Debt Contracting When Borrowers Face Transitory Uncertainty: Evidence from U.S. Gubernatorial Elections

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Abstract

We examine the impact of policy uncertainty surrounding U.S. gubernatorial elections on loan contracting outcomes. Loans made to firms headquartered in election states are more likely to include contingency-pricing provisions and financial covenants. The effect is pronounced for cash flow-based pricing grids and covenants—vis-à-vis balance sheet-based ones—and is stronger when elections are closely contested. Consistent with efficiency of loan contracting under transitory uncertainty, we find no direct effect on loan spreads. However, an important pricing effect is manifested through interest-rate contingencies in pricing grids. The use of rate-increasing grids increases significantly in election years for the firms with geographically concentrated operations and government contract-dependent ones. Our findings suggest that while the contingency-pricing feature curbs an explicit rise in the cost of loans for borrowers facing elections, loan contracts are designed to ensure compensation to lenders for uncertainty—via interest-rate contingencies—and to factor in increased monitoring demand.

Keywords: uncertainty, gubernatorial election, debt contract, contingency pricing, cost of capital

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1. Introduction

How does the uncertainty associated with government policy affect capital markets and firms? The question has received increasing academic interests and media attention. The burgeoning literature assessing such impacts of policy uncertainty documents evidence of its link with corporate investment activities (Julio and Yook, 2012; Gulen and Ion, 2016; Jens, 2017), capital structure (Colak et al., 2018), asset prices and risk premia (Pástor and Veronesi, 2013), IPO activity (Colak et al., 2017), and the prices of corporate bonds (Waisman et al., 2015) and municipal bonds (Gao et al., 2019). This strand of research suggests that firms and investors take actions to mitigate problems associated with changes in political leadership and economic policies. However, despite the growing importance of private loans as a source of capital for many firms, little is known about firms' loan contracting outcomes and the cost of loans in periods of political uncertainty. Our research attempts to fill this void in the literature by investigating how loan contracts are designed to address the problem of uncertainty surrounding U.S. gubernatorial elections.

Exploiting gubernatorial elections as a quasi-natural experiment offers distinct advantages for our investigation of the impact of uncertainty on loan contracting. First, election dates—predetermined by law—are not influenced by states' economic conditions or other determinants of loan contracting outcomes that might also drive changes in government policies and uncertainty. Our identification strategy thus alleviates endogeneity concerns associated with aggregate- and firm-level measures of uncertainty or risk.[1] Second, unlike presidential elections, gubernatorial elections are held in different years across states. The staggered nature of election cycles thus allows us to exploit across-state variation in uncertainty in addition to within-state variation, differencing

[1] That is, what determines firms' credit risk is likely a source of variation in aggregate-level uncertainty indices (e.g., CBOE VIX index, the index developed by Jurado et al. (2015), or the one developed by Baker et al. (2016)) and firm-level variables (e.g., earnings volatility, credit ratings, or firm political risk developed by Hassan et al. (2019)). This can lead to a spurious correlation between such a determinant of credit risk and loan contracting outcome, thus obscuring a true effect of uncertainty on loan contracting outcome.

out other confounders. Third, a state's governor, with a range of executive powers granted regarding state budgets, legislative proposals, and the appointment of officials, is able to make significant influences over the state's economic policies (Peltzman, 1987; Besley and Case, 1995). Therefore, the possibility of change in governorship, whether it is good or bad news, leads to uncertainty about political and economic environments in which firms operate.

To study how lenders assess and respond to increased uncertainty during election years, we examine loan contracting features that help mitigate obstacles to financing under uncertainty.[2] To be sure, loan interest-rate spreads agreed upon, like pricing of other securities, are commensurate with borrowers' creditworthiness and economic conditions facing them. However, interest-rate spread may not be the optimal way to deal with uncertainty—a transitory one in particular—in loan contracting, because the overall efficiency of contracting is an important factor to consider (below we elaborate the notion of contracting efficiency in the context of election uncertainty). We thus focus our analysis on contingency features of loan contracts, namely, covenants, performance pricing (contingency pricing), and the adjustment direction of pricing grids (interest-rate contingencies available in pricing grids).[3] To wit, do lenders raise loan interest spreads in election years or, given the transitory nature of election uncertainty, are they more likely to require that pricing be contingent upon changes in borrowers' fundamentals? Do lenders require more maintenance covenants to facilitate timely monitoring? Moreover, are interest-rate contingencies tilted more toward raising the cost of loans for firms, and if so, what real-side characteristics help firms alleviate the problem? Investigating these issues, we elicit new insights on financial contracting under uncertainty that are not readily available from prior studies on bond and equity offerings in direct capital markets (Waisman et al., 2015; Gao et al., 2019; Colak et al., 2017).

[2] The economic insight derives in the literature concerned with the design of debt contracts to deal with unanticipated changes in future circumstances and asymmetric information problems (Dichev and Skinner, 2002; Gârleanu and Zwiebel, 2009; Roberts, 2015; Hollander and Verriest, 2016; Demerjian, 2017).

[3] We use the terms "performance pricing" and "contingency pricing" interchangeably throughout this paper. Interest-rate contingencies refer to loan interest-rate spreads specified in pricing grids in performance-pricing provisions.

A comparison of loans and direct capital market financing reveals a noteworthy pattern that further motivates our investigation of contingency features of loan contracts. Figure 1 plots transaction volumes of seasoned equity offerings, bond offerings and loans for non-election and election years, respectively, with the volumes in non-election years normalized to 100 for ease of comparison.[4] The mean volumes of firms' equity and bond offerings decline by 12% and 8% (or by $24 million and $62 million), respectively, during election years, consistent with the dampening effects of election on capital raising documented in prior literature (Waisman et al., 2015; Colak et al., 2017). However, the mean loan volume remains almost unchanged in election years—a slight increase by 2% or by $10 million. Our conjecture is that this contrast is attributable partly to contingency pricing in loan contracts, a feature unavailable to bonds and stocks. Since the pricing—cost of capital—of bond and equity determined at issue cannot change, the adverse pricing effect in direct capital markets is imminent in the face of election uncertainty. Such an effect can be mitigated in loan pricing if interest rates are linked to observable measures of borrower creditworthiness.[5]

Using a large sample of U.S. syndicated loans, we find significant impacts of election uncertainty on lenders' demand for contingency pricing and monitoring. Our results show that loans made to firms headquartered in election states are more likely to include performance-pricing provisions and maintenance covenants.[6] The likelihood of performance-pricing provision being included in a loan contract increases by 3% in election years, compared with non-election years.

[4] We first obtain the means and medians of transaction amounts for each state-year. We then calculate the means of these statistics for non-election and election years, respectively. See Figure 1 caption for more details. Combining SEOs and IPOs together into equity financing does not change our conclusion.

[5] This might raise a question why not all firms choose loans over bond and equity issues. However, potential benefits of the contingency-pricing feature should be weighed against other conditions of loans that might be less favorable than those of bonds and stocks. As an exception, Anderson (1999) shows that bond issuers in the Brazil bond market, where uncertainty is high, include contingency-pricing features in indentures. To our knowledge, however, this is rare—if not nonexistent—in the U.S. bond market.

[6] Since we are interested in gauging lenders' intention to monitor changes in firms' economic fundamentals, we focus our analysis on financial covenants. It is well-documented that financial covenants function as a tripwire, establishing a commitment to the transfer of control rights or renegotiation of the contract (e.g., Dichev and Skinner, 2002).

Similarly, the number of covenants increases by 5% (with respect to the sample median). In contrast, loan spreads remain unaffected in election years.

Given the adverse effects of policy uncertainty on equity and bond pricing documented in prior studies (e.g., Pástor and Veronesi, 2013; Waisman et al., 2015), a casual intuition might suggest that private lenders too would command higher loan spreads in election years. However, raising loan spreads is inefficient because the uncertainty associated with election outcome resolves soon after a governor is elected. Had lenders increased loan spreads in response to transitory uncertainty of this sort, they would undergo a surge of renegotiations in the years following elections. In a similar vein, prior studies show that in the face of uncertainty, loan contracts can include a pricing schedule conditioned on changes in observable measures of borrower creditworthiness (Asquith et al., 2005; Armstrong et al., 2010). Consistent with this notion of contracting efficiency, we find that loan spreads are unaffected in gubernatorial election years, whereas the use of contingency-pricing provisions increases. Although lenders' increased demand for monitoring might be undesirable for firms, the contingency-pricing feature presumably helps firms to curb a rise in the cost of loans in election years (as will be discussed shortly, we complete our analysis of loan pricing by examining interest-rate contingencies in each pricing grid).

To corroborate our baseline finding, we extend our analysis in several ways. First, to support the idea that uncertainty in election years is what loan contracts attempt to mitigate, we examine two broad groups of covenants and pricing grids, namely, provisions based on cash-flow measures and those based on balance-sheet measures (performance and capital covenants/grids as in Christensen and Nikolaev (2012)). Since income statement and cash flow statement are more informative about changes in firms' performance in the short run than is balance sheet, covenants and grids based on flow measures help lenders to monitor borrowers more closely and to take actions more quickly. Consistent with this idea, we show that the use of cash flow-based pricing grids and covenants is much more prevalent than that of balance sheet or rating-based ones in election years. The results indicate that election uncertainty leads to greater incentives for lenders

to monitor changes in borrowers' economic fundamentals.

