Discussion:
Losing Control? The 20-Year Decline in Loan Covenant Restrictions
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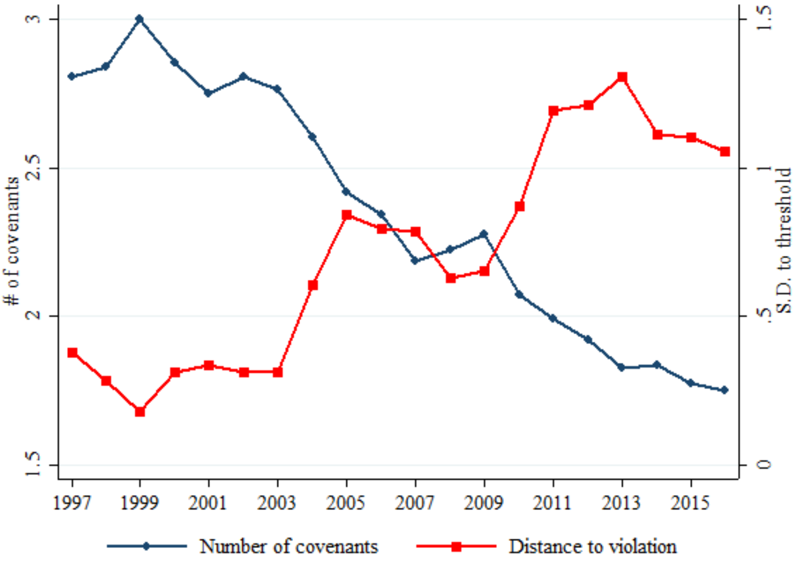
SIMPLE FACT



# of covenants
S.D. to threshold
3
2.5
2
1.5
1.5
1
.5
0
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
Number of covenants
Distance to violation

Explanations

Possible explanations

1. Lender view: reach-for-yield or higher risk tolerance.

2. Borrower view: higher perceived cost of covenants.

3. Syndicate view: better allocation of control rights within syndicate.

4. Technology view: improved signal-to-noise ratio.

Lender view

- Reach-for-yield:
  - Low interest rates $\Rightarrow$ lenders substitute spreads for control rights.
  - Originally seen as cylical (Stein, 2013).
  - Sustained declining interest rates coincident with covenant loosening.
  - Predicts higher spreads, fewer violations.
- Lower risk premium:
  - Higher risk taking by lenders $\Rightarrow$ fewer covenants, lower spreads.
  - More cyclical than secular?

Borrower view

- In Great Recession even healthier violators faced credit reductions if lender was unhealthy (Chodorow-Reich and Falato, 2020; Acharya, Almeida, Ippolito, Orive, 2020).
- Maybe borrowers thereafter preferred to trade-off higher spreads for reduced covenants.
- Predicts higher spreads, fewer violations.
- Can explain post Great Recession decline, not 20 year secular decline.

Syndicate view

- Cov-lite is feature of term loans, not revolvers, and cov-lite term loans are in packages than also feature cov-regular revolvers.
- Allows better targeting to clientele (Becker and Ivashina, 2016).
- Allows better coordination of violations (Berlin, Nini, Yu, 2020).
- Orthogonal to decline in number of covenants within revolvers.

