# Do Institutional Investors Trade on Covenant Violations?*

Anthony Saunders
NYU Stern School of Business

Sascha Steffen
Frankfurt School of Finance & Management
Centre for Economic Policy Research (CEPR)

Paulina M. Verhoff
Frankfurt School of Finance & Management

August 13, 2026

**Abstract**

We develop CovenantAI, an artificial intelligence-powered covenant monitoring methodology, to examine whether institutional investors strategically trade around covenant violations in leveraged loan markets. We show a persistent decline in loan prices during the 100 days preceding violations, with a most pronounced drop 80 days prior to the violation: for example, we find cumulative abnormal returns of -6.39% during the [-80,-60] event window. Price effects are most severe for loans amended post-violation or those that remain in technical default. Loans predominantly owned by leverage-constrained CLOs exhibit steeper pre-violation price declines and more negative abnormal returns. Transaction-level data reveals the mechanism: constrained CLOs are persistent net sellers in the weeks before violations while unconstrained CLOs absorb these positions, and this trading asymmetry is strongest for loans that remain in technical default.

*JEL classification:* G21, G32, G34

*Keywords:* Artificial intelligence, CovenantAI, Covenant violations, Institutional investors, CLOs, Secondary loan markets

*Corresponding author: Sascha Steffen, Frankfurt School of Finance & Management, Adickesallee 32-34. 60322 Frankfurt, Germany. E-mail: s.steffen@fs.de. Authors: Anthony Saunders (asaunder@stern.nyu.edu), Paulina Verhoff (P.Verhoff@fs.de). We thank Svetlana Bryzgalova, Adrian Buss, John Chu (discussant), Redoume Elkamhi, Quirin Fleckenstein, Emilia Garcia-Appendini (discussant), Sharjil Haque (discussant), Nikola Kiprijanovski (discussant), Shohini Kundu, Ralf Meisenzahl (discussant), Christian Opp, Robert Prilmeier (discussant), Francisco Santos (discussant) and Chi (Clara) Xu (discussant) for helpful discussions. We also thank participants at BSE Summer Forum 2026, the LAPE-FINEST Spring Workshop 2026, the FIRS Conference 2026, the Finance Brownbag of Tulane University, SFS Cavalcade North America 2026, the Liechtenstein Workshop on AI in Finance 2026, the Inaugural Rutgers Finance Research Conference, the Sydney Banking and Financial Stability Conference, the 38th Australasian Finance and Banking Conference, the Brownbag of the University of Technology Sydney and the Rising Scholar Conference in Finance 2025

# 1 Introduction

Covenant violations in leveraged loans play a central role in shaping risk and trading behavior in modern credit markets. Despite a general decline in observed violation rates over recent decades (Griffin, Nini, & Smith, 2024), covenant breaches remain frequent among non-investment-grade and unrated borrowers. These events trigger a range of contractual responses, from amendments and waivers to technical defaults, each carrying different economic and market consequences. Importantly, such violations raise the likelihood of downgrades and bankruptcy of firms, especially for leveraged loans most commonly held by Collateralized Loan Obligations (CLOs).

For CLOs and other major institutional investors, regulation and portfolio constraints often require loan sales ahead of or immediately after a covenant breach. Combined with the growing liquidity of the secondary loan market, already exceeding USD 900 billion in annual trading in 2025, these frictions create ample opportunity and incentive for anticipatory trading before borrowers violate covenants. Yet, despite their importance, our understanding of whether and how institutional investors trade in advance of anticipated covenant violations, and how these actions interact with renegotiation outcomes, remains limited.

A key barrier is data: The literature mainly relies on two methods to identify covenant violations, either using reported data on financial covenants in Dealscan (Chava & Roberts, 2008) or using text searches on regulatory Securities and Exchange Commission (SEC) filings (Nini, Smith, & Sufi, 2012).[1] Both approaches have shortcomings. While the thresholds of covenants frequently change until the loan matures making it difficult to identify covenant violations using the originally reported thresholds in Dealscan, a text-search approach on SEC filings has limitations, for example, because of the complex language structure in regulatory filings. Importantly, both approaches overlook the adjustments and creditor interventions tied to different loan renegotiation outcomes, which is a key innovation of our approach.

"CovenantAI" is an advanced artificial intelligence (AI)-based methodology to identify covenant violations that offers several key advantages for academic research. It generates a comprehensive, time-series dataset of covenant violations covering all SEC filings, providing

[1] A few other papers use confidential SNC data from the Federal Reserve Bank Chodorow-Reich and Falato (2022); Haque and Kleymenova (2023). Other papers identify covenant violations by calculating violation probabilities using the approach outlined in Demerjian and Owens (2016), Li, Wang, and Wruck (2020), Bushman, Gao, Martin, and Pacelli (2021),or Christensen, Macciocchi, Morris, and Nikolaev (2022).

a more up-to-date and inclusive analysis compared to traditional methods.[2] Unlike keyword-based approaches, CovenantAI interprets the *context* within regulatory filings, enhancing both accuracy and consistency in identifying covenant violations. Additionally, it can exploit complex language structures to identify nuanced situations, such as pre- and post-violation loan amendments and waivers. Its adaptability and scalability allow it to easily incorporate new data and adjust to changes in financial reporting standards, making it a highly flexible tool for ongoing research. Leveraging this new dataset, we study whether constrained institutional investors, particularly CLOs, strategically divest in anticipation of covenant violations and assess how these trading patterns are linked to subsequent loan price dynamics, abnormal returns, and firm outcomes.

Our initial contribution is methodological, as we present CovenantAI, a tool that enables researchers to extract quarterly information on covenant violations for nearly all U.S. firms directly from their 10-K and 10-Q SEC filings. The model is calibrated using over 580,000 filings, identified through the CIK numbers of the full range of Compustat firms. We apply a small set of filters (as described in detail in Section 3). Our final dataset comprises 11,851 U.S. publicly listed, non-financial firms over the 1996 to 2024 period.

A manual inspection of SEC filings reveals that loan renegotiation outcomes are more complex than previously recognized in the literature. These outcomes include amendments without covenant violations, amendments following violations, combinations of amendments and waivers (where lenders temporarily waive covenant compliance), pure waivers, and technical defaults (where a covenant violation occurs without an amendment or waiver within two quarters).[3] These distinct outcomes reflect varying levels of covenant violation severity that must be carefully accounted for in the analysis. We train a Large Language Model (LLM) to classify our data into categories of covenant violation severity. This is a new lens through which to analyze covenant breaches and reframes violation away from a binary flag to a taxonomy of creditor-borrower renegotiation states, precisely the margin along which incomplete contracting theory predicts that creditor interventions should vary (Garleanu & Zwiebel, 2009) and on which

[2] Chava, Fang, Kumar, and Prabhat (2019) highlight that difficulty in data collection is an important factor impeding research on debt contracts and covenants. Zhu (2024) shows the relevance of accounting changes and misclassification risks associated with covenant violations. Dyreng, Ferracuti, Hills, and Kubic (2025) document measurement error in violation and slack constructed from commercial data.

[3] Chen and Wei (1993) and Beneish and Press (1993, 1995), for example, study how technical defaults are resolved, waiver decisions and the determinants of creditor forbearance.

empirical evidence documents heterogeneous outcomes (Denis & Wang, 2014; Roberts, 2015).

To validate the reliability of CovenantAI for this purpose, we benchmark its classification accuracy against widely used approaches by Nini et al. (2012) and Roberts and Sufi (2009), focusing on a random sample of 102 firm-quarters where the models disagree. Using confusion matrices to compare a binary classification of violation versus no violation, our results show that CovenantAI achieves a much higher accuracy of 79.41%, outperforming both manually adjusted and simple keyword-based methods. In contrast, the approach by Roberts and Sufi (2009) shows only 45.10% accuracy. Moreover and despite a manual adjustment on top of the keywords-based approach, Nini et al. (2012) only finds 66.2% of the covenant violations that are correctly classified in CovenantAI. Roberts and Sufi (2009), however, only identify 27.8% of these violations. Overall, this comparison underscores the advantages of using a LLM to accurately identify covenant violations in SEC filings.

Violations trend downward over the last two decades, consistent with (Griffin et al., 2024), but remain strongly cyclical, spiking during the 2001-2003 dot-com bust, rising again in 2008-2009, and surging by about 50% during COVID-19. The long-run decline is largely accounted for by loan amendments after covenant violations, waivers and technical default, while amendments before violations remain surprisingly persistent.

With CovenantAI at its centre, we construct a novel data set using different sources, which we explain in detail in Section 3. We obtain daily secondary loan market data for U.S. firms from LPC Refinitiv over the 1999 to 2024 period. While this dataset does not obtain transaction data, it comprises bid, ask and mid-quotes as well (for a subset of loans) the dealer banks providing quotes on any given day. Prior literature uses these mid-quotes as a proxy for transaction prices and bid-ask spreads as a measure of loan liquidity (see, for example, Saunders, Spina, Steffen, and Streitz (2025) and the literature cited therein). To study loan level transactions (buying and selling) around covenant violations, we turn to CLOs.

CLOs are actively managed closed-end funds and the largest investors in leveraged loans, which are syndicated term loans to large speculative-grade companies. We obtain data about portfolio holdings of CLOs as well as actual loan transaction data from LPC Collateral. The organizational structure of CLOs results in noticeable differences in the level of discretion managers have to trade portfolio assets. Specifically, this discretion for CLO managers to

make trades is confined primarily to the initial reinvestment period set at the CLO's issuance, typically lasting around 5 years. Beyond this period, their trading discretion is significantly limited, transforming CLOs into largely passive entities.

Importantly, CLOs are typically not involved in the renegotiation process. Berlin, Nini, and Edison (2020) show that most leveraged term loans are covenant-lite and part of so-called "split loans", that is, the same deal contains a revolving (credit line) facility with the same seniority. Covenants are at the credit line level and ensure monitoring and renegotiation by the banks holding the credit line. Cross-default clauses ensure that renegotiation results carry over to the institutional term loan. CLOs can thus respond to the likelihood of covenant violations through their initial portfolio allocation and buy and sell decisions before violation outcomes are resolved.

Consistent with this view, our sample statistics reveal differential institutional investor concentration in leveraged loans: CLOs hold predominantly below-investment-grade borrowers with leverage ratios 2.1 times higher than the broader syndicated loan market, and 16.0 percentage points higher violation frequency. Critically, within violating loans, CLO portfolios show markedly different resolution patterns, 44% involve pre-violation covenant amendments compared to 33% in the full sample, suggesting CLOs preferentially hold loans where renegotiation precedes formal breaches. This composition difference reflects CLOs' strategic portfolio positioning around covenant violation risk. Moreover, loans held by constrained CLOs (45% of sample holdings) experience substantially worse credit fundamentals conditional on violation: firms experiencing technical defaults show ROA of -0.28 and interest coverage of -1.94, yet these distressed loans are substantially smaller (USD 201.3 million) and concentrated among fewer lenders (6.13), limiting borrower flexibility for proactive covenant renegotiation and are consistent with loan divestment incentives for constrained CLOs.

We first document a persistent decline in loan prices in the 100 days prior to a covenant violation using our secondary loan market data and mid-quotes (Section 5). There are noticeable drops in loan prices specifically around 80 days before a covenant violation occurs. We then compute abnormal returns using the same secondary loan market data data for different time windows. As benchmark returns we use (a combination of) the ICE BofA US Corporate Index, the ICE BofA US High Yield Index, the yield on a 3-month Treasury Bill, the change in the

S&P 500 Index and the change in the LSTA index (constructed from daily prices of loans in the LSTA Morningstar Leveraged Loan Index). Consistent with the price drop around 80 days before covenant violations, we find the largest (and statistically most significant) cumulative abnormal returns of -6.39% for the [-80,-60] window. This effect is also economically large.

Do CARs increase with the severity of the covenant violation? We address this question in Section 5.3 in the paper. The literature has largely focused on the "event" covenant violation but not on how they are resolved. Yet, outcomes like waivers, which temporarily maintain original contract terms without penalties, are possible. Notably, waivers usually follow violations, whereas amendments can occur before. This allows us to categorize amendments as either violation-related or independent. Additionally, firms might initially receive waivers, later leading to mandatory loan term adjustments post-waiver. This differentiation is economically significant. Proactively negotiating amendments before violations can place companies in a stronger position, possibly gaining better terms. In contrast, firms amending post-violation may confront tougher negotiation conditions.

We first plot the daily average price of loans that record a covenant violation by violation outcome. As expected, prices of loans that are amended before a violation show hardly any price movement. Price drops of loans that experience covenant violations and are either amended or remain in technical default, however, show noticeable price declines. While loan prices of firms in technical default show the most pronounced decline before the covenant violation, the CARs are larger but statistically insignificant specifically in the [-80, -60] and [-60, -40] windows, suggesting that loan performance is driven by deteriorating fundamentals. Loans with amendments post covenant violations exhibit the most negative significant CARs throughout most event windows. For example, during the [-80,-60] event window, the CAR is approximately -6.283%. Amendments before violations show much smaller CARs, though these remain statistically significant.

Our results are not driven by a decrease in liquidity during these event windows. We compute bid-ask-spreads and do not find an economically large decrease in loan market liquidity for the different violation outcomes. Moreover, the number of dealers providing bid and ask quotes as market makers does not meaningfully decrease compared to a pre-event window. Overall, these results suggests that investors trade out of loan positions for which they anticipate

future – and more severe – covenant violations.

We obtain detailed data for loan portfolio holdings and loan trades for the largest group of institutional investors, CLOs, that allows us to explore the motivation for these investors in more detail. We first ask why CLOs might care about covenant violations. One primary rationale stems from regulatory obligations. To protect senior tranche investors in CLOs from default risks, there are several portfolio constraints, such as portfolio diversification and, importantly, leverage restrictions, particularly maintaining certain Over-Collateralization (OC) ratios. Managers are required to keep these ratios above specific thresholds to mitigate insolvency risks. The OC ratios are regularly monitored, and failing to meet them can have severe consequences for CLO managers, like not receiving fees and damaging their reputation.

Thus, as a first step, we show that covenant violations increase the likelihood that borrowers are downgraded or file for Chapter 7 or 11 bankruptcy. We use our quarterly information about covenant violations from CovenantAI and investigate the impact of covenant violations on firm default and downgrades using common approaches found in the literature (Roberts & Sufi, 2009; Nini et al., 2012). We find that IG-rated firms do not experience an increase in either the likelihood to file for bankruptcy or to be downgraded. There is a sizeable economic effect among Non-IG firms, though, exactly for those firms whose loans are purchased by CLOs. In the four (eight) quarters after a covenant violation, these firms are 4.2% (6%) more likely to default and about 1.8% more likely to be downgraded. The effect of violations on bankruptcy risk among unrated firms is much smaller. Consistent with our hypothesis that different violation outcomes represent also scenarios of varying severity for companies, we find that non-IG rated firms, those that secure amendments before the violation occurs experience a lower likelihood of default compared to firms that obtain amendments or waivers post-violation or remain in technical default. For example, the likelihood that a firms files for bankruptcy after a technical default is between 17.6% and 19% higher, the likelihood to experience a downgrade is about 5% to 6% higher. Overall, our results suggest that there is a significant increase in both downgrade and bankruptcy likelihood particularly among the leveraged (Non-IG rated) loans usually purchased by CLOs. In other words, CLOs, especially those already constrained with regard to their leverage, might need to offload these loans before a violation occurs.

We then measure CLO leverage constraints using data on monthly OC ratio tests obtained

from Creditflux. Following earlier literature (Elkamhi and Nozawa (2022); Fleckenstein (2025); Kundu (2026)) we restrict our sample to those CLOs still in their reinvestment period and compute slack in the OC ratio as the difference between reported OC ratios and the threshold value and use a simple average to compare CLOs across the years. As expected, leverage constraints are more likely for junior tranches. The average CLO has an OC ratio slack for junior tranches ranges from 1.87% to 5.87%. Slack is lower during periods of widespread economic stress, e.g. in the GFC or COVID-19 period. Also the percentage of CCC rated loans relative to CLO assets is very cyclical and likely affects CLO decision to buy and sell loans. During periods of economic stress (such as the GFC or COVID-19) the ratio of CCC loans increases substantially and above the regulatory threshold of 7.5%. In fact,since 2016, CLOs have, on average, exceeded this threshold in every single year. Relative to the share of these risky loans, the junior OC ratio slack is thin, which may constrain CLOs' portfolio choice once hit by adverse events.

In Section 6.3, our focus shifts to examining the influence of constrained CLOs on the CARs surrounding covenant violations. Our findings confirm their significant impact. Initially, we plot the mid-quotes of loans for the 100 days leading up to covenant violations, distinguishing between those held by constrained and unconstrained CLOs. Our analysis reveals that loans in the portfolios of constrained CLOs experience earlier and more pronounced price declines prior to the violation, particularly around 80 days before the violation.

We test this more formally and regress the CARs in the [-80,-60] event window on a measure of CLO portfolio constraints. We initially categorize the loans into two groups: constrained and unconstrained. A loan is classified as constrained if its slack is below the median slack observed among all CLOs on that specific date. Conversely, if the slack exceeds the median, the loan is considered not constrained. We then compute the weighted percentage of constrained CLOs in a loan. This is calculated by dividing the total deal amounts of the constrained CLOs by the aggregate deal amount for that loan. Consistent with our hypothesis, we find that if the share of the loan owned by constrained CLOs is higher, CARs before covenant violations are more negative.[4]

[4] There is a growing literature on the importance of non-bank intermediaries and in particular CLOs. In particular,the rise of CLOs has led to lower credit spreads and more credit for firms during booms (Ivashina & Sun, 2011; Shivdasani & Wang, 2011; Nadauld & Weisbach, 2012), but also a stronger reduction of credit and a larger increase in credit spreads during busts (Fleckenstein, 2025; Fleckenstein, Gopal, Gutiérrez, & Hillenbrand, 2025). Other papers on CLOs have studied the adverse selection of loans into CLOs (Benmelech,

Price declines are consistent with anticipatory trading, but they do not reveal who trades or in which direction. Using CLO transaction-level data from LPC Collateral, we trace the actual flow of loans between constrained and unconstrained CLOs in the weeks before covenant violations. Constrained CLOs are persistent net sellers across all violation categories, while unconstrained CLOs absorb these positions as net buyers over the same period. The magnitude and timing of this divergence varies systematically with violation severity. For loans that eventually obtain amendments, the constrained–unconstrained gap in net trading volume emerges gradually. For waived loans, unconstrained CLOs accumulate large net positions in the final weeks before the violation, consistent with informed rebalancing as resolution uncertainty declines. The starkest separation arises for loans that remain in technical default: constrained CLOs sell aggressively throughout the pre-violation window while unconstrained CLOs build net long positions, producing a sustained and widening wedge between the two groups. This severity gradient rules out a mechanical portfolio-rebalancing explanation – if constrained CLOs sold indiscriminately ahead of anticipated credit events, the trading pattern would not vary with violation outcomes that are realized only ex post. The evidence points to anticipatory risk transfer: constrained CLOs divest selectively from loans with the worst expected resolution, and unconstrained CLOs – facing no OC-test pressure – provide the liquidity by absorbing these positions at discounted prices.

