Do economic conditions drive DIP lending?: Evidence from the financial crisis

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Summary

- The paper analyses the relationship between economic conditions and DIP loan terms;
- The specific instruments of interest:
  1. Roll-ups: Fresh financing in return for higher priority in pre-bankruptcy and restructured debt;
  2. Milestones: Set hard deadlines for important events or the lender will get critical control.
- Major finding:
  1. Loan pricing and reporting covenants are sensitive to economic conditions;
  2. Extraordinary inducements are unrelated to economic conditions;
- Policy implications: Extraordinary inducement often justified as necessary on grounds of economic conditions might not be necessary.

Some clarifications

1. When using fresh financing with roll-ups or milestones, the only real change is in the status of the DIP lenders claims;

2. What justifies the need for intervention?
    - Debtor and their prospective DIP lender typically agree to the terms;
    - We observe near zero default rate for DIP loans;

Some empirical issues

Baseline regression specification:
Loan price/covenants $\sim$ Available credit

1. The measure of 'Available credit' is actually the net credit demand conditional on economic conditions.
2. A better measure of available credit must account for liquidity conditions (amount as well as the cost of credit):
   - Availability of credit can be measured by a benchmark risk free rate;
   - Risk premium (e.g., Spread between investment and speculative grade bonds, VIX).

References

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