Second, we further ensure that the uncertainty about state governments' policy-making is the economic mechanism underlying the link between gubernatorial elections and debt contracting outcomes we find. If this premise is correct, less predictable elections should have a stronger impact on the use of contingency-pricing provisions and maintenance covenants. To confirm our prediction, we use the term limit status of incumbent governors as an instrument for close elections, because winning margins can reflect economic conditions of states, rather than the uncertainty we want to capture. While term limits, being a legal restriction, are exogenous to economic conditions, term-limited elections tend to have narrow winning margins. Our instrumental variable (IV) estimation result confirms the prediction, supporting the causal interpretation of our finding.

Third, to shed further light on the relationship between election uncertainty and loan pricing, we then zoom in on the "inside" of pricing grids in loan contracts. While the contracting efficiency discussed above (Asquith et al., 2005; Armstrong et al., 2010) explains why election uncertainty has no impact on loan spreads, interest-rate contingencies in pricing grids may be designed in favor of lenders, to compensate them for uncertainty. Presumably, lenders demand this (implicit) compensation from the borrowers that are most prone to election uncertainty. We test this hypothesis by examining two types of pricing grids, namely, interest rate-increasing pricing grid (Increasing PG henceforth) and rate-decreasing pricing grid (Decreasing PG) (see Section 3 for the classification in detail). Consistent with our prediction, we find that the effect of election on the use of Increasing PGs is much stronger for firms with operations concentrated in their headquarter states (Garcia and Nori, 2012) and those with high dependence on government sector.[7] Our finding thus

[7] We also perform an analysis using the National Institute on Money in State Politics data on firms' campaign contributions to gubernatorial candidates. However, our results (unreported) show that firms' campaign contributions have no moderating effect on loan contracting outcomes in election years. This is consistent with the idea that firms' campaign contributions do not necessarily resolve the uncertainty about election outcome. In addition, if campaign contributions lead to more government contracts awarded to firms, this in turn could make them more government-dependent and vulnerable to changes in the status of politicians to which they have ties. In line with this, Fisman (2001)

suggests that election uncertainty indeed has an adverse effect on the cost of loans for these firms. As this pricing effect is manifested through the design of interest-rate contingencies in pricing grids, the interest-rate risks for these borrowers carry over to the future.

Our paper makes important contributions to the literature. It speaks to, among others, the growing literature examining the relation between policy uncertainty and corporate and capital-market outcomes, such as corporate investment (Julio and Yook, 2012; Gulen and Ion, 2016; Jens, 2017), mergers and acquisitions (Bonaime et al., 2018), pricing of stocks and bonds (Pástor and Veronesi, 2012, 2013; Waisman et al., 2015), and IPO activity and pricing (Colak et al., 2017). We extend this literature by investigating whether and how policy uncertainty affects private loans, an increasingly important source of financing. Our investigation highlights the role played by contingency features of loan contracting in alleviating problems associated with financing under uncertainty. Moreover, our analysis of interest-rate contingencies in pricing grids yields important implications for the cost of loans that can go unnoticed.

Our study also complements a volume of research concerned with optimal debt contracting. This literature has investigated how contracts are designed to mitigate debt-equity claim conflicts (Jensen and Meckling, 1976; Smith and Warner, 1979), the problem of creditors' monitoring incentives (Rajan and Winton, 1995; Park, 2000), and agency and information problems (Berlin and Mester, 1992; Dessein, 2005; Gârleanu and Zwiebel, 2009; Hollander and Verriest, 2016; Prilmeier, 2017). We pursue the first systematic investigation on how lenders assess gubernatorial elections and use contingency features to deal with transitory uncertainty. In a study related to ours, Demerjian (2017) investigates how borrower characteristics related to uncertainty affect loan contracting outcomes. In a similar vein, Anderson (1999) and Chaplinsky and Haushalter (2010) analyze unique features of bond indentures in the Brazilian debt market and private investments in public equity (PIPE) transactions in the U.S., respectively, that attempt to address the problems

shows that Indonesian firms connected to President Suharto experience abnormally negative returns when rumors about the president's health problem come out.

of financial contracting under uncertainty. However, our paper differs from theirs in that we exploit an exogenous source of variation in uncertainty, rather than borrower-level measures of uncertainty or aggregate market uncertainty.

To our knowledge, there are two recent papers related to our study although their questions—not just empirical settings—differ from ours. Francis et al. (2014) document a positive effect of Economic Policy Uncertainty Index (Baker et al., 2016) on loan spreads. In a contemporaneous working paper, Gad et al. (2020) similarly show that the firm-level political risk measure developed by Hassan et al. (2019) is positively associated with bond and loan spreads. However, neither of them investigates whether and how contingency features of loan contracting play a role in mitigating and dealing with transitory uncertainty as we do here.[8]

The remainder of this paper proceeds as follows. Section 2 develops our main predictions. Section 3 describes our empirical model and data. Section 4 reports and discusses our empirical results. Section 5 concludes.

2. Main Predictions

The literature assessing the impact of political frictions on corporate outcomes suggests that changes in government policies and political leadership lead to uncertainty about economic environment in which firms operate. Although state governments in the U.S. do not possess fully independent sovereignty, they exercise certain functions of government and governors oversee a wide range of economic issues in their states. Peltzman (1987) argues that presidents and governors have similar executive powers in appointment and budget making. As Besley and Case (1995) show, a governor can make influences on, among others, legislative proposals, tax codes, state

[8] In our untabulated results, we find that Hassan et al.'s (2019) political risk measure has a positive impact on loan spreads but not on the use of contingency-pricing provisions and covenants. This suggests that while firm political risk—measured by information self-revealed by firms—certainly is reflected in firms' credit risk, it differs from the uncertainty we want to capture.

contracts and budgets, and appointing officials and judges. With the possibility of changes in governorship and other appointments, gubernatorial elections thus bring about uncertainty concerning economic policies of states. Theory suggests that firms facing uncertainty find it optimal to delay irreversible investment until the uncertainty resolves (Bernanke, 1983; Dixit and Pindyck, 1994). Recent studies provide empirical support to this prediction in conjunction with economic policy uncertainty (Julio and Yook, 2012; Gulen and Ion, 2016; Jens, 2017). Moreover, prior literature shows adverse effects of policy uncertainty on pricing of equity (Pástor and Veronesi, 2012, 2013), pricing of corporate bonds (Waisman et al., 2015) and municipal bonds (Gao et al., 2019), IPO activity and pricing (Colak et al., 2017), corporate takeovers (Bonaime et al., 2018), and target leverage adjustment speed (Çolak et al., 2018).[9]

Building on this line of literature, our study sheds lights on the role of loan contracting features that help ameliorate the problem of uncertainty. Although election outcome and its economic consequences are uncertain, the election cycle is known; that is, election-related uncertainty is anticipated and loan contracts ex ante take this uncertainty into account. Given prior evidence on the effects of policy uncertainty on equity and bond pricing, one could easily speculate that lenders would command higher interest rates for loans closed in election years. However, charging higher loan spreads causes inefficiencies because the uncertainty associated with elections resolves soon after governors—whose stance on economic policy is communicated throughout their campaigns—take the office.[10] Had lenders increased loan spreads in response to election uncertainty, renegotiations of loan contracts (Roberts and Sufi, 2009; Roberts, 2015) to adjust loan spreads would then pile up once each election concludes. This would incur substantial costs for both

[9] In a related study, Dai and Ngo (2018) report that firms' accounting conservatism increases in election years as information asymmetry increases due to policy uncertainty. Similarly, Boone et al. (2017) document that firms disclosure increases in election years to overcome information asymmetry.

[10] For example, the governor of Kentucky Andy Beshear was elected on November 6, 2019, and signed an executive order on December 16, 2019, to repeal ex-governor's plan for Medicaid-managed contracts and cancel previously awarded bids (https://www.kentucky.com/latest-news/article238663378.html).

lenders and borrowers.

Unlike setting loan spreads, including performance-pricing provision in a loan contract enables a commitment to modifying loan spreads on the basis of observable measures of borrower credit-worthiness (Asquith et al., 2005). A performance-pricing provision involves a pricing grid, a mapping between interest-rate contingencies (equivalently loan-spread contingencies) and changes in borrowers' financial performance, credit rating or other similar measures. As Armstrong et al. (2010) argue, in the presence of contracting frictions, performance-pricing provisions help to reduce costly debt renegotiations that would otherwise occur too frequently. When elections are ahead, therefore, both borrowers and lenders can benefit from contingency-pricing provisions, a feature unavailable to direct capital market financing like bond and equity issues.

Moreover, election uncertainty gives rise to a stronger incentive for lenders to monitor borrowers closely and thus to take actions quickly if the borrower condition deteriorates as the result of the election outcome. Contracting theory suggests that the problem of uncertainty can be mitigated by employing a rule that enables the transfer of control rights from the borrower to investors (lenders effectively), conditional on the borrower economic fundamentals (Aghion and Bolton, 1992). It is well-documented that financial covenants function as a tripwire and thus a threshold that triggers the reallocation of control rights (Christensen and Nikolaev, 2012).