Taken together, the results establish three facts. First, loan prices decline significantly in the months before covenant violations, with magnitudes that increase in violation severity. Second, loans held predominantly by leverage-constrained CLOs experience steeper price declines and larger negative abnormal returns. Third, constrained CLOs are net sellers and unconstrained CLOs are net buyers ahead of violations, and this trading asymmetry is strongest for the most severe violation outcomes. These findings show that institutional portfolio constraints interact with contract-level credit events to generate anticipatory trading and systematic risk reallocation within the CLO sector.

Dlugosz, & Ivashina, 2012; Bord & Santos, 2015) and CLO performance (Cordell, Roberts, & Schwert, 2023; Fabozzi, Klingler, Mølgaard, & Nielsen, 2021). Others find that trading can be value destroying because CLO managers sell risky loans at fire-sale prices to avoid OC test failures (Loumioti & Vasvari, 2019; Elkamhi & Nozawa, 2022; Kundu, 2024) – in particular loans of firms they have no relationship with (Bhardwaj & Mukherjee, 2022) – which has real effects for affected firms (Kundu, 2026).

# 2 CovenantAI

To investigate the trading behavior of institutional investors in leveraged loans around covenant violations, we first create a novel dataset of covenant violations and their respective severity (i.e., amendments, waivers or technical default). More precisely, we develop a new machine learning (ML) algorithm to identify covenant violations, which we call "CovenantAI". We provide a summary of this approach in this section, and refer the reader to the Online Appendix for a detailed technical discussion.

## 2.1 SEC filings

The main datasource to develop CovenantAI are regulatory (SEC) filings. Companies issue 10-K reports annually at fiscal year-end, and 10-Q reports for the first three quarters. If a firm reports only three quarters, its 10-K includes the fourth quarter data, and we combine 10-K and quarterly filings to ensure continuity in our dataset. Covenant violations appear in both annual and quarterly reports. 8-K reports, issued immediately following specific events including covenant violations, provide further relevant information such as the timing of the violation.

In total, we extract 132,591 10-K, 451,826 10-Q, and 1,285,768 8-K reports over the 1996 to 2024 period from the SEC Edgar database.[5] As we describe further below and in contrast to other machine learning models, we do not need to further clean these reports as our model interprets the *context* of complete sentences. We develop a data frame capturing paragraphs including 700 characters surrounding the term "covenant." The source files vary in format, newer ones are presented as HTML and older ones as txt filings. We confirm that HTML-based paragraphs adhere to the 700-character limit, as the model cannot process beyond this limit. To optimize labeling of paragraph by our algorithm, we apply a filter to our dataset that highlights paragraphs containing specific words or combinations of words that suggest possible covenant violations and amendments.[6] To verify its accuracy, we randomly sample a subset of our data

[5] In 2009, the XBRL filing program became mandatory for all companies. This filing program ensures a standardized structure for all reports.

[6] We flagged paragraphs as potential amendments or violations if they contained the following specific words: "amends", "waived", "amending", "violate", "amendment", "amended", "violations", "waiving", "violating", "violates", "waives", "amendments", "compliances", "compliance", "amend", "waive", "violation", "violated".

and verify that violations and amendments are correctly classified. Overall, this method yields 1,081,905 paragraphs containing the word "covenant." These paragraphs are then processed and labeled as described below.

## 2.2 Algorithm

A manual inspection of the SEC filings suggest that loan renegotiation outcomes are more complex than the previous literature suggests. For example, there are loan amendments without covenant violations, amendments after covenant violations, waivers (i.e., a situation in which a lender temporarily waives covenant compliance), or technical defaults (i.e., when covenant violations remain unresolved).[7] CovenantAI can account for these different renegotiation outcomes. We provide a brief overview of the design of this new ML algorithm below and refer the reader to Section B of the Online Appendix for an in-depth (technical) discussion.

**Step 1-Labeling**. Building a robust machine learning model to identify covenant violations requires a clean and representative dataset. Ensuring diversity while preventing duplication and data leakage is key to maintaining model integrity and reliability. To address possible duplication and leakage concerns of training and test datasets (Kapoor & Narayanan, 2023), we apply a two-step approach to all paragraphs containing the word *covenant*. We first select only one paragraph per firm out the whole sample of covenant paragraphs and then apply the "Jaccard Similarity Index" to identify and remove duplicates within the sample of paragraphs.[8] The Jaccard Similarity Index is a statistical measure that helps understanding the similarity between finite sample sets that is particularly effective in comparing the presence of words in both samples (Prakoso, Abdi, & Amrit, 2021). This method reduces the dataset from 1,081,905 paragraphs to 14,335 unique paragraphs.[9]

The final manual dataset consists of three parts, the first is a random selection of 2,000 paragraphs out of the previously created unique paragraphs sample. The second manual dataset is extracted quasi random. To make the training of the model more efficient for all classes, we

[7] We combine amendments after covenant violations and amendments and waivers as they are economically similar.

[8] We also ensure that for this selection underlies an equal distribution of years.

[9] To identify similar paragraphs, we start by converting the paragraphs into sets of words. We then calculate the Jaccard Similarity Index, where we use an threshold of 0.5 to eliminate similar paragraphs. After eliminating those paragraphs above the threshold leads to a dataset of 14,335 unique paragraphs that are dissimilar to each other

select the other two parts of the dataset to make the sample more balanced to the different groups. The second sample consists of 2,084 paragraphs, which we balanced by adding more non-zero labeled paragraphs. We conduct a keyword search within the remaining paragraphs of the unique sample paragraphs to identify terms indicating potential violations or amendments, providing a preliminary basis for labeling. 21.35% of the data are labeled as technical defaults, 7.39% of the paragraphs are amendments after violation, 7.29% are waivers and 19.48% are amendments without violations.

Since these two datasets have only a few instances of the *Amendment w/ Violation* class, we add 100 artificially created paragraphs for this label to the manual dataset. This step ensures a more efficient training of the *Amendment w/ Violation* class. The final manual dataset consists of 4,184 observations, which are specific, balanced and unique ensuring a high quality dataset for training and testing our model. To ensure a high-quality labeled dataset, each of the 4,184 selected paragraphs was independently labeled by two individuals: either one of the authors or a trained research assistant. Disagreements occurred in less than 1% of cases, providing strong evidence of accuracy and consistency in the labeling process.

To train the classification algorithm and evaluate model performance, we manually labeled a subset of paragraphs to serve as ground truth. Each paragraph was categorized into one of six groups: *No Violation* (label 0), *Amendment without Violation* (1), *Waiver* (2), *Amendment and Waiver* (3), *Amendment with Violation* (4), or *Technical Default* (5). *No Violation* is assigned when there is no evidence of a breach; *Amendment with Violation* indicates a loan modification to cure a violation; *Technical Default* applies when neither an amendment nor a waiver occurs within two subsequent quarters. Section B of the Online Appendix provides SEC filing examples for each category. The resulting manually labeled dataset has the following distribution across categories:

The random dataset represents the true distribution of the overall sample. There are 3.7% instances of *Technical Defaults*, 2.2% instances of *Amendments w/ Violation*, 4.3% instances of *Waivers* and we detect *Amendments w/o Violations* in 5.65% of the cases.

In our overall sample, there are 519 (12.71%) instances of *Technical Defaults*, 198 (4.85%) of *Amendments w/ Violation*, 238 (5.83%) of *Waivers*, and 519 (12.71%) of *Amendment w/o Violation*. This distribution results from our sampling method, which is designed to balance

the dataset for training and validation.[10]

**Step 2-Classification**. We divide the labeled sentences into three datasets: training (70%), testing (15%), and validation (15%).[11] Each dataset reflects different proportions of technical default, waiver, amendment with violation, amendment without violation, and no-violation observations, and is used to calibrate and evaluate model performance. The test set is constructed solely from a fully random sample to assess accuracy on the true underlying distribution.

For our analysis, we use the MPNet Sentence Transformer, an advanced language model.[12] In short, this model transforms complete sentences into numerical representations, making them suitable for machine learning tasks. It excels at distinguishing between different classes in our dataset by capturing the unique characteristics of each type. Its ability to learn both similarities and differences among categories enables more accurate classifications, which is essential for identifying and categorizing different events, such as technical defaults, amendments, or no violations.

A key advantage of CovenantAI is its ability to interpret complex language structures, allowing us to distinguish between types of loan amendments and covenant outcomes. Violations can result in different resolutions: a waiver (typically granted after a violation and often temporary), an amendment (which may occur before or after a violation), or a sequence involving both. These distinctions matter economically: firms that secure amendments before breaching covenants are likely in a stronger negotiating position and may obtain better terms, while firms amending after a violation often face stricter conditions. During training, the model minimizes error on the training set, while validation data monitor performance and help tune hyperparameters to prevent overfitting. The test set, used only after training, provides an unbiased measure of model accuracy.

Model performance is shown in Panel A of Table 1 for our test data (628 observations). The confusion matrix summarizes how accurately the model assigns each class by comparing

[10] However, this sample is not fully representative of the five categories; a random sample from our full dataset indicates a mean technical default rate of about 3.7%, reflecting a more accurate distribution.

[11] We tested the model using various splits for test, training, and validation set sizes. See Section C in the Online Appendix.

[12] We choose the MPNet sentence transformer because it performs efficiently in sentence similarity and classification tasks, which are crucial for identifying covenant violations. Building on traditional BERT models, MPNet combines masked language modeling with permutation modeling (as in XLNet), allowing it to capture complex sentence dependencies effectively. We integrate MPNet within the Sentence-BERT framework, leveraging its strengths to generate high-quality sentence embeddings. This combination is well-suited for analyzing financial documents, as it accurately captures sentence context and nuances important for classifying covenant violations.

predicted versus actual outcomes. The model achieved 92.17% accuracy on the test set (and 90.95% on the validation set as shown in the Online Appendix), correctly identifying 87% of violations, 93% of amendments with violation, 89% of waivers, 89% of amendments without violation, and 84% of non-violations in the test data. We also report precision and recall in Panel B of Table 1. Precision measures the proportion of predicted violations that are correct, minimizing false positives, while recall measures the proportion of actual violations the model identifies, reducing false negatives. We calculate both macro averages (simple averages across categories) and weighted averages (accounting for category size). The model achieves approximately 91% precision and 93% recall using macro averages, and 94% for both using weighted averages. Additional details are provided in Section C of the Online Appendix.

**Step 3-Full sample analysis**. We merge the 10-K/10-Q data and the quarterly covenant violation data from our machine learning algorithm using the reporting date from the SEC filings. We extract the date that is mentioned within the 700 characters and calculate a difference column to check the distance between the reporting date of the SEC filing and the covenant violation date mentioned in the filing. If the difference between both is larger than 180 days, we do not count the observation as a violation, as it contains information about a previous violation that has already been reported (and recognized as such by our model). We apply the same machine learning algorithm to the 8-K filings to validate our results. 8-Ks give us real-time information because they need to be filed within four days after the event. In cases where a Technical Default is succeeded by an Amendment with Violation, an Amendment with Violation/Waiver, or a Waiver within the subsequent two quarters, it is not classified as a Technical Default.

Applying our algorithm using these criteria, we obtain 19,048 (3.36%) loan amendments without violation, 7,336 (1.26%) amendments after a violation, 7,536 waiver (1.33%) and 5,475 (0.97%) observations with firms in technical default for all firm quarters. The number of firm quarters in which we find a "new" technical default is 2,850 (0.50%), a "new" waiver is 4,425 (0.78%), a "new" amendment with violation is 3,844 (0.68%) and in which we find a "new" amendment without violation is 9,499 (1.68%).[13]

[13] We mark the variable as new if the respective outcome did not occur in the previous two quarters.

## 2.3 Benchmarking CovenantAI

Understanding when and how covenant violations occur is central to identifying periods of institutional trading pressure in loan markets. To validate the reliability of CovenantAI for this purpose, we benchmark its classification accuracy against widely used approaches by Nini et al. (2012) and Roberts and Sufi (2009), focusing on a random sample of 102 firm-quarters where the models disagree. For comparability, we collapse outcomes into a binary violation/no violation measure: Violation equals one if a waiver, an amendment with violation, or technical default is observed; otherwise, it is coded as zero.

Panel C of Table 1 presents the confusion matrices comparing CovenantAI, the Nini et al. (2012) approach, and the Roberts and Sufi (2009a) Dealscan labeling, based on the 102-sample where methods disagree. CovenantAI achieves the highest classification accuracy at 79.41% (sum of true positives for No Violation and Violation: 25.49% + 53.92%), followed by Nini et al. with 53.92% accuracy (7.84% + 46.08%), and Roberts and Sufi (2009a) with 52.74% (4.9% + 47.84%). The keyword-based Roberts and Sufi approach yields the lowest accuracy at 45.10% (38.24% + 6.86%).[14] These results demonstrate that CovenantAI provides more reliable identification of covenant violations in challenging cases, which is critical for robust empirical analysis of trading around these events.[15]

## 2.4 Time-series of covenant violations

Figure 1 plots the annual incidence of each major covenant violation outcome (waiver, amendment with violation, amendment without violation, and technical default) as identified by CovenantAI during the 1996 to 2024 period. The figure shows that amendments without violation are most frequent, while technical defaults and waivers occur less often. All violation types display clear cyclical fluctuations, with noticeable spikes around identified NBER recession periods (shaded), and an especially pronounced increase during the COVID-19 recession. This highlights substantial time-variation and economic sensitivity in both the frequency and type of covenant violations.

[14] Online Appendix X shows examples of paragraphs where CovenantAI does not agree with the labeling of the keyword based approach.

[15] Dyreng et al. (2025) also highlight possible measurement risk associated with these alternative approaches.

# 3 Data Sources

To investigate trading behavior of institutional investors around covenant violations, we obtain data from different data sources. Our main data set is the intersection of data on daily secondary loan market trading and firms that report covenant violations in their SEC filings (and which are identified using CovenantAI). While we do not observe actual trading of loans or the parties who are involved in these trades (except the dealer banks) in this data set, this is the most comprehensive source to identify trading patterns before or around covenant violations.

In a second step, we construct a novel data set at the intersection of secondary loan market data, covenant violations and holdings and trading data of Collateralized Loan Obligations (CLOs), who are the largest investors in leveraged loans. For a subset of our data, we can thus observe trading (buying and selling) of a large group of investors in this market and exploit cross-sectional variation in our data to link the trades around covenant violations to investor characteristics.

## 3.1 Secondary loan market trading

Over the last two decades, the U.S. secondary market for corporate loans has developed into an active and liquid dealer-driven market, where loans are traded like debt securities. This allows the observation of daily price quotes even for private claims, which can be traded by institutional investors legally in possession of material non-public information. This market has developed into a liquid market for private debt claims since 1995, when the Loan Syndication and Trading Association (LSTA) standardized loan contracts and procedures. In 2022, the annual secondary market trading volume reached USD 824 billion (afterwards declined to USD 715 in 2023, though) and the underlying debt claims reached a notional volume of about USD 1.5 trillion at this time (Figure 2).

We use a novel dataset provided by Refinitiv comprised of daily secondary market quotes for corporate loans spanning December 1999 to March 2023. Loan sales are usually structured as assignments,[16] and investors trade through dealer desks at underwriting banks. The data contain daily bid and ask quotes from over 35 dealers that represent over 80% of the sec-

[16] In assignments the buyer becomes a loan signatory. This facilitates trading as ownership is transferred from seller to buyer. In contrast, in participation agreements the lender retains official ownership.

ondary market trading. A recent literature has shown that price quotes provide an accurate representation of prices in this market (Addoum & Murfin, 2020; Berndt & Gupta, 2009).[17]

The secondary loan market appears to be sufficient liquid for institutional investors to effectively trade their positions. Figure 3 plots the median bid-ask spread (scaled by the mid-quote) over the 1999-2023 period as well as the interquartile range (grey area). The median bid-ask spread in the 1999 to 2023 period is 87 bps. For comparison, (Feldhütter & Poulsen, 2018) report an average bid-ask spread for the U.S. bond market of 34 bps over the 2002 to 2015 period.

**Loan origination data.** We complement pricing data with information about the underlying loans from Refinitiv Dealscan. This includes information on various loan terms such as loan size, maturity and interest rates. The databases are merged using the Loan Identification Number (LIN), if available, or else a combination of the borrower name, dates, and loan characteristics.

**Borrower information.** We extend the Chava and Roberts (2008) Dealscan-Compustat link to 2022 and map Compustat firms to our secondary loan market data. Overall 54% (46%) of firms in the secondary loan market data are public (private) firms. We obtain quarterly information about our publicly listed from Computstat/CRSP (and Capital IQ ) can be merged using the GVKEY-CIK identifier. Credit rating information is sourced from S&P. Our information contains the long-term issuer ratings as well as the rating data and unique company ID.

## 3.2 CLO loan holdings and trading

We obtain data on CLOs' security-level portfolio holdings and transactions from the LPC Collateral database provided by Refinitiv. These data are sourced from Trustee Report over the 2005 to 2023 period. If in a given quarter multiple reports are available for a CLO, we include only data from the last report. We restrict the sample to CLO predominantly invested in U.S. dollar denominated syndicated loans.

We also keep credit rating information from the rating agencies Moody's, S&P, and Fitch,

[17] There is little public information about dealers who provide quotes. However, the data identifies dealer banks for a subsample of loans. We show a snapshot of the Top 10 dealer banks in Table A1. The top 25 dealers account for about 90% of all quotes. We rank dealers by their market share in the secondary loan market and underwriter market share in the primary loan market and find a correlation of 0.87.

which we convert to numerical scores following the classification in Becker and Milbourn (2011). For comparability, all rating references are translated to the S&P scale. Additionally, I collect information on a CLO's manager, issue date, reinvestment period and legal maturity date.

The LPC Collateral database covers about 80% of the market for our sample period.[18] On average, each issuer's loans are held in 250 CLOs. We limit the analysis to firms that received a syndicated loan, as indicated in Refinitiv DealScan, to ensure comprehensive coverage across datasets.

The trading data shows the individual transactions of the CLO within each month and provides information such as the activity itself (buy or sale), the transaction amount and price, trade as well as settlement date. We also compute a measure of loan market liquidity based on these transaction data and plot the Amihud (2002) iliquidity measure together with the bid–ask spread for all loans in the *Morningstar LSTA US Leveraged Loan TR USD* index in Figure 3. Noticeably, the Amihud measure based on transaction data exhibits higher volatility and spikes. The cross-sectional correlation, however, is high ($rho = 0.54$).

We can match the loan to the holdings data, Refinitiv Dealscan and the secondary loan market data via the LIN number. This allows us to broaden the scope of our analysis as we can, for example, compare the bid-ask quote provided by dealer banks to the transaction price at which it was executed and link the transaction to overall loan market liquidity.

**CLO overcollateralization test.** We augment our CLO holdings and trading data using collateralization (OC) test results of CLOs on a monthly basis from the Creditflux CLO-i database. CLO-i report the current OC ratio as well as the threshold level for each CLO. As there is no identifier of CLOs across both data providers, we use a fuzzy string match between the CLO names in LPC Collateral and Creditflux. We describe this more in detail in Section 6.1.2 below in this paper.

