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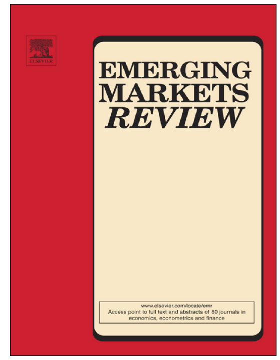

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The role of covenants in bond issue. The case of Russian companies.

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Abstract

This study examines the use and determinants of covenants in public debt issued by Russian companies. Based on issue characteristics and firm characteristics, we investigate the likelihood that the inclusion of covenant clauses in financial contracts is positively related to the riskiness of bond issues. Using a hand-collected database of Russian firms that place bonds in both the domestic and Eurobond markets, we provide evidence that Russian bondholders use covenant protection to compensate for different creditor protections when the firm has Eurobonds in its debt portfolio. We also find a general negative relation between covenant protection and the bond's yield.

Keywords: covenants, bond, Russian companies
JEL: G31, G32

1. Introduction

An extensive body of theoretical and empirical research on capital structure has expanded beyond the choice of debt versus equity and increasingly examines the architecture of corporate liabilities, including characteristic features of financial contracts. Covenants are particular clauses in an indenture or any other formal debt agreement that restrict corporate policy, providing creditors with the opportunity to enforce certain actions (e.g., to demand early repayment) when these covenants are breached. At the centre of the rationale for the presence of covenants in financial contracts is the conflict of interest between shareholders and debtholders[1]. This conflict results in actions undertaken by managers acting on behalf of shareholders that have a negative impact on both the firm's value and the market value of outstanding debts. Studies by Jensen & Meckling (1976), Myers (1977), and Smith Jr & Warner (1979) identify four main sources of conflict: claim dilution, asset withdrawal, asset substitution and underinvestment. One way to mitigate these conflicts and reduce the attendant agency costs is to include appropriate covenants in debt contracts to influence a firm's financial and investment policies and to lower the transfer of wealth to shareholders. However, covenants may produce undesirable effects, reducing flexibility in corporate

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[1] Recently, Demerjian (2017) revised this explanation for covenant use, arguing that financial covenants facilitate contracting under uncertainty.