Although the contingency-pricing feature of loan contracting helps to prevent an explicit increase in the cost of loans for firms facing elections, the design of the interest-rate contingencies in pricing grids may be in favor of lenders. We thus expect interest-rate increasing pricing grids to be required of the borrowers whose businesses are most prone to election-related uncertainty, to compensate lenders for the uncertainty. If a firm's operations are concentrated in a single state (i.e., the firm's headquarter state), election uncertainty can affect the firm relatively more because a large share of its revenues are generated from that state. Compared with the firms with geographically dispersed operations, therefore, geographically concentrated firms are more susceptible to

potential changes in policies in their headquarter states. Similarly, election uncertainty matters more to the firms that are dependent on government contracts. As extant studies argue (Fisman, 2001; Faccio, 2006; Goldman et al., 2013), firms' connections with politicians can help them to win government contracts. These firms face a risk of losing their businesses when there is a change in the status of the politicians to which the firms have ties (as discussed above (footnote 7), Fisman (2001) provides the evidence from the Indonesian firms' performance around the rumors about the president's health issue).

In summary, we hypothesize that, consistent with the efficiency of contracting under uncertainty, (1) loan spreads remain unaffected in gubernatorial election years, whereas (2) the use of performance-pricing provisions increases. As uncertainty gives rise to an incentive for lenders to monitor borrowers, (3) the use of financial covenants increases as well. Additionally, while these loan-contracting features help borrowers to curb an increase in loan interest spreads, we predict that (4) the interest-rate contingencies in pricing grids are tilted more toward raising the cost of loans for the borrowers that are most susceptible to suffering from election uncertainty.

3. Empirical Model and Data

3.1. Empirical Model

To investigate the impacts of gubernatorial elections on loan contracting outcomes, we estimate the following equation:

$$y_{i,j,s,t} = \gamma GE_{s,t} + \beta W_{s,t} + \delta X_{j,s,t} + \phi Z_{i,j,s,t} + a_s + b_t + \varepsilon_{i,j,s,t}\,, \qquad (1)$$

where $y_{i,j,s,t}$ is a contract term included in loan i made to firm j headquartered in state s in year t. Our dependent variables of interest include loan interest spread (natural log of all-in-drawn spread), financial covenant intensity (counting the number of six major covenant groups, Nini et al., 2009), and the use of performance-pricing provision in loan contracts. Section 3.2 discusses these

variables in detail. $GE_{s,t}$ is a dummy variable that equals one if a gubernatorial election is held in state s in year t and zero otherwise. We include vectors of covariates $W_{s,t}$, $X_{j,s,t}$, and $Z_{i,j,s,t}$ to account for time-varying economic conditions of states, firm attributes, and loan characteristics, respectively. Following prior literature, we include in $W_{s,t}$ states' real GDP growth, GDP per capita, and unemployment rate. $X_{j,s,t}$ includes, in a lagged form, firm size, market to book, return on assets (ROA), leverage ratio, asset tangibility, Altman's (1969) *Z*-score, cash to assets, sales growth rate, earnings volatility, the negative-earning dummy, research and development (R&D) expenses to assets, the credit-rating dummy, and the lending-relationship dummy. $Z_{i,j,s,t}$ includes loan maturity, deal size, the secured-loan dummy, and the revolving-loan dummy (loan spread is also included when we analyze performance-pricing provisions and covenants).

By including state fixed effects a_s, we estimate the effect of gubernatorial election after differencing out time-invariant heterogeneities in economic and political conditions across states.[11] Year fixed effects b_t ensure that our results are not driven by aggregate economic conditions. Following Bertrand et al. (2004), we use standard errors accounted for within-state clustering. We winsorize variables at 1% in both tails. Appendix provides the variable definitions in detail.

3.2. Data and the Measurement

To construct our sample, we begin by retrieving all dollar-denominated syndicated loans extended to the U.S. borrowers between 1990 and 2014 from the Thomson Reuters LPC's Dealscan database. Following Christensen and Nikolaev (2012), we focus our analysis on the loan-package level by aggregating the facility information at the package level.[12] We then merge our loan sample with

[11] A firm fixed-effects model is unsuitable since our loan-contract sample is not a firm-year panel.

[12] In most cases, financial covenants apply to all loan facilities in a package, but, as Berlin et al. (2020) document, a split-control-right arrangement has become popular in the later part of our sample period (i.e., 2010–2014). Under this arrangement, a loan package consists of revolving credits with maintenance covenants and term loans without covenants. The term-loan tranche participants—usually dispersed—therefore avoid getting involved in costly renegotiation process, although still benefiting from monitoring activities taken by revolving creditors—mostly banks. 34% of our baseline sample includes multiple facilities and our results are robust to filtering these loans out in our tests.

Compustat and CRSP files to obtain borrower characteristics.[13] Excluding financial firms (SIC codes 6000–6999) leaves us 17,195 observations as our baseline sample. We extract the historical information on firms' headquarter locations from Bill McDonald's website because Compustat only provides the most recent records.[14] The state-level real GDP and GDP per capita are collected from the Bureau of Economic Analysis (BEA) Regional Economic Accounts database. State unemployment rates are from Bureau of Labor Statistics.

Our gubernatorial election data come from Congressional Quarterly Electronic Library. As summarized in Panel A of Table 1, 36 states elect their governors in "Midterm election" years (the midpoint of presidential elections), eleven states in presidential election years, three states in one year before presidential elections, and two states in one year after presidential elections.[15] During our sample period from 1990 to 2014, there are 350 gubernatorial elections and six presidential elections. Panel B of Table 1 reports election winning margins and the distribution of winning margins. As is well known, term-limited elections—for which term-limited incumbent governors are not allowed to run—are more closely contested. In our sample period, 93 elections are term-limited, and the mean winning margins for term-limited and normal elections, respectively, are 12.8% and 18.6%. About 32% (42%) of elections have a winning margin lower than 7% (10%), and the winners of these closely-contested elections on average earned less than 50% of total votes.

[Insert Table 1]

Panel A of Table 2 reports the summary statistics for the variables used in our baseline regressions. These statistics are in line with those reported in prior literature. The sample mean of the number of financial covenants is 2.3, similar to the means reported by Demerjian (2017) and

[13] The Dealscan-Compustat link table comes from Chava and Roberts (2008). We use the version updated up to 2017.

[14] The EDGAR 10-K header information compiled by Bill McDonald and Tim Loughran is available from https://sraf.nd.edu/data/augmented-10-x-header-data/. When the information is missing (before 1994 for most firms), we take the earliest possible records to backward-interpolate.

[15] Governors of New Hampshire and Vermont have two-year terms, elected in even years. Rhode Island's first four-year term governor was elected in 1994 ("Midterm" cycle), until which the state's governors had two-year terms.

Prilmeier (2017). 44% of the loans in our sample include performance-pricing provisions, comparable to Ball et al (2008). The distribution of other loan-level variables in our sample is also similar to that of prior studies (see, e.g., Hasan et al., 2017). Like Hollander and Verriest (2016), we use the number of financial covenants (*Covenant Intensity*) in a loan package to gauge lenders' incentives to monitor. Following prior literature (e.g., Nini et al., 2009), we classify financial covenants into one of the following six groups: (1) ratios of debt to balance sheet items, (2) various coverage ratios, (3) ratios of debt to cash flow items, (4) liquidity ratios, (5) net worth requirements, and (6) EBITDA requirements. We then count the number of these six categories of financial covenants to construct *Covenant Intensity*. Panel B of Table 2 reports the frequency of each group, as well as individual covenants, in our sample. Among the most common are coverage, debt to cash flow, and net worth categories, which, respectively, appear in 83.5%, 66.3%, and 33.8% of loan contracts in our sample. Overall, these statistics are in line with those reported in prior literature (e.g., Prilmeier (2017) reports 79%, 60%, and 43%, respectively, for the top three categories).

[Insert Table 2]

For our baseline analysis of contingency-pricing provision, we construct a dummy indicator that equals one if a contract includes the provision and zero otherwise. As discussed above, we further examine in Section 4.4 the direction of interest-rate contingencies in each pricing grid, namely, whether the menu offered is an interest rate-increasing pricing grid (Increasing PG) or rate-decreasing pricing grid (Decreasing PG). Some pricing grids only contain the interest-rate contingencies that go in one direction (i.e., all contingencies r_τ are either higher or lower than the initial rate r_o), whereas others contain both scenarios. We therefore count the number of rate-increasing contingencies, say, N^{up}, and the number of rate-decreasing contingencies, say, N^{down}, and check which direction is more prevalent in a pricing grid. A pricing grid is then referred to as

Increasing PG if N^{up} is larger than N^{down}.[16] Decreasing PG is similarly defined in the inverse way. When a facility has multiple priding grids, we check whether it has more Increasing PGs than Decreasing PGs and vice versa. Finally, the information is aggregated at the package level.

