

Banking Trends:

Measuring Cov-Lite Right

More business loans today lack traditional covenants governing borrowers. Does that leave banks with fewer tools to ward off default?

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BY EDISON YU

Syndicated loans, in which multiple lenders put up the money for a single large loan, are a major funding source for large U.S. firms, and since the financial crisis, their use has soared (Figure 1). Accompanying this rise in syndicated loans has been a large increase in loans that lack traditional financial covenants designed to prevent default. A financial covenant clause in a syndicated loan contract typically requires the borrower to pass regular financial fitness tests. Because the financial industry considers loan covenants a major device by which lenders can monitor loan repayment performance, many see this rise in covenant-lite lending as evidence of a decline in credit standards.

Since lower lending standards in the home mortgage market set off the events that led to the financial crisis, this development in the syndicated loan market has drawn much concern from regulators and other market participants.¹ One analysis suggests that covenant-lite loans now account for the majority of leveraged—or higher-risk²—syndicated loans and argues that the lack of financial covenants means investors will recover less of their money in the event of default.³ Concern has also been

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expressed that covenant-lite leveraged loans have become the norm in the leveraged loan market and that traditional covenant protection is even viewed as a stigma, a sign that the borrower is very risky.⁴ Regulators' concerns about declining credit standards in the leveraged loan market prompted them to note that covenant-lite loans "may have a place in the overall leveraged lending product set; however, the agencies recognize the additional risk in these structures"⁵ and to subsequently suggest that "loans with relatively few or weak loan covenants should have other mitigating factors to ensure appropriate credit quality."⁶

However, before we can conclude that covenant-lite is an indicator of declining credit standards, we need to know that we are measuring "covenant-liteness" correctly. Increasingly, a significant share of a firm's leveraged loans is being held by nonbank *institutional* lenders. In another departure from traditional syndicated loans, in which all the lenders hold essentially the same types of loans, the institutional members of the syndicate tend to specialize in a different type of loan than the bank members do.

As I will show, this growth and specialization of nonbank lenders in the syndicated loan market means that the surge in covenant-lite loans tells only part of the credit standards story. It means we need to measure the prevalence of covenant-lite

FIGURE 1

A Typical Syndicated Loan Model

A syndicated loan package often consists of a **revolving line of credit**, similar to a credit card, and **term loans**, with an amortization schedule.

