Non-technical summary for 'The Real Effects of Debt Covenants: Evidence from Australia'

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The availability and allocation of business loans and credit is important for economic growth. But financial frictions, such as a lack of information about borrowers' prospects, can limit or distort the flow of credit leading to slower growth and potentially amplifying economic shocks.

Corporate debt covenants are a tool used to limit these frictions. Covenants set out some conditions that the borrower has to meet, such as not borrowing too much from other sources, and the consequences of any violations. In doing so, they provide some certainty to the lender and can, therefore, make them more willing to lend. At the same time, they place some discipline on the behaviour of the borrower, potentially preventing them from investing or expanding, or causing them to cut back on their expenses, like investment and staffing, if they are close to violating the covenant.

Overseas research has shown that debt covenants can be very important. They are widely used and firms are more likely to violate a covenant than actually default, so they potentially have substantive economic effects, particularly during downturns. The COVID-19 pandemic has brought debt covenants into sharp focus again as there were concerns about firms' ability to comply with covenant terms.

Despite their potential importance, little is known about debt covenants in Australia. This paper aims to fill this gap by analysing the effects of debt covenants on business activity using a newly constructed dataset containing information on debt covenants for Australian non-financial listed firms.

This paper examines three questions:

1. Do covenants affect firms' behaviour, such as their investment and employment decisions?
2. Can covenants change how firms respond to monetary policy, for example by limiting their ability to invest and expand when they are close to breaching their covenants?
3. Have changes in the use of covenants affected the overall impact of monetary policy on the economy?

Key findings:

- Debt covenants can discipline firm behaviour, causing them to decrease investment and employment in order to avoid a breach of the covenant.
- Some types of covenants make firms more sensitive to monetary policy, while other types of covenants make them less sensitive.
    - When the covenant requires the firm to keep their earnings high relative to their interest cost, monetary policy has larger effect. This is because a decline in interest rates lowers the firm's interest expenses, and makes covenants less binding.
    - Other types of covenants, linked to the amount of borrowing, reduce the effect of monetary policy. A change in interest rates doesn't affect whether or not the covenants restrict behaviour. As such, even if a firm wants to invest in response to the decline in interest rates, they may still be unable to due to the covenant.
- Over the past decade in Australia there has been a shift towards the use of covenants that reduce the effect of monetary policy. This might have lowered the effects of monetary policy on non-mining investment and potentially explains part of the surprising weakness in non-mining investment over the 2010s.