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Mitigating Credit Risk for Banking Institutions in Uganda

The Value of Loan Covenants

Cristal Knowledge Series

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1. Introduction

Credit risk is the risk of a borrower defaulting on loan repayment. The lender's greatest risks are non-payment of the principal sum and the failure to recover interest (profits) from the borrower. In a recent report by the Bank of Uganda ("BOU" or "Regulator"), debt default by the borrowers to the banks in Uganda increased by about 15% to Uganda shillings 780 billion for the period January 2020 to March 2020. It is expected debt default will rise further in light of the adverse economic impact of the coronavirus pandemic.

Commercial banks in Uganda pay particular attention to credit risk considering that the inability to collect disbursed loans affects their profitability and ultimately capital reserves adequacy that can invoke the action of the regulator. The Bank of Uganda closely monitors the loan portfolio performance of commercial banks and there are various reporting requirements for the banks set out under the Financial Institutions Act, 2004. The Financial Institutions (Credit Classification and Provisioning) Regulations, 2005, for instance, require banks to mark a credit facility as non-performing if its principal or interest is due and has not been paid up after ninety days from the date it was due. In addition, the bank is required to report to the BOU on the "bad debtors" within thirty days after the end of the reference quarter or risk facing administrative sanctions.

Although the Companies Act 2012, generally prohibits directors from committing fraudulent acts against the interests of creditors, this general protection is a "one size fits all" approach which does not provide the best protection to creditors. Thus lenders must contractually seek to monitor the business of the borrower rather than wait until the brink of bankruptcy, which would expose their claims to greater uncertainty.

By the use of covenants, lenders are able to impose obligations and restrictions on the borrowers that safeguard their interests. The first part of this publication discusses how the application of loan covenants addresses the agency conflict of directors. In particular, covenants minimize the risk of the borrower's non-payment through monitoring their day-to-day running in effect ensuring that the directors of the borrower are mindful of the lender's interest. In the second part, the article makes the case that loan covenants may also be valuable to other stakeholders in three ways: Firstly, they enhance the valuation of the borrower, in effect benefitting other creditors, employees and shareholders. Secondly, that loan covenants benefit other small-scale lenders who can free ride on monitoring done by the bigger adjusting creditors. Thirdly, that loan covenants diminish the likelihood of mismanagement or fraud by the borrower. Notwithstanding the foregoing exposition about their value, loan covenants, if excessive can also limit the borrower's management to act in the best interests of the company.

2. Non Payment and Insolvency Risk

It is important to consider what events may lead to nonpayment. Creditors are concerned about dealings that enhance the risk of non-compliance with debt obligations, which may lead to borrower's insolvency. Precarious business activities by the borrower can affect cashflows and eventually the ability to pay off existing loan obligations. Similarly, the disposal of company assets can equally impact the financial condition of a company.

The change in control of the management of a business also poses a significant risk to a creditor. This can enhance credit risk if the new management has other priorities that could be contrary to the contractual requirement of repayment of the loan. Loan covenants through restrictive clauses can prevent the diversion of funds to unnecessary expenditures and in the alternative provide for prior approval from the creditor before new ventures are undertaken.

For the foregoing reasons, creditors seek to keep track of each of these indicators through loan covenants that intricately deal with each of these risks. In that regard, debt governance becomes crucial because, it ensures the company is run with the interests of the creditor in mind.

3. Debt governance

When a company incurs a debt, it inevitably becomes an issue of corporate governance. The management of the borrower is expected to run its business affairs with the aim of settling the debt. However, this is not guaranteed because of the agency dilemma in the management of a borrower. Ordinarily, directors (management) of a company are agents; acting firstly in the interests of the members (shareholders) and other stakeholders like employees and creditors respectively. This is the position in the Companies Act 2012. This duty is owed primarily to the shareholders who yield the power to appoint and dismiss management under company law. Thus, it has been argued that the structuring of a company must also deal with the ways in which the suppliers of finance to corporations can assure themselves of getting a return on their investment. Loan covenants thus become a crucial tool to overcome agency conflicts between the shareholders and creditors.

4. Interest of the creditor must be kept in mind

Loan covenants may be used to align the interests of the principal and agent. Creditors with superior bargaining power may be able to negotiate terms that can safeguard the health of the company, from the signing of the loan facility to when the debt matures. For instance, banks tend to rely on covenants as the most effective means to minimize agency costs and manage borrower's credit risk. This is reflected through the type of covenants. Some are prohibitive - for instance restrictions on dissipation of assets & payment of dividend distributions among others; others are affirmative necessitating an overt action from the management of the company -for instance requiring periodic disclosure of financial accounts or maintaining agreed debt to equity ratios. The latter would act as an indicator to the company's financial and legal position and their effect on the risk of non-payment. Regardless of the form the loan covenants take, they directly affect the actions of the borrower's directors hence supporting the claim that loan covenants ensure that the borrower's business is run with the interest of the lender in mind.