To test our predictions as to the borrowers whose businesses are geographically concentrated and reliant on government contracts, we construct the following measures. To gauge the extent to which a firm's operation is concentrated in its headquarter state, we follow Garcia and Norli (2012) to count how many times the names of the firm's headquarter state and other states are mentioned in its 10-K filings. Specifically, the geographical concentration ratio is calculated as

$$Geog.concentration = \frac{N_{j,t}^{\text{HQ state}}}{N_{j,t}^{\text{HQ state}} + N_{j,t}^{\text{Non HQ}}}$$

where $N_{j,t}^{\text{HQ state}}$ and $N_{j,t}^{\text{Non HQ}}$, respectively, are the number of occurrences of firm j's headquarter state name and that of non-headquarter state names mentioned in 10-K filings. We define a firm as geographically concentrated if its concentration ratio exceeds 50%. To construct a measure of government dependence, we follow Belo et al. (2013) to make use of the BEA Input-Output Accounts database. For each industry, we calculate the proportion of output sold to government sectors (output flow to governments divided by total output) and define a firm as government dependent if its industry has the ratio greater than the sample median.

4. Empirical Results

In this section we empirically investigate how gubernatorial elections affect loan contracting outcomes. The main prediction, as discussed in Section 2, is that the use of performance-pricing provisions and financial covenants increases in election years, whereas loan spreads are unaffected.

[16] There are some cases of tie (i.e., $N^{up} = N^{down}$) at the facility or package level, and we do not include these cases. Asquith et al. (2005) define Increasing PG (Decreasing PG) as a grid that contains *at least* one increasing (decreasing) contingency. Under their approach, an Increasing PG can have more rate-decreasing contingencies than rate-increasing contingencies and vice versa. This approach, thus, is unsuitable for the purpose of our investigation.

Our hypothesis derives in the notion of contracting efficiency, given the transitory nature of uncertainty associated with elections. We conduct additional tests to ensure that uncertainty is the main mechanism underlying our results. We then zoom in on contingency pricing grids to further elicit the implications of election uncertainty for the cost of loans.

4.1. Impact of Gubernatorial Election on Loan Contracting Outcomes

We begin our analysis by estimating Equation (1) using financial covenant intensity, performance-pricing provision dummy, and the natural log of loan spreads, respectively, as our dependent variables. The equation is estimated using either logit model (performance-pricing provision) or linear model (financial covenant intensity and loan spreads), depending on our variable of interest. In all cases, standard errors are adjusted for clustering at the state level (Bertrand et al., 2004).

Panel A of Table 3 reports our baseline regression results for performance-pricing provision and financial covenant intensity. We include state and year fixed effects as our baseline equation although our results are similar or slightly stronger when we additionally control for Fama-French 48 industry dummies (Columns 3 and 4). Across all models, we find that the coefficient on the dummy variable *Gubernatorial Election* is positive and statistically significant. Consistent with our hypothesis, loan contracts are more likely to require performance-pricing provisions and maintenance covenants during gubernatorial election years. The effect we document is also economically significant. The marginal effect reported in Column 1 shows that gubernatorial election is associated with a 3% increase in the likelihood that a loan contract includes performance-pricing provision. This is an economically meaningful effect given the sample mean of 44%. Moreover, the result in Column 2 indicates that the number of financial covenants increases by 5% (equivalent to an increase of 5% relative to the sample median). It is worth noting that our estimate is likely a lower bound given that some firms, with stricter covenant requirements imposed, might have decided not to enter into loan agreements.

[Insert Table 3]

Panel B of Table 3 reports the results of our loan-spread regressions. We find that the coefficient on *Gubernatorial Election* is statistically insignificant. As expected, election uncertainty has no direct impact on loan spreads, consistent with the notion of efficiency of contracting under uncertainty. The election uncertainty facing firms is transitory in its nature and resolves soon after a governor is elected. Had lenders increased loan spreads in response to election uncertainty, renegotiations to adjust loan spreads would then pile up once the election outcome is realized. This would be costly for both lenders and borrowers. We note that loan spreads and the use of performance-pricing provisions may be jointly determined. To account for this, we estimate the equations for loan spreads and performance-pricing provision together in a two-stage least square (2SLS) framework. To identify the system of the two equations, we include industry mean loan spread and industry mean rate of performance-pricing provision, respectively, in the equations for loan spread and performance-pricing provision. Our joint estimation results, reported in Panel C of Table 3, show that the effect of election uncertainty on loan spreads is insignificant, whereas its impact on performance-pricing provision remains significant.[17]

Our finding, collectively, suggests that gubernatorial election has important implications for private loan contracting and the cost of loans. Given the transitory nature of election uncertainty and the prevalence of renegotiations in private contracting, charging higher loan spreads in response to election uncertainty is a costly proposition for both lenders and borrowers. Consistent with this intuition, we find that loan spreads remain unaffected in gubernatorial election years. However, the uncertainty associated with potential changes in political leadership and economic policies brings about an increased demand for the use of contingency pricing grids and maintenance covenants. These provisions allow lenders to monitor borrowers and to take actions in response to subsequent changes in borrowers' creditworthiness. The contingency-pricing feature helps firms to prevent an explicit rise in loan interest spreads in election years, but the

[17] In unreported results, we estimate the loan spread, performance pricing, and debt maturity equations jointly. We find that the results are similar.

contingencies of loan spreads in pricing grids may be designed in favor of lenders. We return to this possibility in Section 4.4.

4.2. Cash Flow-Based Pricing Grids and Covenants

Prior literature shows that financial covenants and pricing grids can be classified into two broad categories, one based on cash flow measures and the other based on balance-sheet measures. Christensen and Nikolaev (2012) argue that these two groups of covenants and pricing grids, namely, performance covenants and performance grids (P-covenants and P-grids henceforth) and capital covenants and capital grids (C-covenants and C-grids), play distinct roles. To wit, C-covenants help align the interests of shareholders with debtholders because the covenants of this type require shareholders to maintain enough skin in the game. In contrast, P-covenants mainly serve as a trip-wire (Dichev and Skinner, 2002) facilitating ex post monitoring and a timely transfer of control rights to debtholders when necessary (Aghion and Bolton, 1992). In a similar fashion, pricing grids are classified into P-grids and C-grids although another common category is the ones based on credit ratings (R-grids henceforth).

Given that financial information based on income statement and cash flow statement is more sensitive to changes in firm performance in the short run than is that of balance sheet, P-covenants and P-grids are akin to early warning signals about borrowers' economic conditions. That is, the provisions based on cash flow measures help lenders to monitor borrowers closely and to take actions quickly when any problem arises after election. We thus expect that in gubernatorial election years, loan contracts are more likely to include P-covenants (P-grids) than C-covenants (C-grids and R-grids).

Following Christensen and Nikolaev (2012), we divide financial covenants into P-covenants and C-covenants, and count the number of each type of covenants to construct our variables,

namely, *P-covenant* and *C-covenant*, respectively.[18] Similarly, we classify pricing grids into three types to construct dummy variables *P-grid*, *C-grid*, and *R-grid*. Summary statistics of these different groups of covenants and pricing grids are reported in Table 2. The sample means (medians) of *P-covenant* and *C-covenant*, respectively, are 0.93 and 0.42 (1 and 0). The means of binary indicators *P-grid*, *C-grid*, and *R-grid*, respectively, are 0.26, 0.03, and 0.16. C-grids are relatively rare.

[Insert Table 4]

Table 4 reports our estimation results for pricing grids (Columns 1–3) and covenants (Columns 4 and 5). All regressions include the covariates in Equation (1). We find evidence consistent with our prediction discussed. Columns 1–3 show that the coefficient on *Gubernatorial Election* is positive and significant for P-grids, whereas it is insignificant for C-grids and R-grids. Similarly, Columns 4 and 5 confirm that the impact of election uncertainty is concentrated in P-covenants. These results suggest that election uncertainty gives rise to an incentive for lenders to focus more on cash flow information in designing pricing grids and covenants, a contracting choice to facilitate effective monitoring and timely action. Our finding thus supports the idea that loan contracts attempt to mitigate the problem of uncertainty surrounding elections.

4.3. Closely Contested Elections

In this subsection, we further ensure that policy uncertainty is the key economic mechanism underlying the relationship between gubernatorial election and loan contracting outcomes we find. While we use gubernatorial elections as a proxy for such uncertainty, the level of uncertainty may differ across elections. Intuitively, the uncertainty increases with the extent to which an election is contested (Julio and Yook, 2012; Boutchkova et al., 2012), and a closely-contested election can

[18] Specifically, the following covenants are classified as C-covenants: quick ratio, current ratio, debt to equity, loan to value, debt to tangible net worth, leverage ratio, senior leverage ratio, and the net worth requirement. Included in P-covenants are: cash interest coverage ratio, debt service coverage ratio, level of EBITDA, fixed charge coverage ratio, interest coverage ratio, debt to EBITDA, and senior debt to EBIT.

be inferred from the winning margin—difference between the shares of votes cast for the winner and the runner-up. However, one problem of using the closeness of election is that it may be correlated with states' economic conditions that affect firms' creditworthiness and loan contracting outcomes. This spurious correlation would then be captured in a simple OLS regression of loan contracting outcome on the election closeness.

To address this concern, we use the term limit status of incumbent governors as an instrument for close elections (Jens, 2017). It is well-known that the probability that incumbents are re-elected is high, and thus the election outcome is more predictable when incumbent governors are running for the office. In contrast, when incumbent governors face their term limit, a close election is more likely, resulting in a relatively narrow winning margin. As reported in Panel B of Table 1, when incumbent governors reach their term limit, the elections are more closely contested; the mean winning margin for term-limited elections is 12.8%, whereas that of normal elections is 18.6%.

