Performance-Sensitive Debt

Gustavo Manso†
Bruno Strulovici‡
Alexei Tchisty§

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Abstract

This paper studies performance-sensitive debt (PSD), the class of debt obligations whose interest payments depend on some measure of the borrower’s performance. For example, step-up bonds compensate credit rating downgrades with higher interest rates, and reward credit rating upgrades with lower interest rates. In an endogenous default setting, we develop an algorithm to value PSD obligations allowing for general payment profiles, and obtain closed-form pricing formulas in important special cases, including step-up bonds. Moreover, we provide a criterion to compare different PSD obligations in terms of their efficiency. In particular, we find that risk-compensating PSD obligations lead to earlier default and lower the market value of the issuing firm’s equity, compared to fixed-coupon bonds of the same market value. We demonstrate that risk-compensating PSD can be used as a signaling device in a setting with asymmetric information. Lastly, we analyze the implications of our results for the policy of credit-rating agencies.

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†MIT Sloan School of Management.
‡Nuffield College, Oxford University and Ecole Nationale des Ponts et Chaussées.
§Leonard N. Stern School of Business, New York University.

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1 Introduction

This paper studies performance-sensitive debt (PSD), the class of debt obligations whose interest payments depend on some measure of the borrower’s performance. For instance, step-up bonds compensate for credit rating downgrades with higher interest rates and for credit rating upgrades with lower interest rates.\textsuperscript{1} Performance pricing loans, a large fraction of commercial loans, also tie their interest rates to some measure of the borrower’s credit quality.\textsuperscript{2}

PSD obligations, including step-up bonds and performance pricing loans, compensate debtholders for changes in the borrower’s credit risk. Practitioners have not yet reached any consensus on the likely effects of these risk-compensating PSD schemes. While proponents laud their high yields and low volatility (some even finding them “too generous”),\textsuperscript{3} critics argue that risk-compensating PSD schemes generate a vicious circle by increasing the burden of debt service during financial strains, harming the issuer even more and, eventually, harming investors.\textsuperscript{4} Underlying this disagreement is the lack of a theoretical model to value PSD and to assess the effect of issuing PSD rather than standard debt. This latter difficulty can be formalized as follows: for a given amount of debt raised, risk-compensating PSD results in paying higher interest than standard debt in times of low performance and lower interest in times of high performance. It is unclear, then, between lighter debt burden in times of high performance and the increased payment strains in times of low performance, which type of debt is more desirable.

In this paper, we try to address the following two major questions. First, how to value PSD obligations? Second, why do firms issue PSD obligations? We develop a pricing algorithm allowing, tractably, for general payment profiles. We show that the equity value associated with PSD satisfies an ordinary differential equation with a boundary condition corresponding to zero value at default, and a “smooth-pasting” condition. We obtain closed-form pricing of PSD in important special cases, including step-up bonds.

Building on our valuation model, we find that, in a setting without market imperfections other than bankruptcy costs, risk-compensating PSD schemes have an overall negative effect on the issuing firm. In particular,

\textsuperscript{1}Step-up bonds exceed $100bn for both US- and European-based issuers (see Lando and Mortensen (2003) and “Step lightly,” CFO Magazine (January 2001)).

\textsuperscript{2}These loans represent over 70\% of commercial loans (see Asquith, Beatty, and Weber (2002)).

\textsuperscript{3}“The price of protection,” Credit Magazine (September 1st, 2002)

\textsuperscript{4}“Credit ratings can harm your wealth,” Investment Adviser (December 9th, 2002).
issuing risk-compensating PSD leads to earlier default and, consequently, lowers the market value of the issuing firm’s equity, holding constant the amount of cash raised by the obligation.

Since risk-compensating PSD obligations increase cost of capital their existence should be explained by market frictions such as adverse selection and moral hazard problems. We demonstrate that risk-compensating PSD can be used as a signaling device in a setting with asymmetric information. A high-growth firm may issue a risk-compensating PSD obligation to separate itself from the low-growth firm.

Finally, our results have implications for the behavior of credit-rating agencies. In trying to avoid the “credit-cliff dynamic” rating agencies are sometimes reluctant to downgrade distressed firms with PSD obligations in their capital structure. This reluctance generates distortions between actual and theoretical ratings, affecting the reliability of credit rating agencies.

Models of the valuation of risky debt can be divided into two classes. The first class treats a firm’s liabilities as contingent claims on its underlying assets, and bankruptcy as an endogenous decision of the firm. This class includes Black and Cox (1976), Fischer, Heinkel, and Zechner (1989), Leland (1994), Leland and Toft (1996) and Duffie and Lando (2001). In the second class of models, bankruptcy is not an endogenous decision of the firm. There is either an exogenous default boundary for the firm’s assets (see Merton (1974) and Longstaff and Schwartz (1995)), or an exogenous process for the timing of bankruptcy, as described in Jarrow and Turnbull (1995), Jarrow, Lando, and Turnbull (1997) and Duffie and Singleton (1999).

Das and Tufano (1996), Acharya, Das, and Sundaram (2002), Houweling, Mentink, and Vorst (2003) and Lando and Mortensen (2003) obtain pricing formulas for step-up bonds using the second class of models of the valuation of risky debt. Since they examine only an exogenous default process, the effect of performance-sensitive debt on the default time is not apparent in their models.

In order to capture this effect, we build on Leland (1994) model, in which the firm’s shareholders choose the default time that maximizes the equity value of the firm. The bankruptcy results in a loss of a fraction of the firm’s assets, but there are no other market imperfections such as adverse selection or moral hazard. Instead of a fixed-coupon consol bond, we consider debt obligations in which the interest rate is linked to some performance measure of the borrower. Performance-sensitive debt is thus fully characterized in this setting by some $C: \Pi \rightarrow R_+$ that maps a performance measure $\pi$ to

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the interest rate $C(\pi)$ charged on the debt. Typical performance measures are credit ratings and financial ratios such as debt-to-earnings, leverage, or interest coverage.

For PSD obligations $C$ and $D$ that are based on the same performance measure, we say that $C$ is more risk-compensating than $D$ if $C - D$ is non-increasing and non-constant. We refer to PSD obligations that are more risk-compensating than a fixed coupon bond simply as risk-compensating PSD obligations. We prove that if $C$ and $D$ raise the same amount of cash, and if $C$ is more risk-compensating than $D$, then $C$ is less efficient than $D$, in the sense that $C$ induces an earlier default time, which means a higher present value of bankruptcy costs, and thus reduces the initial market value of the issuing equity. In particular, a PSD obligation that charges a higher interest rate when the company’s performance deteriorates is less efficient than a debt obligation with a fixed interest rate of the same market value. The most efficient PSD is the least risk-compensating that can be considered as debt for tax purposes. This result is robust as we allow the cash flow to be a general diffusion process.

Thus, the trade-off between the opposite effects of the more risk-compensating scheme – higher coupons in times of low performance and lower coupons in times of high performance – is systematically resolved in favor of the less risk-compensating debt.\footnote{This result is somewhat related to the finding by Hillion and Vermaelen (2004) that the issuance of floating-priced convertibles is followed by significant negative abnormal returns. They point out that the design of floating-priced convertibles encourages speculative short-selling by the convertible holders that can hurt the equity holders. In this paper, we are not considering convertibles or market speculation.} We propose the following interpretation for this result. At the time of default, the more risk-compensating PSD requires higher interest payments, increasing the firm’s losses. Although it is possible that this PSD may impose a lighter debt burden in the future, the current situation puts a higher weight on the equityholders’ decision, and makes it less attractive for them to continue running the firm.

Our paper suggests that in the absence of market frictions other than bankruptcy costs, PSD obligations that charge higher interest rates in times of poor performance are inferior to PSD obligations that reduce interest payments when the firm is financially distressed. In practice, both forms of PSD are observed. Although most debt obligations with explicit performance pricing provisions are of the first type, some debt obligations reduce debt payments when the firm performs poorly. For example, catastrophe bonds, usually issued by insurance companies, promise coupons that are contractually reduced in case total losses in the insurance industry are above
a pre-specified threshold. Very often renegotiation of bank loans\footnote{Hackbarth, Hennessy, and Leland (2005) study renegotiation of bank loans in a setting with endogenous default.} leads to lower interest payments when the firm is financially distressed, which in fact is implicit performance pricing. Asquith, Gertner, and Scharfstein (1994) and James (1995) provide evidence that debt renegotiation may loosen financial constraints on firms.

To explain the existence of risk-compensating PSD, we develop a simple signaling model\footnote{Previous research has studied the use of financial securities for signaling purposes. See, for example, Ross (1977), Leland and Pyle (1977), and DeMarzo and Duffie (1999). These studies, however, restrict themselves to a static setting and fixed-coupon debt. In a dynamic setting with endogenous default, Leland (1998) and Hennessy (2004), study agency problems between equityholders and debtholders. These studies restrict themselves to a moral hazard setting and fixed-coupon debt.}, in which the future growth rate of the firm is unknown to the market, but known to the firm’s equityholders. We demonstrate that there exists a separating equilibrium, in which the high-growth firm issues a risk-compensating PSD obligation, while the low-growth firm issues either a fixed-coupon bond or equity. The low-growth firm does not want to mimic the high-growth firm because for a given risk-compensating PSD obligation the low-growth firm is likely to pay a higher coupon in the future than the high-growth firm. Since higher default risks are (partially) offset by higher interest payments, the value of a risk-compensating PSD obligation is less sensitive to the private information than that of a fixed-coupon bond. In the separating equilibrium, the capital structure decisions of the high-growth firm are consistent with the pecking-order hypothesis\footnote{The pecking-order hypothesis was first introduced by Myers (1984) and Myers and Majluf (1984).}, while the capital structure decisions of the low-growth firm are consistent with trade-off theory.

Empirical research on structural models of corporate bond pricing includes Anderson and Sundaresan (2000), Huang and Huang (2003), and Eom, Helwege, and Huang (2004). These papers use the existing structural models of corporate bond pricing with endogenous default, in which the coupon payment on the debt is assumed to be constant throughout the life of the firm. In practice, however, firms rarely have such a simple debt profile. Our paper provides an algorithm and closed–form pricing formulas that are suitable to empirical analysis of debt with an interest rate that varies with the performance of the firm. More importantly, since a combination of PSD obligations is also a PSD obligation, our model provides a framework to analyze more complex capital structures that are combinations of various...
issues of PSD and fixed-coupon debt.

The remainder of the paper is organized as follows. In Section 2, we illustrate several applications. In Section 3, we present the general model and formalize the notion of PSD. Section 4 analyzes the case of asset-based PSD obligations, demonstrating their relative efficiency. In section 5, we explicitly derive the valuation of step-up and linear PSD obligations. Section 6 demonstrates that risk-compensating PSD can be used as a signaling device in a setting with asymmetric information. Section 7 discusses different performance measures used in practice, and solves for the case of ratings-based PSD. Section 8 discusses the implications of our results for rating agencies policy. Section 9 talks about other reasons that may explain the existence of different types of PSD. Section 10 concludes.

2 Applications of PSD

This section describes PSD obligations that arise in practice. Some types of PSD obligations, such as step-up bonds, performance-pricing loans and catastrophe bonds, have explicit performance-pricing provisions. Other types of PSD obligations are implicitly performance-dependent because the terms of the debt are subject to renegotiation or are the result of an optimal dynamic capital strategy.

Step-up Bonds. A step-up bond, sometimes called a credit-sensitive note, pays an interest rate that is contractually linked with the credit rating of the borrower.

First issued in the late 1980s, credit-sensitive notes have recently experienced an upsurge, specially among European telecommunications companies.\(^\text{10}\)

Performance-pricing loans. Performance-pricing loans explicitly tie their interest to some pre-specified performance measure of the borrower. Typical performance measures used for this purpose are credit ratings and such financial ratios as debt-to-earnings, leverage, and interest coverage.

