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Covenants of Brazilian Debentures: What is Your Role and What Contributes to Its Use?

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Abstract
Since debentures are one of the main financing alternatives in the Brazilian market and it is a recurring practice for companies to provide in the issuance prospectus and in their covenants reference forms, that express the company's commitment to honor the debt, this research discusses with theoretical arguments from previous research, what is the role of covenants and what factors contribute to their use in the covenants of Brazilian debentures. Two attributions were evidenced to the covenants: reduce agency conflict and report on company performance. Regarding the factors that contribute to the presence of covenants in the issuance of debentures, it was found that the factors that inform about risk and companies potential are the ones associated with covenants, since they inform the creditors about the situation and companies expectation. Among the factors, we highlight the following: the contracts duration and the possibility of the debt be converted into shares; the debt profile and profitability of companies; the opportunity for business growth and its size.
Keywords: Covenants, Debentures, agency conflict.

INTRODUCTION

In this financing process there is a relationship between the companies that issue debentures and the creditors, in which the companies purpose is to obtain the capital required to carry out their business and for the creditors is to ensure the borrowed funds receipt plus interest (BEIRUTH and FAVERO, 2016).
In this sense, Povoa and Nakamura (2015) observed that companies with greater information asymmetry tend to raise funds through monitored financing sources , which are characterized by the lender's privileged access to the borrower's information, so it allows to reduce information asymmetry and in turn it reduces risk.
Given this, it is clear that, despite the growth of the debentures market in recent years, investors demand information that allows them to discern which investment to make in order to avoid the default risk and to assess the risk-return ratio, expressed by the issue interest rate and the debenture value .
This is mainly justified by the fact that in the lending relationship one of the reasons that creditors may not recover their funds, partially or completely, is due to the corporate managers inability to create wealth, adverse market conditions or conflict of interest between creditors and borrowers.
To allow a better debenture assessment and to better understand the risks involved in acquiring this bond, companies provide in the issue prospectus and in their reference forms contractual terms expressing the company commitment to honor the debt. These clauses are referred to as covenants and may also reduce conflicts arising from informational asymmetry by setting limits and restrictions on various company aspects , such as issuance of a new debt, dividend payments, expansion and merger restrictions, among others.
Given the above, this research discusses through theoretical arguments the role of covenants and the factors contributing to their use in the covenants of Brazilian debentures. To answer the question about what factors are determinant for the use of covenants we will present the results of the main national and international previous studies that have already investigated this relationship, however, before this, this text discusses the theoretical foundations that support the covenants expectation inserted into debt contracts, seeking to contextualize them with the debt type and the issuing company characteristics .

ISSUE OF DEBENTURES AND THEIR WARRANTIES

Companies need to raise funds to develop their operating activities, debt repayments, working capital increase, new projects and various other purposes. For this, they use their own resources, retained profits; or resort to third party capital , issuing shares or debts such as: debentures, promissory notes, eurobonds, etc.
The two main long-term financing alternatives in the Brazilian market can be obtained from the National Bank for Economic and Social Development (BNES), and with the issuance of securities - the debentures. Debenture is a security, representing a generally long-term loan agreement between the issuer and the debenture holders. These are, therefore, debt securities issued by a publicly-held or publicly-held corporation that give their holders credit rights and thus consist of a capital market fundraising instrument that enables companies to finance their projects and operations.
The effective use of this financing alternative began in 1976, following the publication of the Brazilian Corporate Law, under the terms of the Brazilian Securities Commission (CVM) regulation and became popular after the creation of the National Debenture System (SND), through the Brazilian Association of Financial and

Capital Markets Entities (ANBIMA) in 1987 by enabling the existence of a secondary market, providing greater liquidity for these securities.
Debentures are considered a relevant financing source for investments in the Brazilian market as they generally have different maturities, guarantees and tax benefits than bank loans. They are also easy adaptation to the payment flows and terms of cash generation by businesses (GIACOMINI and SHENG, 2013). This, in turn contributes to these securities occupying the most used security condition in the financial market (ANBIMA, 2015).
Therefore, ANBIMA in 2015 published a model indenture of debentures in order to standardize emissions, so that the information necessary for investors to evaluate the company and debentures conditions were more clear and easy to compare between emissions debentures. The structure is as follows:

1. Qualification of the parties;
2. Issue authorization;
3. Issue requirements ;
4.mission characteristics;
5. General characteristics of the title;
6. Early redemption features;
7. Conditions for early maturity;
8. Other obligations of the issuer;
9. Characteristics of the trustee;
10. Provisions on the general meeting of debenture holders;
11. Guarantees of the issuer; and
12. General provisions of the title.