About 42% of elections have a winning margin lower than 10%, and one third of elections have a winning margin lower than 7%. Consistent with Jens (2017), we use a margin of 7% to define a close election although our results hold when 10% is used as the cutoff. On average the share of votes cast for the winners of these close elections was less than 50%, suggesting that the election outcome was harder to predict, compared with other elections (e.g., in the elections with a winning margin greater than 20%, winners typically earned 64% of votes). Using the instrumental variable (IV) method, we estimate the following equations:

$$CGE_{s,t} = \theta Term\ limit_{s,t} + \beta W_{s,t} + \delta X_{j,s,t} + \phi Z_{i,j,s,t} + a_s + b_t + \varepsilon_{i,j,s,t} \quad (2)$$

$$y_{i,j,s,t} = \gamma \widehat{CGE}_{s,t} + \beta W_{s,t} + \delta X_{j,s,t} + \phi Z_{i,j,s,t} + a_s + b_t + \varepsilon_{i,j,s,t}\,, \quad (3)$$

where $CGE_{s,t}$ is a dummy variable for close elections that equals one if the winning margin is smaller than 7% (10% for our additional check). As discussed, variable $Term\ limit_{s,t}$ is used as the instrument for $CGE_{s,t}$. $\widehat{CGE}_{s,t}$ in Equation (3) is the predicted value of election closeness

estimated from Equation (2).

Table 5 reports our estimation results, using a winning margin of 7% (Panel A) and that of 10% (Panel B), respectively, as the cutoff for close elections. The first stage result in Column 1 shows that our instrument *Term limit* is a strong predictor of close elections. Columns 2 and 3 report the second-stage results for the use of performance-pricing provisions and the covenant intensity, respectively, using probit and linear models. Column 4 is the results for loan spreads.

[Insert Table 5]

We find that when close elections are expected, the likelihood of the use of performance-pricing provision increases by 11.5% or 7.8%, depending on our definition of close election. The covenant intensity increases by 25.5% or 17.3% (although the coefficient in Column 3 of Panel A is insignificant, the *p*-value is 0.106, close to the conventional significance level). Loan spreads are again unaffected. These results confirm that when an upcoming election is expected to be hotly contested, loan contracts are more likely to require performance-pricing provisions and financial covenants to deal with uncertainty. The IV estimation results support the causal interpretation of our finding, suggesting that policy uncertainty associated with gubernatorial elections indeed plays important roles in private debt contracting.

4.4. Are Interest-Rate Contingencies Designed to Compensate Lenders for Uncertainty?

To shed further light on the implications of election uncertainty for the cost of loans, we set out to examine the "inside" of contingency pricing grids. Although the contingency-pricing feature of private loan contracting suppresses a rise in loan interest spreads in election years, the interest-rate contingencies specified in pricing grids may be designed in favor of lenders. An agreement to raising the interest rate—according to a pricing grid—can serve as the compensation to lenders for uncertainty that is not explicitly factored into the interest rate determined at the initiation of a

loan.[19] We predict that lenders demand this (implicit) compensation from the borrowers whose businesses are most vulnerable to election-related uncertainty.

4.4.1. Interest-rate contingencies specified in pricing grids

For the completeness of our analysis, we begin with "unconditional" tests. A casual intuition might suggest that election uncertainty would lead to an unequivocally stronger demand for Increasing PGs than Decreasing PGs. However, we expect the difference, unconditionally, to be small. To elaborate, given the inefficiency associated with explicitly pricing election uncertainty, the initial rate r_o determined at the initiation of a loan does not yet take into account this uncertainty. The contracting parties instead attempt to account for the uncertainty using pricing grids, and the direction of interest-rate contingencies in a grid thus will depend critically on the expectation about how realized election outcome affects individual borrowers. Since election uncertainty can unfold in either way for different borrowers, a prediction as to whether election uncertainty leads to the use of Increasing PG or Decreasing PG, requires conditioning on borrower characteristics. It is also worth noting that Increasing PGs are not as commonly used as Decreasing PGs in general; Increasing PGs comprise 28% of pricing grids in our sample (see, e.g., Asquith et al. (2005) for a similar result) and the share changes to 29% in election years.

[Insert Table 6]

We report in Table 6 the whole sample results without conditioning on any borrower attributes. We conduct a univariate comparison and estimate both multinomial logit model and binary logit model (the covariates in Equation (1) are included in all regressions). The results show that consistent with our prediction discussed, the impact of election uncertainty is similar across the use of Increasing PG and Decreasing PG. The univariate comparison shows that the proportion of loans with Increasing PGs and Decreasing PGs increases by similar magnitudes, 1.1% and 1.4%,

[19] As discussed in Section 2, raising loan interest rates outright in response to transitory uncertainty leads to inefficiencies.

respectively, in election years, compared with non-election years. The multinomial logit and binary logit estimation results confirm this finding: while the coefficient on the election dummy is positive for both Increasing PG and Decreasing PG, the marginal effects, 0.9% and 1.1%, respectively, are not meaningfully different. The election uncertainty implies that the business prospect of firms can change either way, and it is therefore not surprising to see a positive impact on the use of Increasing PG and Decreasing PG, both. As discussed, we expect lenders to demand Increasing PGs—as compensation for election uncertainty—selectively from a subset of borrowers, which is the focus of our subsequent analysis.

4.4.2. Borrowers prone to election uncertainty

We consider the borrowers whose operations are susceptible to election-related uncertainty. As discussed in Section 2, the firms with the operations concentrated in their headquarter states suffer more from the states' policy uncertainty. Similarly, the firms that rely more on businesses with governments are more vulnerable to election uncertainty. We test our predictions using the measures of firms' geographical concentration and government-contract dependence introduced in Section 3.

Table 7 reports our results based on the geographical-concentration subsamples (Panel A) and the government-dependence subsamples (Panel B). For each case, we conduct a univariate comparison, multinomial logit estimation, and binary logit estimation. The univariate comparison in Panel A shows that among geographically concentrated firms (Columns 1 and 2), the proportion of loan contracts with Increasing PG rises by 0.02 in election years (15% increase compared with 0.127 in non-election years), whereas the change is very small for Decreasing PG (from 0.263 to 0.261). Columns 3 and 4 show that these changes are small among geographically dispersed firms; in election years, the use of Increasing PG and Decreasing PG, respectively, goes up by 0.005 (4% increase from 0.115) and 0.011 (4% increase from 0.274). The multinomial logit and binary logit estimation results are consistent with our inferences drawn on the univariate analysis. We see a

significant increase in the likelihood of Increasing PG being included in loan contracts among geographically concentrated firms in election years. The marginal effect is 2.8%, similar to the magnitude of the increase found in the univariate comparison. Such an effect is not observed among geographically dispersed firms. For both groups, the impact on the use of Decreasing PG is small and insignificant.

[Insert Table 7]

Turning to the government-dependence subsamples in Panel B, the pattern of differences across the two groups is similar to that of Panel A. Columns 1 and 2 show that among high government-dependence firms, the proportion of loans with Increasing PG goes up by 0.026 in election years (26% increase compared with 0.099 in non-election years), whereas the change is negligible for Decreasing PG. No noticeable change occurs to low government-dependence firms (Columns 3 and 4). The results estimated from multinomial logit and binary logit models again confirm our conclusions drawn on the univariate analysis. There is a significant increase in the use of Increasing PG in loan contracts among government-contract dependent firms in election years.

These results lend strong support to the prediction that lenders demand compensation for election uncertainty selectively from the firms whose businesses are sensitive to the uncertainty. Notably, this compensation comes in the form of contingency pricing grid, not loan spread, consistent with the efficiency of loan contracting.[20] The interest-rate contingencies agreed upon in pricing grids can provide lenders with commensurate rewards ex post, depending on economic states realized. From the borrowers' perspective, however, election uncertainty has an important effect on the cost of loans because the possibility of an increase in loan spreads carries forward.

[20] We also conduct an analysis of loan spreads for the same subsamples, finding no effect of election across all groups (unreported). These results confirm the discussed idea that contracting efficiency is an important factor to consider for lenders and borrowers facing election uncertainty.

5. Conclusions

This paper offers novel insights on how contingency features of private loan contracting mitigate the problem of financing under uncertainty. Prior literature documents adverse impacts of policy uncertainty on firms' financing and the cost of capital, mostly in the context of direct capital markets. However, the way the uncertainty plays out in private debt contracting is more nuanced than what might be inferred from prior studies. By exploiting the U.S. gubernatorial elections as a shock to uncertainty in states' economic policies, we show that loan contracts in election years are more likely to include contingency-pricing provisions and financial covenants to allow lenders to monitor borrowers closely and take actions quickly when needed. Importantly, we find no impact of election on loan spreads, consistent with the transitory nature of election uncertainty and the notion of contracting efficiency. Instead, interest rate-increasing pricing grids are more frequently required of the borrowers with geographically concentrated businesses and government contract-dependent ones.

Our findings suggest that while the contingency-pricing feature curbs an explicit rise in loan interest-rate spreads for firms facing elections, interest-rate contingencies in pricing grids are designed to ensure compensation to lenders for election uncertainty. Lenders demand this compensation—in the form of interest rate-increasing pricing grid—from the borrowers that are most prone to election-related uncertainty, and, for these borrowers, interest-rate risks carry forward to the future. Therefore, election uncertainty, albeit transitory, has an important implication for the cost of corporate loans that can go unnoticed in a conventional analysis.