## 3.3 Sample construction

We employ multiple samples with increasing specificity depending on our analysis as shown in Table 2. Our foundation is the CovenantAI sample (14,792 firms, 537,804 firm-quarters) containing machine-learning-detected covenant violations for all U.S. public firms. We merge

[18] We use the International Monetary Fund's figures on total outstanding US CLOs to compute this (International Monetary Fund (2020)).

this with Dealscan syndicated loans (3,999 firms, 15,124 loans, 104,359 firm-quarters) to obtain loan information. For analyses of secondary market pricing effects around covenant violations including loan specific information, we further restrict to loans with available transaction-level prices (891 firms, 2,388 loans, 15,033 firm-quarters). However, for our primary analysis of CLO institutional investor trading behavior around covenant violations, we impose the most restrictive requirements: CLO holdings data from LPC (648 firms, 1,611 loans, 11,676 firm-quarters), CLO transaction records (598 firms, 1,476 loans, 10,624 firm-quarters), and CLO overcollateralization constraint metrics from Creditflux. This stringent subsample of 598 firms with 1,476 loans ensures we directly observe covenant violation events, CLO portfolio positions, actual buy-sell transactions, and investor-specific regulatory constraints, both essential elements for examining whether constrained institutional investors trade in anticipation of covenant violations.

## 3.4 Descriptive statistics

**CovenantAI.** Panel A of Table 3 shows statistics related to CovenantAI. In total, we obtain data on 11,428 publicly listed firms in the US via their regulatory filings. On average, about 47% of all firms in our sample violate a covenant at some point during our sample period. Firms might have multiple consecutive violations over time that result in different violation outcomes. 15%, on average, stay in technical default and 28% (33%) amend their contracts after (before) a covenant breach. While 2% of firms default during our sample period, about 87% experience a downgrade at some point during our sample period. The average credit rating is 12.26, which corresponds to a BBB- rating.

**Secondary loan market sample.** The sample contains 14,874 loans to U.S. non-financial firms. We exclude credit lines and special loan types (4,830 loans), i.e., we restrict our sample to term loans.[19] Term loans are fully funded at origination and typically mostly repaid at maturity, i.e., the cash-flow structure is similar to bonds. We require that loans can be linked to LPC's Dealscan and remove loans with a remaining maturity of less than one year. We further exclude loans to private firms resulting in a final sample of 6,782 loans. Panel B of

[19] The vast majority of loans traded in the secondary market are term loans, as (non-bank) institutional investors typically dislike the uncertain cash-flow structure of credit lines Gatev and Strahan (2006, 2009). About 90% of loans in our secondary market dataset are institutional term loans (term loan B). Only around 10% are term loan A.

Table 3 shows summary statistics of loans traded in the secondary loan market. The average number of loans traded in a given year is 905 with an average bid (ask) quote of 95.47 (96.59) and a midquote of 96.03, respectively. The midquote is our measure for the "price" at which a buy/sell is executed. Loans carry a loan spread (which is the All-In-Spread-Drawn from Dealscan) of 362.52bps and the average maturity is 4.31 years; the mean bid-ask-spread is 0.02.

**CLO sample.** We then construct a second sample at the intersection of our secondary loan market data, CLO holdings, trading and collateralization test information and CovenantAI. We start with merging the secondary loan market data to the LPC Collateral database using the LIN identifier. This process results in 8,734 loans. Overall, about 70% of loans available in LPC Collateral could be matched to the Refinitiv Secondary Loan Market database. Panel C of Table 3 shows summary statistics of overall 8,734 loans in CLO portfolios. The average number of loans (# Loans) in a CLO portfolio is 532 with a mean rating of 14.55. The average spread is 430bps. The panel also shows the share of loans by credit ratings. Only 0.72% are IG-rated, 16.31% are BB-rated, 67.78% are B-rated and almost 4% are CCC rated. About 50% of loans in CLO portfolios are originated by public (private) firms. We then use the GVKEY-CIK mapping to link this merged dataset to CovenantAI. We drop all loans to private borrowers as CovenantAI only comprises information about publicly-listed firms.

## 3.5 Characteristics by Sample

Table 4 shows firm and loan characteristics across the different sample (e.g., CovenantAI, after merging with Dealscan, after merging with secondary loan market data, etc.) as well as differences in means. Panel A shows firm characteristics. Firms in the CLO sample (Column 4) differ systematically from the full CovenantAI universe (Column 1), with substantially smaller market capitalizations and higher leverage ratios. CLOs concentrate holdings in below-investment-grade borrowers (Panel B): B-rated loans comprise 19.88% of CLO portfolios versus 5.96% of CovenantAI firms, while CCC-or-below loans increase from 2.32% to 7.13%.

Violation patterns differ markedly across samples (Panel C). The "ever violate" rate declines from 32.79% (CovenantAI) to 16.78% (CLO data), suggesting CLOs strategically avoid serial violators. More importantly, the composition of violation outcomes shifts: technical defaults decline from 15.30% to 7.87%, while amendments before violations increase from 32.55%

to 43.36%. This composition shift indicates CLOs preferentially hold loans where proactive covenant renegotiation precedes formal violations, consistent with anticipatory divestment before technical defaults or post-violation amendments that trigger adverse price movements. CLO-held loans are also substantially larger and carry higher spreads (Panel D).

### 3.6 Violation outcomes, loan characteristics, and CLO ownership

Table 5 shows heterogeneity across firm and loan characteristics for different covenant violation outcomes. Panel A shows that firms experiencing technical defaults exhibit the weakest fundamentals one quarter before a covenant violation occurs: ROA of -0.28, interest coverage of -1.94, and Z-scores of 1.5, compared to ROA of 1.26 for firms receiving amendments before violations. Firms receiving waivers show intermediate credit quality (ROA of 0.21, interest coverage of -0.76), while firms obtaining post-violation amendments display ROA of 0.16. Firms that obtain amendments before a covenant violation exhibit the strongest fundamentals.

Panel B reveals systematic loan characteristic variation across violation types. Loans with no violations average 258.31 bps spreads and USD 421.25m facility size, while technical defaults carry 327.77 bps spreads but are substantially smaller (USD 201.3m) with fewer lenders (6.13). Loans receiving amendments before violations are larger (USD 335.39m) with lower spreads (288.52 bps) and more lenders (8.08), suggesting stronger fundamentals (with less monitoring needs) already at the loan origination stage.

Panel C documents CLO ownership patterns. The average loan is held by 150.38 CLOs (median 109), with 50% held by at least one top-10 CLO manager. The HHI of CLO ownership averages 0.1 (median 0.01), indicating dispersed ownership. Critically, 45% of sample loan holdings are owned by constrained CLOs—those with binding overcollateralization ratios—with substantial cross-sectional variation (interquartile range: 0.39 to 0.54).

## 4 Methodology

We use the merged Secondary Loan Market and CovenantAI dataset to study whether institutional investors trade in loans ahead of covenant violations. If a group of investors collectively sells loan positions in anticipation of a violation, and arbitrage capital does not flow to the market quickly enough, the resulting selling pressure may push loan prices below fundamental

values. We therefore test whether abnormal returns are observable before covenant violations and whether the price reaction is stronger when the expected violation outcome is more severe.

## 4.1 Measuring abnormal returns

We estimate cumulative abnormal returns (CARs) using the dummy-variable regression approach of Thompson (1985) and Karafiath (1988). For each loan $i$ with one or more covenant violations during the sample period, we estimate the following regression over the full daily time series:

$$r_{i,t} \;=\; \alpha_i \;+\; \sum_{s \in \mathcal{W}} \beta_{i,s}\, \mathbf{1}[t = s] \;+\; \boldsymbol{\gamma}_i' \, \mathbf{X}_t \cdot \mathbf{1}[t \notin \mathcal{W}] \;+\; \epsilon_{i,t} \tag{1}$$

where $r_{i,t} = P_{i,t} - P_{i,t-1}$ is the daily change in the secondary-market midquote of loan $i$ on day $t$, expressed in percentage points of par. Following Elkamhi and Nozawa (2022), we treat daily price changes as returns, since leveraged loans are quoted as a percentage of par. $\mathcal{W}$ denotes the set of trading days inside the event window (e.g., $[\tau - 80, \tau - 60]$ where $\tau$ is the covenant violation date), and $\mathbf{1}[t = s]$ is an indicator equal to one on event day $s$. $\mathbf{X}_t$ is a vector of benchmark returns and $\mathbf{1}[t \notin \mathcal{W}]$ is an indicator equal to one on all days *outside* the event window. Because the benchmark returns enter the regression only on non-event days, the factor loadings $\boldsymbol{\gamma}_i$ are estimated exclusively from observations unaffected by the event, and the event-day coefficients $\beta_{i,s}$ capture loan $i$'s return in excess of its unconditional mean on each day $s$ within the window. The cumulative abnormal return for loan $i$ over window $\mathcal{W}$ is:

$$\mathrm{CAR}_i(\mathcal{W}) \;=\; \sum_{s \in \mathcal{W}} \hat{\beta}_{i,s} \tag{2}$$

When a loan experiences multiple covenant violations, we include a separate set of event-day dummies for each violation, so that the CARs for distinct events are estimated jointly within the same regression while sharing common factor loadings.[20]

**Aggregation and inference.** We report average CARs computed as the equal-weighted cross-sectional mean $\overline{\mathrm{CAR}}(\mathcal{W}) = \frac{1}{N} \sum_{i=1}^{N} \mathrm{CAR}_i(\mathcal{W})$, where $N$ is the number of loan–violation observations. We compute $t$-statistics using cross-sectional standard errors, clustering at the

[20] This avoids the overlapping-window problem that arises with the traditional two-step approach of Brown and Warner (1985), where each event requires a separate pre-event estimation window. We verify robustness by also computing CARs using the Brown and Warner (1985) method; results are reported in the Online Appendix.

loan level to account for repeated violations of the same loan.

**Event windows.** We compute CARs for the following windows relative to the violation date $\tau$: $[-80, -60]$, $[-80, -1]$, $[-60, -40]$, $[-60, -1]$, $[-20, -1]$, and $[-1, +1]$. The pre-violation windows are motivated by the institutional setting: CLOs monitor borrower fundamentals on a quarterly basis and may begin divesting weeks or months before a formal covenant breach. The $[-1, +1]$ window tests whether the violation event itself conveys incremental information to the secondary market.

**Advantages over the traditional approach.** This specification has two advantages relative to the standard two-step method of Brown and Warner (1985), which estimates factor loadings on a pre-event window and then computes expected returns during the event window. First, covenant violations can occur multiple times for the same loan at short intervals. Under the traditional approach, computing CARs for a window such as $[-80, -60]$ requires at least 30 pre-event observations for factor-loading estimation, implying a minimum of 120 clean trading days per event—a requirement that is frequently violated when events cluster. The dummy-variable approach avoids this constraint by estimating a single regression per loan over the entire available time series, with event windows flagged by indicator variables. Second, because the factor loadings $\boldsymbol{\gamma}_i$ are estimated on all non-event observations rather than a short pre-event window, the estimates are more precise.

**Benchmark returns.** We use the following set of benchmark returns in $\mathbf{X}_t$, varying their combination across specifications to demonstrate robustness: (i) the ICE BofA US Corporate Index Effective Yield, which tracks investment-grade corporate debt (BAMLC0A0CMEY);(ii) the ICE BofA US High Yield Index Effective Yield, which tracks below-investment-grade corporate debt (BAMLH0A0HYM2EY);(iii) the 3-Month Treasury Bill yield (DGS3MO); (iv) the daily return on the S&P 500 Index; and (v) a self-constructed LSTA Index, computed as the facility-amount-weighted average of daily loan prices from LPC Refinitiv. This index has a correlation of 86.5% with the Morningstar LSTA US Leveraged Loan Index over the same period. Table 6 reports CARs for each event window under different benchmark combinations.

# 5 Price Impact of Covenant Violations

## 5.1 Loan prices before covenant violations

In a first step, we plot the daily average price of loans that record a covenant violation over the [-100,0] day period before a covenant violation occurs (Figure 4a). Loan prices have declined, on average, over the entire period. However, there are noticeable drops in loan prices, for example around 20 days before a covenant violation, and an even more pronounced decline in the window from 80 to 60 days *before* the violation. While we restrict our sample to borrowers experiencing covenant violations, there may be an overall market decline during these periods. Therefore, we compute abnormal returns to isolate the trading behavior of loans with covenant violations.

## 5.2 Cumulative abnormal returns

In a next step, we compute CARs using the methodology outlined above for the following event windows: [-80,-60]; [-80,-1]; [-60,-40]; [-60,-1]; [-20,-1]; [-1,+1]. Table 6 shows the results. We compute the CARs for the different event windows as well as for different combinations of benchmark returns to demonstrate the robustness of our results.

We do not find a significant abnormal return around the covenant violation itself ([-1,+1]), but we do find very significant negative CARs three to four months before the covenant violation, consistent with Figure 4a. In other words, investors trade out of these loans some time before the violation occurs. This is a key result of this table and is insensitive to the benchmark returns that are used in the model.

As we noticed in Figure 4a, the steepest price drop and, as we find, also largest negative abnormal return, is measurable in the 80 trading days before the violation; the CAR during this period is about -6.39 percentage points. The violating firms have over the whole time period an return of -0.02% while the firms that never violate a covenant have an average return of -0.008%.

## 5.3 Understanding CARs: The role of violation outcomes

Do CARs (in absolute terms) increase with the severity of the covenant violation? The literature has largely focused on the "event" covenant violation but not on how they are resolved. Yet, outcomes like waivers, which temporarily maintain original contract terms without penalties, are possible. Notably, waivers usually follow violations, whereas amendments can occur before. This allows us to categorize amendments as either violation-related or independent. Additionally, firms might initially receive waivers, later leading to mandatory loan term adjustments post-waiver. This differentiation is economically significant. Proactively negotiating amendments before violations can place companies in a stronger position, possibly gaining better terms. In contrast, firms amending post-violation may confront tougher negotiation conditions.

CovenantAI is proficient in handling complex language structures and differentiate between these possible outcomes. We thus create different indicator variables that we can summarize in the vector $Z_{Outcome}$, which denotes the respective outcome of the violation: (1) $Z_{Amendment(w/o)}$, (2) $Z_{Amendment(w)}$ (which we group together with waivers), and (3) $Z_{TechnicalDefault}$.

**Descriptive evidence.** We first plot the daily average price of loans that record a covenant violation over the [-100,0] day period before a covenant violation occurs by violation outcome (Figure 4b). As expected, prices of loans that are amended before a covenant violation show little movement, remaining between 95% and 96% over this period. In contrast, loans that experience covenant violations show substantial price declines. For example, loans receiving a waiver decline from 95% to 93%, loans amended after a violation fall from 91% to 88%, and loans issued by borrowers in technical default drop from 87% to 81% during the 100 days before the violation.

**Methodology.** To understand the drivers of CAR around covenant violations, we compute CARs for the different violation outcomes and event windows ([-80,-60]; [-80,-1]; [-60,-40]; [-60,-1]; [-20,-1]; [-1,+1]). Panel A of Table 7 reports the results. Loan prices of firms in technical default exhibit the most pronounced price declines and most negative CARs across all event windows. However, these CARs are statistically insignificant specifically in the [-80,-60] and [-60,-40] windows, consistent with broader deterioration in firm fundamentals rather than covenant-specific anticipation. Loans with amendments post covenant violations (*Amendment*

*w/ violation*) exhibit the largest significant negative CARs throughout all event windows (except the [-60,-40] days before the violation, during which we did not find negative CARs in our analysis). For example, during the [-80,-60] event window, the CAR is about -6.28%. Loans obtaining waivers before the violation, show negative CARs across all event windows, but these are less pronounced and less statistically significant than those with amendments w/ violation. For example, during the [-80,-60] event window, the CAR is about -3.55%. Amendments before violations (*Amendment w/o violation*) significant but much much smaller CARs compared to all other violation outcomes.

In Panel B of Table 7, we report a differences-in-mean test. Importantly, we find significant differences between firms that obtain amendments *after* a violation relative to those that obtain amendments *before* a covenant violation for the event window [-80,-60]. Overall, investors appear to sell loans that obtain amendments (and thus contract adjustments) before the violation occurs.

One potential alternative explanation for our results is a decrease in market liquidity during the event window, leading to a shift in prices relative to the pre-event period. To test this, we calculate bid-as-spreads as well as the number of dealers providing quotes during these time periods. Table 8 reports the results. Panel A shows bid-ask-spreads for different violation outcomes during the pre-event and event [-80,-60] windows. As expected, liquidity is lower the higher the severity of the violation (i.e., the riskier the borrower). We only observe a statistically significant decrease in liquidity for the *Amendments w/ violation* outcome, but the economic effect is not large. Similarly Panel B suggests that the number of dealer banks is not economically meaningfully smaller during the event window. Overall, we conclude that a lack of liquidity is unlikely to drive our results.[21]

[21] We also analyze possible staleness in prices during the event window. We observe that the percentage of stale prices (i.e., without price movements over a period of 5 trading days) is even declining during the event compared to the pre-event window.

# 6 Trading of CLOs Around Covenant Violations

## 6.1 Consequences of covenant violations

Why should CLOs care about covenant violations? In this subsection, we discuss possible concerns of CLOs that facilitate selling of loans prior or after covenant violations. To protect senior tranche investors in CLOs from default risks, there are several portfolio constraints. A key one is portfolio diversification; CLOs must calculate and maintain a "diversity score" to ensure diversification within and across industries. Additionally, CLOs face leverage restrictions, particularly maintaining certain Over-Collateralization (OC) ratios. The OC ratio compares a CLO's assets to its tranches' outstanding amounts. For instance, a CLO with USD 100 in assets and 65% senior and 25% junior tranches will have a senior OC ratio of approximately 154% and a junior OC ratio around 111%. Managers are required to keep these ratios above specific thresholds to mitigate insolvency risks.

The OC ratio fluctuates with changes in assets and liabilities. Assets can decrease in value if loans are downgraded or default, affecting the OC ratio. Managing assets to avoid downgrades below CCC is crucial. Liabilities change over the CLO's life cycle, which includes the ramp-up, reinvestment, and amortization periods. The OC ratios are regularly monitored, and failing to meet them can have severe consequences for CLO managers, like not receiving fees and damaging their reputation.

### 6.1.1 Defaults and downgrades after covenant violations

Thus, as a next step, we ask whether covenant violations have implications for the likelihood that a firms defaults or is downgraded. We use the same sample as in Saunders, Steffen, and Verhoff (2025), which is the intersection of quarterly observations for 11,432 firms for which we obtain SEC 10k and 10Q filings and the merged Compustat / CRSP database that provides firm control variables. We use the GVKEY-CIK match to map the SEC sample to Compustat. We obtain quarterly information about covenant violations from CovenantAI.

