Do Banks Compete on Non-Price Terms? Evidence from Loan Covenants

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ABFER-Corporate Finance
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Motivation and Research Question

- Covenants are (were?) pervasive in lending contracts
  - Around 97% of U.S. private loan agreements contains at least one covenant (Roberts and Sufi, 2009)
- Competition is pervasive in lending markets
  - Traditionally, between banks
  - More recently, between banks and shadow banks
- Question: Do lenders compete on covenant terms?
  - Challenging to separate covenants from other loan terms

This Paper: Methodology

- Exploits a change in banks' ability to compete on covenants
  - Clarification of Supervisory Guidance on Leveraged Lending
    - Affects banks regulated by US authorities (FDIC, Fed, OCC)
    - Sets expectations on leveraged lending standards, including covenants
    - Unaffected group: non-banks, foreign banks
- Studies borrower behavior around policy change
  - Compares previous borrowers of banks vs. non-banks in latest loan
    - Within-lender-time analysis for current borrowers of the same lender
  - Outcome variables:
    - Indicators for switching to new lenders, leaving the market
    - Characteristics of loans offered by previous lenders to *other* borrowers: Covenant terms, interest rate, maturity, collateral, size

This Paper: Findings

- After the Clarification, previous bank borrowers are
  - More likely to be offered loans with more covenants and collateral
  - More likely to be offered loans with lower rates and maturity
  - More likely to switch to new lenders
  - More likely to leave the market if constrained
- Effects on lender market structure
  - Banks' cov-lite lending, overall lending share decreases
  - No overall changes in leveraged lending supply

More Background

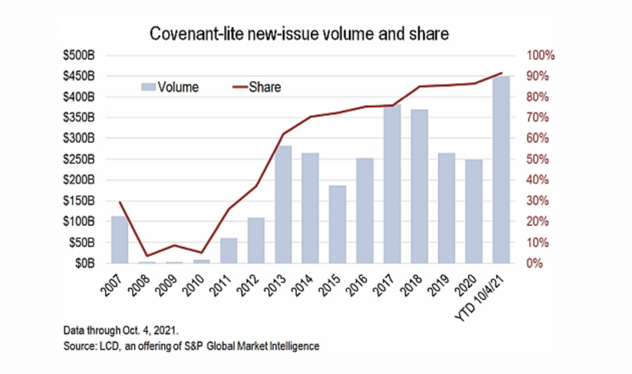
Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high

More than 90% of U.S. leveraged loans issued this year have been covenant-lite, a new record, further marking a two-decade-long transformation of the asset class in which nearly all newly issued loans have shed lender protections that once had been standard.

Source: S&P Global Market Intelligence, October 2021

- Covenant-lite leveraged lending is hot!
- Macro-prudential concerns
  - Regulators tried to address rapid growth early (2013-2014)
  - Continued concerns after 2016 (Yellen, 2018)

More Background



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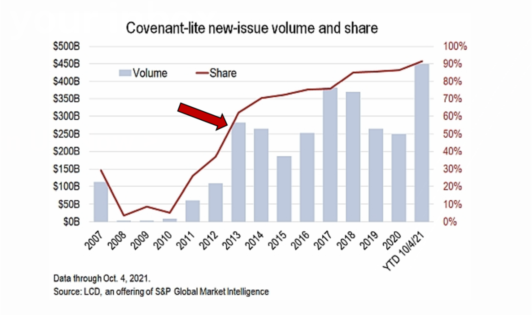
Comment 1: Clarify Institutional Setting



- March 2013. Guidelines announced:

  "The guidance outlined the agencies' minimum expectations on [...] underwriting standards, valuation standards, pipeline management, the risk rating of leveraged loans, and problem credit management." *(Kim et al., 2016)*

- Cov-lite limitations or general regulatory burden?

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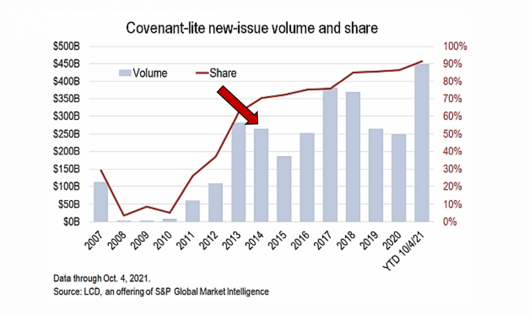

- November 2014, FAQs issued:

  "[After the Clarification] The initial March 2013 guidance also applied to the leveraged lending of nonbank subsidiaries of bank holding companies, to new loans as well as loans acquired in the secondary market, and even to loans originated for distribution to other lenders." (Kim et al., 2016)

- Heterogeneous treatment across bank holding companies?

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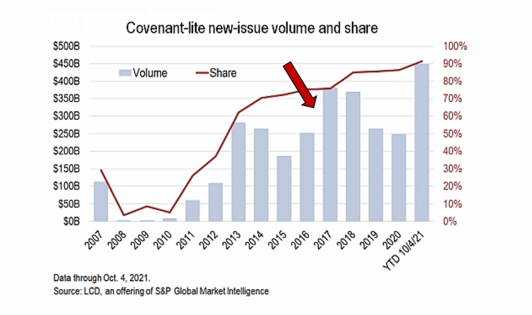


- Trump is elected
  - Signals lower banking regulation/enforcement
  - Roll-back of Dodd-Frank regulations in 2018

Comment 1: Clarify Institutional Setting

OCC Will Not Enforce Leveraged Lending Guidance

by Practical Law Finance

Published on 07 Mar 2018 • USA (National/Federal)

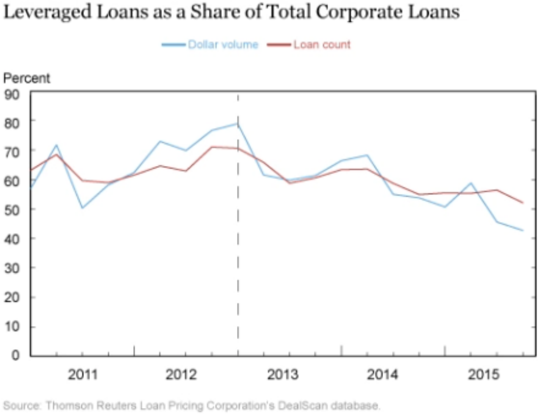
Related Content

Joseph M. Otting, Comptroller of the Currency, announced that banks do not need to adhere to the Leveraged Lending Guidance when providing leveraged financing as long as the bank has adequate capital.