Appendix A. Variable Definitions

Loan characteristics	
Covenant Intensity	Number of financial covenants included in a loan contract (the count of six groups of covenants defined in Table 1).
P-covenant	Number of performance-based covenants (Christensen and Nikolaev, 2012).
C-covenant	Number of capital-based covenants.
Performance Pricing	A dummy variable to indicate performance-pricing provision included in a loan contract.
P-grid	A dummy indicator for performance-based pricing grid.
C-grid	A dummy indicator for capital-based pricing grid.
R-grid	A dummy indicator for rating-based pricing grid.
Increasing (*Decreasing*) *PG*	A dummy variable to indicate increasing (decreasing) pricing grid. *Increasing PG* equals one if a pricing grid includes all interest-rate contingencies r_τ are higher than the initial rate r_o or the number of rate-increasing contingencies ($r_\tau > r_o$) exceeds that of rate-decreasing contingencies ($r_\tau < r_o$). *Decreasing PG* is similarly defined in the inverse way. When a loan facility has multiple priding grids, we check whether it has more Increasing PGs than Decreasing PGs and vice versa. Finally, the information is aggregated at the package level.
Secured	A dummy variable to indicate secured loans.
Revolver	A dummy variable to indicate revolving facility included in a loan.
Relationship lending	A dummy variable that equals one if a loan is extended to a firm that borrows from the same lender in the last five years.
Relative deal size	Total loan amount in a package scaled by borrowers' total assets.
Debt maturity	Average maturity weighted by facility amount.
Spreads	Average all-in-drawn spreads weighted by facility amount.
Firm characteristics	
ln[*Assets*]	Natural logarithm of total assets measured in year *t*–1.
MTB	Market to book in year *t*–1.
Leverage	The sum of long-term and short-term debt divided by total assets in year *t*–1.
Tangibility	Net property, plant, and equipment divided by total assets in year *t*–1.
Z-score	Modified Altman's (1968) Z-score in year *t*–1. Z-score is calculated as (1.2 working capital + 1.4 retained earnings + 3.3 EBIT + 0.999)/total assets (Graham et al., 2008).
Cash holding	Cash and short-term investment divided by total assets in year *t*–1.

Sales growth	Sales in year *t*–1 divided by sales in year *t*–2 minus 1.
Earnings volatility	Standard deviation of quarterly earnings in past three years before the loan initiation year.
Loss	A dummy variable that equals one if a firm's net income in year *t*–1 is negative and zero otherwise.
R&D	R&D expenses divided by total assets in year *t*–1. When missing, R&D expense is replaced with zero.
ROA	Income before extraordinary items divided by total assets in year *t*–1–
Unrated	A dummy variable that equals one if a firm has no S&P rating.
Geographical concentration	The extent to which a firm's business is geographically concentrated in its headquarter state (Garcia and Norli, 2012), calculated as $\frac{N_{j,t}^{\text{HQ state}}}{N_{j,t}^{\text{HQ state}}+N_{j,t}^{\text{Non HQ}}}$, where $N_{j,t}^{\text{HQ state}}$ and $N_{j,t}^{\text{Non HQ}}$, respectively, are the number of occurrences of firm j's headquarter state name and that of non-headquarter state names mentioned in 10-K filings. Following Garcia and Norli (2012), we focus on "Item 1: Business," "Item 2: Properties," "Item 6: Consolidated Financial Data," and "Item 7: Management's Discussion and Analysis" to search state names. A firm is defined as geographically concentrated if the ratio exceeds 0.5.
Government dependence	The extent to which a firm's industry is dependent on government contracts (Belo et al., 2013), calculated as the output sold to government sectors divided by total output using the BEA Input-Output Accounts database. A firm is defined as government dependent if its industry has the ratio greater than the sample median.
State-level variables	
Gubernatorial election	A dummy variable that equals one if a gubernatorial election is held in a state in a given year.
Real GDP growth	State real GDP growth.
ln[*GDP per capita*]	Natural logarithm of state real GDP per capital.
Unemployment rate	State unemployment rate (seasonally adjusted).

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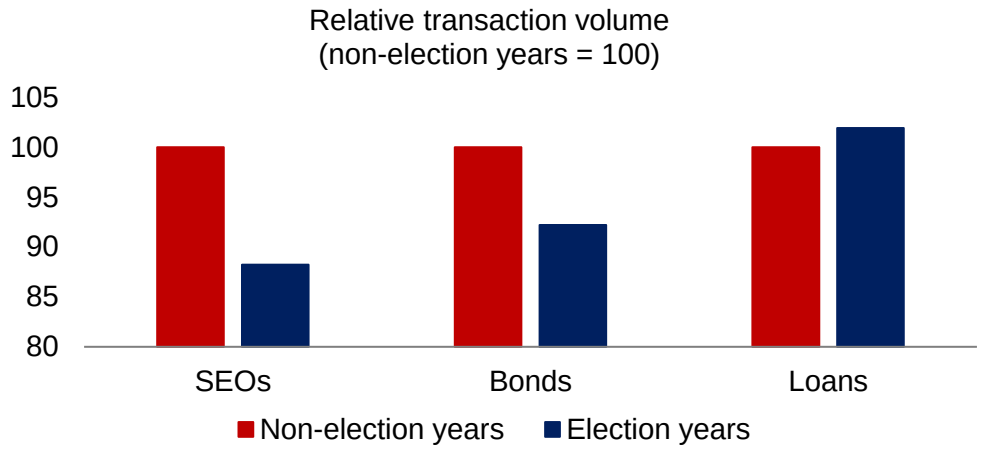
FIGURE 1: Capital Raising in Election Years and Non-election Years



Transaction volume in $mln.

	Non-election years	Election years	Change (in $mln.)	% Change
State-year means:				
SEOs	202.2	178.4	-23.8	-12%
Bonds	798.9	736.6	-62.2	-8%
Loans	497.0	506.6	9.5	2%
State-year medians (averaged):				
SEOs	154.9	139.1	-15.8	-10%
Bonds	662.8	581.4	-81.4	-12%
Loans	287.3	301.7	14.4	5%

This figure reports transaction volumes of seasoned equity offerings (SEOs), bond offerings and loans for non-election and election years, respectively. Data on SEOs and bond offerings come from SDC and loan data from DealScan for the U.S. nonfinancial firms from 1990–2014. We keep observations with the issue amount larger than $1 million and smaller than total assets. To obtain statistics by state and year, we first calculate means and medians of transaction amounts for each state-year. We then calculate the means of these statistics for non-election and election years, respectively. For the bar graphs, the volumes in non-election years are normalized to 100.

TABLE 1: Gubernatorial Election Cycle and the Distribution of Election Winning Margins

Panel A: Gubernatorial election cycle (based on the current cycles adopted by states)

	States	Years of elections (1990–2014)
Before presidential	KY, LA, MS (3 states)	2011, 2007, 2003, 1999, 1995, 1991
Presidential	DE, IN, MO, MT, NC, ND, UT, WA, WV (9 states, plus NH*, VT*)	2012, 2008, 2004, 2000, 1996, 1992
After presidential	NJ, VA (2 states)	2013, 2009, 2005, 2001, 1997, 1993
Midterm	AL, AK, AZ, AR, CA, CO, CT, FL, GA, HI, ID, IL, IA, KS, ME, MD, MA, MI, MN, NE, NV, NM, NY, OH, OK, OR, PA, RI, SC, SD, TN, TX, WI, WY (34 states, plus NH*, VT*)	2014, 2010, 2006, 2002, 1998, 1994, 1990
*Two-year term	Governors of NH and VT have two-year terms, elected in even years. RI's first four-year term governor was elected in 1994 ("Midterm" cycle), until which the state's governors had two-year terms. UT ("Presidential" cycle) had a special election in 2010.	

Panel B: Winning margins

Sample period 1990–2014

Winning margins by term limit				Distribution of winning margins and the earned votes			
	N	Mean	Median		N	Mean	Median
Term limited = 0	257	0.186	0.149	Winning margin < 5%	82	0.488	0.496
Term limited = 1	93	0.128	0.095	Winning margin 5%-7%	30	0.498	0.511
Combined	350	0.171	0.135	Winning margin 7%-10%	35	0.518	0.527
				Winning margin 10%-15%	40	0.530	0.550
				Winning margin 15%-20%	50	0.570	0.575
				Winning margin > 20%	113	0.642	0.636

Extended period 1960–2014

Winning margins by term limit				Distribution of winning margins and the earned votes			
	N	Mean	Median		N	Mean	Median
Term limited = 0	605	0.176	0.124	Winning margin < 5%	181	0.496	0.504
Term limited = 1	172	0.126	0.096	Winning margin 5%-7%	74	0.510	0.523
Combined	777	0.165	0.117	Winning margin 7%-10%	87	0.526	0.536
				Winning margin 10%-15%	118	0.544	0.555
				Winning margin 15%-20%	91	0.574	0.578
				Winning margin > 20%	226	0.650	0.639

This table summarizes U.S. gubernatorial election cycles (Panel A) and the distribution of election winning margins (Panel B).