**Methodology.** We investigate the impact of covenant violations on firm default and downgrades using a "quasi-regression discontinuity design" (RDD) that is common in the literature (Roberts & Sufi, 2009; Nini et al., 2012).[22]

[22] This design is particularly useful in the context of covenant violations: (1) there is a sharp cutoff for compar-

We estimate the following regression model using OLS:

$$y_{i,t+k} - y_{i,t} = \alpha + \beta \times Violation_{i,t} + \theta \times X_{i,t} + \gamma_j + \delta_t + \varepsilon_{i,t} \tag{3}$$

The dependent variable $y_{i,t+k} - y_{i,t}$ is the four ($k = 4$) or eight ($k = 8$) quarter ahead likelihood to file for Chapter 7 or Chapter 11 (*Default*) or likelihood to be downgraded (*Downgrade*). $Violation_{i,t}$ is an indicator variable that is one if firm $i$ has a covenant violation in quarter $t$. $X_{i,t}$ is a vector of covenant control variables (operating cash flow scaled by assets, leverage ratio, the ratio of interest expense to assets, the ratio of net worth to assets, the current ratio, and the market-to-book ratio). We also add industry ($\gamma_j$) and quarter ($\delta_t$) fixed effects. All regressions include higher-order covenant control variables, as well as the four-quarter lag of these variables. We also include a four-quarter lag of our covenant violation dummy $Violations_{i,t-4}$. Standard errors are clustered at the firm level.

Table 9 reports the results. In Panel A, we show the results relating $Violation_{i,t}$ to corporate bankruptcy and downgrades by rating category. We thus interact $Violation_{i,t}$ with indicator variables for different rating categories, i.e., $IG$ if a company is investment-grade rated, $Non-IG$ if a company is non-investment-grade rated, and $Unrated$ (if a firm is not rated). IG firms do not experience an increase in either the likelihood to file for bankruptcy or to be downgraded. There is a sizeable economic effect among Non-IG firms, though. In the four (eight) quarters after a covenant violation, these firms are 4.2% (6%) more likely to default and about 1.8% more likely to be downgraded. The effect of violations on bankruptcy risk among unrated firms is much smaller (about 0.3% to 0.6%).

The results in Panel B are consistent with our hypothesis that different violation outcomes represent also scenarios of varying severity for companies. Columns (1) and (2) indicate a lower likelihood of default within the set of firms that are IG rated (independent of violation outcome). However, among Non-IG rated firms, those that secure amendments before the violation occurs experience a lower likelihood of default compared to firms that obtain amendments or waivers

ison as firms either violate (treatment group) or not violate a covenant (control group); (2) we can control for unobserved heterogeneity between violating and non-violating firms using a first-difference specification; (3) we can control for confounding variables that are related to the likelihood of a covenant violation to isolate the effect of the violation itself on the firm's outcomes; (4) we can identify a causal effect related to covenant violations, separate from the trajectory a firm was already on due to its fundamentals; and (5) there is some flexibility in modeling as to how firm performance changes over time using higher-order controls and controlling for both current and lagged variables.

post-violation or remain in technical default. For example, the likelihood that a firms files for bankruptcy after a technical default is between 17.6% and 19% higher, the likelihood to experience a downgrade is about 5% to 6% higher.

Overall, our results suggest that there is a significant increase in both downgrade and bankruptcy likelihood particularly among the leveraged (Non-IG rated) loans usually purchased by CLOs. In other words, CLOs, especially those already constrained with regard to their leverage, might need to offload these loan before a violation occurs.

### 6.1.2 CLO leverage constraints

In a next step, we directly measure CLO constraints using data from Creditflux. We obtain data for CLO OC ratio test over the 2007 to 2020 period and focus on in our analysis on CLOs with non-missing OC ratio test results. For each CLO, we compute slack in the OC ratio as the difference between reported OC ratios and the threshold value and use a simple average to compare CLOs across the years.[23]

The time series characteristics are reported in Table 10. The average CLO has an OC ratio slack for senior tranches ranging from 7.4% to 20.16% and for junior tranches ranging from 1.87% to 5.87%. Slack is lower during periods of widespread economic stress, e.g. in the GFC period.

Also the percentage of CCC rated loans relative to CLO assets is very cyclical and likely affects CLO decision to buy and sell loans. During periods of economic stress (such as the GFC or COVID-19) the ratio of CCC loans increases substantially and above the regulatory threshold of 7.5%. In fact,since 2016, CLOs have, on average, exceeded this threshold in every single year. Relative to the share of these risky loans, the junior OC ratio slack is thin, which may constrain CLOs' portfolio choice once hit by adverse events. In contrast, the average CLO has ample slack for the senior OC ratio, and thus this ratio is less likely than the junior ratio to constrain CLOs.

In Panel C of Table 3 above we show the cross-sectional distribution of OC ratio slack

[23] We follow the earlier literature to calculate OC ratio slack (Elkamhi and Nozawa (2022); Fleckenstein (2025); Kundu (2026)). The Creditflux data feature diverse test names for OC ratio and other tests, as each CLO has its own terminology. To pinpoint OC ratio test results, we look for "OC" and "Overcollateralization" in the data, then confirm these tests relate to OC ratios. For junior OC ratios, we search specifically for class D and E tests. When only one is present, it's used as the CLO's junior OC ratio. If both are available, the class E test is selected as the junior OC ratio. We drop all other tests, where CLOs fail the OC test and set negative slack to zero. To control for outliers, we winsorize at the 5% (95%) level.

averaged over time. The average CLO has a 4.7% slack against the junior OC ratio threshold with a cross-sectional standard deviation of 2.05%. Thus, there is significant variation across CLOs with respect to distance to OC ratio test failures.

## 6.2 Descriptive evidence of transaction prices

In this section, we delve into the trading behavior of the largest buyers of leveraged loans, CLOs, and use a subsample of our data that is the intersection of our secondary loan market data, loans that we can identify in CLO portfolios (sourced from LPC Collateral as described above) and covenant violation data from CovenantAI. In order to get a better understanding of the data and the trading of CLOs, we first provide descriptive evidence as to (1) whether quotes by dealers banks are different for loans bought by CLOs compared to other loans, (2) the development of transaction prices of loans traded by CLOs in the weeks before covenant violations as well as their selling and buying behavior, and (3) the development of transaction prices as a function of the violation outcome (such as amendment or technical default).

**Prices (Mid-quotes) of loans traded in CLO portfolios.** We first investigate prices of loans that are purchased by CLOs and those that are not purchased by CLOs in the 100 trading days before a covenant violation. Both graphs are shown in Figure 5.

The trend is very similar while prices of loans in CLOs are usually somewhat higher. Around 80 days before the violation, both prices first drop and then diverge, with loans held in CLOs experiencing an earlier and sharper decline compared to loans not in CLOs. The price drop for CLO-held loans occurs earlier and their prices remain rather stable afterwards, while the loans not in CLOs show another, steeper decline beginning around 60 days before the covenant violation.

**Loan transaction prices.** We next focus on loans held in CLO portfolios and plot their transaction prices over the 40 weeks prior to covenant violations (Figure 6). Transaction prices are calculated as the mean of the bid and ask prices at each point in time.

We observe noticeable drops in loan prices around 40 weeks and again 15 weeks before the violation. For example, the price at which CLOs are selling loans drops, on average, from 97 to 96 cents on the dollar between weeks 40 and 30, recover to 95 cents by week 15, and then decline sharply to 93.5 cents thereafter.

The mean volume of loan sales shifts, starting at USD 490k in week -20, increasing to USD 1.5 million in week -19, and then slightly decreasing to USD 1.3 million in week -18 prior to a violation. The most significant CLO sale reached USD 4.5 million in week -20, escalated to USD 24 million in week -19, and then reduced to USD 18 million in week -18.

**Transaction prices of loans traded by CLOs (by violation outcome).** Finally, we zoom into the different violation outcomes and the respective implication for loan prices of those loans purchased by CLOs. We first plot the daily loan prices (mid-quotes) by violation outcome in Figure 7a. Consistent with the evidence from our full sample (Figure 4b), we find that prices of loans are eventually amended before a covenant violation (*Amendment w/o*) exhibit minimal fluctuation. The notable decline in prices is predominantly attributed to three factors: firms that secure amendments subsequent to a violation (*Amendment w/*), firms that obtain waiver (*Waiver*) and loans linked to firms that persist in technical default (*Technical Default*). Although price patterns are strikingly similar across all three categories, the overall decrease in prices tends to be more pronounced when investors anticipate difficulties by amending loans that are in violation.

Figure 7 shows transaction prices of CLO-held loans for different violation outcomes in the weeks before the violation. Loans with amendments *before* the violation remain stable and even rise, while the other three categories exhibit persistent declines. These declines are more pronounced for loans obtaining amendments *after* the violation (*Amendment w/ violation*) and those remaining in *technical default*.

## 6.3 Constrained vs. unconstrained CLOs

If leverage-constrained CLOs drive the pre-violation price decline, two patterns should be visible in the data: constrained CLOs should sell more aggressively than unconstrained CLOs before violations, and the magnitude of this divergence should increase with violation severity. We test both predictions using transaction-level data from LPC Collateral, first graphically and then in a regression framework.

### 6.3.1 Price paths by CLO constraint status

We classify a CLO as constrained if its junior OC ratio slack falls below the cross-sectional median on the date of the covenant violation. Figure 8 plots mid-quotes of loans held by constrained and unconstrained CLOs in the 100 trading days before a violation. Both price paths decline, but the decline for loans held by constrained CLOs begins earlier and is more pronounced. The two series start to diverge around day −80 and remain separated through the violation date, with constrained-CLO loans trading approximately 1 cent on the dollar below unconstrained-CLO loans from day −60 onward. The timing of this divergence aligns with the [-80,-60] window that produces the largest CARs in Section 5, linking the aggregate price effect directly to the portfolio constraints of the marginal seller.

### 6.3.2 Trading volumes by violation category

Price divergence between constrained and unconstrained CLOs is consistent with anticipatory selling, but prices alone do not identify who trades or in which direction. We turn to actual CLO buy and sell transactions to trace the flow of loans between the two groups. Figure 9 plots weekly net trading volume (buy volume minus sell volume) per borrower for constrained and unconstrained CLOs, separately by violation outcome.

For loans that eventually receive an amendment after the violation (Figure 9a), the constrained–unconstrained gap emerges gradually. Both groups are net sellers for most of the pre-violation window, but unconstrained CLOs shift to net buying in the final week before the violation while constrained CLOs continue to sell. The reversal is sharp: unconstrained CLOs absorb a substantial volume precisely as constrained CLOs exit.

For waived loans (Figure 9b), unconstrained CLOs accumulate large net long positions in the final two to three weeks before the violation, while constrained CLOs remain net sellers for most of the pre-violation period. At the time of the violation, the pattern reverses: constrained CLOs increase selling activity and unconstrained CLOs turn to net selling, consistent with resolution of uncertainty compressing the trading opportunity.

The starkest divergence arises for loans that remain in technical default (Figure 9c). Constrained CLOs are net sellers in every week before the violation. Unconstrained CLOs are net buyers in most weeks, building increasingly large net long positions as the violation approaches.

The result is a sustained and widening wedge between the two groups — the strongest among all three violation categories.

Three features of this evidence are worth emphasizing. First, the severity gradient is monotonic: the constrained–unconstrained trading divergence is smallest for amendments, intermediate for waivers, and largest for technical defaults. This rules out mechanical portfolio rebalancing — if constrained CLOs sold indiscriminately ahead of anticipated credit events, the trading pattern would not vary with violation outcomes that are realized only ex post. Second, unconstrained CLOs are not passive bystanders. They actively absorb the loans that constrained CLOs shed, consistent with liquidity provision by less-constrained intermediaries purchasing discounted assets from forced sellers. Third, the timing of the net volume divergence aligns with the [-80,-60] day window that produces the largest CARs, linking the price effect to the actual trading behavior of constrained CLOs.

### 6.3.3 Regression evidence

We quantify the relationship between constrained CLO ownership and pre-violation abnormal returns by estimating:

$$CAR_{ij} = b_0 + b_1 \times (Ownership_i \times Violation_i) + b_2 \times Ownership_i + b_3 \times Violation_i + \gamma \times X_i + \eta_j + \eta_t + \epsilon_{ij} \tag{4}$$

where $CAR_{ij}$ is the cumulative abnormal return of loan $i$ around violation event $j$ in the [-80,-60] window, and $Ownership_i$ is the weighted share of constrained CLOs holding loan $i$, computed as the total deal amounts of constrained CLOs divided by the aggregate deal amount for that loan. $Violation_i$ equals one if loan $i$ experiences a covenant violation (waiver, technical default, or amendment with violation) and zero for amendments without violation. $X_i$ includes loan-level controls: a rated indicator (*Rated*), remaining maturity (*Remaining Maturity*), the loan spread (*Spread*), and the logarithm of the loan amount (*Ln(Loan Amount)*). All specifications include industry ($\eta_j$) and year ($\eta_t$) fixed effects in the saturated model.

Panel A of Table 11 reports the results. The coefficient on *Ownership* × *Violation* is negative and statistically significant across all specifications: $-0.232$ without controls (column 1), $-0.500$ with loan-level controls (column 2), and $-0.188$ with the full set of controls and

fixed effects (column 3). The economic magnitude is substantial. A one-standard-deviation increase in constrained CLO ownership is associated with a 3.8 to 10.0 percentage point more negative CAR in the [-80,-60] window, depending on the specification. Loans with higher constrained CLO ownership experience significantly steeper pre-violation price declines, even after controlling for loan characteristics, industry composition, and time effects.

Panel B decomposes the effect by violation category. The coefficient on *Ownership* × *Amendment w/ Violation* is negative and statistically significant across all three specifications ($-0.176$, $-0.152$, $-0.442$), and its magnitude increases substantially with the inclusion of controls and fixed effects. This indicates that the baseline result in Panel A is concentrated in loans where the violation leads to a post-violation amendment – precisely the category where constrained CLOs face the strongest incentive to sell, as the violation triggers a credit event that may impair OC ratios. The coefficient on *Ownership* × *Technical Default* is negative in the baseline specification ($-0.071$) but loses significance with controls, reflecting limited statistical power: technical defaults are the most severe but also the rarest violation outcome in our sample. The coefficient on *Ownership* × *Waiver* is statistically insignificant throughout, consistent with waivers representing the mildest form of violation resolution and thus generating weaker divestment incentives.

Taken together, the trading volume evidence and the regression results tell a coherent story. Constrained CLOs sell ahead of covenant violations, unconstrained CLOs provide liquidity by absorbing these positions, and the resulting price pressure is concentrated in loans with higher constrained CLO ownership. The interaction of investor-level portfolio constraints with contract-level credit events generates systematic risk reallocation within the CLO sector – transfers from constrained to unconstrained intermediaries at discounted prices.

# 7 Conclusion

This paper shows that institutional portfolio constraints interact with contract-level credit events to generate anticipatory trading and systematic risk reallocation in leveraged loan markets. Leverage-constrained CLOs – those with thin junior overcollateralization ratio slack – selectively divest from loans approaching covenant violations, and this divestment is concentrated in loans with the worst expected resolution. Unconstrained CLOs absorb these positions

at discounted prices, functioning as de facto liquidity providers within the CLO sector. Three features of the evidence are central. First, the trading asymmetry between constrained and unconstrained CLOs is monotonically increasing in violation severity: smallest for amendments, intermediate for waivers, largest for technical defaults. This severity gradient rules out mechanical portfolio rebalancing. Second, the timing of the constrained–unconstrained divergence in net trading volume aligns precisely with the $[-80, -60]$ day window that produces the largest cumulative abnormal returns, linking the aggregate price effect to the actual behavior of the marginal seller. Third, the regression evidence confirms that loans with higher constrained CLO ownership experience significantly more negative pre-violation abnormal returns, with the effect concentrated in post-violation amendments — precisely the category where covenant breaches threaten CLO overcollateralization tests.

Our results carry two broader implications for the understanding of non-bank financial intermediation. First, unconstrained CLOs play a role that has received little attention in the literature: they provide intra-sector liquidity by purchasing loans that constrained CLOs must shed. This risk transfer is risk migration from leverage-constrained to less-constrained vehicles within the same asset class. Whether this reallocation is stabilizing (because it moves assets to investors better positioned to bear the risk) or destabilizing (because it concentrates exposure in a subset of CLOs whose constraints may bind in the next downturn) is an open question with direct implications for macroprudential policy. Second, the interaction between binding OC constraints and covenant violations creates a channel through which idiosyncratic borrower deterioration produces correlated selling by constrained intermediaries. To the extent that constrained CLOs hold overlapping loan portfolios – a feature we document in our data – a cluster of covenant violations can generate coordinated selling pressure that amplifies price declines beyond what borrower fundamentals alone would imply. This amplification mechanism operates through an OC-test channel, activated at the point of an anticipated covenant breach.

The mechanism we document – anticipatory selling driven by the interaction of investor-level leverage constraints and contract-level credit events – is directly relevant to the ongoing prudential debate on non-bank financial intermediation. Regulatory frameworks that tighten CLO portfolio constraints may inadvertently amplify the very procyclical dynamics they seek to contain, by narrowing the OC slack that permits orderly portfolio adjustment ahead of credit

events.

# References


Addoum, J. M., & Murfin, J. R. (2020). Equity price discovery with informed private debt. *The Review of Financial Studies*, *33*(8), 3766–3803.

Amihud, Y. (2002). Illiquidity and stock returns: cross-section and time-series effects. *Journal of financial markets*, *5*(1), 31–56.

Becker, B., & Milbourn, T. (2011). How did increased competition affect credit ratings? *Journal of Financial Economics*, *101*(3), 493-514.

Beneish, M. D., & Press, E. (1993). Costs of technical violation of accounting-based debt covenants. *Accounting Review*, 233–257.

Beneish, M. D., & Press, E. (1995). The resolution of technical default. *Accounting Review*, 337–353.

Benmelech, E., Dlugosz, J., & Ivashina, V. (2012). Securitization without adverse selection: The case of clos. *Journal of Financial Economics*, *106*(1), 91–113.

Berlin, M., Nini, G., & Edison, G. Y. (2020). Concentration of control rights in leveraged loan syndicates. *Journal of Financial Economics*, *137*(1), 249–271.

Berndt, A., & Gupta, A. (2009). Moral hazard and adverse selection in the originate-to-distribute model of bank credit. *Journal of Monetary Economics*, *56*(5), 725–743.

Bhardwaj, A., & Mukherjee, S. (2022). Do lending relationships matter when loans are securitized? *Working Paper*.

Bord, V. M., & Santos, J. A. (2015). Does securitization of corporate loans lead to riskier lending? *Journal of Money, Credit and Banking*, *47*(2-3), 415–444.

Brown, S. J., & Warner, J. B. (1985). Using daily stock returns: The case of event studies. *Journal of financial economics*, *14*(1), 3–31.

Bushman, R., Gao, J., Martin, X., & Pacelli, J. (2021). The influence of loan officers on loan contract design and performance. *Journal of Accounting and Economics*, *71*(2-3), 101384.

Chava, S., Fang, S., Kumar, P., & Prabhat, S. (2019). Debt covenants and corporate governance. *Annual Review of Financial Economics*, *11*(1), 197-219.