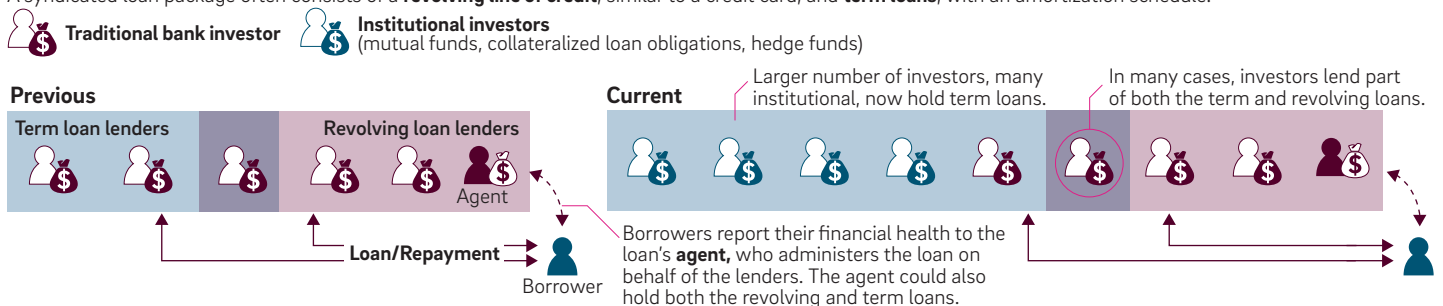
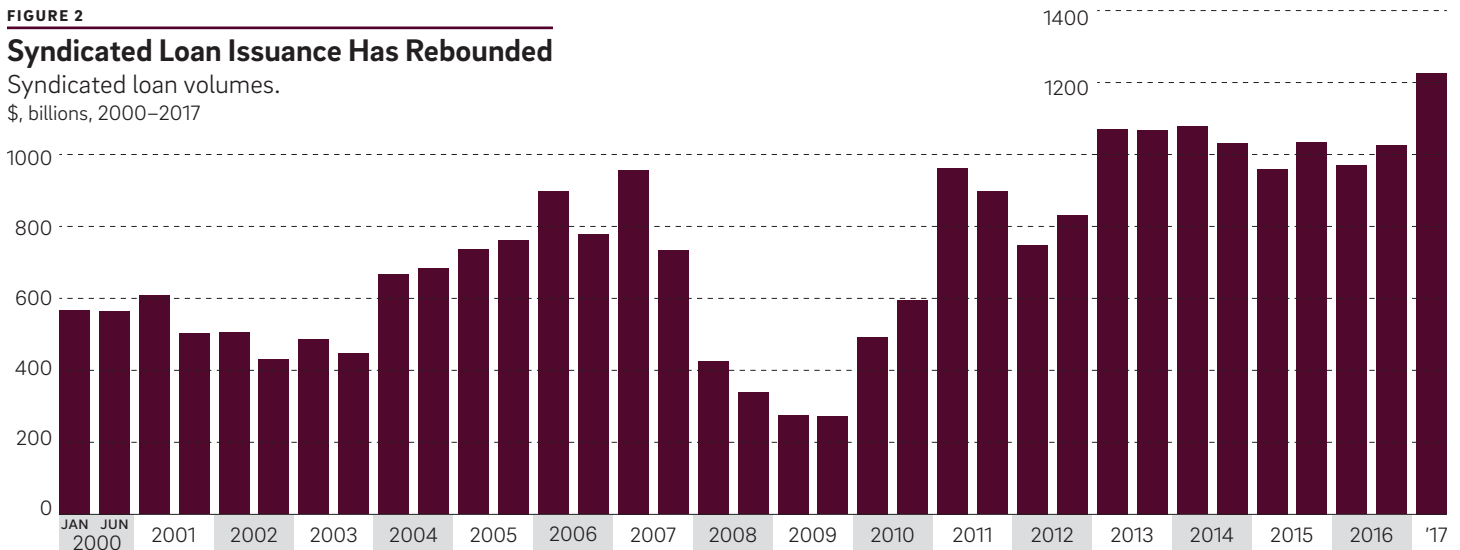


FIGURE 2

Syndicated Loan Issuance Has Rebounded

Syndicated loan volumes.
\$, billions, 2000–2017



Source: Theleadleft.com, <https://www.theleadleft.com/leveraged-loan-insight-analysis-732017/>. Note: Horizontal axis shows six-month intervals.

loans at the borrower level, rather than at the level of the individual loan, by taking into account all the syndicated loans that a business is taking out or has outstanding. Then we can gain a clearer picture of whether borrowers are still meaningfully constrained by these financial clauses and whether lenders, especially banks, still have the contractual muscle to act when a borrower’s financial performance starts to deteriorate.

To achieve this clearer picture, this article will show what I think is a more accurate way to measure covenant-liteness and to weigh concerns about declining loan standards. First, I show how big the rise in covenant-lite loans has been and why that has raised some red flags regarding financial stability.

Rise of Syndicated and Cov-Lite Loans

Syndicated loans are the source of much of the money that U.S. corporations rely on to fund their expansion and day-to-day operations. The outstanding portfolio of syndicated loans worth \$20 million or more rose from about \$2.7 trillion in 1993 to \$4.7 trillion in 2017.⁷ Although syndicated loan issuance slowed after the financial crisis hit in 2007, it resumed rising in 2010. In the first half of 2017, about \$1.2 trillion in syndicated loans were issued, up from \$250 billion in the second half of 2009, their lowest point during the financial crisis (Figure 2).

