Debt Covenants, Investment, and Monetary Policy by Ozgen Ozturk

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Summary

- Very interesting paper!
- Main question: How MP affects firms conditional on their type of debt agreement (debt covenant)?
- Develops a model where firms choose their debt covenant
- Mimics the US data fact according to which firms mostly use a cash flow covenant relative to an asset based
- Current version results:
  - Result 1: Relationship between productivity, capital and the choice of the debt covenant
  - Result 2: An average firm after its 15^{th} period of existence pays off its debt stock and uses exclusively internal funding

The Model

- Firms choose their debt covenant given the default terms of each type of agreement
- Asset based: If the firm defaults the lender gains a fraction of its assets
- Cash-flow based: Lender gains a multiple ϕ of the firm's cash flow (essentially firms output)
- Different levels of productivity, capital and borrowing result to different choices of the debt covenant

Main Comments

The two contracts essentially differ in their default terms

(1) Is loss of the management rights the same with a loss of a cash-flow multiple?

(2) Super important parameter: the multiple ϕ of cash-flow in case of default. How is it (will be) calibrated?

(3) Having endogenous borrowing constraints is quite typical in the literature. What is determined endogenously here and is emphasized since the introduction?

(4) There is no relationship between the debt covenant and the interest rate. Banks charge always the risk-free rate.

- In this way any -direct- MP interest rate effect is the same for both debt types and not different according to their balance sheets. Both pay r^B
- Is this to isolate the debt covenant choice effect?
- Of course indirect effects do change due to the debt agreements
- In the future you could add a friction between banks and firms

Main Comments II

(1) Extension: Borrowing parameters changing inversely with the firms' capital holdings or cash flow?

(2) Is it common to assume that cash-flow equals the output of a firm?

(3) Cash flow covenant collateral includes also capital, the asset in the asset based covenant
   - What's the relationship between the two schemes?
   - Comparative exercise between fraction of capital given in the asset based vs. cash-flow collateral. Lots of it should depend on the parameters

(4) Do the firms choose the covenant according to the higher ability to borrow or the lower penalty in case of default?

(5) Are there empirical studies that firms pay back their debt around their 15^{th} period?

Minor Comments

- Bank's problem is a bit confusing
  - Why households do not hold deposits D directly and have this risk-free bond α that in equilibrium $D = \alpha$? (I had to look at the Appendix for that!)
- Why the households hold firm shares? Doesn't all the lending comes from the banks?
- Definition of debt covenants and covenant types does not belong in the Micro-level evidence.
  - Put this in the introduction, or a small chapter after the introduction. It is really helpful!
- Calibration is a crucial part of the paper. Even though it might not be sophisticated at the moment it should have been included

Overall

- It's a very nice paper and the contribution in the literature is clear
- Also the empirical part is promising but still incomplete
- Any data of how this is in Europe?