CALLABLE INVESTMENTS

Many fixed-income investments are issued with a call feature that allows the investment to be called by the issuer prior to maturity. Issuers reward investors with a higher rate of interest in return for the right to call, or pay back the investor’s principal (at the issuer’s discretion only). An issuer is likely to exercise the call option if interest rates fall. It can then pay off the debt and issue new investments at a lower interest rate. Callable investments are offered in a wide range of maturities, typically three to 20 years. The non-call, or “lockout” period (the time during which an issuer cannot call the investment), is usually one to five years.

WHY ISSUE CALLABLE DEBT?

Issuing callable debt provides issuers with greater flexibility in managing their balance sheet. Once the initial non-callable 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 the issuers have callable liabilities on their books, they may redeem these liabilities as their assets decline.

WHAT CAUSES A CALLABLE INVESTMENT TO BE CALLED?

After the initial non-call 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 call a bond when it can replace the existing debt with new debt at a lower interest rate. Investors considering callable bonds should note that it is unlikely that they would be able to replace their investment with one that pays an equivalent interest rate under this scenario.

WHAT ARE THE RISKS OF A CALLABLE INVESTMENT?

Callable investments are typically issued with longer maturities. Hence, investors should purchase a callable investment only if they understand that the timing of the return of principal may be uncertain due to the call feature 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 which the investment would have earned had it been held to maturity. As noted earlier, if the issuer calls the bond, investors may be unable to reinvest the funds at a rate equivalent to their original investment. If it is not called, investors should be prepared to hold the bond until maturity.

If a callable bond is sold prior to maturity, the value of the investment will be subject to market considerations, including, but not limited to, changes in interest rate, which could result in a price significantly different from their initial investment amount.

CALLABLE STEP-UP BONDS

As the name implies, callable step-up bonds do not pay a constant rate of interest over the life of the instrument. Rather, they have a predetermined schedule of coupon rates, which 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 annually until the bond is called by the issuer or matures. Typically, a step-up also becomes callable on the first date that the coupon resets and is callable either semiannually or at any time thereafter. Step-ups are sold at par, and most have final maturities of 15 years or less. Step-ups may be issued in a variety of ways: government sponsored enterprises (GSEs) issue agency step-up debentures, banks issue step-up certificates of deposit and corporations issue step-up medium-term notes.
A VARIETY OF STEP-UPS

Single Step-Up
A single step-up bond begins with an initial coupon and then adjusts to a different coupon for the remaining life of the bond, if it is not called. Below is an example of a 15-year single step-up certificate of deposit. The coupon rate is 4.00 percent in years one and two and then increases to 7.00 percent in years three to 15.

Years 1-2: 4.00%
Years 3-15: 7.00%

Tri Step-Up
A tri step-up bond has three coupons over the life of the investment, if it is not called. This is an example of a 15-year tri step-up certificate of deposit. The coupon rate is 4.00 percent in year one, increases to 5.00 percent in year two and finally increases to 7.00 percent in years three to fifteen.

Year 1: 4.00%
Year 2: 5.00%
Years 3-15: 7.00%

Multi Step-Up
A multi step-up bond may adjust many times during the life of the investment, if it is not called. For example, a 15-year multi step-up certificate of deposit may begin with a coupon rate of 5.00 percent in year one and adjust in increments to reach 13.00 percent in year 15.

Typically, the coupon paid on a callable step-up bond is initially somewhat lower than the rate available on comparable callable fixed-rate bonds, but eventually increases to a level that is higher than that of the fixed-rate bond. The weighted average of all of the scheduled coupon rates will also be higher than the comparable fixed-rate. 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 life of the bond.

It is important to note, however, that the actual return realized on any callable step-up bond depends greatly upon whether, and when, the issuer exercises the call feature. In the first example, the investor will have received an average coupon of 4.00 percent if the CD is called in year two, 5.50 percent if it is called in year four and 6.60 percent if it remains outstanding until maturity. Clearly, the investor’s assessment of the likelihood that the bond 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 bond.

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 an interest rate lower than that of the outstanding issue. Suppose an issuer has outstanding a single step-up similar to the one described above, but can issue new fixed-rate bonds at 6.00 percent. The issuer would be inclined to call the step-up, so it can pay a 6.00 percent fixed rate rather than pay the 7.00 percent coupon on the step-up issue. Investors in step-up bond 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 life of the bonds, thereby decreasing the chance that the issue will be called.

It is worth noting, however, that even if the step-up is called early on, the investor’s realized yield will probably be higher than that available on short-term fixed-rate bonds of similar quality at the time the step-up was purchased.

WHO INVESTS IN CALLABLE STEP-UP INVESTMENTS?
Callable step-up securities 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.