Since 2000, syndicated loans have

increasingly been held by institutional investors such as pension funds and mutual funds, either directly or through collateralized loan obligations (CLOs).⁸ Institutional investors’ holding of syndicated loans is concentrated in the leveraged loan market. Institutional investors’ contribution to the leveraged loan market has risen

from less than \$40 billion in 2009 to approximately \$300 billion in the years following the financial crisis (Figure 3).

As syndicated loans have risen, so have covenant-lite loans. The contracts on these syndicated loans lack the traditional clauses that require borrowers to meet regular performance tests. The fraction of outstanding leveraged loans that are covenant-lite rose from about 16 percent in 2010 to about 45 percent in 2013, surpassing the precrisis peak in 2007 (Figure 4).⁹

In loans with traditional financial covenants, borrowers are required to report their pertinent accounting information to the *agent* bank, which usually holds the largest share of the loan and administers it on behalf of the other lenders in the syndicate. Failure to comply with a financial covenant constitutes default. This threat of default provides lenders with the means to enforce or renegotiate the loan contract as soon as the borrower’s financial performance starts to decline. Although covenant violations often indicate that the firm is financially distressed, they do not usually lead to default or

bankruptcy; lenders waive most covenant violations after renegotiating with the borrower. However, violations do have real consequences for the borrowing firm. In return for having the violation waived, the borrower must agree to stricter loan terms such as a higher interest rate and reductions in the amount of debt it may issue, money it may invest, and dividends it may pay out to its shareholders.¹⁰ In this way, the regular reporting required by financial covenants and the tougher restrictions imposed in the event the covenants are violated give banks tools to curtail borrowers’ risky behavior.¹¹

Since the financial crisis, regulators have been concerned that lower credit standards can destabilize the financial system. The rise of covenant-lite loans was among the reasons that federal regulators cited for tightening their guidelines on high-risk lending in their Interagency Guidance on Leveraged Lending of 2013. So, should we be concerned with this rise in covenant-lite loans? Our answer has to begin with ensuring that we are correctly measuring the rise.

Cov-Liteness: Loan- vs. Firm-Level Evidence

While it is true that covenant-lite loans have increased, our evidence shows that virtually all borrowing firms are subject to some form of financial covenant. What causes this discrepancy? Firms usually take out multiple syndicated loans at once or have multiple syndicated loans

See “[Example of a Financial Covenant.](#)” →

Example of a Financial Covenant

A covenant might require the borrower to maintain a minimum interest coverage ratio, the ratio of the firm's cash flow to its required interest payments. Typically, the covenant becomes tighter over the life of the loan. For example:

§ 7.11. *Certain Financial Covenants. (a) Interest Coverage Ratio. The Borrower will not permit the Interest Coverage Ratio on any date to be less than the ratio set forth below opposite the period during which such date falls:*

Period	Ratio
From the second restatement effective date through December 31, 2005.	1.60 to 1
From January 1, 2006, through December 31, 2007.	1.75 to 1
From January 1, 2008, and at all times thereafter.	1.90 to 1

Source: Loan agreement from an SEC filing between JP Morgan Chase Bank as administrative agent and Sinclair Broadcast Group, May 12, 2005.

outstanding at the same time, a revolving line of credit, and one or more term loans. Recall that the syndicated loan market has become specialized. In a typical loan package, or *deal*, taken out by a firm, nonbank institutional lenders now often hold nearly all of the firm's *term loans*, while banks retain only the firm's *revolving line of credit*. A revolving line of credit is like a credit card for a firm. The bank allows the borrower to incrementally take out

and repay sums of money up to a specified total amount at any time for as long as the credit line remains active.

See **"Today's Syndicated Loan Structure."**

In a term loan, by contrast, the firm takes out the whole amount all at once at the time the loan is issued and repays it over a specified period. Once the term loan is

repaid, the money is no longer available for the borrower to draw on again.

