

## REFeree's REVIEW

<b>Program:</b>	Master in Corporate Finance
<b>Student:</b>	Rostislav Kotov
<b>Title of thesis:</b>	Bank covenants: construction and analysis given banks are risk-neutral

<b>Justification of the topic choice. Accuracy in defining the aim and objectives of the thesis.</b> Justification of the topic choice; accuracy in defining the aim and tasks of the thesis; originality of the topic and the extent to which it was covered; alignment of the thesis' topic, aim and objectives.	5	4	<u>3</u>	2
<b>Structure and logic of the text flow.</b> Logic of research; full scope of the thesis; alignment of thesis' structural parts, i.e. theoretical and empirical parts.	5	4	<u>3</u>	2
<b>Quality of analytical approach and quality of offered solution to the research objectives.</b> Adequacy of objectives coverage; ability to formulate and convey the research problem; ability to offer options for its solution; application of the latest trends in relevant research are for the set objectives.	5	4	<u>3</u>	2
<b>Quality of data gathering and description.</b> Quality of selecting research tools and methods; data validity adequacy; adequacy of used data for chosen research tools and methods; completeness and relevance of the list of references.	5	4	<u>3</u>	2
<b>Scientific aspect of the thesis.</b> Independent scientific thinking in solving the set problem/objectives; the extent to which the student contributed to selecting and justifying the research model (conceptual and/or quantitative), developing methodology/approach to set objectives.	5	<u>4</u>	3	2
<b>Practical/applied nature of research.</b> Extent to which the theoretical background is related to the international or Russian managerial practice; development of applied recommendations; justification and interpretation of the empirical/applied results.	5	4	<u>3</u>	2
<b>Quality of thesis layout.</b> Layout fulfils the requirements of the Regulations for master thesis preparation and defense, correct layout of tables, figures, references.	5	4	<u>3</u>	2

Each item above is evaluated on the following scale, as applicable: 5 = excellent, 4 = good, 3 = satisfactory, 2 = poor.

### Additional comments:

Principles of providing bank loans to the businesses are extremely important. Since uncertainty is unavoidable then the topic of covenants' design is one of key problems.

The survey of literature is present but it is highly incomplete. Nothing to say that classical advanced text "Microeconomics of Banking" (Freixas & Rochet), devoted to the major extent to contracts and covenants, is not even mentioned (thought this book is recommended by Prof. Bogdan Stacescu as additional reading in his compulsory course taught in MCF program). The author does not provide even any stylized cases.

Unfortunately there is no diversity of banks and firms in the setting. It is difficult to understand what the hypothesis of this thesis is. At the page 17 the following three sentences are provided:

According to the common sense the stricter the covenant the greater an income for a bank. Although there are problems of incomplete contracts and a minimum manager's benefits. That is why there could be some deviations.

If the common sense is treated as hypothesis then what is the role of two other sentences?

At page 18 the author claims:

First of all there is no distinction between interests of the manager and the owner of the company and there are no points on different issues which can appear in a holding company. It is assumed that only one person is the owner of the company and at the same time he is the manager of this company.

At page 19 the author's claim is opposite:

With the introduction of the verifiable – non-verifiable income concept in the model, the classic approach of the agency theory is used.

What is finally true? Hence, verbal description of the problem is of minor assistance in understanding of the whole idea. The central motive of existing both verifiable and non-variable income is not clear. Usual fringe benefits mentioned in the paper would not be kept by a manager if the company is not successful with its only project. In this setting unsuccessful company is a bankrupt together with cars and carpets. So, corporate governance setting is unclear.

Tables at the page 20 will benefit from more explanations. For example, a reader should figure out that wave over the letter means that it is a random variable. Rho is correlation coefficient rather than correlation. Any functional dependencies are not presented either here or in the formulation of the problem (page 24). They are added in the course of what is called the Solution by the author (pages 26, 28). It makes difficult to check the correctness. Also at the page 23 it is erroneously said that a random variable is the target function what is impossible in principle. This mistake is corrected at the page 24 with a pass to expected values. It is interesting to notice that the crucial topic of (non)-verifiable income is hidden in the main statement at this page. There are many minor inaccuracies. For example, Restriction 1 (better to say, Assumption) at page 21 says that  $I < 0.5$  but at page 23 we read that an interest rate is equal to  $D/(I - 1)$ . So the rate is negative. It is nonsense.

I would like also to mention that the major part of the model is borrowed from supervisor's preprint of 2012 with minor simplification. The author's original contribution is related to numerical solution obtained by means of computer programming (see graphs and Appendices). This is the main positive ingredient of the paper.

Managerial applications are presented poorly. At page 44 the author claims that

According to the model the less agency costs in a company the higher should be the level of a covenant in order to avoid ineffective areas.

This ridiculous result is caused by wrong modeling where stealing manager is not punished because consequences of bankruptcy are not taken into account. It is wrong to speak about the manager only when a firm applies for a loan.

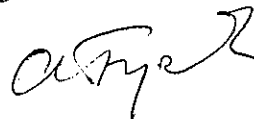
English is poor. Sometimes it is difficult to understand what the author did want to say.

So the paper contains many deficiencies.

Master thesis of Mr. Rostislav Kotov meets the requirements of Master in Corporate Finance program, and deserves a satisfactory grade, thus the author can be given the desired degree.

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