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What Is the Cost of Financial Flexibility? Theory and Evidence for Make-Whole Call Provisions

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Abstract

Firms commonly incorporate make-whole call provisions in their newly issued debt, presumably to improve their ability to retire debt early if circumstances require. In return for increased financial flexibility, firms must compensate bondholders with additional (incremental) yield. To estimate theoretical incremental yields, we use and calibrate a structural model for a large sample of callable and noncallable US corporate bonds issued between 1995 and 2004. In a frictionless model where calls occur only when they are in-the-money, theoretical incremental yields average approximately 2 basis points (bp). In an extended model that incorporates taxes, transactions costs, and randomly occurring exogenous events requiring early bond retirement, incremental yields average approximately 5 bp. Empirical analysis, however, indicates that observed incremental yields are significantly greater than model-generated values, averaging between 13 and 24 bp. In the later years of our sample period, however, observed incremental yields begin to converge to model-generated values.

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