In an analysis of the Loan Pricing Corporation Database, Asquith, Beatty, and Weber (2002) found that the proportion of lending agreements including performance pricing provisions covered by this database increased from 40% in 1994 to over 70% in 1998.\(^\text{10}\)

\(^{10}\)Houweling, Mentink, and Vorst (2003) and Lando and Mortensen (2003) study the pricing of the recent European telecommunications step-up bonds.
Put-call provisions. Suppose a debt issue has provisions allowing the lending bank to put the debt back to the issuer when some performance measure drops below a contractual threshold. When such a provision is triggered, the lending bank often renegotiates the initial terms of the loan in effect, increasing the interest rate.

The borrower may be given an option to call the loan when its credit quality improves. This permits the borrower to refinance the debt at lower interest rates after good performance. The outcome of these forms of optionality is effectively PSD.

Reset bonds. A reset bond, sometimes called a payment-in-kind (PIK) bond, has an interest rate that is adjusted periodically so that the market value of the bond is the same as its principal. In some cases the new interest rate is determined by an auction. The associated coupon rate $C$ is thus decreasing with the credit quality of the borrower and a reset bond is, in effect, a form of PSD. Default in the junk-bond market may be induced by the rise in coupon payments of reset bonds.\textsuperscript{11}

Short-term debt. The simplest case of PSD is short-term debt, such as commercial paper, since the coupon rate rises and falls continuously with the credit quality of the borrower. Myers (1977) argues that short-term debt may be used to mitigate agency costs. In Diamond (1991), risky firms do not issue short-term debt in order to avoid early liquidation. Guedes and Opler (1996) provide empirical evidence supporting both claims.

Catastrophe bonds. Catastrophe (CAT) bonds, usually issued by insurance companies, promise coupons that are reduced in case total losses in the insurance industry are above a pre-specified threshold.\textsuperscript{12}

Dynamic capital structure. In a setting with taxes and bankruptcy costs, the optimal amount of debt outstanding varies with asset level. When the asset level increases, for example, issuers are better off issuing more debt, since this gives them higher tax benefits. On the other hand, when the asset level decreases, debt reductions are optimal, ignoring transaction costs, as they reduce the present value of bankruptcy costs. The net effect, under some conditions, is PSD. This setting is studied in Goldstein, Ju, and Leland (1998).

\textsuperscript{12}See Fitch IBCA (2001) for a survey of the market for CAT bonds.
3 The General Model

We begin by specifying a general model. Further assumptions will be added in later sections. We consider a generalization of the optimal liquidation models of Fischer, Heinkel, and Zechner (1989) and Leland (1994).

A firm generates cash flows at the rate $\delta_t$, at each time $t$. We assume that $\delta$ is a diffusion defined by

$$d\delta_t = \mu(\delta_t)dt + \sigma(\delta_t)dB_t,$$  \hspace{1cm} (1)

where $\mu$ and $\sigma$ satisfy the classic assumptions for the existence of a unique strong solution\textsuperscript{14} to (1) on a fixed probability space $(\Omega, F, P)$ with the information filtration $(\mathcal{F}_t)$ generated by the standard Brownian motion $B$.

For simplicity, we assume that all agents are risk-neutral. There is a constant risk-free interest rate $r$, with $\mu < r - \varepsilon$ for some positive constant $\varepsilon$. The market value $A_t$ at time $t$ of the future cash flows of the firm is then

$$A_t = E_t \left[ \int_t^\infty e^{-r(s-t)} \delta_s \, ds \right] < \infty$$ \hspace{1cm} (2)

where $E_t$ denotes the $\mathcal{F}_t$-conditional expectation. By the Markov property, $A_t$ only depends on $\{\delta_s\}_{s \leq t}$ through $\delta_t$. Specifically, there exists a smooth function $A : \mathbb{R} \to \mathbb{R}$ such that $A_t = A(\delta_t)$, which implies that $\{A_t\}_{t \geq 0}$ is a diffusion:

$$dA_t = \mu(A_t)dt + \sigma(A_t)dB_t.$$ \hspace{1cm} (3)

For the sake of ulterior computations, we assume

**Condition 1** $\mu$ and $\sigma$ are smooth and bounded and $\sigma$ is coercive.\textsuperscript{15}

Since $E_t[\delta_s]$ is increasing\textsuperscript{16} in $\delta_t$, $A_t(\cdot)$ is increasing in $\delta_t$, which implies the existence of a continuous inverse function $\delta : \mathbb{R} \to \mathbb{R}$ such that $\delta_t = \delta(A_t)$.

We consider a performance measure represented by an $\mathcal{F}_t$-adapted stochastic process $(\pi_t)_{0 \leq t < \infty}$ taking values in a totally ordered, topological space

\textsuperscript{13}While these models consider the case of geometric Brownian motion and a consol bond, we consider here a general diffusion model and performance-sensitive debt.

\textsuperscript{14}A sufficient conditions is that $\mu$ and $\sigma$ be continuous and bounded. See for example Karatzas and Shreve (1991).

\textsuperscript{15}In the one-dimensional case, coerciveness is equivalent to the existence of a real number $\sigma$ such that $0 < \sigma \leq \sigma$. Throughout, smoothness means continuous differentiability.

\textsuperscript{16}$E_t[\delta_s]$ is increasing in $\delta_t$ because, given any path of the underlying Brownian motion, the trajectory of the cash flow process starting at point $\delta_t' > \delta_t$ will be always above the trajectory of the cash flow process starting at $\delta_t$. 

In general, πₜ can be any statistic that measures the firm’s ability and willingness to serve its debt obligations in the future. Financial ratios and credit ratings are among commonly used performance measures.

A performance-sensitive debt (PSD) obligation is a claim on the firm that promises a non-negative payment rate that may vary with the performance measure of the firm. Formally, a PSD obligation $C(\cdot)$ is a measurable function $C : \Pi \to \mathbb{R}$, such that the firm pays $C(\pi_t)$ to the debtholders at time $t$. For example, the consol bond of Leland (1994) is a degenerate case of PSD. The reader should note that, while our earlier sections dealt mostly with “risk-compensating” PSD (that pay higher coupons when performance worsens), our definition encompasses more general kinds of PSD. It is also worth noting that $C$ represents the total debt payment. If the firm has a complex capital structure which includes various issues of PSD obligations and also fixed coupon debt, then $C(\pi_t)$ is the sum of the payments for each of the firm’s obligations at time $t$ given the performance $\pi_t$.

Given a PSD obligation $C$, the firm’s optimal liquidation problem is to choose a default time $\hat{\tau}$ to maximize its initial equity value $W^C_0$, given the debt structure $C$. That is,

$$W^C_0 \equiv \sup_{\bar{\tau} \in T} E \left[ \int_0^{\bar{\tau}} e^{-rt}[\delta_t - (1 - \theta)C(\pi_t)] \, dt \right], \quad (4)$$

where $T$ is the set of $\mathcal{F}_t$ stopping times and $\theta$ is the corporate tax rate on earnings. If $\tau^*$ is the optimal liquidation time, then the market value of the equity at time $t < \tau^*$ is

$$W^C_t = E_t \left[ \int_t^{\tau^*} e^{-r(s-t)}[\delta_s - (1 - \theta)C(\pi_s)] \, ds \right]. \quad (5)$$

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17We are considering perpetual debt, which is a standard simplifying assumption for the endogenous default framework. See, for example, Leland (1994). However, our model can be extended to the case of finite average debt maturity, if we assume that debt is continuously retired at par at a constant fractional rate. See Leland (1998) for more on this approach.

18If different PSD obligations issued by the firm depend on different performance measures, the total debt payment by the firm can be represented as PSD that depends on a single performance measure. This is possible because, as we will see later, any relevant performance measure can be described by the current asset level and the asset level at which the firm goes bankrupt.
Analogously, the market value $U_t^C$ of the PSD obligation $C$ at time $t$ is

$$U_t^C \equiv E_t \left[ \int_t^{\tau^*} e^{-r(s-t)} C(\pi_s) \, ds \right] + E_t \left[ e^{-r(\tau^*-t)} (A_{\tau^*} - \rho(A_{\tau^*})) \right], \quad (6)$$

where $\rho(.)$ defines the portion of the asset value lost at bankruptcy. We assume that $\rho$ is an increasing function such that $0 \leq \rho(x) \leq x$ for all $x \geq 0$. If $\delta_t$ is lower than $(1 - \theta)C(\pi_t)$, equityholders have a net negative dividend rate.\(^{19}\) Equityholders will continue to operate a firm with negative dividend rate if the firm’s prospects are good enough to compensate for the temporary losses.

4 Asset-Based PSD

In all the applications of PSD listed in Section 2, the interest rate charged to the borrower depends on the borrower’s credit quality. Since the market value $A$ of assets is a time-homogeneous Markov process, the current asset level $A_t$ is the only state variable in our model, and any measure of the borrower’s earnings prospect at time $t$ is determined solely by $A_t$.

Therefore, it is natural to consider the asset level $A_t$ as a performance measure. An asset-based PSD is a PSD whose coupon rate depends only on the current asset level. Specifically, an asset-based PSD is a measurable function $C : \mathbb{R}_+ \to \mathbb{R}$, under which the firm pays coupons at rate $C(A_t)$ at time $t$. Using this definition, we derive valuation and efficiency results for asset-based PSD.

4.1 Valuation

Given an asset-based PSD, the initial value of the equity is:\(^{20}\)

$$W(A_0) \equiv \sup_{\tilde{\tau} \in T} E \left[ \int_0^{\tilde{\tau}} e^{-r t} \left[ \delta(A_t) - (1 - \theta)C(A_t) \right] \, dt \right].$$

The Markov property and time homogeneity imply that there exist asset levels $A_B$ and $A_H$ with $A_B < A_0 < A_H$, such that an optimal default

\(^{19}\)Limited liability is satisfied if the negative dividend rate is funded by dilution, for example through share purchase rights issued to current shareholders at the current valuation.

\(^{20}\)Throughout this section, we omit the superscript $C$ and the subscript 0 whenever there is no ambiguity.
time of the firm is of the form \( \tau^* = \min(\tau(A_B), \tau(A_H)) \), where \( \tau(x) \equiv \inf \{ t : A_t = x \} \). Even though the existence of an upper asset boundary \( A_H \) above which the firm would default is mathematically possible, we exclude this unnatural possibility with the following condition.

**Condition 2** There exist levels \( x < \bar{x} \) and a positive constant \( c \) such that

1. \( (1 - \theta)C(x) \geq \delta(x) \) if and only if \( x \leq \bar{x} \).
2. \( (1 - \theta)C(x) \geq \delta(x) + c \) for \( x \leq \bar{x} \).

The first part of Condition 2 states that for asset levels higher than \( \bar{x} \), the cash flow rate is higher than the coupon payment rate. It can be easily verified that, under this condition, \( A_H = +\infty \), so that the optimal default time simplifies to \( \tau^* = \tau(A_B) \). Therefore, the equityholders’ optimal problem can be expressed without loss of generality as:

\[
W(x) = \sup_{y < x} \bar{W}(x, y), \quad (7)
\]

where

\[
\bar{W}(x, y) = E_x \left[ \int_0^{\tau(y)} e^{-rt} [\delta(A_t) - (1 - \theta)C(A_t)] dt \right].
\]

The second part of Condition 2 ensures that the company will default at some positive asset level. In order to derive an ordinary differential equation (ODE) for \( W \), we impose the following condition on \( C \):

**Condition 3** The PSD obligation \( C \) is such that:

1. There exist non-negative constants \( k_1 \) and \( k_2 \) that satisfy

\[
0 \leq (1 - \theta)C(y) \leq k_1 + k_2y.
\]

2. \( C \) is right continuous on \([0, \infty)\) and has left limits on \((0, \infty)\).

Using the strong Markov property of \( \{A_t\}_{t \geq 0} \),

\[
\bar{W}(x, y) = f(x) - \xi(x, y)f(y), \quad (8)
\]

where\(^{21}\) for \( x > y \),

\[
\xi(x, y) = E_x[e^{-\tau(y)}],
\]

\(^{21}\)Previous assumptions on \( \mu \) and \( \sigma \) imply that \( \xi \) is well-defined, continuous, increasing in \( y \) and less than 1 (see Karatzas and Shreve (1991)).
and
\[ f(x) = E_x \left[ \int_0^\infty e^{-rt} \left[ \delta(A_t) - (1 - \theta)C(A_t) \right] dt \right]. \]

The next lemma shows that, under Condition 2, the default triggering level \( A_B \) is strictly positive.

