
The Costs of Debt Contracts and the Repeated Use of Debt Covenants

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Abstract

I examine a tendency to repeatedly use the same financial covenant in debt contracts for the same firm and economic determinants of such repeated use. Using a selection model and a switch model for covenant choice, I find a strong tendency to repeatedly use the same financial covenant for the same firm. I also find that this tendency becomes stronger when a lender has high search costs for an informative covenant or high negotiation costs. I further find that this tendency becomes weaker when a borrower has a high risk of default, proxied by the relative size of a loan, maturity, and a borrower's default risk. This suggests that a lender searches for an informative covenant when the informativeness of a covenant is critical. My study provides evidence that the cost of writing a contract is economically meaningful and needs to be considered to avoid overstating the effect of accounting informativeness on covenant choice.

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