

# **How Well Do Financial Covenants Detect Distress?**

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## **ABSTRACT**

This paper evaluates the ability of maintenance covenants to differentiate between distressed and non-distressed borrowers by estimating Receiver Operatic Characteristic (ROC) curves for common covenant packages. We develop a measure of covenant quality based on a model in which lenders balance the cost of loose covenants – failing to catch a distressed borrower before default (false negatives) – with the cost of tight covenants – triggering renegotiation for too many non-distressed borrowers (false positives). We find that lenders today rely on less restrictive covenants than 20 years ago, driven by a shift in the composition of borrowers and a sharp decline in the use of balance sheet-based covenants. Our evidence suggests that the shift from balance sheet to cash flow covenants enabled lenders to rely on fewer, but higher quality, covenants that better detect distress and substantially reduce the expected number of false positive violations.