TABLE 2: Descriptive Statistics

Panel A: Descriptive statistics					
N = 17,195	Mean	Std. Dev.	P1	Median	P99
Main dependent variables					
Covenant Intensity	1.351	1.367	0.000	1.000	5.000
P-covenant	0.931	1.064	0.000	1.000	4.000
C-covenant	0.419	0.704	0.000	0.000	3.000
Performance Pricing (0/1)	0.442	0.497	0.000	0.000	1.000
P-grid (0/1)	0.263	0.440	0.000	0.000	1.000
C-grid (0/1)	0.031	0.173	0.000	0.000	1.000
R-grid (0/1)	0.163	0.369	0.000	0.000	1.000
Firm-level variables					
ln[*Assets*]	7.095	1.792	3.214	7.051	11.067
MTB	2.574	3.355	-9.818	1.978	18.782
ROA	0.086	0.081	-0.182	0.084	0.308
Leverage	0.288	0.195	0.000	0.274	0.940
Tangibility	0.345	0.241	0.022	0.283	0.907
Z-score	1.849	1.266	-1.653	1.842	5.174
Cash holding	0.083	0.106	0.000	0.041	0.511
Sales growth	0.073	0.202	-0.683	0.072	0.607
Earnings volatility	0.021	0.027	0.002	0.012	0.160
Loss dummy (0/1)	0.202	0.401	0.000	0.000	1.000
R&D	0.016	0.037	0.000	0.000	0.181
Unrated (0/1)	0.445	0.497	0.000	0.000	1.000
State-level variables					
Real GDP growth	0.027	0.025	-0.041	0.026	0.082
ln[*GDP per capita*]	10.594	0.276	9.978	10.604	11.128
Unemployment rate	5.885	1.511	3.967	5.542	9.608
Loan-level variables					
Revolver (0/1)	0.809	0.393	0.000	1.000	1.000
Relationship lending (0/1)	0.513	0.500	0.000	1.000	1.000
Secured (0/1)	0.455	0.498	0.000	0.000	1.000
Relative deal size	0.296	0.323	0.007	0.195	1.840
Deal maturity	45.1	21.5	5.0	48.0	94.8
ln[*Spread*]	4.831	0.830	2.862	5.011	6.397

[*continued*]

TABLE 2 [continued]

Panel B: Financial covenants by groups	Proportion (%) of loans (loans with corresponding cov./all loans with any cov.)
1. Debt to balance sheet covenant (28.7%)	
Debt to equity covenant	0.53
Debt to tangible net worth covenant	6.63
Leverage ratio covenant	21.35
Loan to value covenant	0.06
Senior leverage covenant	0.13
2. Coverage covenant (83.5%)	
Cash interest coverage covenant	1.11
Debt service coverage covenant	5.46
Fixed charge coverage covenant	38.05
Interest coverage covenant	38.92
3. Debt to cash flow covenant (66.3%)	
Debt to EBITDA covenant	57.09
Senior debt to EBITDA covenant	9.91
4. Liquidity covenant (10.3%)	
Current ratio covenant	8.55
Quick ratio covenant	1.75
5. Net worth covenant (33.8%)	
Net worth covenant	17.84
Tangible net worth covenant	19.30
6. EBITDA covenant (8.3%)	
EBITDA requirement	8.30

This table reports the summary statistics for the variables used in Equation (1) (Panel A) and the financial covenants by groups (Panel B). The sample consists of 17,195 loan observations from 1990 to 2014 from DealScan database matched with Compustat and CRSP. The loans with multiple facilities are aggregated at the loan package level. The loan- and state-level variables are measured as at year *t*. The firm-level characteristics are measured as at year *t*–1. All ratios are winsorized at the 1% and 99% levels. Appendix A provides the variable definitions in detail.

TABLE 3: Effect of Gubernatorial Election on Loan Contracting Outcomes

Panel A: Performance-pricing provisions and financial covenants				
	(1) Performance Pricing (0/1)	(2) Covenant Intensity	(3) Performance Pricing (0/1)	(4) Covenant Intensity
Gubernatorial Election	0.116***	0.047**	0.125***	0.048**
	0.042	0.022	0.046	0.023
[Gub.Elec. marginal effect]	[2.8%]		[3.0%]	
Real GDP growth	2.147**	0.337	2.193**	0.426
	0.889	0.554	0.947	0.561
ln[GDP per capita]	-0.202	0.195	-0.178	0.241
	0.647	0.316	0.628	0.307
Unemployment rate	-0.077	-0.054*	-0.075	-0.056*
	0.071	0.030	0.073	0.029
ln[Assets]	0.069**	-0.121***	0.084**	-0.115***
	0.032	0.012	0.037	0.013
MTB	-0.007	-0.003	-0.007	-0.004
	0.005	0.004	0.005	0.004
ROA	2.635***	1.350***	2.156***	1.082***
	0.281	0.281	0.321	0.259
Leverage	-0.444***	-0.248***	-0.496***	-0.218***
	0.120	0.076	0.112	0.080
Tangibility	-0.901***	-0.226***	-0.543**	-0.040
	0.246	0.066	0.235	0.103
Z-score	-0.091***	-0.055***	-0.027	-0.021
	0.028	0.013	0.036	0.018
Cash holding	-0.848***	-0.399***	-0.852***	-0.455***
	0.218	0.124	0.211	0.126
Sales growth	0.029	0.144*	0.118	0.138*
	0.139	0.082	0.125	0.078
Earnings volatility	-5.621***	-2.634***	-4.219***	-2.357***
	0.765	0.363	0.604	0.373
Loss dummy	-0.239***	-0.113***	-0.256***	-0.130***
	0.045	0.036	0.058	0.035
R&D	-1.133	-0.507	-1.680**	-1.018**
	0.720	0.391	0.665	0.396
Unrated	-0.041	0.130***	-0.080	0.118***
	0.056	0.030	0.066	0.031
Revolver	0.912***	0.476***	0.948***	0.479***
	0.073	0.038	0.078	0.039
Relationship lending	-0.122***	-0.001	-0.117***	-0.002
	0.039	0.016	0.041	0.017
Secured	0.195***	0.552***	0.212***	0.547***
	0.068	0.039	0.068	0.039
Relative deal size	0.562***	0.013	0.648***	0.010
	0.132	0.046	0.127	0.047
Deal maturity	0.011***	0.002**	0.011***	0.002**
	0.001	0.001	0.001	0.001
ln[Spread]	-0.254***	0.045**	-0.258***	0.039**
	0.045	0.019	0.045	0.019
StateFE/Year FE	Yes/Yes	Yes/Yes	Yes/Yes	Yes/Yes
Industry FE	-	-	Yes	Yes
Pseudo or Adjusted R-sq	0.128	0.275	0.139	0.282
N	17,195	17,195	17,043	17,043

[*continued*]

TABLE 3 [continued]

Panel B: Loan spread (single equation)			
	(1)	(2)	(3)
Gubernatorial Election	0.000	0.002	0.008
	0.009	0.009	0.009
Real GDP growth	-0.450	-0.421	-0.361
	0.330	0.333	0.329
ln[GDP per capita]	0.271*	0.268*	0.259*
	0.155	0.153	0.149
Unemployment rate	0.101***	0.100***	0.100***
	0.019	0.019	0.019
ln[Assets]	-0.147***	-0.145***	-0.147***
	0.007	0.007	0.007
MTB	-0.016***	-0.016***	-0.015***
	0.002	0.002	0.002
ROA	-1.056***	-1.014***	-0.948***
	0.231	0.232	0.232
Leverage	0.670***	0.661***	0.664***
	0.039	0.039	0.039
Tangibility	-0.163***	-0.176***	-0.258***
	0.038	0.038	0.051
Z-score	-0.025***	-0.026***	-0.032***
	0.009	0.009	0.010
Cash holding	0.221***	0.207***	0.173**
	0.073	0.073	0.068
Sales growth	0.107***	0.107***	0.094***
	0.035	0.036	0.034
Earnings volatility	0.257	0.171	0.148
	0.212	0.214	0.228
Loss dummy	0.138***	0.134***	0.135***
	0.020	0.020	0.021
R&D	-0.800***	-0.812***	-0.648**
	0.268	0.273	0.292
Unrated	0.024	0.023	0.015
	0.017	0.017	0.017
Revolver	-0.058***	-0.044***	-0.042***
	0.012	0.012	0.012
Relationship lending	-0.012	-0.014	-0.016
	0.011	0.011	0.010
Secured	0.503***	0.504***	0.483***
	0.017	0.017	0.016
Relative deal size	0.050	0.059*	0.070**
	0.032	0.032	0.028
Deal maturity	0.003***	0.003***	0.003***
	0.000	0.000	0.000
Performance Pricing		-0.074***	-0.073***
		0.013	0.012
State FE/Year FE	Yes/Yes	Yes/Yes	Yes/Yes
Industry FE	-	-	Yes
Adjusted R-sq	0.568	0.570	0.581
N	17,195	17,195	17,043

[*continued*]

TABLE 3 [continued]