Additionally, according to the provisions of Law 6,404, from 12/15/76, the issuance of debentures may be made with or without guarantees. These guarantees are intended to ensure that debenture holders comply the main obligation, that can be cumulative and replaced as long as registered in the dead of issue. The main types of collateral are collateral, floating, unsecured, subordinated collateral, and ancillary collateral. The following table summarizes the characteristics of each warranty.

Table 01: Debentures classification according to types of guarantees

Warrants type	Feature
Debentures with Real Warranty	It involves the compromise of assets or rights that cannot be trade without the debenture holders' approval, so that the guarantee is not compromised. Examples of collateral are movable and immovable securities given in mortgage, disposal and fiduciary assignment, pledge or anti-seizure by the issuing company, its conglomerate, or even third parties
Debentures with Floating Warranty	Ensures privilege over the assets of the broadcaster but does not prevent the negotiation of the assets that make up this asset.
Chirograph debentures	The debenturist has no guarantee or preference in the event of liquidation of the company, competing on an equal level with the other chirographers' creditors of the broadcaster
Subordinateded Debentures	They are the ones that are specifically subordinate to other types of debt. Although subordinated debt holders are below all other long-term creditors regarding settlement and payment of interest, their claims need to be met before ordinary and preferred shareholders' shareholders

Source: Prepared by the authors (2020)

Covenants are configured as a type of collateral used in a complementary manner. They represent a set of obligations that the issuing company assumes with the objective of ensuring, directly or indirectly, the fulfilment of the main obligation, that is, the payment of the debt to the debenture holder. The term covenant (original) means something similar to the notions of convention, covenant, agreement, contract clause, so that it can be understood as a clause agreed between the financing agent and the borrower, in order to safeguard the creditor in situations of possible default or possible structural changes by the borrower. It is, therefore, configured as a lender's protection mechanism.

METHODOLOGY

The present study has the general objective to identify what the role of covenants are and what factors contribute to its adoption in Brazilian bonds , for this purpose, we took as theoretical support the seminal works on capital structure, theory of agency and corporate governance. Then, a mapping of the main studies that analysed covenant practices in debt contracts was performed. Therefore, this research achieves its results with theoretical reflections, configuring itself as a theoretical essay on the importance and adoption of covenants.

THE ROLE OF COVENANTS

Generally, in companies, shareholders delegate to the manager the decision-making power over the company. At this point, disagreements may arise in what shareholders and managers consider to be the best for the company. These divergences fall within the scope of Agency Theory, which seeks to address the difficulties of information asymmetry and conflicts of interest between managers and shareholders (KLANN; BEUREN; HEIN, 2008).

As advocated by agency theory (JENSEN & MECKLING, 1976), it is found that shareholders can expropriate debenture holders' wealth in a variety of ways, for example, they can pay themselves dividends, or they can repurchase shares, or even invest in equity ofhigh-risk projects by issuing additional debt. These conflicts can be overcome by the use of good corporate governance practices (IBGC, 2016).

The role that can be played by the covenant in the relationship between company and creditors can be interpreted as a Corporate Governance mechanism, since covenants generate benefits to the firm, creditors and shareholders, as they imply the agency conflict reduction as well as the negative effect reduction of uncertainty about the future company performance (AGHION; BOLTON, 1992; CHRISTENSEN; NIKOLAEV, 2012), thus constituting the reasons why companies include covenants in their contracts, regardless of whether their shares are traded in B3.

Therefore, the factors that guide the use of these clauses are varied and are related to the context in which the issuing company is inserted, such as the country in which the company is headquartered, and the characteristics of the company, namely: size, indebtedness, profitability, growth opportunity (Citron, 1995; Lin, Malatesta and Xuan, 2011; Demnerian, 2014; Bradley and Roberts, 2015).

Concerning the expectation on reducing agency conflicts, covenants have the role of preventing company managers from acting detrimental to creditors, as covenants mitigate agency problems that could occur from the moment they occur, by the moment the company enters a more advanced state of financial hardship as they timely ensure the transfer of control over debt to the lenders. Thus, performance covenants reduce the likelihood that shareholders (represented by managers) will expropriate creditors' resources as the company encounters more severe financial difficulties (CHRISTENSEN; NIKOLAEV, 2012). It was in this context that Silva (2008) found that the accounting covenants breach of debentures issued in Brazil is usually resolved through debt renegotiation and, on average, does not generate a high cost to companies.By reflecting on the adoption of covenants to mitigate the risk related to uncertainty about the company's future performance, they act as a facilitating mechanism for renegotiating the debt contract terms if the firm fails to comply with the terms agreed in the contract. This company performance deterioration makes the loan, in the current company performance context , to become a higher risk investment than the one initially contracted (DEMERJIAN, 2014).