There is some disagreement about the precise reasons for this evolution in the syndicated loan market, but it is consistent with the theory that banks have a comparative advantage in providing liquidity funding in the form of lines of credit because of their liquidity reserve and its natural synergy with deposit-taking activities. That is, as long as depositors are a steady source of funding, banks have an advantage over other types of intermediaries in providing borrowing firms with funds on demand.¹² In contrast, institutional investors can hold term loans more cheaply than banks can because institutional investors do not bear the cost of capital requirements and other regulations.

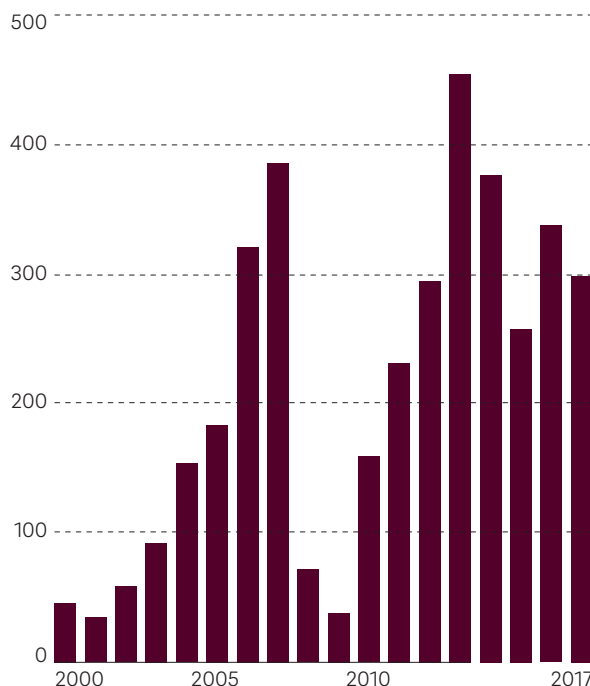
This new structure of syndicated loans holds the key to the discrepancy between the rise of covenant-lite loans and the lack of covenant-lite firms. It turns out that almost all contracts for revolving lines of credit contain financial covenants.¹³ Furthermore, many contracts include both a revolving line of credit and a term loan governed by the same covenants, but the line of credit lenders—the banks—have the exclusive right to renegotiate or waive the financial covenants.¹⁴ When a firm has multiple loan contracts but only the revolving line of credit includes a financial covenant, or when a firm has a single loan contract and the bank has the unilateral right to renegotiate or waive the financial covenant, we have termed this new contract structure as having *split control rights*.¹⁵ We say the control rights have been split because, for reasons I will discuss, the banks have been given the right to exercise unilateral control over the firm by monitoring its compliance with the covenants and holding the power to waive or renegotiate the covenants.

When aggregated to the firm level to take into account all the loans a firm had taken out, the proportion with a covenant-lite term loan rose from nearly

FIGURE 3

Rise of Institutional Lenders in Syndicated Market

U.S. leveraged loan issuance, annual.
\$, billions, 2000–2017

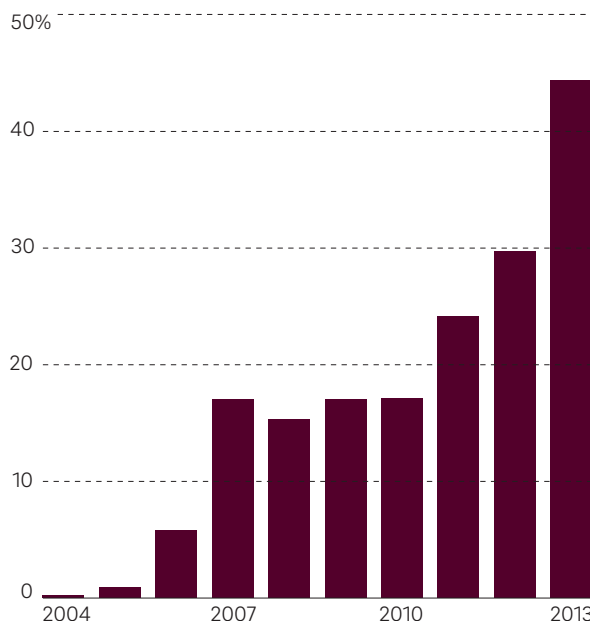


Source: S&P Global Market Intelligence Leveraged Commentary & Data via leveragedloan.com, <http://www.leveragedloan.com/wp-content/uploads/2012/01/annual-us-leveraged-loan-issuance-4.jpg>.