Chava, S., & Roberts, M. R. (2008). How does financing impact investment? the role of debt covenants. *The journal of finance*, *63*(5), 2085–2121.

Chen, K. C., & Wei, K. J. (1993). Creditors' decisions to waive violations of accounting-based debt covenants. *Accounting review*, 218–232.

Chodorow-Reich, G., & Falato, A. (2022). The loan covenant channel: How bank health transmits to the real economy. *The Journal of Finance*, *77*(1), 85–128.

Christensen, H. B., Macciocchi, D., Morris, A., & Nikolaev, V. V. (2022). Financial shocks to lenders and the composition of financial covenants. *Journal of Accounting and Economics*, *73*(1), 101426.

Cordell, L., Roberts, M. R., & Schwert, M. (2023). Clo performance. *The Journal of Finance*, *78*(3), 1235–1278.

Demerjian, P. R., & Owens, E. L. (2016). Measuring the probability of financial covenant violation in private debt contracts. *Journal of Accounting and Economics*, *61*(2-3), 433–447.

Denis, D. J., & Wang, J. (2014). Debt covenant renegotiations and creditor control rights. *Journal of Financial Economics*, *113*(3), 348–367.

Dyreng, S., Ferracuti, E., Hills, R., & Kubic, M. (2025, 07). Measurement error when estimating covenant violations. *The Accounting Review*, 1-26.

Elkamhi, R., & Nozawa, Y. (2022). Fire-sale risk in the leveraged loan market. *Journal of Financial Economics*, *146*(3), 1120–1147.

Fabozzi, F. J., Klingler, S., Mølgaard, P., & Nielsen, M. S. (2021). Active loan trading. *Journal of Financial Intermediation*, *46*, 100868.

Feldhütter, P., & Poulsen, T. K. (2018). What determines bid-ask spreads in over-the-counter markets? *Available at SSRN 3286557*.

Fleckenstein, Q. (2025). Intermediary frictions and the corporate credit cycle: Evidence from clos. *Working Paper*.

Fleckenstein, Q., Gopal, M., Gutiérrez, G., & Hillenbrand, S. (2025). Nonbank lending and credit cyclicality. *The Review of Financial Studies*, hhaf024.

Garleanu, N., & Zwiebel, J. (2009). Design and renegotiation of debt covenants. *The Review of Financial Studies*, *22*(2), 749–781.

Gatev, E., & Strahan, P. E. (2006). Banks' advantage in hedging liquidity risk: Theory and evidence from the commercial paper market. *Journal of Finance*, *61*(2), 867-892.

Gatev, E., & Strahan, P. E. (2009). Liquidity risk and syndicate structure. *Journal of Financial Economics*, *93*, 490-504.

Griffin, T. P., Nini, G., & Smith, D. C. (2024). Losing control? the two-decade decline in loan covenant violations. *The Journal of Finance*.

Haque, S. M., & Kleymenova, A. (2023). *Private equity and debt contract enforcement: evidence from covenant violations*. Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board.

Ivashina, V., & Sun, Z. (2011). Institutional stock trading on loan market information. *Journal of financial Economics*, *100*(2), 284–303.

Kapoor, S., & Narayanan, A. (2023). Leakage and the reproducibility crisis in machine-learning-based science. *Patterns*, *4*(9).

Karafiath, I. (1988). Using dummy variables in the event methodology. *Financial Review*, *23*(3), 351–357.

Kundu, S. (2024). Financial covenants and fire sales in closed-end funds. *Management Science*, *70*(2), 860–884.

Kundu, S. (2026). Covenant-driven fire sales. *Working Paper*.

Li, Z., Wang, L., & Wruck, K. (2020). Accounting-based compensation and debt contracts. *Contemporary Accounting Research*, *37*(3), 1475–1511.

Loumioti, M., & Vasvari, F. P. (2019). Portfolio performance manipulation in collateralized loan obligations. *Journal of Accounting and Economics*, *67*(2-3), 438–462.

Nadauld, T. D., & Weisbach, M. S. (2012). Did securitization affect the cost of corporate debt? *Journal of financial economics*, *105*(2), 332–352.

Nini, G., Smith, D. C., & Sufi, A. (2012). Creditor control rights, corporate governance, and firm value. *The Review of Financial Studies*, *25*(6), 1713–1761.

Prakoso, D. W., Abdi, A., & Amrit, C. (2021). Short text similarity measurement methods: a review. *Soft Computing*, *25*, 4699–4723.

Roberts, M. R. (2015). The role of dynamic renegotiation and asymmetric information in financial contracting. *Journal of Financial Economics*, *116*(1), 61–81.

Roberts, M. R., & Sufi, A. (2009). Control rights and capital structure: An empirical investigation. *The Journal of Finance*, *64*(4), 1657–1695.

Saunders, A., Spina, A., Steffen, S., & Streitz, D. (2025). Corporate loan spreads and economic activity. *The Review of Financial Studies*, *38*(2), 507–546.

Saunders, A., Steffen, S., & Verhoff, P. (2025). Covenantai-new insights into covenant violations. *Available at SSRN 4640653*.

Shivdasani, A., & Wang, Y. (2011). Did structured credit fuel the lbo boom? *The Journal of Finance*, *66*(4), 1291–1328.

Thompson, R. (1985). Conditioning the return-generating process on firm-specific events: A discussion of event study methods. *Journal of Financial and Quantitative Analysis*, *20*(2), 151–168.

Zhu, C. (2024). Treatment of accounting changes and covenant violation errors. *Journal of Accounting Research*, *62*(2), 783–824.

# Figures and Tables

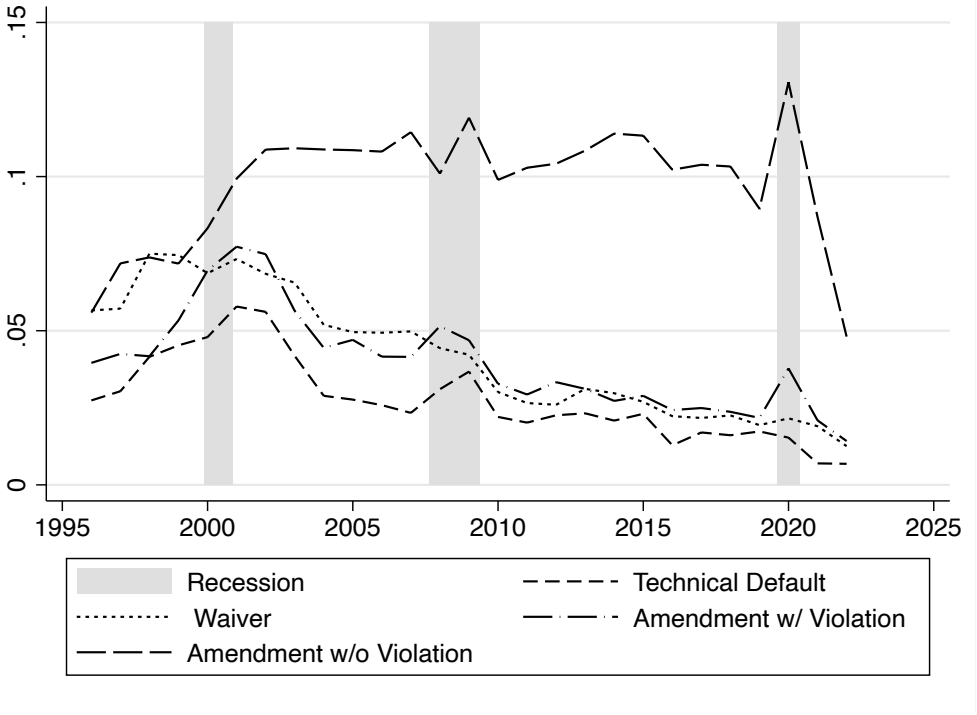
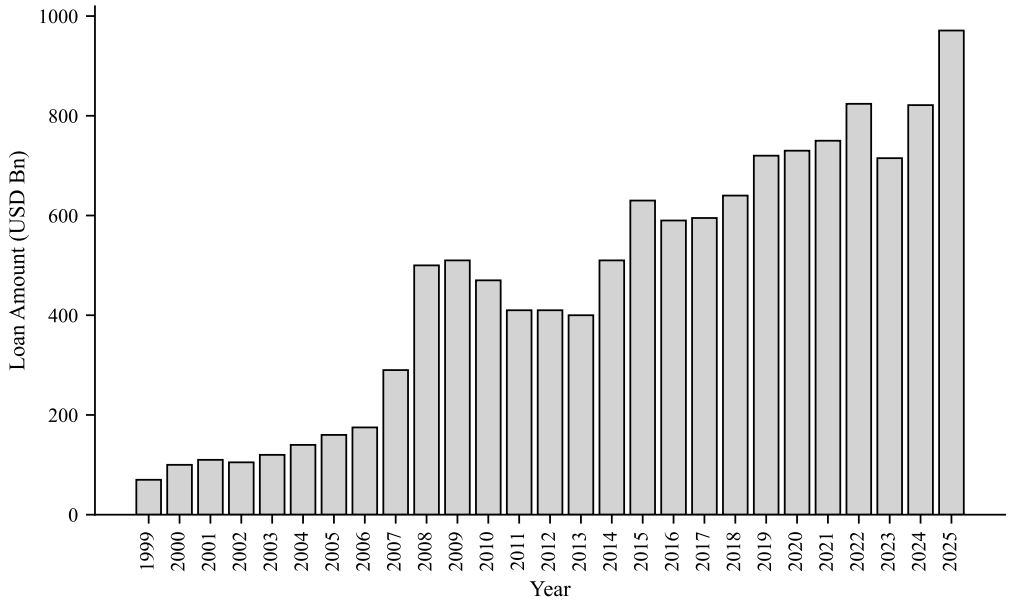
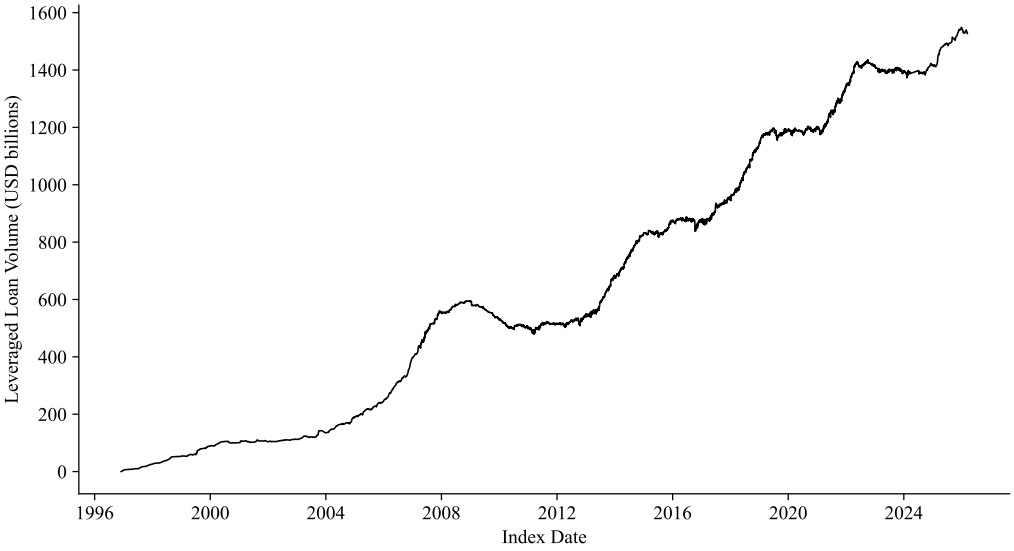



Figure 1: **Time-series of covenant violations**
This figure plots the annual share of the different violation outcomes for the full sample of U.S. publicly listed, non-financial firms. The shaded areas represent the NBER recession periods.




(a) Traded loan volume




(b) Notional amount of traded loans

Figure 2: **Secondary loan market trading volume**
This figure plots the development of total loan volume traded in the secondary U.S. syndicated loan market (Panel A) and the notional amount of loans traded in the Morningstar LSTA Leveraged Loan Index (Panel B) over the 1999 to 2025 period. Source: LSTA.

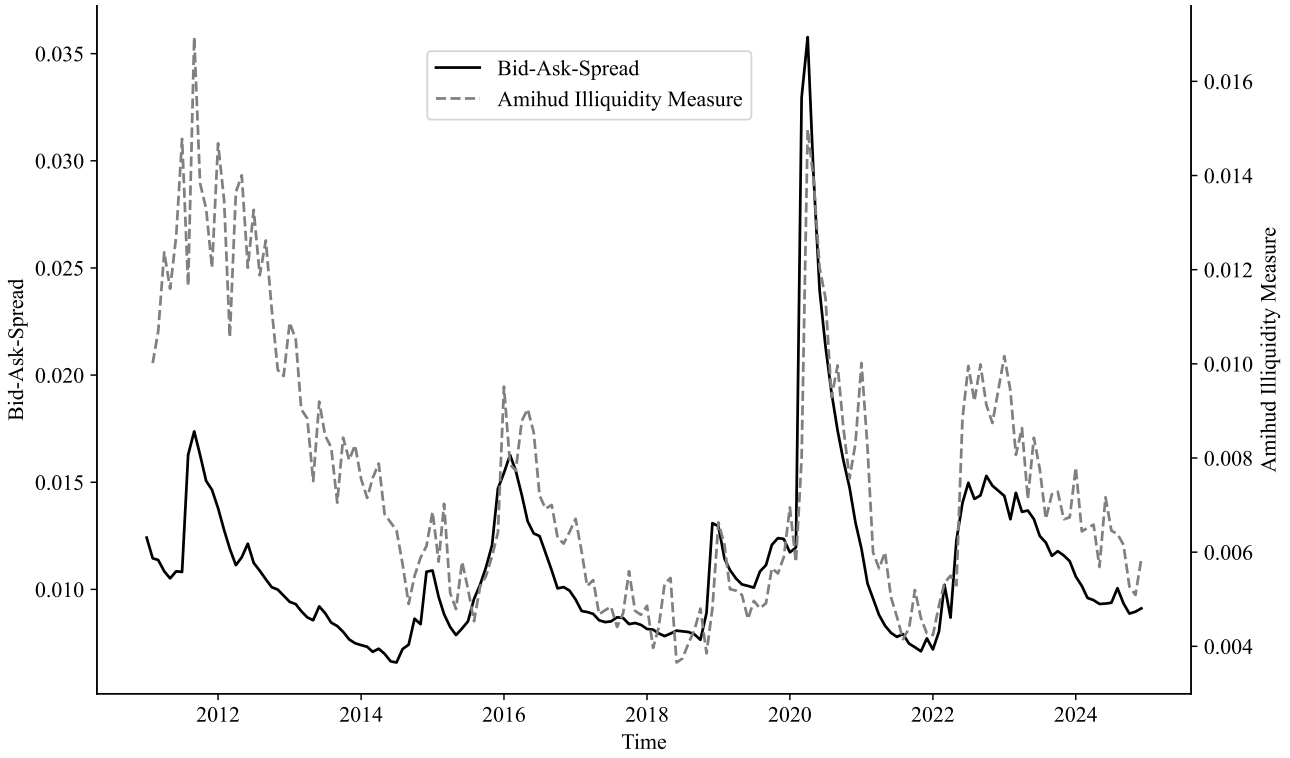
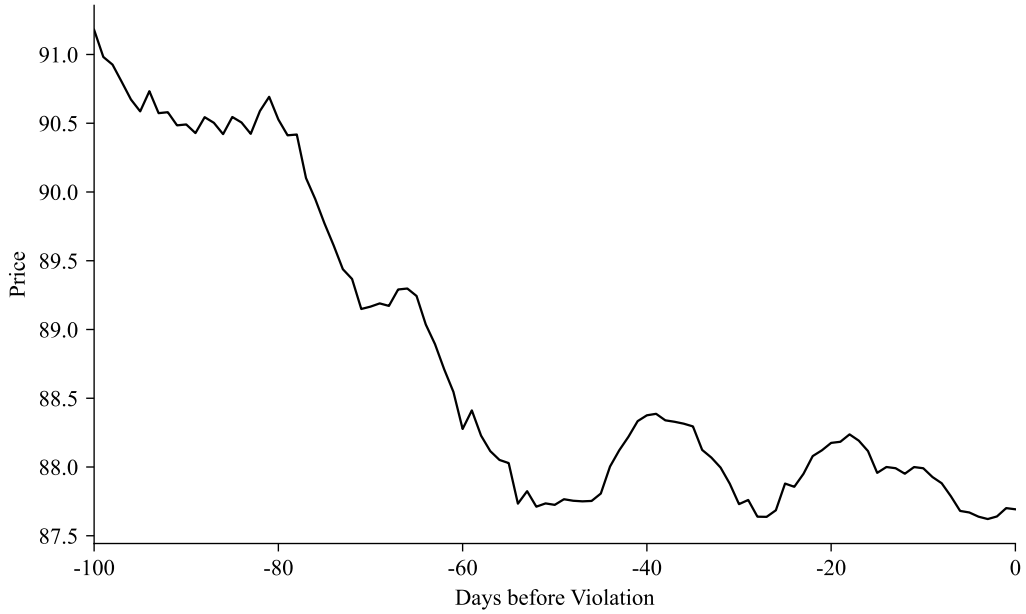


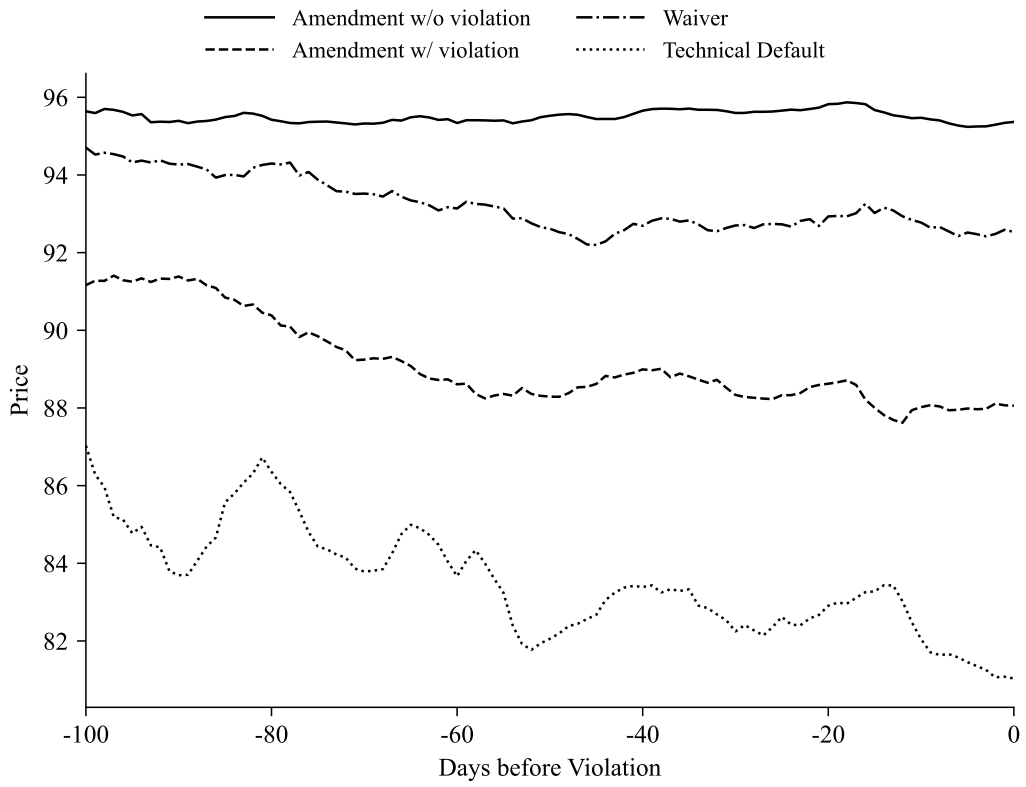

Figure 3: **U.S. secondary loan market liquidity.** This Figure plots the median bid-ask spread of loans in the *Morningstar LSTA US Leveraged Loan TR USD* (scaled by the mid-quote) over the 1999-2025 period. It also plots (right y-axis) the Amihud Illiquidity Measure (*ILLIQ*) (Amihud, 2002), which is calculated as

$$ILLIQ_{im} = \frac{|r_{im}|}{VOL_{im}}$$

where instead of using the average daily measure, we use monthly loan market returns and monthly aggregated volume of buy and sale transactions (in million USD).




