Callable Step-Up Investments

Attractive Investments for a Rising-Interest-Rate Environment

For those interested in fixed-income investments, callable investments provide an opportunity to invest in a product that carries a higher current return than would be available with noncallable investments of comparable credit quality. One such fixed-income investment is a "callable step-up."A callable investment with a step-up feature provides the added benefit of increasing coupon rates as long as the issuer doesn't call the investment.

Callable Investments

Many fixed-income investments are issued with a call feature. This means that the issuer can "call" the investment at its discretion prior to maturity and pay the investors' par plus accrued interest. Issuers reward investors with a higher interest rate in return for the right to call the bonds. Callable investments are offered in a wide range of maturities, typically two to 30 years. The noncall, or "lockout," period (the time during which the issuer cannot call the investment) is usually six months to five years.

Why would a callable investment be called?

After the initial noncall period, the issuer has the right (but not the obligation) to call the investment for any reason prior to its stated maturity. As a practical matter, an issuer will generally decide to call the investment when it determines that market conditions are such that it can issue new debt at a lower coupon rate than the existing debt. Investors considering an investment in a callable product should note that it is unlikely that they would be able to replace their investment with a comparable one that pays an equivalent interest rate if the investment is called.

Why issue callable debt?

Issuing callable debt provides an issuer with greater flexibility in managing its balance sheet. Once the initial noncallable period has expired, the issuer has the option to call the debt according to the terms of the particular product's call provision. This means that if interest rates decline, the issuer can replace the investment with less expensive liabilities. Issuers, in most cases, have interest-rate-sensitive assets on their books, such as mortgage loans. These assets tend to prepay as interest rates fall. Therefore, if an issuer has callable liabilities on its books, it may redeem these liabilities as their assets decline.

What are callable investment risks?

Investors should purchase a callable investment only if they understand that the timing of the return of principal may be uncertain and may, in fact, be at the maturity date. Callable investments may be paid off prior to maturity as a result of a call by the issuer and, in certain cases, the total return may be less than the yield the investment would have earned if it had been allowed to reach maturity. As noted earlier, if the issuer calls the investment, investors may be unable to reinvest the funds at a rate equivalent to the original investment. If it is not called, investors should be prepared to hold the investment until maturity. If a callable investment is sold prior to maturity, its value will be subject to full market considerations, including, but not limited to, interest rate changes, which could result in a significant loss from the initial investment amount. Since callable investments tend to have longer maturities, their price sensitivity to interest rate changes is greater.

Callable Step-Up Investments

As the name implies, callable step-up investments do not pay a constant interest rate over the instrument's lifetime; rather, they have a predetermined schedule of coupon rates that begin somewhat below that of similar fixed-rate investments and gradually increase, or "step up," over a specified time frame. The coupon may step up only once or as often as quarterly until the investment is either called by the issuer or matures. Typically, a step-up investment becomes callable on the first date that the coupon resets and is callable on a predetermined schedule. Step-up investments can be sold at par, a premium or a discount and generally have maturities ranging from two to 30 years. Step-up investments may be issued in a variety of ways:

- Government-sponsored enterprises (GSEs) issue agency step-up debentures
- Banks issue step-up certificates of deposit (CDs)
- Corporations issue step-up medium-term notes
- Municipalities

What different types of callable step-up investments may be available?

- **Single step-up investment.** A single step-up investment begins with an initial coupon, and if it is not called, it then adjusts to a different coupon for the remainder of the investment's lifetime. Below is an example of a 15-year single step-up CD. The coupon rate is 4% in the first two years, and then it increases to 7% in the remaining years

  Year 1 and 2: 4%

  Years 3 – 15: 7%

- **Tri step-up investment.** If it is not called, a tri step-up investment has three coupons over the investment's lifetime. This is an example of a 15-year tri step-up CD. The coupon rate is 4% in the first year, 5% in the second and, finally, 7% in the remaining years.

  Year 1: 4%

  Year 2: 5%

  Years 3 – 15: 7%

- **Multi step-up investment.** If it is not called, a multi step-up investment may adjust many times during the investment's lifetime. For example, a 15-year multi step-up CD may begin with a 5% coupon rate in year one and adjust in increments to reach 13% in year 15.

How do callable step-up investment coupon rates compare to those of callable fixed-rate investments?