Following this, many determinants influence the inclusion of loan covenants. It could be premised on whether the lending is secured or unsecured, the size of the borrower company, the anticipated growth opportunities and the parties' respective bargaining power and the state of the loan market. For instance, a negative pledge clause that would prohibit any further grant of security of the borrower's assets is usually applicable to unsecured loans. Its purpose is to protect the ability of the lender to enforce the loans against the assets of the borrower. It in effect limits the ability of management to grant security of any of the borrower's assets, thus buttressing the premise that loan covenants ensure that the business is run with the interest of the lender in mind. Having established that, this article will now demonstrate how covenants are valuable to stakeholders in a company.

5. Enhanced valuation of the borrower

In some jurisdictions, loan covenants may boost the value of the company consequently benefiting the shareholders and other lenders. A study (by Shepherd, Tung and Yoon, 1986) noted, that the prospect of a bank monitoring a company added value to the company's shares. This is because of the perception that a creditor's monitoring deters borrowers mishandling and reduces the risk on all the company's debt (Triantis & Daniels 1995).

In addition, shareholders' oversight is reduced by the discipline and vision provided by creditors aimed at keeping optimal levels of risk. This is seen through financial covenants that monitor cash flow and maintenance of favourable debt to equity ratios. An "intervening clause" may then be inserted in the event that the debt and equity ratios become alarming. Although monitoring is crucial, what is most important, is the ability of a creditor to intervene which is usually guaranteed through loan covenants. This is primarily because covenants reduce the likelihood of the management of company deviating from a policy that maximizes the value of the company (Clifford W Smith & J.B Warner). In the circumstances above, loan covenants are therefore of value to shareholders and other lenders since they have a potential to boost the value of the company.

6. Curb management oversight by borrower's directors

Loan covenants provide protection from errant acts by the borrower's management team, by curbing management excesses. The extent to which lenders influence decision-making prevents managerial incompetence, fraud and self-interest, which could be of significant value to the shareholders and other creditors (Triantis & Daniels 1995). In large part, these are safe-

guarded through restrictions on disposal of assets, maintenance of a specified asset to liabilities ratios leading to enhanced scrutiny on decisions that could directly affect the borrower's liquidity and ability to settle their debts in the end.

Further, such monitoring is most effective if exercised by a single lender (bank)as the plurality of lenders might complicate the process of decision-making. Triantis & Daniels 1995 offer a well-founded criticism to loan covenants as a limitation to management abuse. They argue that covenants are imperfect predictors of management behavior because there is a difficulty of assessing a borrower's future actions and performance based entirely on the covenants entered into. Alternatively, it may argued that loan covenants do not offer any more safeguards than what is already included under Section 174 (b) 2 of the Companies Act 2012 that provides for the prohibition on directors committing fraudulent acts against the interest of creditors. Nevertheless, it is always, ideal to spell out the extent of this obligation, contractually.

7. 'Free riding'

Other creditors, for whom monitoring and influence would be a huge cost, can benefit from a 'free ride' premised on the actions of the lender who can do this more cheaply (Levmore, 1982). This is an incentive to smaller credit firms to participate in both public and private markets because they can freely ride on the enhanced oversight provided by bank lenders. They can effectively benefit by following the early distress signals as to the performance of a company. The other creditors may also be able to benefit from any anticipated correctional measures that may be undertaken by the lenders in the monitoring role. Triantis & Daniels (1995) argue that any such correctional measures may urge the remaining stakeholders to take action before the company's condition becomes irreparable.

Thus, debt covenants provide a window through which other lenders and even shareholders could take action. There are two counter arguments to this proposition. Firstly, those monitoring creditors do not act as fiduciaries, they act on their own interest, thus may only act on a breach if it is in their best interest. Therefore, other creditors may not be able to benefit from the value of any correctional measures taken from a breach of covenants. Second, this proposition assumes that information about the covenants of one creditor are within the perfect knowledge of another.

8. Dividend and investment restrictions

Notwithstanding the foregoing value of loan covenants, prohibitive covenants limiting expenditure, investment ventures & portfolio can limit director's discretion to act in the interest of the shareholders, which in the long run would potentially benefit the creditors. Dividend payment restrictions can also negatively affect shareholders. Concerning the former, it can stifle a startup by constraining the director's choices (Billet 2007) since they would ordinarily need to expand, branch out or diversify its production. All these could be categorised as risk averse practices prohibited under loan covenants. In the end, what would have been an investment opportunity for shareholders is prohibited by covenants and may reduce the prospects of success for a borrower.

9. Conclusion

Loan covenants are an important tool in minimizing the risk of non-payment and insolvency. The nature of loan covenants as discussed is intended to directly affect the management of the borrower. They enhance prudent managerial practice and the valuation of the company, which are of positive value to stakeholders. As discussed, debt governance is also a crucial tool in addressing the agency conflict between shareholders and directors, and, ultimately ensures that the borrower's business affairs are run with the interest of the lenders in mind., That notwithstanding, shareholders stand to lose the most from such arrangements as their rights become secondary to the creditors.

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