

High-Yield Debt Covenants and Their Real Effects

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ABSTRACT

High-yield debt, including leveraged loans, features incurrence financial covenants or "cov-lite" provisions. Unlike traditional maintenance covenants, incurrence covenants impose specific restrictions on the borrower only after certain thresholds are crossed, while preserving equity control rights. Contrary to the prevailing belief that incurrence covenants offer limited protection for creditors, our research reveals a significant and sudden decline in investments upon triggering these covenants. This and other evidence presented in this paper suggest that incurrence covenant structure is binding to borrowers when economic conditions deteriorate. Our findings reveal a novel propagation mechanism for economic shocks, wherein contractual restrictions play a crucial role in the *highly-leveraged* corporate sector, becoming binding well before default or bankruptcy occurs.