Typically, the coupon paid on a callable step-up investment is initially somewhat lower than the rate available on comparable callable fixed-rate investments, but it eventually increases to a level that is higher than that of the fixed-rate investment. The weighted average of all of the scheduled coupon rates will also be higher than the comparable fixed-rate investment. The step-up investor chooses to sacrifice some interest income in the early years in exchange for the potential to receive a higher yield over the investment's lifetime.

It is important to note, however, that the actual return realized on any callable step-up investment depends greatly upon whether and when the issuer exercises the call feature. In the single step-up investment example above, the investor will have received an average coupon of 4% if the CD is called in year two, 5.5% if it is called in year four and 6.6% if it remains outstanding until maturity. Clearly, the investor's assessment of the likelihood that the investment will remain outstanding until at least some of the higher coupons have been received is the pivotal factor in deciding between a step-up and a fixed-rate investment.

Another factor that should be considered is how the step-up structure affects the economics of the call from the issuer's perspective. The issuer will generally call an issue when it determines that it can issue a new instrument at a lower interest rate than that of the outstanding issue. Suppose an issuer has outstanding both a 6% fixed-rate issue and one similar to the single step-up example described above, each with 13 years remaining until maturity. The issuer is more inclined to call the step-up investment, on which it must now pay 7%, than the 6% fixed-rate issue. Investors in step-up investments should understand that it is doubtful that they will receive all of the higher coupons scheduled to be paid in the later years unless market rates increase over the investment's lifetime, thereby decreasing the chance that the issue will be called.

Who invests in callable step-up investments?

Callable step-up investments generally attract investors with expectations of gradually rising interest rates but who also seek protection if rates rise more than expected. In this scenario, the increasing coupons may keep pace with rising market rates, which can help to offset unfavorable price movements. Callable step-up investors should have a buy-and-hold philosophy.

Is there a secondary market for callable step-up investments?

Callable step-up investments are most suitable for purchasing and holding to maturity. However, most of these investments are traded in the secondary market, which provides an opportunity for investors to sell their investment at the prevailing market levels, which may be more or less than the original amount invested. While some broker-dealer companies maintain a secondary market, none are obligated to do so and liquidity in the secondary market can be limited.

Callable step-up benefits

- More protection in a rising rate environment than a traditional callable investment
- State- and local-tax-exempt interest on some agency bonds
- Survivor's option on CDs and some agency-issued investments
- FDIC insurance on CDs

What agencies may issue callable step-up debt?

The main issuers of step-up bonds are GSEs, also known as U.S. agencies. GSEs are privately owned but federally chartered companies created by Congress. While they enjoy certain competitive advantages as a result of their government charter, their debt obligations are unsecured and are not guaranteed by the U.S. government. GSEs include: Freddie Mac, Fannie Mae, Federal Home Loan Bank (FHLB), Federal Farm Credit Bank system (FFCB), Student Loan Marketing Association (SLMA or "Sallie Mae") and Tennessee Valley Authority (TVA).

What additional features do callable step-up CDs offer?

Banks will sometimes issue CDs as callable step-up investments. CDs are "time deposits" that pay a contractual interest rate over a specified time period. Callable step-up CDs offer investors the following features:

- **FDIC insurance.** Callable step-up CDs are backed by the full faith and credit of the U.S. government through Federal Deposit Insurance Corporation (FDIC) insurance. The standard insurance amount is $250,000 per depositor, per insured depository institution for each account ownership category. These limits apply to all deposits with a particular issuer even if purchased through multiple institutions.* If a CD is purchased at a premium in the secondary market, the premium over the face amount is not covered by FDIC insurance.
- **Estate feature.** A valuable feature of callable step-up CDs is commonly referred to as the "survivor's option," which is designed to protect estate assets. This provision allows for the full withdrawal of the principal and interest in the event of the death or adjudication of incompetence of the beneficial owner, regardless of whether the current market value has fallen. It is important to note that very few fixed-income investments offer this attractive feature.

**You can learn more about FDIC insurance coverage at the FDIC website at www.fdic.gov or by calling 1-877-ASK-FDIC (1-877-275-3342) Monday through Friday from 8:00 a.m. to 8:00 p.m., Eastern Time. For the hearing-impaired, the number is 1-800-925-4618.*

Investing in fixed-income securities involves certain risks, such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed-income investments may be worth less than original cost upon redemption or maturity.

Yields and market value will fluctuate so that your investment, if sold prior to maturity, may be worth more or less than its original cost.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

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