**Lemma 1** Under Condition 2, there exists a level \( \tilde{x} \) such that any optimal default time \( \tau \) satisfies \( \tau \leq \tau(\tilde{x}) \) almost surely.

An important consequence of Lemma 1 is that default occurs with positive probability. Our next theorem characterizes the solution of the optimal stopping problem (7).

**Theorem 1** If a PSD \( C \) satisfies Conditions 1–3, the following statements are equivalent:

1. \( A_B \) is an optimal default triggering level:
\[ W(x) = E_x \left[ \int_0^{\tau(A_B)} e^{-r(s-t)} [\delta(A_s) - (1 - \theta)C(A_s)] ds \right]. \]

2. \( W(x) \) and \( A_B \) satisfy:
   
   (i) \( A_B \in (0, \tilde{x}) \).
   
   (ii) \( W \) is continuously differentiable and \( W' \) is bounded and left and right differentiable.
   
   (iii) \( W \) vanishes on \([0, A_B]\) and satisfies the following ODE at any point of continuity of \( C \):
\[ \frac{1}{2} \sigma^2(x)W''(x) + \mu(x)W'(x) - rW(x) + \delta(x) - (1 - \theta)C(x) = 0. \] (9)

A proof is given in the Appendix.\(^{22}\)

The continuous differentiability of \( W \) and the fact that \( W = 0 \) on \([0, A_B]\) imply that \( W'(A_B) = 0 \), which is known as the smooth-pasting condition. Theorem 1 provides a method for solving the firm’s optimal liquidation problem. The proposed algorithm is the following

\(^{22}\)The Appendix also gives two separate equations involving the right and left derivatives of \( W' \) at discontinuity points of \( C \) (cf. equations (38) and (39)).
1. Determine the set of continuously differentiable functions that solve ODE (9) at every continuity point of $C$. It can be shown that any element of this set can be represented with two parameters, say $L_1$ and $L_2$.

2. Determine $A_B$, $L_1$, and $L_2$ using the following conditions:

   a. $W(A_B) = 0$.
   b. $W'$ is bounded.
   c. $W'(A_B) = 0$.
   d. $A_B \in (0, \bar{x})$.

   We interpret (a) as the boundary condition on the solution at the point $A_B$ of the ODE. Condition (b) says that $W'(x)$ remains bounded as $x \to +\infty$ and constitutes the second boundary condition on the solution of the ODE. The smooth-pasting condition (c) is interpreted as the first order optimization condition that defines the optimal bankruptcy boundary. Condition (d) verifies that condition 2.(i) of Theorem 1 is satisfied.

Now that we know how to price the equity associated with PSD, we can also price the PSD itself. Using the fact that the sum of the equity value, the PSD value, and the expected losses resulting from the bankruptcy is the sum of the asset level and the present value of the tax benefits, we obtain the PSD pricing formula:

$$U(A_t) = \frac{1}{1 - \theta} [A_t - W(A_t) - [\rho(A_B) + \theta(A_B - \rho(A_B))] \xi(A_t, A_B)].$$ (10)

### 4.2 The Relative Efficiency of Asset-Based PSD

In this subsection, we study the relative efficiency of alternative asset-based PSD. Specifically, we derive a partial order, by “efficiency,” among alternative PSD issues that raise the same amount of cash. We need the following definitions and condition, that we state in terms of a general performance measure $\pi$. These will also be used in Section 7.2 for the case of credit ratings.

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23In fact, we really consider here solutions of coupled equations (38) and (39), which boil down to the ODE (9) at any continuity point of $C$. One can easily check that the set of solutions of the coupled equations is still a two-dimensional vector space.

24Bankruptcy cost is $\rho(A_B) \xi(A_t, A_B)$. The tax benefits are given by $TB(A_t) = \int_0^{\tau(A_B)} e^{-rt} \theta C(A_t) dt = \theta U(A_t) - (A_B - \rho(A_B)) \xi(A_t, A_B)$.
Definition 1 (Relative Efficiency). Let $C$ and $D$ be PSD that raise the same funds, $U_0^C = U_0^D$. We say that $C$ is less efficient than $D$ if it determines a lower equity price, that is, if $W_0^C < W_0^D$.

Definition 2 (Risk Compensating). Let $C$ and $D$ be PSD issues based on the same performance measure. We say that $C$ is more risk-compensating than $D$ if $C - D$ is a non-increasing, not constant function.

A fixed-coupon bond is a natural benchmark to compare PSD obligations. We will refer to PSD obligations that are more risk-compensating than a fixed-coupon bond simply as risk-compensating PSD obligations.

Figure 1 illustrates the “risk-compensating” concept.

Condition 4 (Efficiency Domain). A PSD issue $C$ is said to be in its efficiency domain if, for any constant $\alpha > 0$, we have $U_0^{C-\alpha} < U_0^C$, where $C - \alpha$ denotes a PSD issue that pays $C(A_t) - \alpha$ at time $t$.

Condition 4 means that it is not possible to raise the same amount of cash as $C$ by a constant downward shift in its coupon rate. For example, a bond paying a fixed coupon rate $c$ raises an increasing amount of cash as $c$ increases, until $c$ reaches a point at which the loss due to precipitated default dominates the gain due to the increase of coupon payment (as in Figure 2). The forms of PSD that we consider are in their efficiency domain, for otherwise efficiency in the sense of Definition 1 can be trivially improved by uniformly reducing the interest rate paid.
Figure 2: A fixed-coupon bond is in its efficiency domain if \( c \in [0, \bar{c}] \).

**Theorem 2** Suppose \( C \) and \( D \) both are asset-based PSD, satisfying \( U_0^C = U_0^D \) and Conditions 1–4. If \( C \) is more risk-compensating than \( D \), then \( C \) is less efficient than \( D \).

A proof of the theorem is given in the appendix.

The above result is supported by the following intuition. Equityholders decide to declare bankruptcy when coupon payments become too high compared to the future prospects of the firm. At this time, the firm pays higher interest rates with \( C \) than with \( D \). While there is a possibility that the situation be reversed in the future, the urgency of the current situation increases the firm’s incentive to declare bankruptcy.

The intuition can be further illustrated by the opposite, extreme example of a bond paying a coupon rate equal to the dividend rate \( C(A_t) = \delta(A_t) \). This coupon rate decreases to zero as the asset level goes to zero. The coupon payments never exceed the dividends, so the firm never goes bankrupt. Such a bond transfers all the value of the firm to debtholders, and, if it could qualify as “debt” for tax purposes, would reduce tax payments to zero since the tax benefit resulting from coupon payments is equal to the tax on the dividends. Equityholders could decide to buy all of the debt, in which case this bond allows them to receive all of their dividends in the form of coupon payments.

**Corollary 1** Let \( C \) be a PSD issue satisfying Conditions 1–4. If \( C \) is non-
increasing and not constant, it is less efficient than the fixed-interest PSD issue raising the same amount of cash and verifying Condition 4. If $C$ is non-decreasing and not constant, it is more efficient than any fixed-interest PSD issue raising the same amount of cash.

The result suggests that, in many settings, the issuer would choose the least risk-compensating form of debt that qualifies as "debt" for tax treatment.

The following numerical example compares “one-step” PSD issues $C$ that raise the same amount $M$, in the class $C_M$ of PSD defined by

$$C(A_t) = \begin{cases} 
C_1, & A_t \geq G_2 \\
C_2, & A_t < G_2 
\end{cases},$$

such that $C_2 \geq C_1$ and $U^C(A_0) = M$.

We assume that the asset is a geometric Brownian motion with parameters $\mu = 0.01$, $\sigma = 0.1$, and that $\rho(x) = 0.25x$, $\theta = 0$, $r = 0.03$, $A_0 = 100$, $G_2 = 80$, and $M = 50$, and that $M$ can be raised by issuing a bond that promises to pay a fixed coupon rate of 2. To see the inefficiency of step-up bonds, we compute for one-step PSD issues in $C_M$ the present value of bankruptcy losses, which is by definition

$$Q(C) \equiv 0.25 E \left[ e^{-rt(A^C)} A^C_B \right] = 0.25 A^C_B \left( \frac{A_0}{A^C_B} \right)^{-\gamma_1},$$

where $\gamma_1 = \frac{m + \sqrt{m^2 + 2\gamma^2}}{\sigma^2}$ and $m = \mu - \frac{\sigma^2}{2}$. According to Definition 2, $(C_1, C_2)$ is more risk-compensating than $(C_1', C_2')$ if $C_2 - C_1 > C_2' - C_1'$.

Figure 3 shows the relationship between the present value of bankruptcy losses and the degree of risk-compensation $(C_2 - C_1)$ associated with the PSD. One can see that the fixed-coupon PSD results in a bankruptcy cost of 2.8, while being worth 50. On the other hand, as the difference $(C_2 - C_1)$ rises, the bankruptcy cost climbs quickly.

5 Examples of Asset-Based PSD

In this section, we solve our model explicitly for two important cases: step-up and linear PSD. Step-up PSD is more likely to be seen in practice, while linear PSD has a convenient pricing formula. Throughout this section, we

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25 See Section 5
assume that the asset process is a geometric Brownian motion with drift $\mu$ and volatility $\sigma^2$. This implies that $\delta(x) = (r - \mu)x$, and that $\xi(x, y) = \left(\frac{x}{y}\right)^{-\gamma_1}$, where $\gamma_1 = \frac{m + \sqrt{m^2 + 2r\sigma^2}}{\sigma^2}$ and $m = \mu - \frac{\sigma^2}{2}$. In addition, the value of PSD is given by

$$U(A_t) = \frac{1}{1 - \theta} \left[ A_t - W(A_t) - [\rho(A_B) + \theta(A_B - \rho(A_B))] \left( \frac{A_t}{A_B} \right)^{-\gamma_1} \right].$$

(11)

5.1 Step-Up PSD

Step-up performance-sensitive debt is defined as a PSD obligation whose coupon payment is a non-increasing step function of the asset level. For a decreasing sequence $\{G_i\}_{i=1}^{I+1}$ of asset levels such that $G_I = +\infty$ and $G_{i+1} = A_B$, the coupon rate of a step-up PSD obligation can be represented as

$$C(A_t) = \bar{C}_i \text{ whenever } A_t \in [G_{i+1}, G_i),$$

(12)

where $\{\bar{C}_i\}_{i=1}^{I}$ is an increasing sequence of constant coupon rates. With this coupon structure, the general solution of the ODE (9) is
\[ W(x) = \begin{cases} 
L_i^{(1)} x^{-\gamma_1} + L_i^{(2)} x^{-\gamma_2} + x - \frac{(1-\theta)c_i}{r}, & G_{i+1} \leq x \leq G_i, \\
0, & x \leq A_B, 
\end{cases} \]  

(13)

for \( i = 2, \ldots, I+1 \), where \( \gamma_1 = \frac{m + \sqrt{m^2 + 2r\sigma^2}}{\sigma^2}, \gamma_2 = \frac{m - \sqrt{m^2 + 2r\sigma^2}}{\sigma^2}, \)

\( m = \mu - \frac{\sigma^2}{2} \)

and where \( L_i^{(1)} \) and \( L_i^{(2)} \) are constants to be determined shortly.