(a) All violation outcomes




(b) Loan prices by violation outcome

Figure 4: **Loan prices before a covenant violation**
This figure plots the (mean) price of loans trading in the secondary loan market and issued by publicly listed U.S. firms 100 trading days before a covenant violation. Panel (a) shows this for all loans with covenant violation, Panel (b) by violation outcome (i.e., amendment w/o violation, amendment w/ violation, waiver and those that remain in technical default.

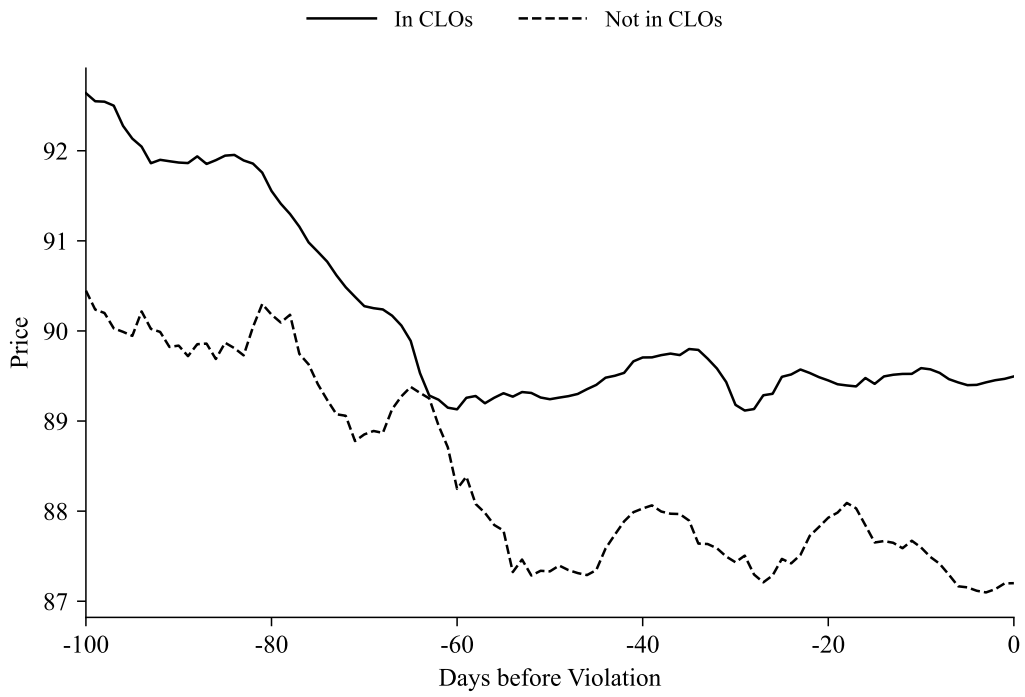



Figure 5: **Prices of loans (not) in CLO portfolios before covenant violations**
This figure plots the (mean) price of loans trading in the secondary loan market and issued by publicly listed U.S. firms 100 days before a covenant violation. We plot this time-series separately for loans that are (not) purchased by CLOs.

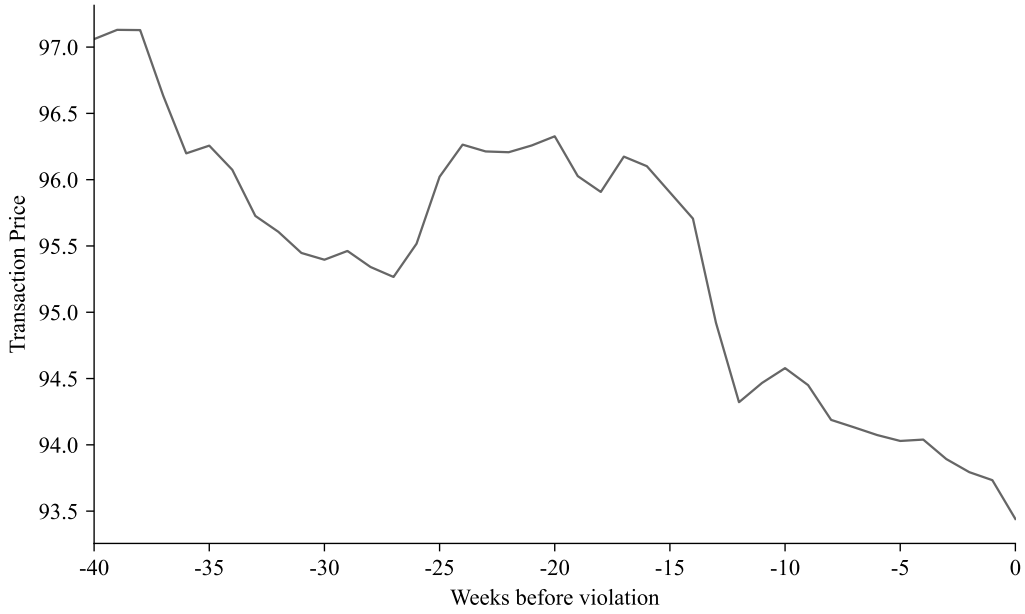
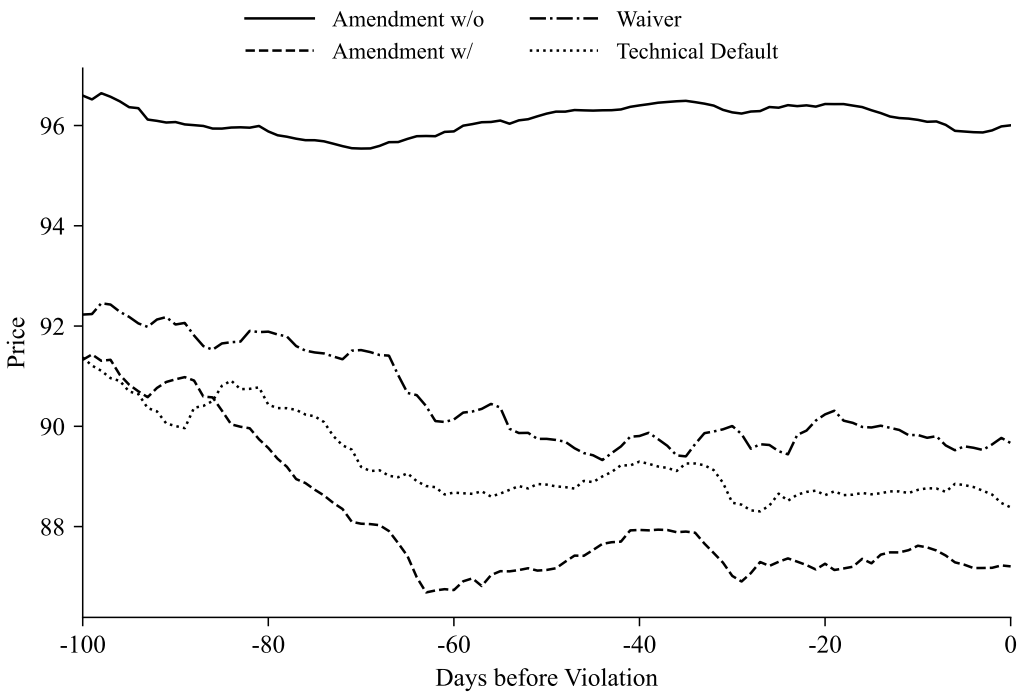
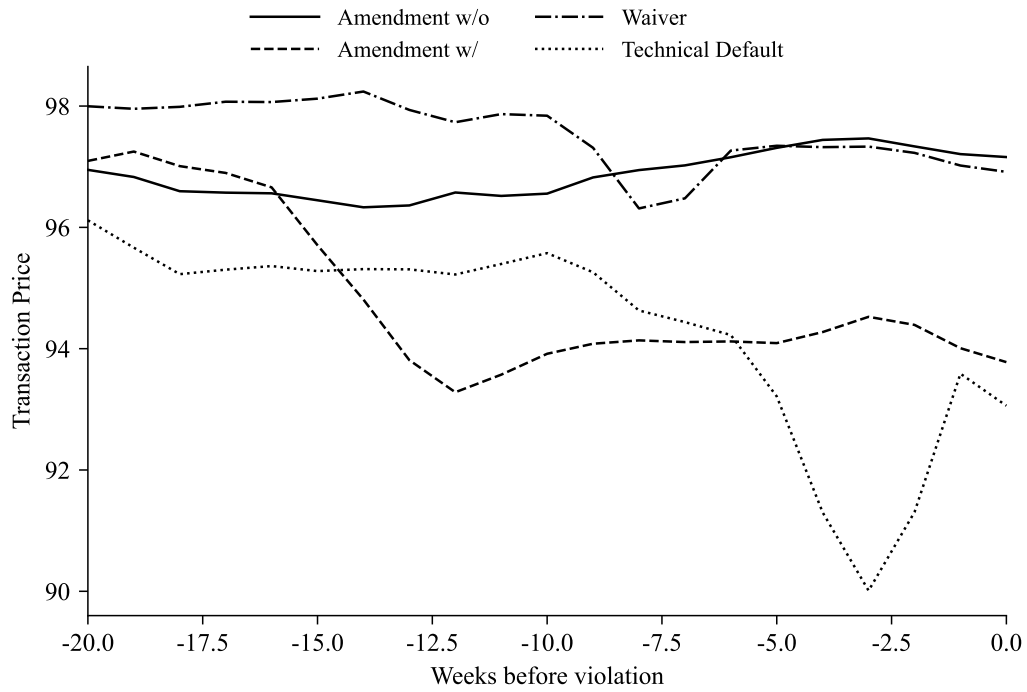



Figure 6: **CLO Transaction prices before covenant violations**
This figure plots the weekly transaction price in our sample of loans owned by CLOs in the 40 weeks prior to a covenant violation. The transaction price is measured as the average of the bid and ask prices.




(a) Prices (mid-quotes) of loans in CLOs (by violation outcomes)




(b) Transaction prices of loans traded by CLOs (by violation outcome)

Figure 7: **Prices of loans in CLO portfolios before a covenant violation**
This figure plots loan and CLO prices around covenant violations. Panel (a) shows loan prices by violation outcome (i.e., amendment without violation, amendment with violation, waiver, and loans remaining in technical default) in the 100 trading days before the violation. Panel (b) shows CLO transaction prices, computed as the mean of the bid and ask prices, over the 20 weeks before the violation.

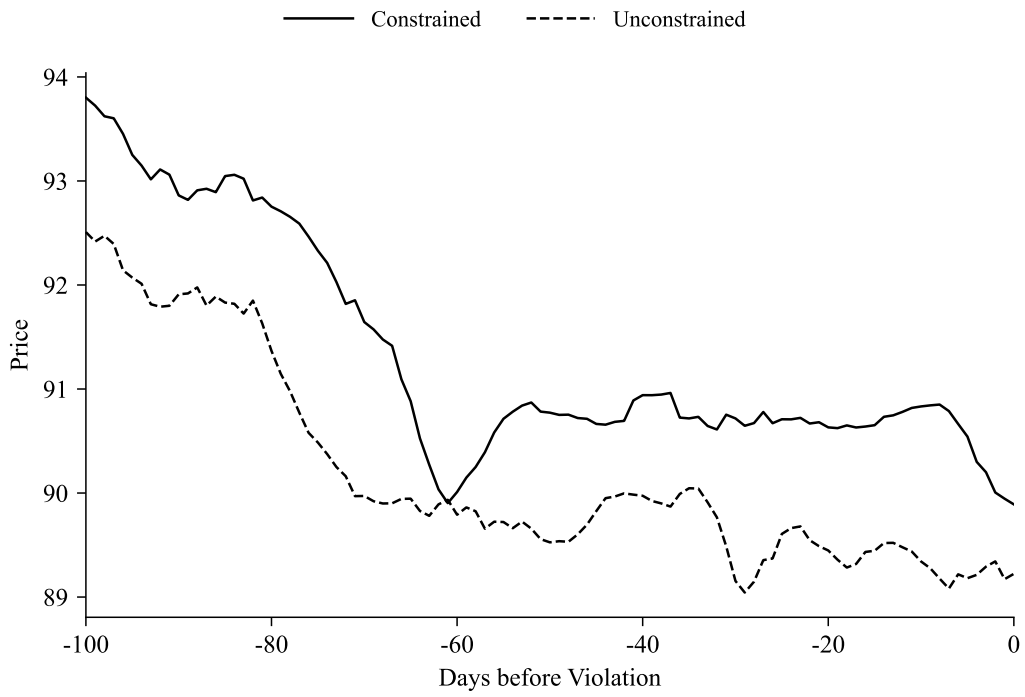
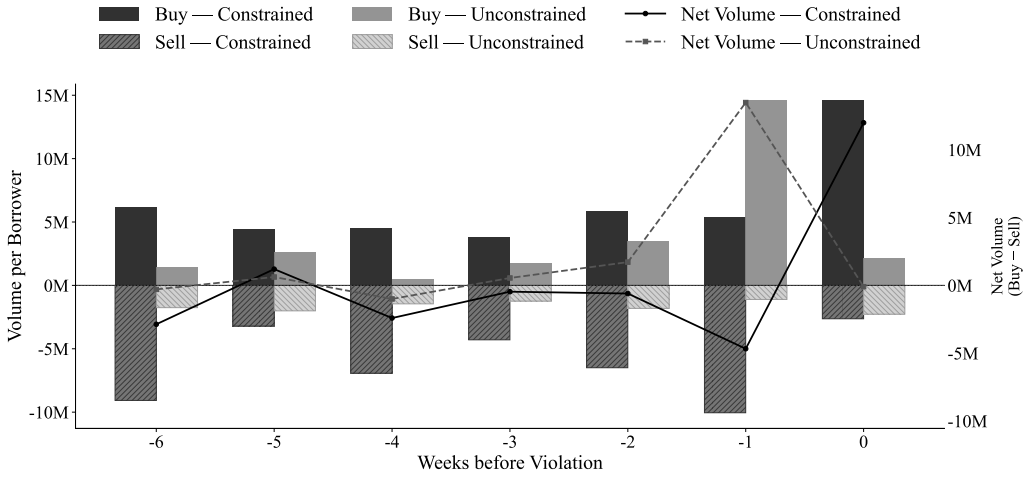
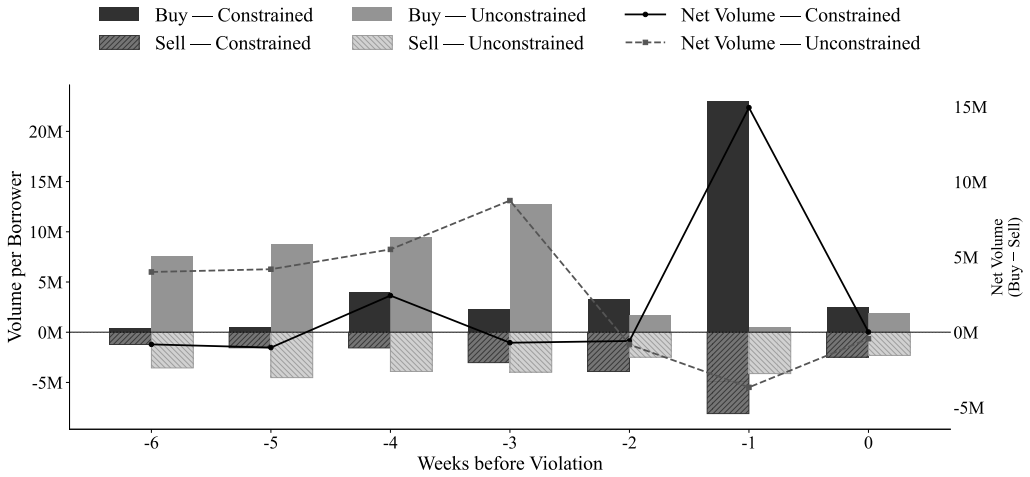


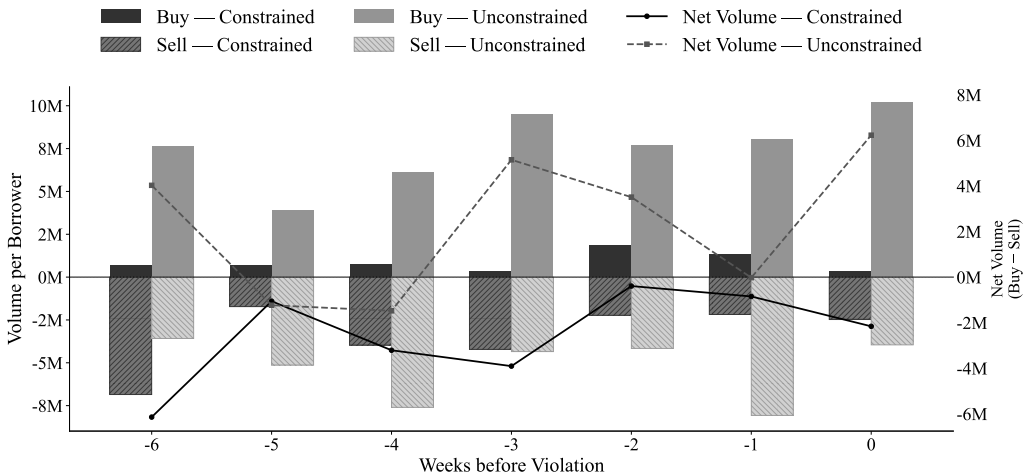

Figure 8: **Price of Loans in portfolios of constrained vs. unconstrained CLO**
This figure plots the (mean) price of loans trading in the secondary loan market and issued by publicly listed U.S. firms 100 days before a covenant violation. We plot this time-series separately for loans in portfolios of constrained vs. unconstrained CLOs.




