DISCUSSION:
LOSING CONTROL? THE 20-YEAR DECLINE IN LOAN COVENANT RESTRICTIONS
BY: GRIFFIN, NINI, SMITH

Gabriel Chodorow-Reich
Harvard University and NBER

AFA
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Figures and Tables

Figure 1. Financial covenants in corporate loan agreements

Note: The figure plots the annual mean number of covenants (blue line, measured on left axis) and the annual mean number of standard deviations to violation for the tightest covenant (red line, measured on right axis) at contract origination. The sample is a large set of loans in Dealscan issued to U.S. nonfinancial firms in Compustat.

Electronic copy available at: https://ssrn.com/abstract=3277570
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.

Lender view

- Reach-for-yield:
  - Low interest rates ⇒ lenders substitute spreads for control rights.
  - Originally seen as cyclical (Stein, 2013).
  - Sustained declining interest rates coincident with covenant loosening.
  - Predicts higher spreads, fewer violations.

- Lower risk premium:
  - Higher risk taking by lenders ⇒ 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.
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

**Firm Assets > $1b**

**Firm Assets < $250m**

- **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 physical proximity requirements as instrument for employment.

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

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