Panel C: Loan spread (system of equations)		
	(1)	(2)
	Loan Spread	Performance Pricing (0/1)
Gubernatorial Election	0.001	0.021*
	0.013	0.011
Real GDP growth	-0.377	0.316
	0.254	0.215
ln[GDP per capita]	0.217**	-0.056
	0.107	0.091
Unemployment rate	0.089***	-0.033**
	0.017	0.014
ln[Assets]	-0.140***	0.036***
	0.004	0.006
MTB	-0.015***	0.001
	0.001	0.001
ROA	-1.056***	0.584***
	0.075	0.069
Leverage	0.647***	-0.191***
	0.028	0.031
Tangibility	-0.132***	-0.085***
	0.022	0.019
Z-score	-0.027***	-0.009**
	0.005	0.004
Cash holding	0.177***	-0.164***
	0.047	0.040
Sales growth	0.084***	0.014
	0.022	0.019
Earnings volatility	0.079	-0.871***
	0.179	0.147
Loss dummy	0.115***	-0.060***
	0.013	0.012
R&D	-0.572***	0.050
	0.132	0.114
Unrated	0.013	-0.015
	0.012	0.010
Revolver	-0.053***	0.191***
	0.014	0.010
Relationship lending	-0.015*	-0.022***
	0.009	0.007
Secured	0.472***	-0.014
	0.010	0.017
Relative deal size	0.043***	0.114***
	0.016	0.013
Deal maturity	0.003***	0.002***
	0.000	0.000
ln[Spread]		0.075**
		0.031
Performance pricing	-0.008	
	0.040	
Industry mean loan spread	0.446***	
	0.016	
Industry mean performance pricing		0.959***
		0.032
State FE/Year FE	Yes/Yes	Yes/Yes
Adjusted or Pseudo R-sq	0.589	0.176

N	17,195	17,195

This table reports the regression results for the impact of gubernatorial elections on the use of performance-pricing provisions and financial covenant intensity (Panel A) and loan spreads (Panels B and C). The dependent variables are *Performance Pricing* (dummy indicator), *Covenant Intensity* (number of financial covenants), and *Loan Spread* (natural log of all-in-drawn spread), respectively. The system of equations in Panel C is identified by industry means of the dependent variables. Appendix A provides the variable definitions in detail. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively, based on standard errors robust to clustering at the state level.

TABLE 4: Cash Flow-Based Pricing Grids and Covenants

	(1) P-grid (0/1)	(2) C-grid (0/1)	(3) R-grid (0/1)	(4) P-covenant	(5) C-covenant
Gubernatorial Election	0.129***	0.005	0.073	0.034*	0.013
	0.049	0.110	0.053	0.018	0.014
[marginal effect]	[2.0%]	[0.0%]	[0.4%]		
Controls	Yes	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/Yes	Yes/Yes	Yes/Yes	Yes/Yes	Yes/Yes
Pseudo or Adjusted R-sq	0.225	0.174	0.319	0.266	0.205
N	17,195	17,195	17,195	17,195	17,195

This table reports the regression results for the impact of gubernatorial elections on the use of pricing grids and financial covenants. The dependent variables *P-grid*, *C-grid*, and *R-grid* are dummy indicators, respectively, that take the value of one if a loan includes performance-based, capital-based, and rating-based pricing grids, respectively. *P-covenant* and *C-covenant* are the numbers of performance-based and capital-based covenants, respectively, included in a loan. All regressions include the same covariates used in Table 3. Appendix A provides the variable definitions in detail. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively, based on standard errors robust to clustering at the state level.

TABLE 5: Closely Contested Elections

	(1) IV 1st stage (Dependent: CGE)	(2) Performance Pricing (0/1)	(3) Covenant Intensity	(4) Loan Spread
Panel A: CGE = 1 if winning margin < 7%				
Term-limited Election	0.262***			
	0.097			
Close Gub. Election (CGE)		0.294*	0.256	-0.054
		0.178	0.157	0.056
[marginal effect]		[11.5%]		
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/Yes	Yes/Yes	Yes/Yes	Yes/Yes
Weak ID F-stat (Kleibergen-Paap)	7.4	-	-	-
N	17,195	17,195	17,195	17,195
Panel B: CGE = 1 if winning margin < 10%				
Term-limited Election	0.387***			
	0.115			
Close Gub. Election (CGE)		0.200*	0.173*	-0.037
		0.103	0.098	0.035
[marginal effect]		[7.8%]		
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/Yes	Yes/Yes	Yes/Yes	Yes/Yes
Weak ID F-stat (Kleibergen-Paap)	11.3	-	-	-
N	17,195	17,195	17,195	17,195

This table reports the IV regression results for the impact of close election on loan contracting outcomes. Term limit status is used as the instrument for closely contested elections in the first stage (Column 1). The dummy variable *Close Gubernatorial Election* (*CGE*) in Panel A equals one if the winning margin is lower than 7% and zero otherwise; the cut-off value used in Panel B is 10%. The dependent variables are *Performance Pricing* (dummy indicator), *Covenant Intensity* (number of financial covenants), and *Loan Spread* (natural log of all-in-drawn spread), respectively. All regressions include the same covariates used in Table 3. Appendix A provides the variable definitions in detail. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively, based on standard errors robust to clustering at the state level.

TABLE 6: Interest-Rate Contingencies in Pricing Grids (whole sample results)

	(1) Increasing PG	(2) Decreasing PG
Univariate (proportion of loans with PGs):		
Nonelection years (a)	0.104	0.267
Election years (b)	0.115	0.281
Difference (b – a)	0.011	0.014
% Change	10.4%	5.1%
Multinomial logit (base = no pricing grid):		
Gubernatorial Election	0.177*	0.100*
	0.097	0.057
Controls	Yes	Yes
State FE/Year FE	Yes/Yes	Yes/Yes
Pseudo R-sq	0.129	0.129
N	17,193	17,193
Binary logit:		
Gubernatorial Election	0.143	0.071
	0.097	0.058
[marginal effect]	[0.9%]	[1.1%]
Controls	Yes	Yes
State FE/Year FE	Yes/Yes	Yes/Yes
Pseudo R-sq	0.128	0.117

This table reports the results of the analysis of the impact of gubernatorial elections on the interest-rate contingencies in pricing grids. *Increasing PG* (*Decreasing PG*) is a dummy that equals one if a loan contract includes interest-rate increasing (decreasing) pricing grid, as defined in Section 3, and zero otherwise. The base case for the multinomial logit estimation is the loans without either type of pricing grid. All regressions include the same covariates used in Table 3. Appendix A provides the variable definitions in detail. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively, based on standard errors robust to clustering at the state level.

TABLE 7: Geographical Concentration and Government Contract Dependence

	(1)	(2)	(3)	(4)
Panel A: Geographical Concentration				
	Geog. Concentration = High		Geog. Concentration = Low	
	Increasing PG	Decreasing PG	Increasing PG	Decreasing PG
Univariate (proportion of loans with PGs):				
Nonelection years (a)	0.127	0.263	0.115	0.274
Election years (b)	0.147	0.261	0.120	0.285
Difference (b – a)	0.020	-0.002	0.005	0.011
% Change	15.4%	-0.6%	4.2%	3.9%
Multinomial logit (base = no pricing grid):				
Gubernatorial Election	0.346**	0.041	0.106	0.059
	0.172	0.136	0.114	0.092
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/ Yes	Yes/ Yes	Yes/ Yes	Yes/ Yes
Pseudo R-sq	0.135	0.135	0.116	0.116
N	3,234	8,845	3,234	8,845
Binary logit:				
Gubernatorial Election	0.333**	-0.019	0.082	0.040
	0.166	0.130	0.113	0.092
[marginal effect]	[2.8%]	[-0.3%]	[0.6%]	[0.7%]
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/ Yes	Yes/ Yes	Yes/ Yes	Yes/ Yes
Pseudo R-sq	0.142	0.115	0.126	0.101
Panel B: Government Contract Dependence				
	Gov. Contract Dependence = High		Gov. Contract Dependence = Low	
	Increasing PG	Decreasing PG	Increasing PG	Decreasing PG
Univariate (proportion of loans with PGs):				
Nonelection years (a)	0.099	0.255	0.105	0.274
Election years (b)	0.124	0.251	0.104	0.287
Difference (b – a)	0.026	-0.004	-0.001	0.013
% Change	26.1%	-1.5%	-0.7%	4.9%
Multinomial logit (base = no pricing grid):				
Gubernatorial Election	0.333**	0.006	-0.051	0.074
	0.138	0.089	0.162	0.125
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/ Yes	Yes/ Yes	Yes/ Yes	Yes/ Yes
Pseudo R-sq	0.154	0.154	0.115	0.115
N	6,032	6,032	6,056	6,056
Binary logit:				
Gubernatorial Election	0.324**	-0.057	-0.077	0.089
	0.133	0.084	0.159	0.124
[marginal effect]	[2.1%]	[-0.9%]	[-0.4%]	[1.6%]
Controls	Yes	Yes	Yes	Yes
State FE/Year FE	Yes/ Yes	Yes/ Yes	Yes/ Yes	Yes/ Yes
Pseudo R-sq	0.150	0.127	0.153	0.126

This table reports the results of the subsample analysis of the impact of gubernatorial elections on the interest-rate contingencies in pricing grids. *Increasing PG* (*Decreasing PG*) is a dummy that equals one if a loan contract includes interest-rate increasing (decreasing) pricing grid, as defined in Section 3, and zero otherwise. The base case for the multinomial logit estimation is the loans without either type of pricing grid. All regressions include the same covariates used in Table 3. Appendix A provides the variable definitions in detail. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively, based on standard errors robust to clustering at the state level.