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Options trading and the cost of debt

Iván Blanco [a], Sergio J. García [b,*]

[a] CUNEF, Leonardo Prieto Castro, 2, 28040 Madrid, Spain
[b] Universidad Pontificia Comillas (ICADE), Alberto Aguilera, 23, 28014 Madrid, Spain

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ABSTRACT

Equity option markets can have a dual effect on firms' cost of debt. On the one hand, options attract more informed investors, which increases price informativeness and reduces information asymmetries in the market, facilitating firm financing. On the other, by attracting more informed investors who provide reassurance regarding managerial career concerns, options can increase the potential for risk shifting in firms. We explore these two channels via different tests on corporate bond yields and use different econometric specifications including quasi-natural experiments to mitigate endogeneity concerns. We find evidence consistent with the preeminence of the risk-shifting channel when private managerial risk-taking incentives are sufficiently high and debtholders are more exposed to expropriation.

1. Introduction

Despite the exponential growth in the total equity option volume traded in the U.S., from 676 million contracts in 2000 to over 4420 million contracts in 2019,[1] there is still considerable disagreement about the real effects of these instruments on the underlying firms. In this paper, we aim to unveil the influence of option markets on one of the key variables on the corporate front: the cost of debt. On the one hand, options are nonredundant securities in the real world that contribute by completing the market, attracting more informed investors and improving the overall information environment (e.g., Ross, 1976; Easley et al., 1998; Pan and Poteshman, 2006; Hu, 2014, 2017), easing firm financing. On the other hand, options can act as a managerial disciplining mechanism that increases stock price informativeness so that it better reflects fundamentals (Holmström and Tirole, 1993). By attracting more informed investors that provide reassurance regarding managers' career concerns, options can encourage firms to undertake riskier activities, such innovation (Aghion et al., 2013; Blanco and Wehrheim, 2017). Rational debtholders may, consequently, price firms' debt anticipating the potential for risk shifting.

These conflicting channels of influence raise an interesting empirical question regarding how bondholders, an important group of claimholders in the capital structure, view an active option market. In this paper, we aim to shed light on the trade-off between these

* Corresponding author.
E-mail addresses: ivan.blanco@cunef.edu (I. Blanco), sjgarcia@comillas.edu (S.J. García).

[1] Data from http://www.optionsclearing.com/webapps/historical-volume-queryOptions Clearing Corporation: http://www.optionsclearing.com/webapps/historical-volume-query.

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