Convertible Debt and Commitment

Abstract

We show that convertible debt, beyond mitigating asset substitution, plays a key role in addressing both the leverage ratchet effect and inefficient default, thus it cannot be replicated by simply issuing plain vanilla bonds and call warrants. Debt convertibility matters in both good and poor states, where it affects firm's capital structure through endogenous conversion decisions and restores commitment on corporate debt policies even before any conversion occurs. Our theory indicates that debt accumulation slows down at low leverage and active deleveraging is induced at high leverage, with highly leveraged firms design contract with lower coupon rate and conversion price.

Keywords: Capital structure, convertible debt, credit risk, leverage ratchet effect.

JEL Classification: G13, G32, G33.