

Multiple Lenders, Strategic Default, and the Role of Debt Covenants

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This paper investigates the relationship between competition and contract design in capital markets subject to moral hazard. Financial contracts are non-exclusive, i.e. entrepreneurs can trade with several investors at a time, and investors can include covenants in their contracts to restrict entrepreneurs' ability to trade with competitors. In such a context, we provide a full characterization of the set of equilibrium allocations and we show that the features of market equilibria crucially depend on investors' ability to design covenants. If covenants are precluded, the equilibrium outcome is always efficient, and unique when the moral hazard problem is severe enough. Then, the aggregate of lenders earns a monopolistic profit. If covenants contingent on the project's cash-flow can be included in financial contracts, every feasible allocation can be supported at equilibrium: market equilibria are indeterminate and Pareto-ranked. The introduction of institutional mechanisms which prevent borrowers from strategically defaulting on their loans can restore the competitive outcome as the unique equilibrium allocation.