(a) Net Volume of Amended Loans




(b) Net Volume of Waived Loans




(c) Net Volume of Loans in Technical Default

Figure 9: **Trading Volume of Loans by Violation Category in CLO Transactions**
This figure plots the trading volume of loans traded by constrained and unconstrained CLOs by violation category in the weeks before the violation. The left axis shows the average trading volume by borrower, with buys displayed above the horizontal axis and sells below the horizontal axis. The right axis shows the net trading volume, calculated as buy volume minus sell volume. Panel (a) plots the trading volumes of loans that obtained an amendment, Panel (b) plots those of loans for which the violation was waived, and Panel (c) those of loans that ended in a technical default.

# Table 1: **CovenantAI Model Performance**

This figure plots the accuracy of our machine learning algorithm. The true value is displayed on the vertical axis, and the value predicted by our model is on the horizontal axis. Panel A uses the test data to show model performance and Panel B the validation dataset. Panel B shows the Precision, Recall and F1-Score for the test data, when splitting them only into three categories (No Violation, Amendment and Technical Default). Panel C compares the performances of the different approaches for two categories *No Violation* and *Violation*. We compare the performance of CovenantAI, where we created the "Violation" class by adding up *Waiver*, *Amendment w/ Violation* and *Technical Default* cases with the performance of the labeling by Nini et al. (2012), the replication of the approach by Nini et al. (2012) without manual adjustments and the performance of the Roberts and Sufi (2009) approach. The confusion matrices are constructed based on a random dataset of 102 firm quarters, where CovenantAI didn't agree with either of the approaches and it is therefore not representative for the full sample.

**Panel A: Confusion Matrix of the Test Data**

| | | Predicted Label | | | | |
|---|---|---|---|---|---|---|
| | | No Violation | Amendment w/o | Waiver | Amendment w/ | Technical Default |
| True Label | No Violation | **78.12%** | 3.35% | 1.28% | 0.32% | 1.12% |
| | Amendment w/o | 0.64% | **4.95%** | 0.00% | 0.00% | 0.00% |
| | Waiver | 0.00% | 0.00% | **3.83%** | 0.48% | 0.00% |
| | Amendment w/ | 0.00% | 0.16% | 0.00% | **2.08%** | 0.00% |
| | Technical Default | 0.00% | 0.00% | 0.16% | 0.32% | **3.19%** |

**Panel B: Precision, Recall, F1-score for Test Data**

| | Precision | Recall | F1-Score | Number |
|---|---|---|---|---|
| No Violation | 0.99 | 0.93 | 0.96 | 529 |
| Amendment w/o | 0.58 | 0.89 | 0.70 | 35 |
| Waiver | 0.73 | 0.89 | 0.80 | 27 |
| Amendment w/ | 0.65 | 0.93 | 0.76 | 14 |
| Technical Default | 0.74 | 0.87 | 0.8 | 23 |
| Accuracy | | | 0.92 | 628 |
| Macro Average | 0.74 | 0.90 | 0.80 | 628 |
| Weighted Average | 0.94 | 0.92 | 0.93 | 628 |

**Panel C: Confusion Matrices of the Different Approaches**

| | | Predicted Label | |
|---|---|---|---|
| | | No Violation | Violation |
| True Label | **CovenantAI Labeling** | | |
| | No Violation | **25.49%** | 13.73% |
| | Violation | 6.86% | **53.92%** |
| | **Nini et al. (2012)** | | |
| | No Violation | **7.84%** | 31.37% |
| | Violation | 14.71% | **46.08%** |
| | **Roberts and Sufi (2009)** | | |
| | No Violation | **4.9%** | 34.31% |
| | Violation | 2.94% | **47.84%** |
| | **Roberts and Sufi Labeling** | | |
| | No Violation | **38.24%** | 0.98% |
| | Violation | 53.92% | **6.86%** |

Table 2: **Sample Construction**

This table describes the progressive assembly of the analysis sample across multiple data sources. Panel A shows the filtering process beginning with the CovenantAI Full Sample of 14,792 U.S. public firms from SEC filings (1996–2024), comprising 537,804 firm-quarter observations. We sequentially impose data availability requirements: firms with syndicated term loans from Dealscan (3,999 firms, 15,124 loans, 104,359 firm-quarters), loans with available secondary market pricing (891 firms, 2,388 loans, 15,033 firm-quarters), loans held by CLOs with quarterly holdings data from LPC (Collateral) (648 firms, 1,611 loans, 11,676 firm-quarters), CLO transaction-level data availability (598 firms, 1,476 loans, 10,624 firm-quarters), and CLO overcollateralization ratio constraints measured via Creditflux (589 firms, 1,456 loans, 10,463 firm-quarters).

**Panel A: Descriptives Datasets**

| | N (Firms) | N (Loans) | N (Firm-Quarters) | Description |
|---|---|---|---|---|
| CovenantAI Full Sample | 14,792 | | 537,804 | All U.S. public firms in SEC filings, 1996-2024 |
| Has syndicated loan (Dealscan) | 3,999 | 15,124 | 104,359 | Firms with syndicated term loans |
| Secondary market pricing available | 891 | 2,388 | 15,033 | Loans actively traded in secondary market |
| CLO holdings data (LPC Collateral) | 648 | 1611 | 11,676 | Loans held by CLOs with quarterly holdings |
| CLO transaction data available | 598 | 1,476 | 10,624 | Subset with actual buy and sell transactions |
| CLO OC ratio data (Creditflux) | 589 | 1,456 | 10,463 | CLOs with quarterly OC constraint measures |

# Table 3: **Descriptive Statistics**

This table provides summary statistics of important firm characteristics. Panel A shows the summary statistics for our CovenantAI dataset. *Violation* is an indicator variable that is one if a firm violates a covenant in a specific quarter. *Technical Default*, *Amendment w/ Violation* and *Amendment w/o Violation* represent the share of firms that reported a violation within these outcome-categories. *Default* is an indicator that is one if the company filed for Chapter 7 or Chapter 11 during this period and *Downgrade* is an indicator that is one if the firm was downgraded over the whole period. *Credit rating* is a numerical translation of S&P rating information, where 1 is the best rating (AAA+). Panel B shows loan characteristics of the Secondary Loan market data for all *publicly listed* firms. The *# Loans* represents the average number of loans per year. The *Ask Price*, *Bid Price*, the *Midquote* and the *Spread* are reported as averages per loan. The *Maturity* is the average remaining maturity of the loan stated in years. The *Bid-Ask-Spread* is calculated by $\frac{AskPrice-BidPrice}{Midquote}$. Panel C shows the summary statistics of all publicly listed firms in the LPC Collateral (CLO) data. S&P Rating is the numeric translation of the rating symbol (Where AAA+ is 1). *Spread* is reported in basis points. The share of loans by credit ratings is reported in the bottom part of Panel C. *IG* includes all firms that are BBB- rated (equal to a numerical rating of 10) or better. The *BB* rating includes all loans that are rated BB+, BB and BB-.

**Panel A: Summary Statistics: CovenantAI**

| | Mean | Median | Min | Max | SD |
|---|---|---|---|---|---|
| Violation | 0.47 | 0.00 | 0.00 | 1.00 | 0.50 |
| Technical Default | 0.15 | 0.00 | 0.00 | 1.00 | 0.36 |
| Amendment w/ Violation | 0.28 | 0.00 | 0.00 | 1.00 | 0.45 |
| Amendment w/o Violation | 0.33 | 0.00 | 0.00 | 1.00 | 0.47 |
| Default | 0.02 | 0.00 | 0.00 | 1.00 | 0.13 |
| Downgrade | 0.87 | 1.00 | 0.00 | 1.00 | 0.33 |
| Credit Rating | 12.26 | 13.00 | 1.00 | 26.47 | 3.10 |
| Observations | 11,428 | | | | |

**Panel B: Summary Statistics Secondary Loan Market Data**

| | Mean | Median | Min | Max | SD |
|---|---|---|---|---|---|
| # Loans | 904.76 | 852 | 325 | 1,453 | 320.37 |
| Ask Price | 96.59 | 100.03 | 2.27 | 155.22 | 10.66 |
| Bid Price | 95.47 | 99.33 | 1.11 | 150.05 | 11.41 |
| Midquote | 96.03 | 99.69 | 1.69 | 152.64 | 11.03 |
| Spread | 362.52 | 325.00 | 12.50 | 1,600.00 | 183.70 |
| Maturity | 4.31 | 4.36 | 0.17 | 9.15 | 1.57 |
| Bid-Ask-Spread | 0.02 | 0.01 | 0.00 | 1.00 | 0.05 |
| Observations | 6,782 | | | | |

**Panel C: Summary Statistics CLO Data**

| | Mean | Median | Min | Max | SD |
|---|---|---|---|---|---|
| **OC ratio slack** | | | | | |
| Slack(S) (%) | 20.24 | 11.39 | 0.00 | 117.62 | 18.44 |
| Slack(J) (%) | 4.67 | 4.86 | 0.00 | 10.74 | 2.05 |
| **Loan Characteristics** | | | | | |
| # Loans | 531.94 | 484.50 | 1.00 | 2,346.00 | 355.48 |
| S&P Rating | 14.55 | 14.54 | 7.18 | 21.00 | 0.60 |
| Spread | 371.06 | 365.99 | 175.00 | 755.00 | 48.22 |
| **Share of loans by credit ratings (%)** | | | | | |
| IG | 1.04% | 0.76% | 0% | 78.36% | 2.14% |
| BB | 18.75% | 19.63% | 0% | 100% | 8.84% |
| B | 62.95% | 68.44% | 0% | 100% | 18.31% |
| CCC | 2.24% | 1.68% | 0% | 36.26% | 2.97% |
| Observations | 2,100 | | | | |

# Table 4: **Characteristics by Sample**

This table compares firm and loan characteristics across four samples: (1) the full CovenantAI universe of leveraged loans with covenant data, (2) loans merged with Dealscan data, (3) loans matched to the secondary market database, and (4) loans held by CLOs. Panel A reports firm fundamentals (total assets, market capitalization, leverage ratio, market-to-book, ROA, and sales growth). Panel B presents credit characteristics including ratings distribution and S&P numeric ratings. Panel C documents violation characteristics: the percentage of firms that ever violate covenants, incidence of technical defaults, amendments following or preceding violations, and waivers granted. Panel D provides loan-level characteristics including facility size, spread, maturity, and bid-ask spreads. Column (5) reports the differences between the CovenantAI sample and the CLO sample, with t-statistics testing equality of means.

**Characteristics by Sample**

| Characteristic | (1) CovenantAI Only | (2) Dealscan Merge | (3) Secondary Market | (4) CLO Data | (1)-(4) Difference | t-stat |
|---|---|---|---|---|---|---|
| **Panel A: Firm Fundamentals** | | | | | | |
| Total Assets ($M) | 7,189.98 | 8,765.3 | 6,815.67 | 7,523.67 | -333.69 | -1.907 |
| Market Cap ($M) | 1,845.14 | 3,087.1 | 2936.59 | 3,338.58 | -1493.44*** | -43.991 |
| Leverage Ratio | 0.23 | 0.42 | 0.49 | 0.49 | -0.26*** | -163.479 |
| Market-to-Book | 1.31 | 0.89 | 0.73 | 0.74 | 0.56 *** | 96.765 |
| ROA (%) | 0.87 | 2.86 | 3.05 | 3.05 | -2.18*** | -117.497 |
| Sales Growth (%) | 0.04 | 0.03 | 0.02 | 0.02 | 0.01*** | 9.365 |
| **Panel B: Credit Characteristics** | | | | | | |
| Investment Grade (%) | | 6.41 | 2.93 | 2.38 | 4.03*** | 8.857 |
| BB (%) | | 6.37 | 9.80 | 13.83 | -7.46*** | -7.872 |
| B (%) | | 5.96 | 13.95 | 19.88 | -13.92*** | -12.790 |
| CCC or below (%) | | 2.32 | 4.96 | 7.13 | -4.81*** | -6.857 |
| Unrated (%) | | 78.93 | 68.36 | 56.77 | 22.16*** | 16.170 |
| Avg S&P Rating (numeric) | | BB- | B+ | B | -1.73*** | -47.56 |
| **Panel C: Violation Characteristics** | | | | | | |
| Ever violate (%) | 32.79 | 37.41 | 23.54 | 16.78 | 16.00*** | 9.944 |
| Technical default (%) | 15.30 | 16.08 | 9.91 | 7.87 | 7.43*** | 6.385 |
| Amend after violation (%) | 18.16 | 23.91 | 12.16 | 7.87 | 10.29*** | 8.800 |
| Amend before violation (%) | 32.55 | 48.54 | 45.27 | 43.36 | -10.81*** | -5.127 |
| Waiver (%) | 20.17 | 19.45 | 8.67 | 4.37 | 15.80*** | 17.246 |
| **Panel D: Loan Characteristics** | | | | | | |
| Loan Size ($M) | | 369.7 | 621.77 | 752.97 | -383.27*** | -49.296 |
| Loan Spread (bps) | | 270.7 | 302.75 | 318.35 | -47.65*** | -36.098 |
| Maturity (years) | | 5.63 | 6.1 | 6.1 | -0.48*** | -45.181 |
| Bid-Ask Spread (bps) | | 0.21 | 0.0 | 0.0 | 0.21*** | 4.158 |

## Table 5: **Firm, Loan and CLO Characteristics Around Covenant Violations**

Panel A reports firm financial metrics measured in the quarter preceding covenant violation (t–4), stratified by violation resolution: amendment before violation, amendment after violation, technical default, and waiver granted. Panel B presents loan-level characteristics conditional on violation outcomes, including pricing (spread), structure (maturity, size, number of lenders and covenants), and liquidity characteristics. Panel C documents CLO ownership concentration and constraint intensity for loans in the sample: number of CLOs per loan (count), concentration among top-10 CLO managers (percentage), ownership dispersion measured by Herfindahl-Hirschman Index (HHI), and measure of constraint intensity, the percentage of each loan held by CLOs with binding overcollateralization ratios (constrained CLOs).

**Fundamentals Before Violation**

| $\text{Characteristic}_{t-4}$ | Amendment Before | Amendment After | Technical Default | Waiver |
|---|---|---|---|---|
| Leverage | 0.33 | 0.34 | 0.35 | 0.3 |
| Interest Coverage | 3.43 | -0.78 | -1.94 | -0.76 |
| Cash/Assets | 0.12 | 0.1 | 0.11 | 0.12 |
| ROA | 1.26 | 0.16 | -0.28 | 0.21 |
| Z-Score | 1.76 | 0.97 | 1.5 | 0.73 |

**Loan Characteristics**

| Loan Characteristic | No Violation | Amendment Before | Amendment After | Technical Default | Waiver |
|---|---|---|---|---|---|
| Spread (bps) | 258.31 | 288.52 | 318.11 | 327.77 | 297.01 |
| Maturity (years) | 4.89 | 5.32 | 5.16 | 5.36 | 5.23 |
| Loan Size ($M) | 421.25 | 335.39 | 159.7 | 201.3 | 161.71 |
| #Lenders | 7.69 | 8.08 | 6.4 | 6.13 | 5.88 |
| #Covenants | 2.37 | 2.81 | 3.01 | 3.01 | 3.02 |

**CLO Characteristics**

| Ownership Measure | Mean | Median | SD | p25 | p75 |
|---|---|---|---|---|---|
| # CLOs per Loan | 150.38 | 109.0 | 150.75 | 26.0 | 226.0 |
| % Held by top 10 CLOs | 0.5 | 1.0 | 0.5 | 0.0 | 1.0 |
| HHI of CLO Ownership | 0.1 | 0.01 | 0.24 | 0.0 | 0.04 |
| % Held by constrained CLOs | 0.45 | 0.47 | 0.2 | 0.39 | 0.54 |

## Table 6: **Cumulative abnormal returns**

This table reports estimates of cumulative abnormal returns (CARs) for different event windows and benchmark specifications. The event windows are $[-80,-60]$, $[-80,-1]$, $[-60,-40]$, $[-60,-1]$, $[-20,-1]$, and $[-1,+1]$. For each loan $i$, we calculate the CARs using the following regression

$$r_{i,t} = \alpha_i + \sum_{s \in \mathcal{W}} \beta_{i,s} \, \mathbf{1}[t = s] + \boldsymbol{\gamma}_i' \mathbf{X}_t \cdot \mathbf{1}[t \notin \mathcal{W}] + \epsilon_{i,t},$$

where $r_{i,t}$ is the daily price change, $\mathbf{1}[t = s]$ is an indicator equal to one on event day $s$, $\mathbf{X}_t$ is a vector of benchmark returns, and $\mathbf{1}[t \notin \mathcal{W}]$ is an indicator equal to one outside the event window. The CAR is computed as

$$\text{CAR}_i(\mathcal{W}) = \sum_{s \in \mathcal{W}} \hat{\beta}_{i,s}.$$

Benchmark returns in $\mathbf{X}_t$ include combinations of the ICE BofA US Corporate Index Effective Yield (*Corporate*), the ICE BofA US High Yield Index Effective Yield (*High-Yield*), the 3-Month Treasury Bill yield (*T-Bill*), the S&P 500 Index (*SP500*), and the LSTA Index (*LSTA*). T-statistics are in parentheses (significance levels are $^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$).

| Benchmark Returns | [-80,-60] | [-80,-1] | [-60,-40] | [-60,-1] | [-20,-1] | [-1,+1] |
|---|---|---|---|---|---|---|
| **LSTA, T-Bill, Corporate** | -6.385%* | -2.668%*** | -1.276% | -2.712%*** | -2.185%** | 0.185% |
| | (-1.695) | (-3.762) | (-0.863) | (-3.350) | (-2.000) | (0.064) |
| **LSTA, T-Bill, Corporate, SP500, HY** | -6.376%* | -2.812%*** | -1.346% | -2.820%*** | -2.296%** | 0.134% |
| | (-1.693) | (-3.879) | (-0.909) | (-3.418) | (-2.096) | (0.046) |
| **LSTA, T-Bill, SP500** | -6.447%* | -2.574%*** | -1.318% | -2.575%*** | -2.113%* | 0.284% |
| | (-1.713) | (-3.485) | (-0.894) | (-3.080) | (-1.918) | (0.098) |
| **LSTA, T-Bill, Corporate, SP500** | -6.405%* | -2.690%*** | -1.278% | -2.719%*** | -2.191%** | 0.173% |
| | (-1.700) | (-3.736) | (-0.864) | (-3.316) | (-2.008) | (0.060) |

# Table 7: **Understanding CARs**

Panel A shows cumulative abnormal returns (CAR) for different covenant violation outcomes and event windows ([-80,-60]; [-80,-1]; [-60,-40]; [-60,-1]; [-20,-1]; [-1,+1]). As benchmark returns we use LSTA, T-Bill, Corporate, SP500 and High Yield. We show CARs separately for technical defaults (*CAR Technical Default*), amendments after covenant violations (*CAR Amendment w/ violation*), waiver (*CAR Waiver*) and amendments before covenant violations (*CAR Amendment w/o violations*). Panel B shows differences in mean tests between CARs associated with different outcomes. The difference-in-means tests include LIN fixed effects and cluster standard errors at the LIN level. T-statistics are in parentheses (significance levels are $^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$).