According to Theorem 1,

\[ W(A_B) = 0 \]  

(14)

and

\[ W'(A_B) = 0, \]  

(15)

and \( W(\cdot) \) is continuously differentiable. In particular, for \( i = 2, \ldots, I \),

\[ W(G_i-) = W(G_i^+), \quad W'(G_i-) = W'(G_i^+). \]  

(16)

Because the market value of equity is non-negative and cannot exceed the asset value,\(^{26}\)

\[ L_i^{(2)} = 0. \]  

(17)

The system (14)-(17) has \( 2I+1 \) equations with \( 2I+1 \) unknowns \((L_i^{(j)}), j \in \{1, 2\}, i \in \{1, \ldots, I\}, \) and \( A_B \). Substituting (13) into (14)-(17) and solving gives

\[ L_i^{(1)} = \frac{(\gamma_2 + 1)A_B - \gamma_2 \frac{c_i}{r}}{(\gamma_1 - \gamma_2)A_B^{-\gamma_1}}, \]  

(18)

\[ L_i^{(2)} = -\frac{(\gamma_1 + 1)A_B + \gamma_1 \frac{c_i}{r}}{(\gamma_1 - \gamma_2)A_B^{-\gamma_2}}, \]  

(19)

\[ L_j^{(1)} = L_I^{(1)} + \frac{\gamma_2}{(\gamma_1 - \gamma_2)r} \sum_{i=j}^{I-1} \frac{c_{i+1} - c_i}{G_i^{-\gamma_1}}, \quad j = 2, \ldots, I, \]  

(20)

\[ L_j^{(2)} = L_I^{(2)} - \frac{\gamma_1}{(\gamma_1 - \gamma_2)r} \sum_{i=j}^{I-1} \frac{c_{i+1} - c_i}{G_i^{-\gamma_2}}, \quad j = 2, \ldots, I, \]  

(21)

\[ 0 = -(\gamma_1 + 1)A_B + \gamma_1 \frac{c_I}{r} - \sum_{i=1}^{I-1} (c_{i+1} - c_i) \left( \frac{A_B}{G_{i+1}} \right)^{-\gamma_2}, \]  

(22)

where, for convenience, we let \( c_i \equiv (1-\theta)\bar{C}_i \).

\(^{26}\)Since \( \gamma_1 > 0 \) and \( \gamma_2 < 0 \), the term \( L_i^{(2)} x^{-\gamma_2} \) would necessarily dominate the other terms in the equation (13) violating the inequality \( 0 \leq W(x) \leq x \), unless \( L_i^{(1)} = 0 \).
5.2 Linear PSD

Next, we consider the coupon scheme given by

\[ C(x) = \beta_0 - \beta_1 x, \]

with \( \beta_0 > 0 \).

Applying Theorem 1, the corresponding equity value is

\[ W(x) = \lambda \left( x - A_B \left( \frac{x}{A_B} \right)^{-\gamma_1} \right) - \frac{\beta_0}{r} \left( 1 - \left( \frac{x}{A_B} \right)^{-\gamma_1} \right), \quad (23) \]

and the optimal bankruptcy boundary is

\[ A_B = \frac{\gamma_1 \beta_0}{\lambda (1 + \gamma_1) r}, \]

where \( \lambda = \frac{r-\mu+\beta_1}{r-\mu} \).

When \( \beta_1 = 0 \), formula (23) for \( W \) corresponds to the fixed coupon case with \( C = \beta_0 \). As expected, \( W \) is increasing in \( \beta_1 \) due to the reduction in the coupon rate.

6 Performance-Sensitive Debt as a Signalling Device

Thus far, we have shown that PSD that results in higher interest payments when the company performs poorly is inferior to fixed-coupon debt under the assumption that there are no market frictions other than bankruptcy costs. This result is robust as it holds for a wide class of cash flow processes and performance measures. Despite its potential inefficiency, risk-compensating PSD is widely used in practice. In order to explain its existence, we need to introduce market imperfections in our model. In this section, we develop a simple signaling model in the spirit of Spence (1974) and demonstrate that under general conditions performance-sensitive debt can be used as a signalling device in a setting with asymmetric information.

Unlike a fixed coupon bond, interest payment on a risk-compensating PSD obligation is negatively related to the financial quality of the issuing firm. Since higher default risks are (partially) offset by higher interest payments, the value of a risk-compensating PSD obligation is usually less sensitive to the private information. If the pecking-order hypothesis is correct,
then a risk-compensating PSD obligation is a better choice than a fixed-coupon bond for a firm worried about a possibility of its securities being undervalued. In this section, we demonstrate under different settings that a high-growth firm can signal its growth rate by issuing a risk-compensating PSD obligation, while a low-growth firm does not want to mimic the high-growth firm because it will have to make higher interest payments on the same PSD obligation in the future than the high-growth firm.

We consider a firm that needs to raise $M$ amount of capital at time zero to finance its investment opportunities. For simplicity, we assume that the firm has no debt outstanding and no cash reserves at time zero and there are no tax benefits associated with debt.\textsuperscript{27} We also assume that the firm’s cash-flows follow a geometric Brownian motion. The initial cash flow $\delta_0$ and the volatility $\sigma$ are publicly known, but the future growth rate (drift) of the cash flows depends on the quality of the firm’s investment opportunities that are known to the equityholders of the firm but not known to the market at time zero. The cash flow growth rate is either low $\mu_L$ or high $\mu_H$, $\mu_H > \mu_L$, depending on the quality of the investment opportunities. Given the initial cash flow $\delta_0$, the initial asset levels are $A_L = \delta_0 / (r - \mu_L)$ for the low-growth firm and $A_H = \delta_0 / (r - \mu_H)$ for the high-growth firm. We assume that if the firm does not undertake the investment opportunities the firm’s growth rate $\mu_0$ will be sufficiently low so that it is optimal even for the low-growth firm to raise $M$ and invest.

In this section, we restrict our attention to the class of linear asset-based PSD $C_1 (A) = \beta_0 - \beta_1 A$. Linear asset-based PSD obligations are convenient to deal with, because it is easy to compare them in terms of their relative efficiency. According to Theorem 2, keeping the market value constant, an increase in $\beta_1$ makes a linear PSD obligation less efficient. In addition, we have the closed form formula to value linear asset-based PSD.\textsuperscript{28}

We start the analysis with a simple example with deterministic cash flows. Then, we consider three different signaling frameworks. In the first framework, the growth rate becomes public knowledge after the debt issuance and the firm can issue either a fixed coupon bond or asset-based linear PSD to raise $M$. In the second framework, the growth rate is not re-

\textsuperscript{27}It is easy to extend our argument to a setting with a more complex capital structure and tax benefits of debt. Considering an all-equity firm with no cash reserves, however, simplifies presentation of our argument.

\textsuperscript{28}A more interesting exercise would be to characterize the set of all separating equilibria without imposing any restrictions on PSD obligations. Equilibria with linear PSD obligations would be a part of this set. However, this would make matters too complicated due to the nature of this problem.
vealed to the market after the debt issuance while the firm can issue either a fixed coupon bond or asset-based linear PSD. In the third framework, in addition to PSD the firm can issue equity. In all the three frameworks, we show that there is a separating equilibrium in which the high-growth firm issues PSD while the low-growth firm issues fixed coupon debt or equity.

6.1 Deterministic Cash Flows

We start our analysis by assuming that there is no uncertainty associated with the future cash flows: $\sigma = 0$. The cash flows grow deterministically at the constant rate of $\mu_L \geq 0$ for the low-growth firm and $\mu_H > \mu_L$ for the high-growth firm. We assume that the initial cash flow $\delta_0$ is high enough, so that both the high-growth and low-growth firms can raise $M$ through issuing risk-free debt. The growth rate is revealed after the firm raises the capital.

It is easy to see that there exists a separating equilibrium, in which and the low-growth firm raises $M$ through issuing a fixed coupon bond or equity, while the high-growth issues PSD $C_1 (A) = \beta_0 - \beta_1 A$, with $\beta_1 > 0$, such that

$$U_{C_1}^H (A_H) = M,$$

(24)

where $U_{C_1}^H (A_H)$ is the market value of $C_1$.

In the equilibrium, the market believes that only the high-growth firm issues PSD. Suppose the low-growth firm deviates and issues PSD $C_1$ as well. This will raise $M$ since the firm will be perceived by the market as the high-growth firm at the time of the issuance. After the issuance, however, the asset level of the low-growth firm will be revealed. Because the asset level of the low-growth firm is always below that of the high-growth firm and $\beta_1 > 0$, the low-growth will end up paying a higher coupon than the high-growth firm. As a result, the value of PSD $C_1$ issued by the low-growth firm must be greater than $M$:

$$U_{C_1}^L (A_L) > M.$$

Since the debt is risk-free, the equity value is just the asset level minus the value of the debt.

$$W_{C_1}^L (A_L) = A_L - U_{C_1}^L (A_L) < A_L - M.$$

Clearly, the low-growth firm would be better off if it does not mimic the high-growth firm. Raising $M$ through issuing a fixed-coupon bond or equity would result in the equity value of $A_L - M$ for the low-growth firm. On
the other hand, the high-growth firm is indifferent between issuing the PSD or the fixed coupon bond, since the value of the fixed-coupon bond is the same for both firms. Thus, we have a separating equilibrium in which the high-growth firm raises \( M \) through issuing PSD and the low-growth firm raises \( M \) through issuing a fixed coupon bond or equity.

6.2 Signaling Game 1

In the setting with deterministic cash flows and risk-free debt, the high-growth firm does not really need to signal its type, because it can just issue a fixed-coupon bond. However, with stochastic cash flows (\( \sigma > 0 \)) and risky debt the firm may benefit from signaling the high-growth rate by being able to borrow at a lower interest rate. Under the assumption that the firm can issue either a fixed coupon bond or asset-based linear PSD, but not equity,\(^{29}\) we will demonstrate the existence of separating equilibria in the setting with stochastic cash flows.

The value of the equity for the firm of type \( i = L, H \) is given by

\[
W^C_i (A_i) = A_i - U^C_i (A_i) - B^C_i (A_i),
\]

(25)

where \( B^C_i (A_i) \) denotes the expected present value of the bankruptcy costs associated with PSD \( C \). As before, let \( C_1 \) denote \( C_1 (A) = \beta_0 - \beta_1 A \), with \( \beta \geq 0 \), such that equation (24) holds. Let \( C_0 \) denote a fixed coupon bond such that

\[
U^{C_0}_L (A_L) = M.
\]

In the separating equilibrium, the PSD \( C_1 \) is priced under the expectation that the issuing firm is of the high-growth type, while \( C_0 \) is priced under the expectation that the issuing firm is of the low-growth type. Thus, both \( C_1 \) and \( C_0 \) raise the capital \( M \), no matter what firm issues the debt. However, the market value of \( C_1 \) or \( C_0 \) will be different from \( M \) if the firm’s type is different from the market’s initial expectation. It is incentive compatible for the low-growth firm to issue \( C_0 \) if

\[
W^{C_0}_L (A_L) \geq W^{C_1}_L (A_L),
\]

(26)

Similarly, the high-growth firm prefers to issue \( C_1 \) if

\[
W^{C_1}_H (A_H) \geq W^{C_0}_H (A_H).
\]

\(^{29}\)It may be the case that the firm is not publicly traded, or the issuance cost is too high to issue equity.
We use the following parameters to demonstrate the properties of the signaling equilibrium:

\[ r = 0.05, \quad \sigma = 0.2, \quad \mu_L = 0, \quad \mu_H = 0.02, \quad \rho(A_B) = 0.5A_B, \quad \delta_0 = 5, \quad M = 50. \]

The initial asset levels corresponding to these parameters are \( A_L = 100 \) and \( A_H = 166.7 \). The fixed coupon PSD \( C_0 = 3.1615 \) raises \( M = 50 \) for the low-growth firm. There is a continuum of linear PSD obligations \( C_1(A) = \beta_0 - \beta_1 A \) that satisfy equation (24). Figure 4 shows debt payments \( C_1(A_L) \) and \( C_1(A_H) \) for the low-growth and high-growth firms at time zero as a function of \( \beta_1 \).

The difference \( W_{C_1}^L(A_L) - W_{C_0}^L(A_L) \) shows how the stock value of the low-growth firm changes if it issues \( C_1 \) instead of \( C_0 \) and the market prices \( C_1 \) assuming it was the high-growth firm. The difference \( W_{C_1}^H(A_H) - W_{C_0}^H(A_H) \) shows how the stock value of the high-growth firm changes if it issues the
$C_0$ instead of $C_1$ and the market prices $C_0$ assuming it was the low-growth firm. In a separating equilibrium, both differences should be below zero.