Figure 1 outlines the dual role that convenants can play in the company and creditor relationship, which can be interpreted as a Corporate Governance mechanism. In this relationship, covenants generate benefits for the firm, creditors and shareholders by reducing two types of borrowing-related problems: agency conflict and uncertainty about the company's future economic performance.

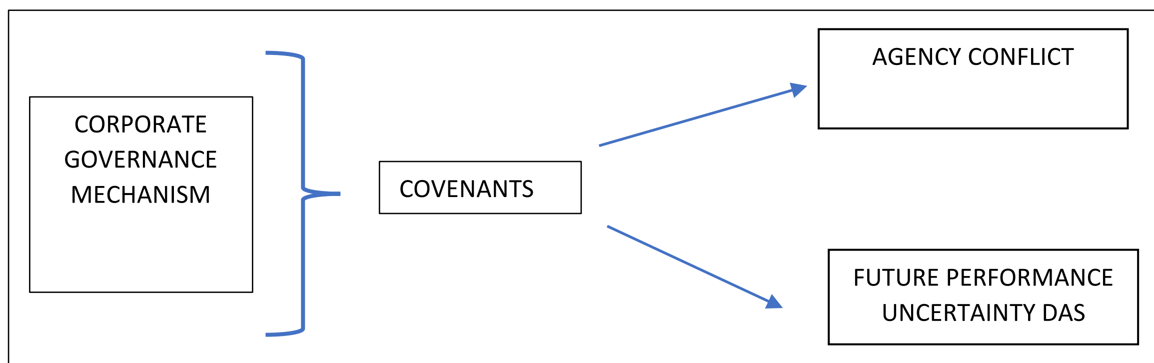

Figure 1: Covenants as a corporate governance mechanism and its dual function.
Source: Developed by the author (2020)

To the extent that covenants allow greater transparency and reconcile expectations between the company and its creditors about future situations, covenants can be said to play an important role in corporate governance, thereby reducing the problems arising from agency conflict and contribute to a better understanding of the company future performance .

Despite agency theory, (JENSEN; MECKLING, 1976) point out that agency conflicts occur when, after contracting debt, the debtor intentionally performs actions that are detrimental to creditors' rights, such as activities that transfer the lenders creditors capital . to shareholders. These actions increase the company risk

and compromise the investment recovery made by the lender. That said, the covenant agency function is to prevent creditors' rights from being compromised.
About this, JENSEN; MECKLING, 1976; BRADLEY; ROBERTS, 2015 point out that debt agency problems are more frequent in companies with financial difficulties, as uncertainty about future cash flows is stronger and, therefore, shareholders are most likely to expropriate the wealth of lenders.
That said, Smith and Warner (1979) cite the four major conflict sources between shareholders and creditors, in which shareholders can divert wealth from creditors to themselves through: (a) underinvestment (MYERS, 1977; SMITH; WARNER, 1979); (b) payment of excessive dividends (SMITH; WARNER, 1979; AHMED et al., 2002); (c) payment preference dilution (SMITH; WARNER, 1979); and, riskshifting problem or asset substitution (JENSEN; MECKLING, 1976; SMITH; WARNER, 1979). Thus, it can be inferred that these sources of agency conflict tend to be split into covenants. Table 01 below gives the definitions of each of these conflict sources .

Table 1 - Definitions of sources of conflict between shareholder and creditors

Conflicts between shareholders and creditors	**Definitions**
Underinvestment	It occurs when the company management is facing investment alternatives with positive net present value, but which does not offer the residual return intended by the shareholders.
Payment of excessive dividends	It occurs when a firm changes its dividend policy after contracting debt to increase the amount of funds distributed to shareholders (SMITH; WARNER, 1979). As a result, managers can transfer wealth from creditors to shareholders, which reduces the likelihood that creditors will repay their loans if the firm goes bankrupt (AHMED et al., 2002)
Payment Preference Dilution	Occurs when, after contracting debt, management issues or contracts new debts with settlement priority equal to or higher than the initial debts.
Investment Substitution	It occurs when, after contracting the debt, management changes the investments to be made with the credit raised and prioritizes the higher risk investments (SMITH; WARNER, 1979).