Technology view

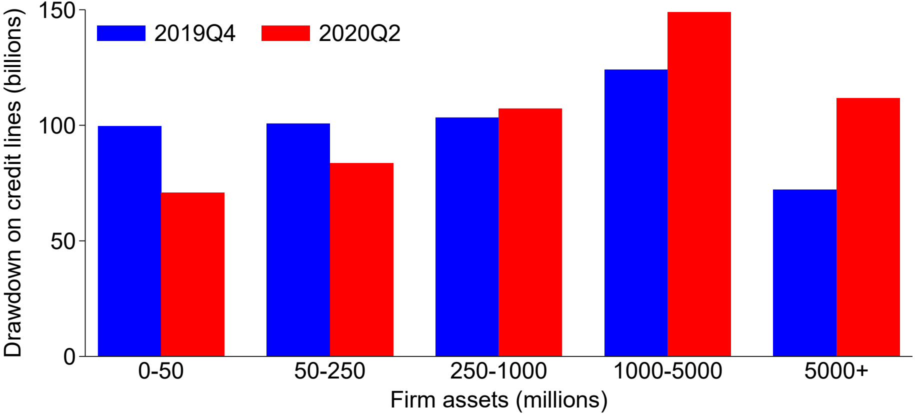
- This paper: loans dropped noisy balance sheet-based covenants.
- Evidence for noisy: less predictive of default, violations now less likely to receive waiver.
  - Small comment: is default prediction kosher if lenders can take action? Imagine covenant that measures management quality. When triggered, lender replaces management and avoids default.
- Extremum: mapping of shocks to control rights unchanged, but contracts more efficient.
- Better technology $\Rightarrow$ more surplus $\Rightarrow$ lower spreads?

Assessment

- Trend is clear.
- I am convinced cov-lite is a separate phenomenon.
- Post Great Recession explanations invalidated by long secular trend.
- Decline in consequence-free waivers seems important.
- Behavior of spreads a bit puzzling.
- Firm composition seems important too (table 7). Maybe more here...

Will the trend continue?

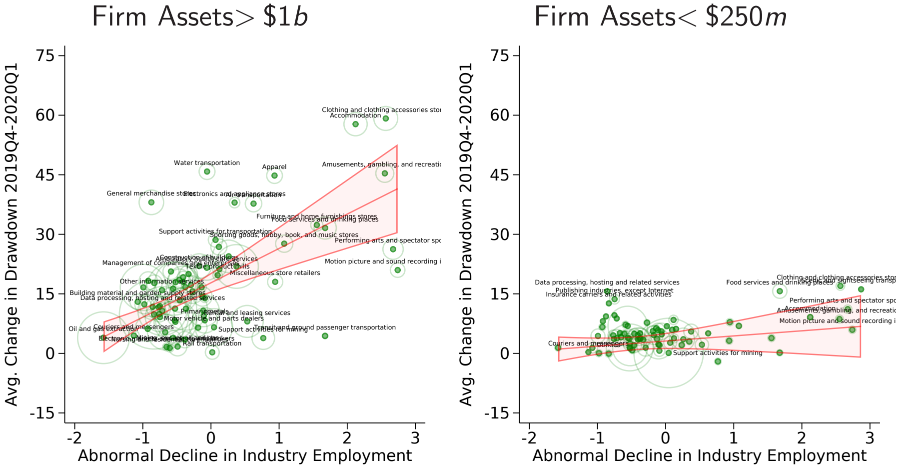
Large firms accessed credit lines during COVID



Source: Chodorow-Reich, Darmouni, Luck, Plosser, "Bank Liquidity Across the Firm Size Distribution".

- Y-14 data covering commitments of $1m+ from large lenders.
- Large firms drew on pre-committed lines of credit in COVID, small firms did not.

… EVEN IN DISTRESSED INDUSTRIES



Source: Chodorow-Reich, Darmouni, Luck, Plosser, "Bank Liquidity Across the Firm Size Distribution".

- Lower axis: change in employment in firm's industry between 2019Q2 and 2020Q2 less trailing 5-year average.
- Large firms drew in response to industry shocks, small firms did not.
- Holds using phsyical proximity requirements as instrument for employment.

Cash-flow covenants replaced by... balance-sheet covenants!

The most common approach in the amendments we have seen so far has been to waive financial covenant compliance from, and including, the first quarter of 2020 up to, and including, the fourth quarter of 2020...

In exchange for the financial covenant waiver and/or reset, most lenders are asking for a new covenant that requires the borrower to comply with a minimum liquidity level during each day of the financial covenant waiver period. Liquidity is defined as the sum of unrestricted cash plus undrawn commitments under revolving credit facilities.

Ropes and Gray, May 21, 2020

Appendix slides