In general, there are multiple separating equilibria. Any $C_1$ with $\beta_1 \in [0.0028, 0.0257]$ that satisfies equation (24) can be used to signal the high-growth type in an equilibrium. However, a higher $\beta_1$ results in higher bankruptcy costs for the issuing firm. The most efficient equilibrium is the one with the smallest $\beta_1 : C_1^* (A) = 3.516 - 0.0028A$. The most efficient equilibrium is also a unique equilibrium under the Cho and Kreps (1987) refinement criteria.

In the most efficient signaling equilibrium, the low-growth firm is indifferent between issuing $C_0$ and $C_1^*$: $W_{C_0}^L (A_L) = W_{C_1^*}^L (A_L) = 45.15$. On the other hand, issuing $C_1^*$ increases the equity value of the high-growth firm from 105.87 to 114.65, or by 8.3%. The high-growth firm starts paying $C_1^* (A_H) = 3.0512$ at time zero and its debt payments will go down as the firm grows. Note that $C_1^* (A_H)$ is lower than what the low-growth firm will be paying forever ($C_0 = 3.1615$). Nonetheless, the low-growth firm is indifferent between issuing $C_0$ and $C_1^*$ because if it issues $C_1^*$ it will be paying $C_1^* (A_L) = 3.2378$ after its type is revealed. Moreover, its asset level may go down which will increase the debt payments even further and may lead to a costly bankruptcy.

The market value of PSD $C_1^*$ is much less sensitive than $C_0$ to the type of the issuing firm. If the low-growth firm issues $C_1^*$, the value of $C_1^*$ would be 49.42, which is only slightly below $M = 50$. On the other hand, the value of $C_0$ issued by the high-growth firm is 58.86, which is substantially higher than 50. As predicted by the pecking-order theory, the high-growth firm issues the less information sensitive obligation $C_1^*$.

6.3 Signaling Game 2

One of the modeling assumptions made in Signaling Game 1 is that the firm’s growth rate is revealed immediately after the debt issuance. In practice, it may take some time for the market to learn the quality of the firm’s investment projects that determine the growth rate. Here, we demonstrate that there exists a separating similar to that in Signaling Game 1 in a setting, in which the growth rate is revealed after some time after the debt issuance.

In the equilibrium, the market believes that the firm that issued a fixed-coupon bond has the low growth rate, while the firm that issued a PSD obligation has the high growth rate. Until the true growth rate is revealed to the market, the low-growth firm that deviated and issued PSD will be treated by the market as the high-growth firm. That is, the market believes
that the asset level of this firm at time $t$ is $A'_t = \delta_t/(r - \mu_H)$, whereas its actual asset level is $A_t = \delta_t/(r - \mu_L) < A'_t$. Even when it is perceived by the market as the high-growth firm, the low-growth firm is likely to make higher interest payments on the PSD than the high-growth firm. This is because the perceived asset level depends on the observable cash flows $\delta_t$, which are likely to be lower for the low-growth firm.

The coupon payment for the low-growth firm in deviation before the growth rate is revealed is given by

$$C'_1(A_t) = C_1(A'_t) = C_1 \left( \frac{r - \mu_L}{r - \mu_H} A_t \right) = \beta_0 - \beta'_1 A_t,$$

where $\beta'_1 = \beta_1 \frac{r - \mu_L}{r - \mu_H}$.

To demonstrate that there exists a signaling equilibrium when the growth rate is not revealed immediately, we consider an extreme case, in which the growth rate is never revealed. In this setting, issuing $C_1$ means that the low growth firm will be actually paying $C'_1(A_t) = \beta_0 - \beta'_1 A_t$. Thus, the incentive compatibility constraints are given by

$$W_C^L(A_L) \geq W_C^{C'_1}(A_L)$$

for the low-growth firm, and

$$W_C^H(A_H) \geq W_C^{C'_0}(A_H)$$

and for the high-growth firm.

Since $C'_1(A) < C_1(A)$, the deviation payoff $W_C^{C'_1}(A_L)$ for the low-growth firm is higher than $W_C^L(A_L)$. As a result, the IC constraint (27) is tighter than (26). In the intermediate case, in which the growth rate is revealed to the market after a finite period of time, the deviation payoff for the low-growth firm is in between $W_C^{C'_1}(A_L)$ and $W_C^{C'_0}(A_L)$. Thus, if there exists a signaling equilibrium when the growth rate is never revealed, then there exists a signaling equilibrium in any intermediate case.

### 6.3.1 Example 2

We use the same parameters as in Example 1 to characterize a signaling equilibrium when the growth rate is never revealed. As Figure 5 shows, the situation is similar to that on Figure 4. A major difference is that the coupon paid by the low-growth firm just after the issuance is equal to the coupon paid by the high-growth firm: $C'_1(A_L) = C_1(A_H)$. 

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In the most efficient signaling equilibrium, the high-growth firm issues $C_{1}^{**}(A) = 4.2461 - 0.0051A$. Because the incentive compatibility constraint for the low type is tighter, PSD $C_{1}^{**}$ is more risk-compensating than $C_{1}^{*}$ in Example 1. The low-growth firm is indifferent between issuing $C_0$ and $C_{1}^{**}$, and its equity value is the same as in Example 1: $W_{L}^{C_{0}}(A_{L}) = 45.15$. On the other hand, issuing $C_{1}^{**}$ increases the equity value of the high-growth firm from 105.87 to 113.91. Due to higher bankruptcy costs associated with the more risk-compensating PSD, the equity value of the high-growth firm is 0.74 less than the equity value of the high-growth firm in Example 1.

As in Example 1, the market value of PSD $C_{1}^{**}$ is less sensitive than $C_0$ to the type of the issuing firm. As before, the value of $C_0$ issued by the high-growth firm is 58.86 vs. 50, when $C_0$ is issued by the low-growth firm. On the other hand, if the low-growth firm issues $C_{1}^{*}$, the actual value of $C_{1}^{*}$ would be 48.23, which is fairly close to 50. Consistent with the pecking-order

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*30* The most efficient equilibrium is a unique equilibrium under the Cho and Kreps (1987) refinement criteria.
theory, the high-growth firm issues the less information sensitive obligation $C_{1*}$.

### 6.4 Signaling Game 3

In the previous signaling frameworks, the firm was allowed to issue debt only. We now allow the firm to issue equity. As in Signaling Game 1, we assume that the growth rate becomes public knowledge after the firm issues securities.

Issuing equity is the most efficient way to raise capital $M$ because it minimizes the bankruptcy costs. Thus, in a signaling equilibrium, the low-growth firm should raise $M$ through issuing equity. The total equity value of the low-growth firm will be $A_L$, of which fraction $1 - M/A_L$ will be held by the old equityholders and the rest will be held by the new equityholders. The incentive compatibility constraint for the low-growth firm is given by

$$A_L - M \geq W_{C_1}^L (A_L), \quad (28)$$

where PSD $C_1 (A) = \beta_0 - \beta_1 A$ is such that equation (24) holds.

If the high-growth firm issues equity in a signaling equilibrium, it will be perceived as the low-growth firm and its stock will be underpriced. To raise $M$, the high-growth firm will have to sell the fraction $M/A_L$ of its equity, which leads to the following incentive compatibility constraint:

$$W_{C_1}^H (A_H) \geq A_H \left(1 - \frac{M}{A_L}\right). \quad (29)$$

Any PSD $C_1$ that satisfies equations (28) and (29) can be used as a signaling device.

An important property of the signaling equilibrium is that for a wide range of parameters a fixed-coupon bond does not satisfy the IC constraint (28) and therefore cannot be used as a signaling device. This is because a fixed-coupon bond does not differentiate between the high and low growth rates. If issuing a fixed-coupon bond makes the market believe that the issuing firm will have the high-growth rate, then issuing a fixed-coupon bond may be a cheaper way than equity to raise the capital for the low-growth firm. Indeed, using (25) one can rewrite (28) as follows:

$$U_{C_1}^L (A_L) + B_{C_1}^L (A_L) \geq M. \quad (30)$$

Now, let’s consider the fixed-coupon bond $C_0$, such that

$$U_{C_0}^L (A_L) = M.$$
Since the low-growth firm defaults earlier than the high-growth firm,

\[ U_{L}^{C_{0}}(A_{L}) < M. \]  \hspace{1cm} (31)

This strict inequality is true even when there is no bankruptcy cost \((\rho(A) = 0)\), because the firm defaults when its asset level is strictly below \(C_{0}\). This means that \(C_{0}\) does not satisfy the IC constraint (30) when the bankruptcy cost is sufficiently low. Thus, we have proven the following proposition:

**Proposition 1** There is no signaling equilibrium with a fixed-coupon bond when the bankruptcy cost is sufficiently low.

Proposition 1 says that a fixed-coupon bond is not a good signaling device. An important difference between a fixed-coupon bond and a risk-compensating PSD obligation is that the value of the latter is less sensitive to the type of the issuing firm. This is because a risk-compensating PSD obligation imposes a higher debt load on the low-growth firm than on the high-growth firm, which compensates for higher default risks associated with the low type. As a result, for sufficiently high \(\beta_{1}\) the IC constraint for the low-growth firm will be satisfied, which ensures existence of the signaling equilibrium. In the special case of zero bankruptcy cost \((\rho(A) \equiv 0)\), the PSD whose value is the same for both types is employed in the most efficient signaling equilibrium.

The high-growth firm has to worry about the possibility of its securities being undervalued. The fact that it issues PSD is consistent with the pecking-order hypothesis, according to which the firm should strive to issue claims whose valuation is least affected by the asymmetry of information. On the contrary, claims of the low-growth firm cannot be undervalued. In the separating equilibrium, the low-growth firm issues equity - a high-information-intensity claim without any bankruptcy implications.\footnote{While the capital structure of the high-growth firm in the separating equilibrium is consistent with the pecking-order hypothesis, the capital structure of the low-growth firm is determined by the trade-off theory. When there are no tax benefits associated with debt financing, the optimal capital structure is 100% equity for the low-growth firm. However, if there are tax benefits, depending on the initial capital structure, the low growth firm may want to issue a fixed-coupon debt instead of equity. Then, the separating equilibrium will be determined by the conditions similar to that of the Signaling Game 1.}

### 6.4.1 Example 3

Figure 6 shows that for the parameters used in Example 1 and Example 2, there is no signaling equilibrium with a fixed coupon bond. The most
efficient signaling equilibrium\textsuperscript{32} is the one with $C_{1}^{***}(A) = 2.957 - 0.001A$.

Again, PSD $C_{1}^{***}$ is less sensitive to the type of the issuing firm than a fixed coupon bond of an equivalent value. The market value of $C_{1}^{***}$ is 50 for the high-growth firm, and 45.98 for the low-growth firm. The value of a bond with the fixed coupon of 2.637 is 50 for the high-growth firm and only 43.79 for the low-growth firm. As predicted by the pecking-order theory, the high-growth firm issues the less information sensitive obligation $C_{1}^{***}$.

7 Performance Measures

Earlier, we derived valuation formulas and an inefficiency theorem for PSD obligations whose coupon payments are determined by the asset level of the firm. Since, in our model, $A_{t}$ incorporates all information about future

\textsuperscript{32}The most efficient equilibrium is also a unique equilibrium under the Cho and Kreps (1987) refinement criteria.
earnings of the firm, the asset level is the natural choice for a performance measure.

In practice, however, PSD contracts are usually written in terms of other performance measures such as credit ratings and financial ratios. In this section, we explicitly consider the valuation and relative efficiency of PSD obligations based on these other performance measures.