Source: Adapted from Konraht (2017)

Based on the foregoing, the presence of covenants in debt contracts consists in limiting managers' decisions regarding investments and financing that may represent a loss to creditors' rights. Thus, covenants limit, for example, the excessive distribution of dividends, the contracting of additional debt or the sale of assets (SMITH; WARNER, 1979). It is also noteworthy that covenants can reduce the adverse selection problem generated by information asymmetry when they have informational content about the company's risk to the lender.
In relation to another function that the covenant can assume: reducing uncertainty about future performance, there is a legal guarantee to renegotiate the debt terms if the risk presented by the company is higher than the one estimated at the beginning of the loan.
In this context, covenants act as an agreement reached at the time of contracting the debt and define how these potential problem situations will be resolved in the future. Therefore, they guarantee greater protection to the creditors rights .
Based on the foregoing, Smith and Warner (1979) identified four main types of contractual restrictions: asset, clause of dividends, financing and payment. As for Watts and Zimmerman (1986), a more specific perspective, classified plow contractual covenants six types, namely:

a) Restrictions on the dividends payment ;
b) Restrictions on the issuance of new shares;
c) Maintenance of working capital;
d) Restrictions on investments in other companies;
e) Restrictions on the assets disposal ; and
f) Restrictions on contracting new debt

In turn, Christensen and Nikolaev (2012) broadened covenant ratings in two approaches: capital covenants and performance covenants , with the former attempting to minimize agency conflict while the latter measures firm efficiency; to safeguard third party capital during the term of the debt contract.
To measure the company's efficiency, Garleanu and Zwiebel (2009) state that the most used covenants are based on net worth,, working capital, leverage, interest coverage and cash flow. While among nonfinancial covenants, restrictions on debt issuance, payment of interest on equity, payment of dividends, and investments stand out. (BEIRUTH, 2015).

Covenants establish limits and conduct in order to ensure greater control regarding compliance with contractual clauses and the debtor behavior, they are guarantees that focus on good management and integrity of the assets. In this sense, Demerjian (2014) examined the relationship between future performance uncertainty and financial covenants in debt contracts, and concluded that the uncertainty of receipt could be highlighted as the main reason for delineating financial covenants, as Limitation of actions by the borrower company is exercised through accounting numbers , which in turn helps the investor to understand the financial company situation and realize the possibility of not repaying the amount borrowed. They are, therefore, clauses based on financial ratios, such as EBITDA and Debt Service Coverage Ratio (“ICSD”).
In Demerjian's (2014) approach, the role of covenants is to mitigate the problematic effect that the lack of information about future economic events, that affect the company's ability to make payments, has on the creditor's risk when contracting debt. That said, accounting covenants contribute to the formulation of more efficient debt contracts, as they reduce the effect of future performance uncertainty on loan repayment.
In short, the role played by covenants in debt relations is to mitigate the imperfections of incomplete contracts (AGHION; BOLTON, 1992; CHRISTENSEN; NIKOLAEV, 2012). As a result, covenants minimize agency conflicts over the loan life and allow debt terms to be renegotiated if the company experiences financial difficulties in the future.
Given the above, it was estimated to present the main theoretical frameworks that contribute to the presence of covenants in debentures issues and, therefore, support the main arguments about the factors that determine covenants. Next, it will be discussed what are the factors presented in the literature that determine the covenants in the debentures.

