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# COVENANT LITE AND INVESTOR RISK IN LEVERAGED LOANS

What challenges do loans without financial ratio covenants present to borrowers and lenders? How do they measure up against more traditional loans, and are they really riskier?

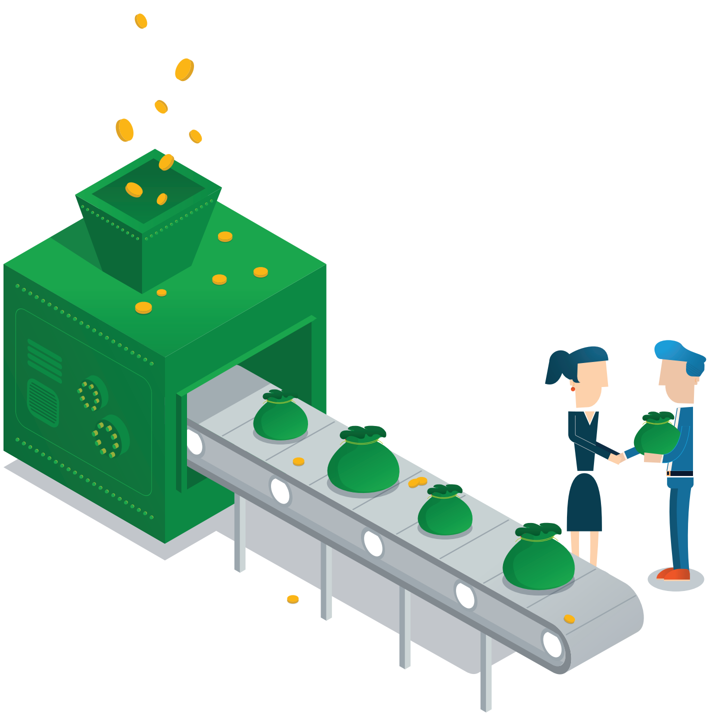
**By Mark Carey, Co-President, GARP Risk Institute**

In the past, loan contracts contained covenants that gave power to lenders when borrowers showed evidence of distress. Today, leveraged term loans without such financial ratio covenants – also known as "covenant-lite" loans – are prevalent.

Indeed, more than 80 percent of leveraged loans are now covenant lite. Risk-related changes in loan contracts (like covenant lite) raise the possibility that losses in the future will differ from losses on loans with financial ratio covenants.

Loans with "maintenance" covenants have text that requires the borrower to maintain specified financial ratios or other measures of risk within specified ranges. For example, the ratio of total debt to EBITDA might be required to be less than five.

If ratios go outside the specified ranges, implying increased risk for lenders, the borrower is in technical default and the lender may choose to accelerate maturity of the loan, meaning the borrower must immediately repay it in full. Usually, the borrower negotiates with lenders for changes in loan terms that remove the technical default. Such revisions often involve fees paid to lenders and changes in the loan interest rate.



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However, lenders may also choose acceleration, which usually forces the borrower into bankruptcy. Lenders are more likely to do so when they believe further deterioration is likely to cause them to suffer a loss in bankruptcy.

If the loans are small relative to the firm's total debt and well secured (i.e., first in priority in bankruptcy to be paid from available assets), lenders may permit the borrower to become deeply insolvent, because they will still achieve a full recovery of what they are owed. If loans are most of total debt or junior to most other debt, lenders may pull the plug around the point of insolvency to protect their recovery.

Bonds, especially publicly-issued bonds, rarely have maintenance covenants, because the owners of bonds are dispersed and inexperienced at renegotiating debt terms. Loans traditionally had covenants because the number of lenders was relatively small, and most were banks experienced at renegotiation. Bonds are rarely secured, whereas loans are usually secured.

Today's covenant-lite loans are similar to bonds in their lack of covenants. For firms that truly have no loans with maintenance covenants, the dynamics of distress are changed: Only the shareholders and/or management decide when bankruptcy is declared.

Shareholders rarely have an incentive to choose bankruptcy because, if the firm is insolvent, they are likely to receive nothing if they put it into bankruptcy. Instead, shareholders hope that the firm's condition will improve to a solvent state if it continues to operate.

COVENANT LITE MAY HAVE **LITTLE OR NO EFFECT** ON THE RISK BORNE BY LENDERS.

If they end up in bankruptcy, firms that are bereft of loans with maintenance covenants are likely to have much less firm value remaining to distribute to lenders. So, even well-secured lenders are likely to suffer much larger losses than on loans with covenants, where they can force timely bankruptcy.

On the other hand, some firms that become deeply insolvent will go on to recover, so fewer will end up in bankruptcy. For covenant-lite loans, the net effect on loan losses is likely to depend on business conditions.

## TRUE RISK IMPACT

Despite all the press stories about covenant lite, few firms have debt structures that are completely covenant lite. Most borrowers have a loan package with a line of credit and one or more term loans. Though the term-loan tranches bought by institutional investors (such as CLOs and loan mutual funds) are likely to be covenant lite, the line of credit is usually provided by banks and will have one or more maintenance covenants.

If all tranches of the loan package share the same collateral, the bank will negotiate in a way that protects recovery in bankruptcy for all tranches, because all share the same recovery. Consequently, covenant lite may have little or no effect on the risk borne by lenders.

An exception is cases where the amount drawn on the line of credit is small. In the past, that was unusual, because distressed borrowers generally needed funds and drew on their lines. However, if the borrower has other sources of contingency funds, such as a private equity sponsor, the drawn amount may remain small.

Banks may then respond differently: With little loan principal to protect, they may focus on earnings from covenant waiver fees or other services they provide to the borrower, or place value on the relationship they have with a private equity sponsor (if one is present). In such cases, covenant lite may increase loss-given-default and reduce probability-of-default.

Overall, the effects of covenant-lite loan tranches on risk borne by lenders are likely to be smaller than many fear.

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