SECONDARY MARKET
Callable step-up bonds are most suitable for purchasing and holding to maturity. However, most callable step-up bonds are traded in the secondary market, which provides an opportunity for investors to sell their security at the prevailing market levels, which may be worth more or less than the original amount invested. While some broker-dealer companies may maintain a secondary market, none are obligated to do so.
AGENCIES THAT MAY ISSUE CALLABLE STEP-UP DEBT

The main issuers of step-up bonds are government-sponsored enterprises (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
Freddie Mac is a publicly held government-sponsored enterprise. Created on July 24, 1970, its charter is to provide stability in the secondary market for home mortgages by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing. The principal activity of Freddie Mac consists of the purchase of first lien mortgages from lending institutions and the resale of loans and participations in the form of guaranteed mortgage securities. Mortgages retained by Freddie Mac are financed with short- and long-term debt and equity capital.

Fannie Mae
A federally chartered and stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act, Fannie Mae is the largest investor in home mortgage loans in the United States. It was established in 1938 as a government agency to provide supplemental liquidity to the mortgage market and was later transformed into a stockholder-owned and privately managed corporation by legislation enacted in 1968. Fannie Mae provides funds to the mortgage market by purchasing mortgage loans from lenders, thereby replenishing their funds for additional lending. Fannie Mae acquires funds to purchase loans from many capital market investors that ordinarily may not invest in mortgage loans, thereby expanding the total amount of funds available for housing.

Federal Home Loan Bank (FHLB)
The Federal Home Loan Banks (FHLBanks) are privately owned wholesale banks that provide readily available, low-cost funding, known as advances, and other credit products to over 7,902 stockholder members. FHLB System members include commercial banks, savings institutions, credit unions and insurance companies. Each member belongs to one of 12 regional FHLBanks.

Federal Farm Credit Bank System (FFCB)
Federal Farm Credit is the oldest of the GSEs, dating back to 1916 when Congress established the Federal Land Bank. The Farm Credit System is a cooperatively owned nationwide system of banks and associations that provide mortgage loans, short- and intermediate-term credit and related services to farmers, ranchers and rural homeowners. The banks and associations of the Farm Credit System are not depository institutions and consequently rely on the money and credit markets to raise lendable funds. Farm Credit securities are exempt from state and local taxes.

Student Loan Marketing Association (SLMA) or “Sallie Mae”
Sallie Mae is a stockholder-owned corporation established by an Act of Congress in 1972. It is the largest source of financing for education loans in the United States. Sallie Mae’s products and services include student loan purchases, commitments to purchase student loans and secured advances to originators of student loans. Sallie Mae also offers operational support to originators of student loans. Sallie Mae is the major intermediary to the nation’s education credit market providing liquidity, primarily through secondary market purchases and warehousing advances, for originators of student loans made under federally sponsored student loan programs. The Higher Education Act of 1965, as amended, and related federal statutes provide that interest on the debt obligations of Sallie Mae is exempt from taxation by state, municipal or local authorities, subject to certain limitations.

Additionally, entities exist that are U.S. federally related; they are U.S. federally owned or sponsored. They are not obligations of or guaranteed by the U.S. government, but are perceived to approximate Treasury status by the market.

Tennessee Valley Authority (TVA)
A wholly owned corporation of the United States government that was established in 1933, TVA’s purpose is to develop the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense. Power operations are separated from non-power operations. TVA is currently authorized to issue debt up to $30 billion. Under this authorization, TVA may also obtain advances from the Treasury of up to $150 million. TVA securities represent obligations of TVA, payable solely from TVA’s net power proceeds and are neither obligations of nor guaranteed by the United States. TVA securities are exempt from state and local taxes.

Continued ...
CALLABLE STEP-UP CERTIFICATES OF DEPOSIT (CDS)
Banks will sometimes issue certificates of deposit as callable step-ups. CDs are “time deposits” that earn a contractual rate of interest over a specified period of time. Callable step-up CDs offer investors the following advantages:

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 current limit is $100,000 (including principal and interest) for all deposits held in the same capacity per depositor, per institution. Investors can obtain expanded FDIC coverage by purchasing CDs from multiple issuing institutions.*

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 death or adjudication of incompetence of the beneficial owner, regardless of whether the current market value has fallen. It is important to note that few fixed-income investments offer this attractive feature.

STEP-UP INVESTMENT BENEFITS INCLUDE:
• More protection in a rising rate environment than in traditional callable investments
• Enhanced yield versus comparable quality non-callable investments
• Limited credit risk
• Interest earned on some agency bonds is exempt from state taxes in some states
• CDs and some agency issued investments include a survivor’s option
• CDs carry FDIC insurance

*For additional information about FDIC insurance and maximizing insured accounts, please refer to the Web site www.FDIC.gov and/or the FDIC brochure, “Questions and Answers About Your Insured Deposit.”

Piper Jaffray does not provide legal or tax advice.