On February 27, 2018, Reuters reported that Joseph M. Otting, Comptroller of the Currency, stated that banks do not need to adhere to the Leveraged Lending Guidance (see Legal Update, US Bank Regulators Release Supervisory Guidance on Leveraged Lending) as long as the bank has adequate capital. While the guidance regarding corporate borrowing will remain in place, Otting clarified that it is merely a guide and not meant as a rule. According to Reuters, Otting stated that banks have the right to do what they want as long as it does not impair the safety and soundness of the bank.

- Guidelines never made into law
  - Not clear when to end sample (currently 2018)
  - Potential lender selection into following the guidelines

Comment 2: Are Cov-lite Restrictions what Binds?



Source: Kim et al. (2016)

- Leveraged loans growth slows after guidelines announcement

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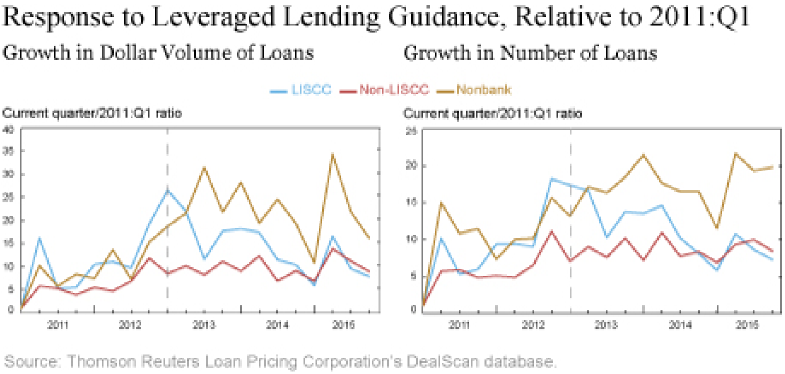

Source: Kim et al. (2016)

- Non-banks pick up banks' slack

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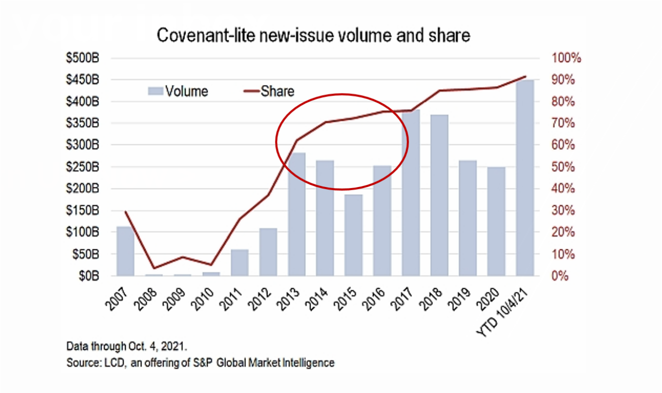

- Share of covenant-lite loans around 2013-2014 does not change

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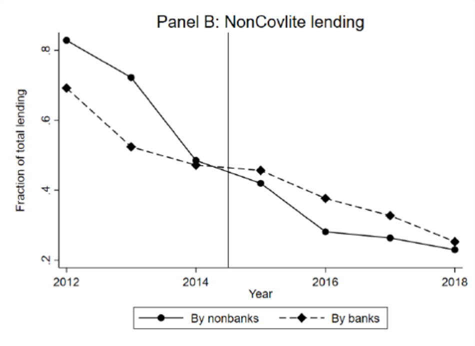

- In-sample, share of covenant-lite lending keeps increasing
  - True for both non-banks *and banks*
- Tests are mostly cross-sectional, but reconciling aggregate effects more important for policy

Comment 3: Lenders' Incentives

- Borrowers help with identification (can use lender $\times$ time FE), but distract from covenant competition question

- Treatment affects lenders, need more on lenders' incentives
  - Covenant terms following competition shock:
    - Intensive margin—-more covenants at origination?
    - Stricter covenants at origination (Murfin, 2012)?
    - More enforcement (Bird et al., 2022)?
  - Guidelines and clarification only affect lead arranger
    - Syndicates change lead arranger to non-bank?

Other Comments and Suggestions

- LBOs, acquisitions, are infrequent events
  - How frequent is repeated borrowing in the leveraged loan market?
  - How many loans are new? How many are refinancing existing loans?
    - Problematic for switching tests treatment assignment
- Exploit other details of clarification for identification
  - E.g. BHC bank/non-bank subsidiary lead arrangers before/after clarification
- More discussion on collateral interactions
  - Past bank borrowers have twice as high a probability of a collateralized loan relative to the sample mean after the Clarification
  - Switching only to low-collateral lenders in Table A.13

Conclusion

- Well-motivated paper on relevant topic
  - Lending competition on non-price terms is under-studied
  - Policy: fast growth in cov-lite markets
    - Need to understand participants' incentives and market structure
- My suggestions:
  - More thorough discussion of institutional details, implications for testing and interpretation
  - More work to convince that cov-lite restrictions are what binds
  - Deeper exploration of lenders' incentives and covenant terms around experiment