FIGURE 4

Rise of No-Covenant Leveraged Loans

Share of outstanding loans that are covenant-lite.
Percent, 2004–2013



Source: S&P Capital LCD via www.creditwritedowns.com, <https://pro.creditwritedowns.com/2013/11/covenant-light-loans-are-on-the-rise.html>.

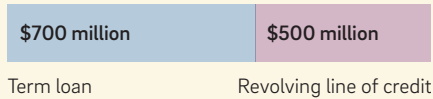
Today's Syndicated Loan Structure

Increasingly, firms are obtaining very large loans not from a single lender but from many. One example is a \$1.2 billion syndicated loan arranged by Citibank, JP Morgan, Morgan Stanley, and Wells Fargo. It consisted of a \$500 million revolving line of credit and a \$700 million term loan. Ten banks held the revolving line of credit, and institutional investors funded most of the term loan. By December 2014, more than 100 collateralized loan obligations (CLOs) owned about \$260 million of the term loan.

FIGURE 5

Syndicated Loan Example

Total: \$1.2 Billion

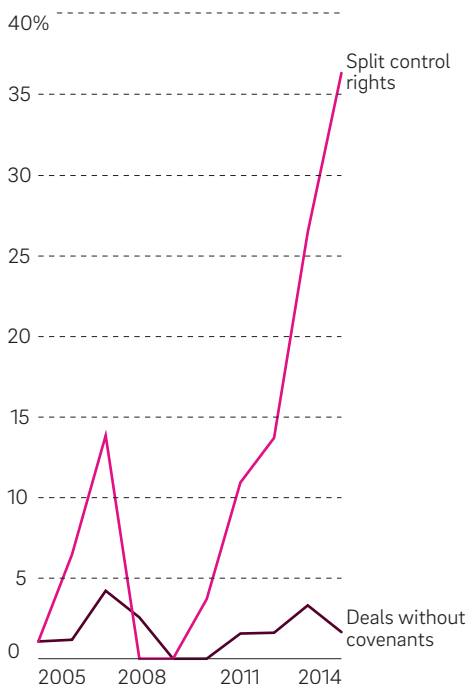


Source: Loan agreement from an SEC filing between Citibank as administrative agent and Time, Inc., April 2014.

FIGURE 6

Almost All Borrowing Firms Are Bound by Covenants

Fraction of firms under no loan covenants vs. fraction with covenant-lite term loan. Percent, 2005–2014



Source: Berlin, Nini, and Yu (2017).

zero in 2005 to close to 40 percent in 2014. By contrast, the proportion of firms with no financial covenants in any of their loans remained below 4 percent throughout the period. This means that almost all firms borrowing through syndicated loans were constrained by financial covenants in at least one of their loans, usually the line of credit (Figure 6).¹⁶

But if the revolving line of credit has a covenant and the term loan doesn't, does this mean that the term lenders are not protected by the covenant? No, because loan contracts usually have default clauses stipulating that violating any covenant in any loan contracts, including the revolving line of credit contract, also constitutes default in the term loan, even if it lacks financial covenants.¹⁷

Various Explanations for the Rise of Cov-Lite

Is this distinction between the proliferation of covenant-lite term loans and the dearth of covenant-lite borrowers important? To answer this question, we need to figure out why the use of covenant-lite term loans has risen while revolving lines of credit have continued to carry traditional covenants. There is not yet a consensus as to why covenant-lite lending is rising, but the research literature so far proposes a few explanations.

