CIFREM SEMINARS

A bank covenants pricing model

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Covenants are particular clauses in firms' debt contracts that restrict business policy, giving creditors the possibility to put specific action into force when the covenants are violated. Three main reasons are accounted for in the literature: (1) covenants resolve the conflicts of interest between shareholders and bond-holders, (2) they are used as instruments of business policy, and (3) they are used as credit monitoring by the banks, i.e. to control that the initial estimation of the expected loss rate (elr) of a loan does not change during time. In fact, if a cove-nant is violated the bank can normally ask for an anticipated refund of the loan, or for a change in the initial conditions. Therefore, the choice of the limit be-yond which the covenant is violated becomes crucial. We find, using a simple model, that (1) the elr depends on this limit, and (2) that the elr function has a minimum value, so the choice of the limit can be find with a minimization model.

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