### 7.1 General Performance Measures

We assume that performance measures reflect the borrower’s capacity and willingness to repay the debt. With \( \mu \) and \( \sigma \) given, the borrower’s asset level \( A_t \) and chosen default triggering boundary \( A_B \) fully determine its default characteristics at any time \( t \). Since \( A_B \) is not directly observed by outsiders, the performance measure \( \pi_t \) is a function \( \bar{\pi}(A_t, A_B) \), where \( A_B \) is the perceived default triggering level of assets. Although we do not make explicit use of this condition, it is natural to assume that \( \bar{\pi}(\cdot, \cdot) \) is nondecreasing in \( A_t \) and nonincreasing in \( A_B \).

A PSD obligation \( C \) therefore pays the coupon \( C(\pi_t) = C(\bar{\pi}(A_t, A_B)) \).

The Markov structure and the time homogeneity of the setting imply that any optimal default time of the firm can be simplified to a default triggering boundary hitting time \( \tau(A_B) \) (still imposing Condition 2). In this setting, a consistency problem arises, as the default triggering level chosen by the firm may depend on the perceived default triggering level. With \( y \) denoting the actual default triggering level of the firm, the value of the equity is

\[
\bar{W}(x, y, A_B) = E_x \left[ \int_0^{\tau(y)} e^{-rt} \left[ \delta_t(A_t) - (1 - \theta)C(\bar{\pi}(A_t, A_B)) \right] dt \right].
\]

Knowing that the firm seeks to maximize the value of the equity, the ratings agency therefore chooses an \( A_B \) that solves the fixed point equation:

\[
A_B \in \arg \max_{y \leq x} \bar{W}(x, y, A_B). \tag{32}
\]

This equation may have one or several solutions, or no solution at all. To avoid ambiguity, we impose the following condition.

**Condition 5** There exists a unique positive solution of equation (32).

Given Condition 5, the coupon rate paid by the PSD obligation at time \( t \) is \( C(\bar{\pi}(A_t, A_B)) \). Since \( A_B \) does not change over time, this PSD, which is defined under performance measure \( \pi \), is equivalent to an asset-based
PSD $\bar{C}$, defined by $\bar{C}(A_t) \equiv C(\pi(A_t, A_B))$. Equation (32) implies that $C$ and $\bar{C}$ have the same optimal default boundary $A_B$. Hence, provided that $\bar{C}$ satisfies Conditions 2, 3, and 4, we can compare $C$ in terms of efficiency with asset-based PSD obligations that satisfy the same conditions by applying Theorem 2. In particular, if $\bar{C}(A_t)$ is a nonincreasing non-negative function, then a fixed-coupon bond with the same market value is more efficient than $C$.

If $\pi$ can take a finite number of values, then $\bar{C}(A_t)$ satisfies Conditions 2 and 3. Thus, we have proven the following theorem.

**Theorem 3** Suppose that a performance measure $\pi$ can take only a finite number of values, and that a PSD $C$ is nonincreasing and nonnegative. Suppose Conditions 4 and 5 are satisfied. Then, a fixed-coupon PSD $D$ that satisfies Condition 4, and has the same market value as $C$ ($U_0^C = U_0^D$), is more efficient than $C$.

### 7.2 Ratings-based PSD

Here we consider $I$ different credit ratings, 1, . . . , $I$, with 1 the highest (“Aaa” in Moody’s ranking) and $I$ the lowest (“C” in Moody’s ranking). We let $R_t$ denote the issuer’s credit rating at time $t$. We say that $C \in \mathbb{R}^I$ is a ratings-based PSD obligation if it pays interest at the rate $C_i$ whenever $R_t = i$, with $C_{i+1} \geq C_i > 0$, for $i$ in $\{1, \ldots, I - 1\}$. Thus, a ratings-based PSD is more risk-compensating than a fixed coupon PSD.

We say that an accurate rating agency is one whose credit ratings are a function of the probability of default over a given time horizon $T$. Naturally, higher ratings correspond to lower default probabilities.

The default time for a ratings-based PSD is a stopping time of the form $\tau(A_B) = \inf\{s : A_s \leq A_B\}$, for some $A_B$. Therefore, the current asset level $A_t$ is a sufficient statistic for $P(\tau(A_B) \leq T \mid \mathcal{F}_t)$, for any $T \geq t$. A rating policy is thus given by some $G : \mathbb{R} \mapsto \mathbb{R}^{I+1}$ that maps a default boundary $A_B$ into rating transition thresholds, such that $R_t = i$ whenever
\( A_t \in [G_{t+1}(A_B), G_t(A_B)) \). In our setting, this policy has the form\(^{33}\)

\[
G(A_B) = A_B g, \tag{33}
\]

where \( g \in \mathbb{R}^I \) is such that \( g_1 = +\infty, g_{I+1} = 1, \) and \( g_i \geq g_{i+1} \).

The results developed for step-up PSD can be applied to ratings-based PSD. In particular, the maximum-equity-valuation problem (4) is solved by \( \tau(A_B) = \inf\{s : A_s \leq A_B\} \), where \( A_B \) solves equation (22).

Plugging (33) into (22), we obtain

\[
A_B = \frac{\gamma_1}{(\gamma_1 + 1)\hat{C}}, \tag{34}
\]

where

\[
\hat{C} = \sum_{i=1}^{I} \left[ \left( \frac{1}{g_{i+1}} \right)^{-\gamma_2} - \left( \frac{1}{g_i} \right)^{-\gamma_2} \right] c_i,
\]

and \( c_i = (1 - \theta)C_i \). We note that the ratings-based PSD issue \( C \) has the same default boundary \( A_B \) as that of a fixed-coupon bond paying coupons at the rate \( \hat{C} \).

Plugging (34) into (18)-(21), (13), and (6), we obtain closed-form expressions for the market value \( W \) of equity and the market value \( U \) of debt for any ratings-based PSD obligation.

We now derive the inefficiency theorem for the case of ratings-based PSD. We keep the same definitions as in Section 4, except that the performance measure now corresponds to credit ratings, and not asset levels.

**Theorem 4** Suppose \( C \) and \( D \) are ratings-based PSD, satisfying \( U_0^C = U_0^D \) and Condition 4. If \( C \) is more risk-compensating than \( D \), then \( C \) is less efficient than \( D \).

The proof of the theorem is given in the Appendix.

**Corollary 2** Let \( C \) be a ratings-based PSD issue satisfying Conditions 2, 3, and 4. If \( C \) is not constant, it is less efficient than any fixed-interest PSD issue raising the same amount of cash and satisfying Condition 3.

\(^{33}\)Since \( A_t \) is a geometric Brownian motion, its first passage time distribution is an inverse Gaussian:

\[
P(\tau(A_B) \leq T \mid \mathcal{F}_t) = 1 - \Phi \left( \frac{m(T-t) - x}{\sigma \sqrt{T-t}} \right) + e^{\frac{2mx}{\sigma^2}} \Phi \left( \frac{x + m(T-t)}{\sigma \sqrt{T-t}} \right),
\]

where, \( x = \ln \left( \frac{A_B}{A_t} \right) \), \( m = \mu - \frac{1}{2} \sigma^2 \), \( A_t \) is the current level of assets and \( \Phi \) is the normal cumulative distribution function. Since \( P(\tau(A_B) \leq T \mid \mathcal{F}_t) \) depends on \( A_t \) only through \( \frac{A_B}{A_t} \), we have the linearity of \( G(\cdot) \).
8 Rating Agency Policy

Credit ratings differ from other measures because of the circularity issues that are imposed. In a ratings-based PSD obligation, the rating determines the coupon rate, which affects the optimal default decision of the issuer. This, in turn, influences the rating. We have so far assumed that rating agencies are accurate, in the sense that they assign credit ratings according to the probability of default over a time horizon \( T \). In this section, we discuss what can happen when credit-rating agencies fail to account for the effect of credit-rating changes on the firm’s financial standing.

Only after recent deteriorations in credit qualities of several major companies did rating agencies begin to worry about the unintended adverse effects of rating triggers.\(^{34}\) Even after several incidences of default and cascading downgrades related to ratings-based PSD, it is not difficult to find examples of reluctance by rating agencies to incorporate the negative consequences of ratings-based PSD into credit ratings.\(^{35}\) The following passage is from Standard & Poor’s (2001):

\[
\text{(…)} \text{How is the vulnerability of rating triggers reflected all along in a company’s ratings? Ironically, it typically is not a rating determinant, given the circularity issues that would be posed. To lower a rating because we might lower it makes little sense – specially if that action would trip the trigger!}
\]

Another reason that rating triggers may not be incorporated into credit ratings is that often, due to confidentiality constraints, they are not publicly disclosed by the issuer. Some steps have already been taken to punish issuers who refuse to provide information about their rating triggers, although there is still no legal procedure to enforce disclosure.\(^{36}\)

We say that an agency is unresponsive if, when assigning credit ratings, it ignores the adverse effects of rating triggers on the liquidation of the firm.

We suppose, for purpose of illustration, that a firm having a fixed-coupon note \( C \) refinances its outstanding debt by issuing a ratings-based PSD obligation \( D \). Figure 7 plots the accurate agency policy \( G(\cdot) \), which is obtained from (33), and equityholders’ optimal default strategies \( A_D^G(\cdot) \) and \( A_D^P(\cdot) \), which are obtained from (22). Points 1 and 5 in the figure yield the solution to (32) before and after the refinancing of the debt takes place. With

\(^{34}\)See Moody’s (2001) and Standard & Poor’s (2001).

\(^{35}\)Moody’s adopted a more critical view of ratings trigger after recent default events. See Moody’s (2001).

\(^{36}\)See Moody’s (2002).
an accurate rating agency, issuance of ratings-based PSD obligations thus triggers a chain reaction that ceases only when it reaches point 5. This chain reaction, which we call the credit-cliff dynamic, might induce a drastic downgrade or even immediate default if $A_C > A_0$.

By ignoring the effects of ratings triggers, an unresponsive rating agency may avoid the perverse effects associated with the credit-cliff dynamic. In the context of figure 7, an unresponsive rating agency would interrupt the chain reaction at point 2, leading to a lower optimal default boundary than with an accurate rating agency.

One would then be tempted to say that the outcome of a ratings-based PSD with an unresponsive rating agency is superior to the one with an accurate one. We claim that this is not necessarily true. With unresponsive rating agencies, credit ratings do not reflect true probabilities of default and are thus less informative. Moreover, firms may be tempted to issue more risk-compensating ratings-based PSD, compensating for the unresponsiveness of rating agencies.

Figure 7: Rationalizing the credit cliff dynamic.
9 Additional Discussion

Even though one of our main results is that more risk-compensating PSD obligations lead to higher inefficiency, companies do issue these obligations in practice. In order to understand why this is the case, one could introduce market frictions such as adverse selection, moral hazard, contracting costs, or incomplete markets. In Section 6, we showed that PSD can be used as an efficient signaling device in a setting with asymmetric information. In this section, we discuss other possibilities why companies may want to issue PSD.

Moral hazard can justify the use of risk-compensating PSD. A scheme that punishes bad performance with higher interest rates could serve as an additional incentive for the firm’s manager to exert effort. It could also discourage the manager from undertaking inefficient investments. Tchistyi (2005) shows that risk-compensating performance pricing can be part of an optimal contract in a situation in which the manager of the firm can privately divert the firm’s cash flows for his own consumption at the expense of outside investors. However, Bhanot and Mello (2005) show that rating triggers that increase coupon rates are in general inefficient in preventing asset substitution.\footnote{Bhanot and Mello (2005) also demonstrate that rating triggers that force early payment of debt can prevent asset substitution.}

Contracting costs may be another reason for some types of PSD. When the credit quality of the borrower changes, the issuer and the investors in its debt often get involved in costly negotiation over the terms of the debt. An increase in credit quality may prompt the borrower to seek refinancing of its debt on better terms. Conversely, the lender may demand higher interest payments in compensation for the deterioration in credit quality. Some types of PSD may resolve the renegotiation problem by automatically adjusting the interest rates.

