



Determinants of the call option on corporate bonds ☆

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Abstract

A number of hypotheses have been proposed as explanations of the call feature in corporate bonds. Using a large sample of callable and noncallable corporate bonds issued during the period 1977–1986, this paper simultaneously examines the empirical validity of five hypotheses that have been offered to explain the call option. The evidence provides no support for the hypotheses that the call option provides managerial flexibility or tax advantages. There is mixed support for agency cost explanations of the corporate call feature. The call feature is found to be highly correlated with the level of interest rates and the maturity of debt issues. That is, the call feature is found to be more likely during periods of higher interest rates and for longer maturity bonds.

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...Many papers document that fixed-price calls are utilized by smaller firms with worse credit quality (see e.g. Mitchell, 1991, Kish and Livingston, 1992, Roback and Kish, 2000, Banko and Zhou, 2010, and Chen et al., 2010). In addition, fixed-price callable issuers show evidence of higher growth (Kish and Livingston, 1992, Roback and Kish, 2000) and fixed-price calls are more prevalent in longer-term bonds (Roback and Kish, 2000). Most studies, such as Banko and Zhou (2010), conclude that based on ex-ante characteristics of the issuer, fixed-price call issuers are more affected by problems of asymmetric information and underinvestment than non-callable bond issuers....

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...The call protection period affords flexibility to mitigate underinvestment (Thatcher, 1985). We hypothesize that the call premium compensates investors for a call due to either a decline in interest rates (Kish and Livingston, 1992), an improvement in the credit rating for high-risk firms (Diamond, 1991), or the realization of growth options for low-risk firms (Bodie and Taggart, 1978). Other options to mitigate the investors' loss in the event of a call include a lower issue price, higher coupon rate, and greater call protection....

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