Factor Considerations Determine The Use Of Covenants

Debt maturity refers to the term for redemption or debt settlement Longer-term debt involves a higher level of uncertainty about the company's future performance. The argument that longer-term debt securities require covenants was evidenced by Citron (1995) for the UK market and Inamura (2009) who examined the determining factors for the use of accounting covenants in debt securities issued in Japan.
According to the covenants functions to mitigate agency conflicts and reduce the uncertainty of the company future performance, corporate bonds with longer **maturities** require more guarantees because they represent a higher risk to the lenders regarding the company future performance
The results found by Demerjian (2014), when investigating the US credit market, indicate that the greater the uncertainty regarding the future performance of the company, the greater the amount of accounting covenants used in debt contracts. In this sense, Demerjian (2014) found that loans from **more indebted are** more likely to be bankrupt, and more profitable companies tend to have more accounting covenants.
Still regarding loans made in the United States, Bradley and Roberts (2015) found that longer-term debt has greater use of accounting clauses in their loan agreements.
Regarding **profitability,** Lin et al. (2011) state that companies with higher profitability are generally more economically stable and less prone to bankruptcy, which may increase lenders' preference for providing credit. The implication of this bankruptcy lower risk is the reduction of potential agency conflicts, causing a lower demand for the use of covenants. These arguments were validated by Bradley and Roberts (2015) in concluding that debenture issues from higher-yielding companies have fewer accounting clauses.
With regard to **growth opportunity** as a determining factor for covenants, firms with high growth rates have a significant portion of their value derived from future returns expectations . According to Brito; To run; Batistella (2007) this perspective raises the bankruptcy-related agency conflicts of these companies, so companies with high growth rates tend to include accounting covenants in their debenture issues to minimize these conflicts.
In this sense, Silva, Saito and Barbi (2013) identified that companies use fewer restrictive clauses in debentures, when they have lower level of growth options. Demerjian (2014) also concluded that loans from companies with higher growth opportunities use fewer accounting clauses.
In turn, companies with high **debt levels** are more likely to present financial difficulties (GRAHAM; LI; QIU, 2008). This heightens potential debt agency conflicts, and lenders from more indebted companies tend to be more encouraged to demand additional protection from the capital provided, which tends to result in a higher requirement for accounting covenants in the securities issuance because it makes the wealth transfer from creditors to shareholders more advantageous (Jensen; Meckling 1976; Myers 1977; Citron 1995). Debt level was tested by Citron (1995), his results indicates that this factor does not direct the use of accounting clauses in UK debt securities. Regarding this factor and its relation to the presence of covenants in debt contracts, it is worth noting the political, economic and cultural reflection on the country context in which the debenture issuing companies are located, as well as the sector and legal incentives. Considering the investor profile, the activity sector and even the political context of the debenture issuing company, the presence of covenants in highly indebted company contracts is expected, as its function reduces the uncertainty of the debt, future performance, as cited by Smith and Warner (1979).

According to this expectation, Inamurra (2009) found a positive relationship in his study, concluding that companies with higher debt levels tend to use more accounting clauses in their debt contracts.

The **size of the company** tends to reduce agency conflicts related to information asymmetry, so the use of restrictive covenants is smaller (Malitz, 1986). Large companies generally have greater diversification in their lines of business, and this makes the company risk in financial distress decreases (Titman; Wessels, 1988; El-Jazzar; Pasteena, 1991; RAJAN; ZINGALES, 1995). In addition, companies with this profile generally have more assets that can be liquidated to repay debts in the event of financial difficulties.

Given these arguments, it is concluded that larger companies present less risk to the lender than small and medium enterprises and this tends to reduce the need for accounting covenants as the size of the company rises. Inamurra (2009) found an inverse relationship, that is, larger companies are less likely to include covenants in their doubt contracts. This relationship is guided in the fact that companies with greater equity net, generally are already consolidated in the market and are in the mature stage, thus presenting less risk to the debenture holder and in turn, the future performance uncertainties are lower.

In addition to this argument, **debt securities that can be converted into shares** and issued by companies with greater growth opportunities reduce the likelihood of using accounting covenants, as the possibility of converting debt into shares is a guarantee. In addition, there may be cases where the presence of covenants represents a limitation for growing companies, these arguments were developed and tested by Citron (1995) in UK debt securities.

These results, however, suggest the prospect of using accounting covenants as a signal of the company's creditworthiness to lenders. Thus, the better the quality of the company, the greater is its propensity to accept the use of accounting covenants as a way of signaling credit quality to creditors (DEMIROGLU; JAMES, 2010). Given this context, it is expected that the level of uncertainty presented by the company at the time of contracting debt is positively related to the probability of using accounting covenants.

RESEARCH FINDINGS, COMMENTS & RECOMMENDATIONS

From the above discussions, it can be inferred that the financial covenants are used as a mechanism for the risk of credit reduction , aid transparency by reducing the agency conflict and report on the situation of the company. This is one of the main functions performed by accounting covenants, which is the establishment of minimum acceptable conditions for the debtor's financial situation, in situations in which the estimate of the debtor's future performance is uncertain, as is the case with the long time horizon. Thus, the use of accounting covenants controls the possibility of changing the company's risk landscape over the debt term. Additionally, covenants play an important role in the debentures valuation , assisting creditors in the investments selection process , so it is interesting to further investigate what covenants are most commonly used and what is the relationship between covenants and debentures, as well as the debentures spread .

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