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Article

Callable Bonds: A Risk-Reducing Signalling Mechanism

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ABSTRACT

The theory of financial economics has failed to distinguish advantages of callable bonds from those of short-term debt. This paper shows that either type of borrowing can signal a firm's better prospects but that short-term debt does so at the cost of weakened risk-sharing with capital markets. By issuing either equity or long-term, non-callable debt, a firm with poor investment opportunities will not pool its prospects with those of a better firm. But equity produces superior risk-sharing. Perhaps this explains the almost complete absence of long-term, non-callable bonds from observed corporate capital structures.

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