Asquith, Beatty, and Weber (2002) and Beatty, Dichev, and Weber (2002) indeed found empirical evidence that private debt contracts are more likely to include performance pricing schemes that increase interest rates in times of poor performance when agency costs associated with asymmetric information, moral hazard, or recontracting costs are significant. They also point out that risk-compensating performance pricing provisions are especially popular in syndicated loans. Since monitoring of the firm may be too costly for some lenders, the latter fact seems to be in line with the hypothesis that risk-compensating performance pricing provisions are part
of a mechanism built into debt contracts that resolves agency problems and makes the debt more liquid. Our paper, however, establishes that solving these problems with PSD comes with a cost.

Our analysis suggests that if there is no agency problem, the optimal PSD is the one that reduces interest payments when the firm is financially distressed so that the firm is never forced into bankruptcy. The fact that in practice debt is often renegotiated when the firm is in a poor financial shape, and lenders are often willing to reduce the firm’s debt load in order to save it from bankruptcy, is in agreement with our analysis. We interpret this renegotiation as implicit performance pricing. If the borrower and the lenders expect the debt renegotiation in the future, it will be reflected in the current price of the firm’s debt and equity as if the debt were PSD with lower interest rates in times of poor performance.

Nonetheless, debt contracts with explicit provisions that reduce the interest rate in times of poor performance are very rare in practice. A possible explanation for this is that those types of contracts seem to be very vulnerable to moral hazard. For example, the firm’s owners may try to hide or divert the firm’s cash flows in order to reduce the debt payments, or the manager of the firm may not have enough incentives to work hard since higher cash flows would also mean higher debt payments. Because of the potential moral hazard problems it is not optimal to promise explicitly in a contract a debt payment reduction in times of poor performance. Instead, the creditors can implicitly agree to reduce the debt payments if they believe that the firm’s poor performance is caused purely by bad luck. Another reason why performance pricing schemes that explicitly decrease interest rates in times of poor performance and increase them in times of good performance are not widespread is because they resemble equity and therefore might not be recognized as debt for tax purposes.

We have assumed throughout the paper that all the agents in the economy are risk-neutral. It is straightforward, however, to extend our results to the case of risk-averse agents, in the absence of arbitrage (specifically, assuming the existence of an equivalent martingale measure).

If markets are incomplete, performance-sensitive debt might be issued to meet the demands of risk-averse investors, providing them with hedge

\[38\] PSD obligations that charge higher interest rates in times of poor performance are also vulnerable to some moral hazard problems, but to a lesser extent. Enron, which had issued debt obligations with rating triggers, systematically overstated its earnings partially in order to avoid higher debt payments triggered by credit rating downgrades.

\[39\] Saving the firm from bankruptcy may be in the creditors’ best interests when the firm’s liquidation value is sufficiently small.
against credit deterioration of the firm. Our results suggest, however that financial guarantors, rather than the debt issuing firms, should be providing this kind of hedge.

Our inefficiency results hold for alternative definitions of financial distress. If we assume, for example, that default happens when assets do not generate enough cash flow to meet current obligations,\textsuperscript{40} then it is easy to see that a more risk-compensating PSD will lead to more inefficiency. In this \textit{flow-based} insolvency definition, however, shareholders declare bankruptcy even though it may be still possible to issue additional equity to cover the shortage.

10 Conclusion

Using an endogenous default model, we develop a convenient method of valuing different types of performance-sensitive debt and prove that, given the same initial funds raised by sale of debt, more risk-compensating PSD leads to earlier default and consequently lowers the market value of the issuing firm's equity. Despite its inefficiency, risk-compensating PSD is a widespread form of financing. To explain the existence of PSD obligations, we then propose a signaling model in which the future growth rate of the firm is unknown to the market but known to the firm's equityholders. We show that there exists a separating equilibrium in which the high-growth firm issues a risk-compensating PSD obligation, while the low-growth firm issues either a fixed-coupon bond or equity.

Existing models of the valuation of PSD obligations have difficulty fitting the market prices of PSD obligations. For example, Lando and Mortensen (2003) find that PSD obligations are underpriced by the market. As opposed to these models, we derive our results in an endogenous default setting. Therefore, our valuation method explicitly incorporates the effects of performance-sensitive debt on the default time of the issuing firm. It would thus be interesting to apply the method derived here to study market prices of PSD obligations.

In the paper, we focused on the signaling explanation for the existence of PSD obligations. It is possible, however, that PSD obligations are issued to solve other types of agency problems, such as adverse selection and moral hazard, or to avoid contracting costs. We leave it for future research to investigate these other potential reasons for firms to issue PSD. It would be particularly interesting to derive testable implications from each of the

\textsuperscript{40}This setting is studied in Kim, Ramaswamy, and Sundaresan (1993).
different models that would allow one to identify the most important forces determining the use of PSD. For example, the signaling hypothesis developed in this paper predicts that a firm that issues a risk-compensating PSD will experience a less negative impact on its stock price than a firm that issues a fixed-coupon bond.

11 Appendix

Proof of Lemma 1. The proof is based on the following claim:

Claim: There exists a level $\tilde{x}$ such that $\forall x \leq \tilde{x}$, $W(x) = \sup_\tau W(x, \tau) = 0$.

Proof. From Condition 2, there exist positive constants $\bar{x}$ and $\bar{c}$ such that

$$ (1 - \theta)C(x) > \delta(x) + \bar{c} $$

for all $x \leq \bar{x}$. Let $\Xi = \sup_\tau W(x, \tau) < \infty$. For any stopping time $\tau$ and $x < \bar{x}$,

$$ W(x, \tau) = E_x \left[ 1_{\tau < \tau(x)} \int_0^\tau e^{-rt} (\delta(A_t) - (1 - \theta)C(A_t)) \, dt \right] + $$

$$ E_x \left[ 1_{\tau > \tau(x)} \int_0^\tau e^{-rt} (\delta(A_t) - (1 - \theta)C(A_t)) \, dt \right] $$

$$ \leq -\frac{\bar{c}}{r} E_x \left[ (1 - e^{-r\tau}) 1_{\tau < \tau(x)} \right] + $$

$$ E_x \left[ \left[ -\frac{\bar{c}}{r} \left( 1 - e^{-r\tau(x)} \right) + \xi(x, x) \Xi \right] 1_{\tau > \tau(x)} \right] .$$

Let $x^* > 0$ be the unique solution (in $x$) of

$$ -\frac{\bar{c}}{r} \left( 1 - e^{-r\tau(x)} \right) + \xi(x, x) \Xi = 0. $$

Since $\xi$ is nondecreasing in $x$, we have for all $x \leq \tilde{x} = x \wedge x^*$,

$$ W(x, \tau) \leq -\frac{\bar{c}}{r} E\left[ (1 - e^{-r\tau}) 1_{\tau < \tau(x)} \right] \leq 0, $$

the optimum $W(x, \tau) = 0$ being reached for $\tau \equiv 0$. This claim proves that, starting from any level $x$ and for any stopping time $\tau$, the stopping time $\tau^- = \tau \wedge \tau(\tilde{x})$ is at least as good as $\tau$. In other words, we can restrict ourselves, in our search for optimality, to the set of stopping times $\bar{T} = \{ \tau \text{ s.t. } \tau \leq \tau(\tilde{x}) \}$.

Proof of Theorem 1. First we prove the necessary conditions, then the sufficient conditions.

1. The proof of the necessary conditions is based a series of lemmas:
Lemma 2 Under Conditions 1–3, $f$ is continuously differentiable and $f'$ is bounded and left and right differentiable. Moreover, $f$ satisfies the following equations:

$$
\frac{1}{2}\sigma^2(x)f''_l(x) + \mu(x)f'(x) - rf(x) + \delta(x) - (1 - \theta)C_l(x) = 0
$$

$$
\frac{1}{2}\sigma^2(x)f''_r(x) + \mu(x)f'(x) - rf(x) + \delta(x) - (1 - \theta)C(x) = 0,
$$

(35)

where $f''_l(x)$ (resp. $f''_r(x)$) is the left (resp. right) derivative of $f'$ at $x$, and $C_l(x)$ is the left limit of $C$ at $x$.

Proof From Condition 1, there exists a fundamental solution $\zeta(x, s, y, t)$ with the same generator as \{\(A_t\)\}_{t \geq 0}, such that for $s < t$,

$$
P_{x,s}[A_t \in \mathcal{B}] = \int_\mathcal{B} \zeta(x, s, y, t)dy
$$

for any Borel subset $\mathcal{B}$ of $\mathbb{R}$ and

$$
\frac{1}{2}\sigma^2(x)\frac{\partial^2 \zeta}{\partial x^2}(x, s, y, t) + \mu(x)\frac{\partial \zeta}{\partial x}(x, s, y, t) + \frac{\partial \zeta}{\partial s}(x, s, y, t) = 0.
$$

(36)

If $C$ is continuous, letting $\phi(x) = \delta(x) - (1 - \theta)C(x)$, Friedman (1975) and an application of the Fubini theorem imply that

$$
f(x) = \int_{\mathbb{R}} \phi(y) \left[ \int_0^\infty e^{-rt}\zeta(x, 0, y, t)dt \right] dy,
$$

which, by time homogeneity of \{\(A_t\)\}_{t \geq 0}, implies that

$$
f(x) = \int_{\mathbb{R}} \phi(y) \left[ \int_0^\infty e^{-rt}\zeta(x, -t, y, 0)dt \right] dy.
$$

(37)

When $C$ is discontinuous, the second part of Condition 3 implies that there is a countably finite number of discontinuities. A limit argument using approximating continuous functions then shows that (37) also holds in this case. To derive an ODE when $C$ is continuous, a straightforward differentiation of (37) using (36) shows (35), which boils down to a single equation at any continuity point. When $C$ is discontinuous, differentiation applied to all continuity points of $C$ shows that (35) holds at such points, while right and left limit arguments at discontinuity points show that (35) holds at these points as well. The boundedness of $f'$ comes from the boundedness of $\frac{\partial \zeta}{\partial t}(x, v)$, proved in Friedman (1975), and the fact that $\mu_\delta$ is uniformly bounded away from $r$. ■

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41 See Friedman (1975).
Corollary 3  \( W \) satisfies the following equations on \([A_B, \infty)\):

\[
\frac{1}{2} \sigma^2(x) W''_l(x) + \mu(x) W'(x) - r W(x) + \delta(x) - (1 - \theta) C_l(x) = 0 \quad (38)
\]

\[
\frac{1}{2} \sigma^2(x) W''_r(x) + \mu(x) W'(x) - r W(x) + \delta(x) - (1 - \theta) C_l(x) = 0, \quad (39)
\]

where \( W''_l(x) \) (resp. \( W''_r(x) \)) is the left (resp. right) derivative of \( W' \) at \( x \), and \( C_l(x) \) is the left limit of \( C \) at \( x \). In particular, \( W \) solves ODE (9) at any continuity point of \( C \).

Proof From Lemma 2 and (8), \( \hat{W}(x, y) \) is continuous with respect to \( y \). From Lemma 1, and compactness of \([0, x]\) there exists a level \( A_B > 0 \) such that \( W(x) = \hat{W}(x, A_B) \). The proof is then straightforward from Lemma 2 and (8).

Corollary 4 \( W' \) is bounded on \([0, \infty)\)

Proof Straightforward, from (8) and the fact that \( f' \) is bounded on \([0, \infty)\).

Corollary 5 If a PSD obligation \( C \) satisfies Conditions 1–3, then \( \hat{W}(x, y) \) is continuously differentiable in both components, and \( \frac{\partial \hat{W}}{\partial x}(x, A_B) \) is left and right differentiable in \( x \).

Proof This comes directly from the Lemma 2 and equation (8).

Lemma 3 If a PSD obligation \( C \) satisfies Conditions 1–3, then the optimal default boundary \( A_B \) verifies \( \frac{\partial \hat{W}}{\partial x}(A_B, A_B) = 0 \).

Proof From (7) and Lemma 1, it follows that \( A_B \) satisfies \( \frac{\partial \hat{W}}{\partial x}(x, A_B) = 0 \). Moreover, we have for any \( y \), \( \hat{W}(y, y) = 0 \) (since the firm defaults immediately). Differentiating this last equation and using the fact that \( \frac{\partial \hat{W}}{\partial x}(x, A_B) = 0 \) yields \( \frac{\partial \hat{W}}{\partial x}(A_B, A_B) = 0 \).