Lower Credit Standards

Some studies find a connection between loans marketed to institutional lenders and less monitoring of borrowers and lower lending standards. Some researchers see an analogy with credit problems in the securitized housing market, arguing that banks that originate loans and then sell off their exposure to the borrowers have less incentive to monitor them. For example, banks that securitized a large share of the loans they originated before the crisis, so-called *securitization active* banks,¹⁸ were found to have imposed less restrictive financial covenants and subsequently suffered worse loan performance. However, another study showed that loans securitized before 2005 performed no worse than comparable unsecuritized loans originated by the same bank during the financial crisis.¹⁹

Conflicting Interests

Costs and incentives for institutional investors can differ from and even conflict with those of banks. Depending on the degree of conflict, the optimal contract design may be one without financial covenants. In one model of contract design, borrowers may take excessive risks, and thus lenders would like to impose financial covenants to reduce risk-taking.²⁰ Banks have a comparative advantage in monitoring borrower risk but face higher lending costs than institutional investors do because of capital requirements. So it is optimal for banks to monitor and enforce covenant violations on behalf of all lenders, as long as bank lending costs are not too high. In this model, however, banks and institutional lenders also have conflicting interests regarding when to enforce versus when to waive a covenant. While the institutional lender cares only about its payoff from the single loan, the bank also earns *relationship rents* stemming from the ongoing nature of its revolving loan. That is, the bank's ability to continue to profit from this relationship depends on the borrower being allowed to continue to operate and borrow, so the bank may choose not to strictly enforce the covenant and induce default, even if that would be the best action for the firm's other lenders. The conflicting interests between the relationship lender and other lenders are greatest when the bank's share of the deal is small—because lending costs are high owing to high capital requirements—so its share of any financial losses is small.

The model predicts that when the bank's share of a loan is very small, this conflict of interest becomes so severe that it is best to eliminate covenants entirely and issue covenant-lite loans. Of course, without covenants, lenders lose the ability to actively control borrower risk-taking, so they demand a higher interest rate as compensation for accepting more risk. The study's authors provide some empirical evidence for their model's predictions from a sample of syndicated loans. However, their results are subject to question insofar as they may have measured covenant-lite incorrectly by not taking into account all of the firm's loans.²¹

Bargaining Frictions

There is evidence that lenders have turned to the new contract structure to reduce *bargaining frictions*, or the costly time and effort of negotiating. Syndicated loans used to be held exclusively by banks and had fewer lenders in the syndicate. However, the arrival of institutional investors in the market has increased both the number and types of lenders in the loan syndicate, which complicates renegotiating the loan contract. For example, changing the financial covenants typically requires the consent of a majority of lenders in the syndicate. The larger and more diverse the syndicate, the harder it is for lenders to agree on a change such as waiving a covenant. Each lender or each type of lender might face different funding situations that create more or less of an incentive to waive a covenant. For example, during the financial crisis, some lenders were under more financial distress than others, and the more distressed a lender is, the less willing it may be to waive a covenant. Reaching agreement also may be difficult because each institutional lender holds a small share of the loan and does not find it profitable to bear the cost of investigating a borrower's financial situation in order to reach an informed opinion about how to deal with a covenant violation. Disagreement could also arise because of conflicting interests, such as those mentioned previously, or simply because lenders disagree about a firm's prospects.

Looking at term loans only, one study finds no evidence that rising demand for syndicated loans lowers credit standards.²² Rather, it finds evidence that the new contract structure is designed to reduce bargaining costs. Specifically, it finds that lenders that participate in syndicated loans omit financial covenants from contracts when there are many—and different types of—institutional lenders. According to this study, dispensing with financial covenants eliminates the need to renegotiate terms with the borrower when a covenant is violated because there are no covenants to violate in the first place. This suggests that covenant-lite loans are being used as a way to avoid the costs of renegotiation. A direct implication of this interpretation is that covenant violations should be occurring less frequently in real-world business lending, but we do not find that in our research, as I discuss below.²³