Panel A: Mean Cumulative Abnormal Returns

| Mean CAR | [-80,-60] | [-80,-1] | [-60,-40] | [-60,-1] | [-20,-1] | [-1,+1] |
|---|---|---|---|---|---|---|
| (1) CAR Technical Default | -9.454% | -3.605%** | -1.442% | -3.987%*** | -3.504%* | -2.050% |
| | (-1.157) | (-2.424) | (-0.537) | (-2.770) | (-1.769) | (-0.267) |
| (2) CAR Amendment w/ violation | -6.283%* | -4.966%** | 0.053% | -5.007%** | -1.755% | 1.606% |
| | (-1.701) | (-2.064) | (0.027) | (-1.975) | (-1.526) | (0.494) |
| (3) CAR Waiver | -3.547%* | -1.755%** | -2.187% | -1.450% | -3.497%* | 1.636% |
| | (-1.806) | (-2.023) | (-1.554) | (-1.355) | (-1.669) | (0.310) |
| (4) CAR Amendment w/o violation | -1.871%* | -1.462%** | -0.088% | -1.715%** | -2.240%*** | 3.136%* |
| | (-1.843) | (-2.371) | (-0.124) | (-2.447) | (-2.663) | (1.758) |

Panel B: Differences in Mean Test

| Comparison | [-80,-60] | [-80,-1] | [-60,-40] | [-60,-1] | [-20,-1] | [-1,1] |
|---|---|---|---|---|---|---|
| (1)-(2) | -0.136 | 0.180 | 0.101 | 0.205 | -0.116* | -0.013 |
| | (-1.272) | (0.832) | (1.063) | (0.949) | (-1.845) | (-0.101) |
| (1)-(3) | -0.236** | 0.088 | 0.092 | 0.105 | -0.094** | 0.152 |
| | (-2.361) | (0.655) | (1.568) | (0.778) | (-2.070) | (1.211) |
| (1)-(4) | -0.250** | 0.094 | 0.076 | 0.124 | -0.081* | -0.028 |
| | (-2.349) | (0.689) | (1.470) | (0.909) | (-1.753) | (-0.264) |
| (2)-(4) | -0.114* | -0.086 | -0.025 | -0.081 | 0.035 | -0.015 |
| | (-1.692) | (-1.029) | (-0.467) | (-0.961) | (1.049) | (-0.211) |
| (3)-(4) | -0.014 | 0.006 | -0.016 | 0.019 | 0.013 | -0.180 |
| | (-0.259) | (0.380) | (-0.681) | (0.987) | (0.557) | (-1.549) |

# Table 8: **Liquidity Around Covenant Violations**

This table reports changes in secondary loan market liquidity around covenant violations. Panel A compares bid-ask spreads (in basis points) during the pre-event window [-121,-101] and the event window [-80,-60] by violation outcome. Panel B reports the average number of dealer banks providing quotes during the same windows. Δ denotes the difference between event and pre-event windows. T-statistics test equality of means. Significance levels are *p < 0.10, **p < 0.05, ***p < 0.01.

**Panel A: Bid-Ask-Spreads**

| Violation Outcome | [-121,-101] Bid-Ask (bps) | [-80,-60] Bid-Ask (bps) | Δ | t-stat | N |
|---|---|---|---|---|---|
| Amendment w/ violation | 307.15 | 366.26 | 59.11*** | 3.66 | 143 |
| Amendment w/o violation | 139.84 | 142.25 | 2.40 | 0.88 | 801 |
| Technical Default | 387.91 | 410.39 | 22.48 | 0.78 | 109 |
| Waiver | 203.37 | 192.38 | -10.99 | -0.69 | 72 |

**Panel B: # Dealer**

| Violation Outcome | [-121,-101] #Dealers | [-80,-60] #Dealers | Δ | t-stat | N |
|---|---|---|---|---|---|
| Amendment w/ violation | 4.33 | 4.09 | -0.23** | -2.21 | 143 |
| Amendment w/o violation | 4.99 | 4.85 | -0.14** | -2.27 | 801 |
| Technical Default | 5.19 | 4.40 | -0.78*** | -3.47 | 109 |
| Waiver | 4.70 | 4.37 | -0.34** | -2.09 | 72 |

# Table 9: **Covenant Violations - Firm Default and Downgrades**

This table relates covenant violations to the financial performance of firms. The unit of observation is the firm-quarter level $t$. The sample period is 1996 to 2024. $Violation$ is an indicator variable that is one if a firm $i$ violates a covenant in quarter $t$. Panel A relates covenant violations to *Default*, an indicator variable that is one if a firms files for Chapter 7 or Chapter 11 in the four $(t+4)$ or eight $(t+8)$ quarters after a violation, and *Downgrade*, an indicator variable equal to one if a company is downgraded in the four $(t+4)$ or eight $(t+8)$ quarters after a violation. Panel B relates the outcomes of covenant violations (interacted with credit rating categories) to *Default* and *Downgrade*, both four quarters $(t+4)$ to eight quarters after a covenant violation. The outcome variables are Amendments without Violations (*Amendment w/o Violation*), Amendments with Violations (*Amendment w/ Violation*), and *Technical Defaults*. *Amendment w/o Violation* is an indicator variable that is one if the firm obtained an amendment without being in violation of a covenant and *Amendment w/ Violation* is an indicator variable that is one if the firm obtained an amendment in combination with a covenant violation. *Technical Defaults* is an indicator variable equal to one if the firm remains in technical default. *IG* is an indicator that is one if the firm has an investment-grade rating. *Non-IG* is an indicator that is one if the firm has a non-investment-grade rating. *Unrated* is an indicator variable that is one if the firm is unrated. All regressions include the following firm characteristics as control variables that are frequently used as covenants in loan contracts (*Covenant Controls*): the ratio of operating income over average assets, leverage ratio, the ratio of net worth over assets, the market-to-book-ratio, the ratio of interest expenses and average assets, and the current ratio. Each specification includes a four-quarter lag of the covenant violation variable ($Violation_{t-4}$), four-quarter lags of *Covenant Controls*, and higher order terms of *Covenant Controls*. Each specification includes industry and quarter fixed effects (calendar and fiscal quarter) and we cluster standard errors at the firm and the reporting quarter level. We use industry fixed effects, and cluster standard errors at the industry level. Standard errors are reported in parentheses ($^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$).

**Panel A: Default and Downgrade**

| | (1) Default$_{t+4}$ | (2) Default$_{t+8}$ | (3) Downgrade$_{t+4}$ | (4) Downgrade$_{t+8}$ |
|---|---|---|---|---|
| Violation x IG | 0.004 | 0.005 | 0.010 | 0.008 |
| | (0.006) | (0.010) | (0.017) | (0.021) |
| Violation x Non-IG | 0.042*** | 0.060*** | 0.018** | 0.012 |
| | (0.005) | (0.007) | (0.008) | (0.008) |
| Violation x Unrated | 0.003* | 0.006** | | |
| | (0.002) | (0.002) | | |
| Observations | 221,167 | 221,167 | 90,122 | 90,182 |
| $R^2$ | 0.032 | 0.046 | 0.093 | 0.181 |
| FE | Industry, Quarter | Industry, Quarter | Industry, Quarter | Industry, Quarter |
| Covenant Controls | YES | YES | YES | YES |
| Higher Order Controls | YES | YES | YES | YES |
| Lagged Covenant Controls | YES | YES | YES | YES |

**Panel B: Default and Downgrade & Rating Interaction**

| | (1) Default$_{t+4}$ | (2) Default$_{t+8}$ | (3) Downgrade$_{t+4}$ | (4) Downgrade$_{t+8}$ |
|---|---|---|---|---|
| Amend w/o violation x IG | -0.002 | -0.003 | 0.008 | -0.009 |
| | (0.004) | (0.006) | (0.017) | (0.021) |
| Amend w/ violation x IG | 0.026 | 0.029 | 0.041 | 0.114** |
| | (0.019) | (0.026) | (0.051) | (0.055) |
| Technical Default x IG | 0.026 | 0.054 | -0.045 | -0.038 |
| | (0.034) | (0.047) | (0.051) | (0.073) |
| Amend w/o violation x Non-IG | 0.011*** | 0.025*** | 0.010 | 0.008 |
| | (0.003) | (0.005) | (0.007) | (0.009) |
| Amend w/ violation x Non-IG | 0.059*** | 0.085*** | 0.017 | 0.009 |
| | (0.009) | (0.012) | (0.016) | (0.016) |
| Technical Default x Non-IG | 0.176*** | 0.191*** | 0.059** | 0.046* |
| | (0.025) | (0.026) | (0.023) | (0.025) |
| Amend w/o violation x Unrated | -0.001 | 0.005** | | |
| | (0.001) | (0.002) | | |
| Amend w/ violation x Unrated | 0.002 | 0.005 | | |
| | (0.002) | (0.003) | | |
| Technical Default x Unrated | 0.014*** | 0.013** | | |
| | (0.004) | (0.005) | | |
| Observations | 212,644 | 212,644 | 87,278 | 87,330 |
| $R^2$ | 0.039 | 0.050 | 0.093 | 0.176 |
| FE | Industry, Quarter | Industry, Quarter | Industry, Quarter | Industry, Quarter |
| Covenant Controls | YES | YES | YES | YES |
| Higher Order Controls | YES | YES | YES | YES |
| Lagged Covenant Controls | YES | YES | YES | YES |

Table 10: **CLO Constraints**

This table shows time-series summary statistics related to CLO leverage constraints over the 2007 to 2020 period. It reports the number of CLOs, average size of the CLO (in USD millions), the slack in junior and senior OC ratios and the percentage of CCC-rated loans in the CLO.

| Year | N(CLO) | CLO Amount ($ mil) | Slack (J) (%) | Slack (S) (%) | CCC (%) |
|---|---|---|---|---|---|
| 2009 | 275 | 404 | 1.51 | 9.06 | 12.03 |
| 2010 | 704 | 460 | 2.75 | 11.69 | 5.04 |
| 2011 | 808 | 455 | 3.99 | 16.69 | 5.57 |
| 2012 | 899 | 413 | 4.84 | 22.03 | 6.39 |
| 2013 | 1130 | 373 | 5.93 | 30.86 | 8.44 |
| 2014 | 1433 | 376 | 5.94 | 31.54 | 6.55 |
| 2015 | 1651 | 390 | 5.70 | 31.10 | 7.11 |
| 2016 | 1725 | 389 | 5.10 | 31.87 | 9.19 |
| 2017 | 2010 | 396 | 4.91 | 27.66 | 11.15 |
| 2018 | 2212 | 429 | 5.41 | 23.09 | 9.84 |
| 2019 | 2248 | 455 | 5.45 | 21.89 | 7.99 |
| 2020 | 2492 | 440 | 4.10 | 10.72 | 12.28 |
| 2021 | 2115 | 425 | 4.60 | 15.04 | 10.03 |
| 2022 | 1925 | 424 | 5.01 | 13.53 | 8.70 |
| 2023 | 2182 | 429 | 4.72 | 11.94 | 9.27 |
| 2024 | 2353 | 431 | 4.83 | 13.41 | 9.25 |
| 2025 | 2318 | 419 | 5.31 | 14.40 | 8.75 |

# Table 11: **CARs - Constrained vs unconstrained CLOs**

This table shows the results of OLS regression of CARs in the [-80,-60] window on loan ownership by constrained CLOs and control variables. $Ownership_i$ represents the weighted proportion of constrained CLOs within a given loan. A CLO is classified as constrained if its junior overcollateralization (OC) ratio slack is below the median of all CLOs in the same month-year. *Rated* is a dummy variable equal to one if the loan is rated at the time of the covenant violation and zero otherwise. *Remaining Maturity* is the time until the loan matures, measured in months. *Spread* represents the loan spread in basis points and *Ln(Loan Amount)* denotes the natural logarithm of the loan amount. We include industry and year fixed effects and cluster standard errors at the loan level. Standard errors are reported in parentheses ($^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$).

**Panel A: Loans in Violation**

| | (1)<br>CAR [-80,-60] | (2)<br>CAR [-80,-60] | (3)<br>CAR [-80,-60] |
|---|---|---|---|
| Ownership x Violation | -0.232* | -0.500** | -0.188* |
| | (0.126) | (0.253) | (0.108) |
| Ownership | 0.127 | 0.323 | 0.028 |
| | (0.112) | (0.221) | (0.065) |
| Violation | 0.113* | 0.181* | 0.014 |
| | (0.061) | (0.103) | (0.046) |
| Rated (0/1) | | -0.079 | 0.033 |
| | | (0.056) | (0.029) |
| Remaining Maturity | | -0.001 | -0.001* |
| | | (0.001) | (0.001) |
| Spread | | 0.000 | 0.000 |
| | | (0.000) | (0.000) |
| Ln (Loan Amount) | | 0.102 | 0.056** |
| | | (0.070) | (0.026) |
| Industry FE | NO | NO | YES |
| Year FE | NO | NO | YES |
| Observations | 1107 | 494 | 481 |
| R-squared | 0.004 | 0.022 | 0.190 |

**Panel B: CARs by Violation Category**

| | (1)<br>CAR [-80,-60] | (2)<br>CAR [-80,-60] | (3)<br>CAR [-80,-60] |
|---|---|---|---|
| Ownership x Technical Default | -0.071* | 0.009 | -0.023 |
| | (0.042) | (0.067) | (0.094) |
| Ownership x Waiver | 0.020 | -0.170 | -0.210 |
| | (0.118) | (0.209) | (0.383) |
| Ownership x Amendment w/ Violation | -0.176* | -0.452* | -0.442** |
| | (0.102) | (0.257) | (0.212) |
| Ownership x Amendment w/o Violation | 0.127 | 0.322 | 0.030 |
| | (0.112) | (0.220) | (0.063) |
| Technical Default | 0.088 | 0.113 | -0.073 |
| | (0.059) | (0.082) | (0.053) |
| Waiver | 0.097 | 0.156 | 0.074 |
| | (0.076) | (0.123) | (0.173) |
| Amendment w/ Violation | 0.135** | 0.276* | 0.116 |
| | (0.066) | (0.144) | (0.074) |
| Rated (0/1) | | -0.090 | 0.026 |
| | | (0.062) | (0.030) |
| Remaining Maturity | | -0.001 | -0.001* |
| | | (0.001) | (0.001) |
| Spread | | 0.000 | 0.000 |
| | | (0.000) | (0.000) |
| Ln(Loan Amount) | | 0.105 | 0.058** |
| | | (0.073) | (0.026) |
| Industry FE | NO | NO | YES |
| Year FE | NO | NO | YES |
| Observations | 1107 | 494 | 481 |
| R-squared | 0.004 | 0.024 | 0.191 |

# A Appendix

## A.1 Dealer Banks in the Secondary Loan Market

Table A1: **Top 10 dealers in the secondary loan market**

This table shows the loan market lead arranger (underwriter) market share in the primary syndicated loan market as well as the dealer market share in the secondary market for syndicated loans for the top 10 dealers.

| Name | Dealer Market Share (Secondary) | Underwriter Market Share (Primary) |
|---|---|---|
| Credit Suisse | 9.0% | 6.6% |
| Bank of America | 8.3% | 12.3% |
| Barclays | 7.7% | 7.7% |
| Citigroup | 6.0% | 7.3% |
| JP Morgan | 5.8% | 12.4% |
| Morgan Stanley | 5.7% | 6.4% |
| Deutsche Bank | 5.2% | 5.1% |
| BNP Paribas | 3.9% | 2.9% |
| Wells Fargo | 3.5% | 3.2% |
| Royal Bank of Canada | 3.3% | 1.8% |

## A.2 Variable Definition

Table A2: Compustat variables used for quarterly financial data

| Variable Names | Variables | Compustat Variables/ Capital IQ |
|---|---|---|
| Assets | Total assets | = atq |
| $\overline{Assets}$ | Average assets | = ($atq_t$ + $atq_{t-1}$) /2 |
| MV | Market value | = Market value of equity – book value of equity + atq |
| MV Equity | Market value of equity | = prccq × cshoq |
| BV Equity | Book value of equity | = atq – ltq + txditcq |
| Debt | Total debt | = dltcq + dlttq |
| PPE / Assets | PPE scaled by assets | = ppentq / atq |
| Div | Dividends | = dv adjusted for dependend quarter accumulation |
| Stock purchased | Purchase of common and preferred stocks | = prstkc adjusted for dependend quarter accumulation |
| CapEx | Capital expenditures quarterly | = capxy adjusted for fiscal quarter accumulation |
| CashAcqui | Cash acquisitions quarterly | = aqcy adjusted for fiscal quarter accumulation |
| Sales | Sales | = saleq |
| Net Worth | Net Worth | = atq - ltq |
| Tangible Net Worth | Tangible Net Worth | = actq + ppentq + aoq - ltq |
| | Control Variables | |
| Operating Income/ Assets | Operating income scaled by average assets | = oibdpq / Average assets |
| Leverage Ratio | Leverage ratio | = Total debt / Total assets |
| Interest Expenses/ Asset | Interest expense scaled by average assets | = xintq / Average assets |
| NWA/ Assets | Net worth to assets ratio | = seqq / Total assets |
| Current Ratio | Current ratio | = actq / lctq |
| MTB | Market-to-book-ratio | = Market value / Total assets |
| | Dependent Variables | |
| $\Delta$ Ln(Assets) | Change in Ln(assets) | = Ln(Total $assets_{t+4}$)-Ln(Total $assets_t$) |
| $\Delta$ Ln(PPE) | Change in Ln(PPE) | = Ln($PPE_{t+4}$)-Ln($PPE_t$) |
| $\Delta\frac{CapEx}{Assets}$ | Capital expenditures scaled by average assets | = Capital expenditures / Average assets |
| $\Delta\frac{CashAcq}{Assets}$ | Cash acquisitions scaled by average assets | = Cash acquisitions / Average assets |
| Empl Growth | Relative change of employees | = ($emp_t$- $emp_{t-1}$) / $emp_{t-1}$ |
| $\Delta\frac{NDI}{Assets}$ | Net debt issuance scaled by average assets | = (Total $debt_t$ – Total $debt_{t-1}$) / Average $assets_t$ |
| $\Delta$ Ln(Debt) | Change in Ln(total debt) | = Ln(total $debt_{t+4}$)-Ln(total $debt_t$) |
| $\Delta\frac{Cash}{Assets}$ | Cash scaled by assets | = cheq /Total assets |
| $\Delta$ Ln(Payout) | Change in Ln(shareholder payout) | = Ln(shareholder $payout_{t+4}$)-Ln(shareholder $payout_t$) |
| $\Delta\frac{OpIncome}{Assets}$ | Change Operating cash flow by average assets | = (OpIncome/$Assets_{t+4}$) - (OpIncome/$Assets_t$) |
| $\Delta$ Ln(Sales) | Change in Ln(sales) | = Ln($Sales_{t+4}$)-Ln($Sale_t$) |
| $\Delta$ Ln(Cost) | Change in Ln(Operating Costs) | = Ln(Operating $Costs_{t+4}$)-Ln(Operating $Costs_t$) |
| $\Delta$ Cash Ratio | Total assets | = cheq/ (undrawn_balance + cheq) |
| $\Delta$ Usage | change in usage | = $usage_{t+4}$-$usage_t$ |