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## CALL PROTECTION IN CONVERTIBLE BONDS: HOW MUCH AND WHY?\*

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*Convertible bonds typically feature both call provisions and call protection terms that revoke or limit issuers' rights to call their bonds. We examine the determinants of the strength and the length of that call protection. Our findings suggest that issuers consider the timing of their future capital investment plans when designing their convertibles. Firms that expect to make subsequent investments sooner tend to offer weaker call protection. By retaining their ability to call, and thus force conversion to equity, issuers preserve flexibility to match the timing of their real options and the timing of financial options attached to their convertibles.*



Most convertible bonds may be called for redemption by the issuing firms, and call provisions feature varying degrees of investor protection. Clearly, investors value protection from convertible calls because such actions impose abrupt changes in the risk and reward characteristics of their investments. Indeed, wholesale “forced conversion” is commonplace. That is, firms often call in-the-money convertible issues, where conversion value exceeds effective call price, thus forcing investors to convert

to common. Call provisions are valuable to convertible issuing firms because they enable managers to reduce leverage quickly, making subsequent acquisition of capital easier.

We have conducted some large-scale research recently on how firms design their convertible securities' call provisions. Our research focuses on the length of the call protection period, and as importantly, the strength of call protection during that period. Protection strength ranges from absolute, whereby the firm is strictly prohibited from calling at any time in the life of the bond, to a complete absence of protection wherein the firm may call any time under any circumstances. In some cases, call protection strength changes over time; e.g. the bond may have absolute protection for a specified period, then it may be callable under restrictive conditions thereafter. The length of the call protection period varies as well—from zero to 7 years in our sample, with 2 and 3 years the most prominent by far.

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