While the research by my coauthors and me supports the view that bargaining frictions are the underlying cause of the contractual innovations in the leveraged loan market, recall that we find that borrowers are still bound by financial covenants. What has changed is that the new type of loan contracts gives lenders that extend revolving lines of credit the right to unilaterally renegotiate covenant terms with these borrowers; that is, nonbank lenders have delegated the task of monitoring borrowers to the banks, which, as I noted earlier, may have a comparative advantage in this regard. Indeed, we find evidence that borrowers continue to be monitored, in that covenant breaches are about as prevalent among loans that include split control rights as among traditional loans. Furthermore, evidence from the Shared National Credit Program shows that the line of credit commitment size is similar between loans with and without split control rights and that agent banks continue to retain substantial exposure to their syndicated borrowers, such as holding a larger share of the loan commitment, evidence that they have the incentive

to monitor, since they retain significant exposure to loss if the firm defaults.

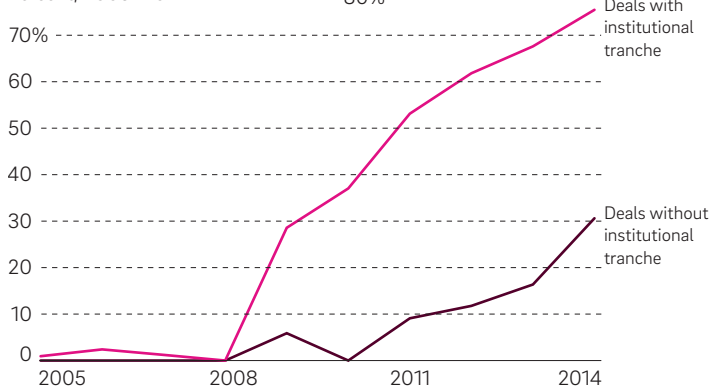
There are additional reasons to believe that bargaining frictions are driving the covenant-lite trend. When institutional lenders are part of the lending syndicate, the use of other contract clauses to simplify renegotiation greatly increases. Syndicates that include institutional lenders are much more likely to permit contractual changes without agreement from all lenders. While traditional loan contracts require unanimous agreement to change the maturity or rate, many contracts now permit a fraction of the lenders to agree to such changes on their own contracts.²⁴ The share of loan contracts with clauses that facilitate renegotiation increased dramatically after the crisis, and the rise is most noticeable among loans in which institutional investors participate (Figure 7). Furthermore, split control rights are much more likely to appear in contracts that have these other clauses.

FIGURE 7

Bigger Rise Among Loans with Institutional Lenders

Share of loan contracts with clauses facilitating renegotiation.


Percent, 2005–2014



Source: Berlin, Nini, and Yu (2017).

Conclusion

Our observations—that the large increase in covenant-lite syndicated loans in recent years has been driven almost entirely by the rise in covenant-lite term loans and that revolving lines of credit almost always retain financial covenants—should address at least some of the concern that covenant-lite is evidence of declining credit standards. Borrowers are still constrained by regular financial tests for at least one of their loans. Recent research also provides some evidence that the new contract structure is designed to lower renegotiation costs, and our results are consistent with continued monitoring by banks and provide no evidence of declining credit standards.

Nevertheless, it will take time to see whether the recovery rate on defaulted loans is lower for those with split control rights. In the meantime, it remains unclear just how much protection this new contract design provides to term loan lenders. Therefore, it is too early to say definitively that credit standards have not declined. 

Notes

1 See the paper by Guido Lorenzoni for evidence that banks may have incentives to make too many loans. The paper by Robin Greenwood and Samuel Hanson provides evidence that rapid growth in credit to risky borrowers is a sign of an overheating market.

2 A leveraged loan is a syndicated loan made to a riskier borrower, much as the junk bond market is the portion of the corporate bond market for riskier bond issuers. Although definitions vary on what constitutes "risky," Loan Pricing Corporation defines a leveraged loan as one that is either unrated or rated BB+ or lower with an interest rate spread exceeding 150 basis points.