Combining equation (8), the above lemmas, and the fact that \( W(x) = \hat{W}(x, A_B) \) concludes the proof of all necessary conditions but one. It remains to show that \( A_B \leq \bar{x} \), which is immediate since, for \( A_t > x \), the cash flow rate exceeds the coupon rate implying that it is never optimal to default at this level.
2. The verification of the sufficient conditions is similar to the proof of Proposition 2.1 in Duffie and Lando (2001). Define a stochastic process $\chi_t$ as

$$\chi_t = e^{-rt}W(A_t) + \int_0^t e^{-rs} \phi_s \, ds,$$

where for $x > A_B$, $W(x)$ is the solution of the ODE that satisfies all the conditions listed in the theorem, and $W(x) = 0$ for $x \leq A_B$.

Since $W$ is $C^1$, an application of Itô's formula leads to

$$d\chi_t = e^{-rt}d(A_t) \, dt + e^{-rt}W'(A_t) \sigma(A_t) dB_t,$$

(40)

where $d(x) \equiv \frac{1}{2} W''(x) \sigma^2(x) + W'(x) \mu(x) - rW(x) + \phi(x)$.

Since by assumption $W'$ is bounded, the second term is a martingale, and since $E_x \left[ \int_0^\infty (e^{-rt}W'(A_t)\sigma(A_t))^2 \, dt \right] < \infty$, $\int_0^t e^{-rs}W'(A_s) \sigma A_s dB_s$ is a uniformly integrable martingale, which implies that $E_x \left[ \int_0^T e^{-rs}W'(A_s) \sigma A_s dB_s \right] = 0$ for any stopping time $\tau$. By the assumptions of the theorem

$$\phi(A_B) \leq 0.$$  (41)

This inequality means that when the firm declares bankruptcy, its cash flow $\delta = (r - x) A_B$ is less than the coupon payment. It is easy to verify that the drift of $\chi_t$ is never positive: $d(x)$ vanishes for $x > A_B$ since $W$ solves the ODE, and negative for $x < A_B$, because of the inequality (41) and $W(x) = 0$ for $x < A_B$. Because of the non-positive drift, for any stopping time $T \in T$, $q_0 \geq E(\chi_T)$, meaning

$$W(A_0) \geq E \left[ \int_0^T e^{-rs} \phi_s \, ds + e^{-rT}W(A_T) \right].$$

For the stopping time $\tau$, we have

$$W(A_0) = E \left[ \int_0^\tau e^{-rs} \phi_s \, ds \right] \geq E \left[ \int_0^T e^{-rs} \phi_s \, ds \right],$$

where the inequality follows from non-negativity of $W$. Therefore, the stopping time $\tau$ maximizes the value of the equity. ■

**Proof of Theorem 2.** The proof is based on the following lemma:
Lemma 4  Let $C$ and $D$ be asset-based PSD satisfying Conditions 1–3, and $A^C_B \leq A^D_B$. If $h \equiv C - D$ is not constant on $[A^D_B, \infty)$ and changes sign at most once from positive to negative on $[A^D_B, \infty)$, then, $W^C_0(x) > W^D_0(x)$ for any starting asset level $x \in (A^C_B, \infty)$.

Proof  Without loss of generality, we assume that the tax rate $\theta$ is zero. First, assume that $A^C_B = A^D_B = A_B$. Since $h$ changes sign at most once from positive to negative on $[A_B, \infty)$, there exist constants $A_1, A_2$ verifying $A_B \leq A_1 \leq A_2$ and such that $h > 0$ for $A \in [A_B, A_1)$, $h = 0$ for $A \in (A_1, A_2)$, and $h < 0$ for $A \in (A_2, \infty)$.

We first consider the case where $A_1 = A_B$. Then necessarily $A_2 < \infty$, otherwise $h$ would be constant on $[A_B, \infty)$. Thus, $h$ is zero on $[A_B, A_2)$ and negative on $(A_2, \infty)$. It is easy to verify that for any PSD $C$ with initial asset level $x$ and defaulting boundary $A_B$, we have

$$U^C_0(x) = E_x \left[ \int_0^{\tau(A_B)} e^{-rs} C(A_s) ds \right] + (A_B - \rho(A_B))\xi(A_0, A_B). \quad (42)$$

Since $(A_2, \infty)$ has a positive measure, (42) implies that $U^D_0(x) > U^C_0(x)$ for all $x \in (A_B, \infty)$. Equation (6) then allows to conclude that $W^C_0(x) > W^D_0(x)$ for all $x \in (A_B, \infty)$.

Now we consider the case in which $A_1 > A_B$. Thus, $h(A_B) > 0$. We will first show that $W^C_0(x) > W^D_0(x)$ for all $x \in (A_B, A_1)$. From equations (38) and (39), we have for $H(x) \equiv W^C_0(x) - W^D_0(x)$:

$$\frac{1}{2} H''(x) \sigma^2(x) + H'(x) \mu(x) - r H(x) - h_i(x) = 0 \quad (43)$$

$$\frac{1}{2} H''(x) \sigma^2(x) + H'(x) \mu(x) - r H(x) - h(x) = 0, \quad (44)$$

where $H''(x)$ (resp. $H''(x)$) is the left (resp. right) derivative of $H'$ at $x$, and $h_i(x)$ is the left limit of $h$ at $x$, which exists according to Condition 3 and Theorem 1. Also from Theorem 1, $W^i(A_B) = 0$ and $(W^i)'(A_B) = 0$ for $i = C, D$. Therefore, $H(A_B) = H'(A_B) = 0$. Since $h(A_B) > 0$, it follows from equation (44) that $H''(A_B) > 0$. This implies that $H'(x) > 0$ and $H(x) > 0$ in a right neighborhood of $A_B$. Precisely, there exists $\eta > 0$, such that $H'(x) > 0$ and $H(x) > 0$ for $x \in (A_B, A_B + \eta)$. We will now prove by contradiction that $H'(x) > 0$ for all $x \leq A_1$. Letting $y$ denote the first time

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42By convention $[a,a)$ and $(a,a]$ equal the empty set. The precise values at $A_1$ and $A_2$ are unimportant.
when \( H'(y) = 0 \), we have necessarily \( H(y) > 0 \). From equation (43) and the fact that \( h(y) \geq 0 \) for \( y \leq A_1 \), it follows that \( H''(y) > 0 \), contradicting the fact that \( y \) was the first time where \( H'(y) = 0 \). Therefore, \( H'(x) > 0 \) and \( H(x) > 0 \) on \((A_B, A_1]\). Last, we prove that \( H(x) > 0 \) on \((A_1, \infty)\). By definition of \( W^C \), \( W^D \), and \( A_B \), we have:

\[
W^C_0(x) = E_x^Q \left[ \int_0^{\tau^*} q_t (\delta_t - C(A_t)) dt \right]
\]

and

\[
W^D_0(x) = E_x^Q \left[ \int_0^{\tau^*} q_t (\delta_t - D(A_t)) dt \right],
\]

where \( q_t = e^{-rt} \), \( \tau^* = \tau(A_B) \). Therefore,

\[
H(x) = -E_x^Q \left[ \int_0^{\tau(A_1)} q_t h(A_t)dt \right].
\]

It follows that for any \( x > A_1 \), we have, since \( \tau(A_1) < \tau(A_B) = \tau^* \) and \( \int_0^{\tau(A_1)} = \int_0^{\tau(A_1)} + \int_{\tau(A_1)}^{\tau^*} \),

\[
H(x) = -E_x^Q \left[ \int_0^{\tau(A_1)} q_t h(A_t)dt \right] + E_x^Q (e^{-r\tau(A_B)}) H(A_1).
\]

Since \( h(.) \) is non-positive on \((A_1, \infty)\) and we have seen that \( H(A_1) > 0 \), it follows that \( H(x) > 0 \ \forall x \in (A_B, \infty) \), which concludes the proof of the lemma in the case \( A^C_B = A^D_B = A_B \). Now we consider the case where \( A^C_B < A^D_B \). Then, \( W^C_0(x) > 0 \) and \( W^D_0(x) = 0 \) for \( x \in (A^C_B, A^D_B) \), whence the claim holds trivially on this interval. The rest of the proof is identical to the first part for \( x > A^D_B \).

From this lemma, we will first conclude the proof of the theorem in the case of asset-based PSD. We proceed by contradiction. We assume first that \( A^C_B = A^D_B = A_B \). Then, the pair \((C, D)\) satisfies the conditions of the lemma, which allows to conclude that \( W^C_0(x) > W^D_0(x) \ \forall x > A_B \). By formula (6), we conclude in particular that for \( x = A_0 \), \( U^C_0 < U^D_0 \), which contradicts the hypothesis of Theorem 1. We now assume that \( A^C_B < A^D_B \). Then, we can lower the value of the interests paid by \( D \) uniformly, proceeding by translation: we consider the PSD \( D_\varepsilon \) that pays the interest function \( D_\varepsilon = D - \varepsilon \). Then, with the assumption that \( D \) is in the efficiency domain of its translation class (Condition 4), we have \( U^{D_\varepsilon}_0 < U^D_0 = U^C_0 \). On the
other hand, since the interest payments are getting lower as \( \varepsilon \) increases, there exists an \( \varepsilon_0 > 0 \) such that \( A_{B}^{D_{0}^{+}} \leq A_{B}^{C} \leq A_{B}^{D_{0}^{-}} \). Moreover, since \( h = C - D \) is non-increasing and not constant, so is \( h_{\varepsilon} \equiv C - D_{\varepsilon} = C - D + \varepsilon \). In particular, \( h_{\varepsilon} \) is not constant and changes sign at most once. Since \( D \) satisfies Conditions 2 and 3, it is easy to verify that so does \( D_{\varepsilon} \), \( \forall \varepsilon > 0 \). Therefore, the pairs \( (C, D_{\varepsilon}) \) with \( \varepsilon \) in a left neighborhood of \( \varepsilon_0 \) satisfy the hypothesis of the lemma, which implies that \( W_{0}^{C}(x) > W_{0}^{D_{\varepsilon}}(x) \) for any starting asset level \( x \in (A_{B}^{C}, \infty) \). By (6), we conclude that \( U_{0}^{C} < U_{0}^{D_{\varepsilon}} \) for any \( \varepsilon \) in a right neighborhood of \( \varepsilon_0 \), which contradicts the fact that \( U_{0}^{D_{\varepsilon}} \leq U_{0}^{D} = U_{0}^{C} \) for all \( \varepsilon > 0 \).

Proof of Theorem 4. The proof is based on the proof of Theorem 2. In the case of ratings-based PSD obligations it is easy to see that Conditions 1–3 are automatically satisfied. We suppose first that \( A_{B}^{C} = A_{B}^{D} \). This implies that \( G(A_{B}^{C}) = G(A_{B}^{D}) \). From Lemma 4, \( U_{0}^{C} > U_{0}^{D} \). This contradicts the fact that \( U_{0}^{C} = U_{0}^{D} \). Now suppose that \( A_{B}^{C} < A_{B}^{D} \). Take \( \varepsilon > 0 \) such that \( A_{B}^{C} = A_{B}^{D_{\varepsilon}} \). Then \( G(A_{B}^{C}) = G(A_{B}^{D_{\varepsilon}}) \) and Lemma 4 implies that \( U_{0}^{C} < U_{0}^{D_{\varepsilon}} \). Condition 2, on the other hand implies that \( U_{0}^{D_{\varepsilon}} < U_{0}^{D} = U_{0}^{C} \) and we have a contradiction. Therefore \( A_{B}^{C} > A_{B}^{D} \). Since \( U_{0}^{C} = U_{0}^{D} \), the result follows from (6).

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\(^{43}\)Here we use the fact that \( W_{0}^{D_{\varepsilon}}(x) \) is continuous in \( \varepsilon \), which is an easy consequence of Corollary 5.


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