared to other new loans from other non-violating borrowers, i.e. who also switched).

Comments (6/6)

3) What about clustering of covenant violation in time? How does this affects your results?

4) It could be informative to look at the CDS behavior of the firms which violate covenants.

5) p.13, §4: You refer to Fig2 but insert Fig1.

6) p.14, §1: You talk about Fig3 without introducing it.

7) P.15, §1: You talk about Tab4 but I think you mean Tab3.

8) Tab3: Number of financial covenants = 2.02
   - Capital covenants = 0.56
   - Profitability covenants = 0.77
   - If they are exclusive and exhaustive groups then why their averages are nowhere near to 2.02?

Conclusions

- Interesting paper with promising analysis the dynamic allocation of control rights and monitoring of private loan contracts.
- *Message*: the loans that follow covenant violation include more covenants.
- Contributions to:
  - literature which *reduces dimensionality* in loan covenants.
  - measurement of covenant *looseness*.
  - new perspective on covenants as a monitoring tools.