3 See the research note from Moody's Investors Service.

4 See the 2017 *Bloomberg* article.

5 See the 2013 interagency guidance. On October 19, 2017, the Government Accountability Office ruled that the leveraged lending guidance should be subject to the requirements of the Congressional Review Act and thus required the guidance to be approved by both houses of Congress. The decision means regulators must now decide whether to reissue the guidance through the rule-setting procedures of Congress, revise it, or let it drop entirely.

6 See the interagency FAQs from 2014.

7 Shared National Credit Program, August 2017, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170802a1.pdf>. The SNC portfolio covers all syndicated loans of \$20 million or more that are shared by three or more regulated institutions in the U.S.

8 Collateralized loan obligations in the syndicated loan market are a form of securitization in which payments from different loans are pooled and distributed among the CLO's owners.

9 According to S&P Global Market Intelligence Leveraged Commentary & Data, as reported in a November 4, 2013, blog post on Credit Writedowns Pro by Sober Look, <https://pro.creditwritedowns.com/2013/11/covenant-light-loans-are-on-the-rise.html>.

10 See my working paper for a review of the empirical and theoretical evidence on the effects of covenant violations.

11 Although they do not contain financial *maintenance covenants*, which are monitored on a regular basis for early warning signs of credit problems, covenant-lite contracts do contain *incurrence covenants* that restrict some actions by the borrower. For example, a borrower might not be allowed to borrow more money or make investments above some minimum amount without the term lenders' agreement.

12 See the papers by Anil Kashyap, Raghuram Rajan, and Jeremy Stein; by Evan Gatev and Philip Strahan; and by Greg Nini for examples.

13 Please refer to my paper with Mitchell Berlin and Greg Nini for details on how we collected the contract-level data that revealed the inclusion of covenants in revolving credit contracts.

14 Bank lenders usually charge a fee to waive covenant violations.

15 In our sample, split control rights are implemented by separate contracts 30 percent of the time and through a single contract that gives the bank unilateral control rights 70 percent of the time.

16 Another factor that might be partly driving the rising trend in the fraction of firms bound by covenants shown in Figure 6 is that firms may be shifting their source of funding away from corporate bonds toward syndicated loans. Corporate bonds are often issued by large publicly held firms and do not usually have financial covenants. If firms are switching from bonds to syndicated loans, that might suggest that regulators have less reason for concern about declining credit standards because almost all loan borrowers in our sample are constrained by financial covenants, and loan borrowers have higher seniority in asset claims in the event of borrower default.

17 Other research has used the number of financial covenants as a measure for monitoring intensity. In this article, I show that most firms are still constrained by at least one financial covenant, which is consistent with the view that banks are still monitoring their borrowers for default risk. However, the presence of a financial covenant is no guarantee that monitoring has not declined. This issue warrants future research on the exact magnitude of the change in monitoring intensity.

18 See the work of Yihui Wang and Han Xia. They rank banks according to the share of securitized loans in the total number of loans they originate in a year. Those with shares above the median are termed securitization active.

19 See the study by Efraim Benmelech and his coauthors.

20 See the study by Matt Billett and his coauthors.

21 Billett and his coauthors argue that the term lender is not protected by covenants when bank lenders have the unilateral right to monitor covenants. Our evidence—cited below—is inconsistent with their view. However, the extent to which conflicts between banks and institutional lenders undermine the value of bank monitoring remains an open question that will require more years’ worth of data to fully answer.

22 See the work of Bo Becker and Victoria Ivashina.

23 Recall that even covenant-lite contracts still contain incurrence covenants that restrict some actions by the borrower.

24 An amend-and-extend provision allows a borrower to extend the maturity of a portion of a loan without having to obtain the consent of all lenders at the time of the extension. A refinancing provision permits the borrower to add a new loan tranche using an existing credit agreement without the consent of all lenders, provided that the proceeds are used to refinance a portion of the existing loan.

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