Covenants and Collateral in Japanese Corporate Straight Bonds: Choice and Yield Spread

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Abstract: How a firm chooses a set of covenants and of collateral to pledge when issuing straight bonds publicly in Japan? Covenants and collateral are contract clauses intended to protect rights of the bondholders. If the protection is priced and brings a better price in the issue, why do firms try to put them all in the issue? Taking it into account that we only observe an endogenously chosen covenants-collateral type for an issue, we estimate a relation between issue prices (yield spreads) and credit risk factors and other firm/issue characteristic variables. We obtained a distinct relationship for each covenants-collateral type from two-step estimations of a Heckman type. In the first step we estimate multinomial logit models of covenants-collateral choice, and found supports for the physical cost hypothesis, the hysteresis hypothesis, and signaling hypothesis. Most notably, however, we found that strategic default concerns involve direct costs in the choice, not through indirect effects on the yield spread.

JEL classification number: G12, G32.

Keywords: Collateral and covenant choice, Yield spread, Japanese corporate straight bonds, Selection biases, Two step estimator of Heckman type, Multinomial logit model.

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