Issuer Callable Note

How It Works...

As an example, we're using a note with a 6-year term linked to the FTSE 100 Index, delivering the opportunity for high participation in the growth of the index, together with a strong level of capital protection and a "callable" feature which means the issuer can redeem the note early on the basis a high coupon is paid. The example assumes participation rates of 300% in GBP, a 60% final level barrier for capital return and coupons of 1% pm for GBP. The table below shows the returns investors would receive if the index produced the following returns and wasn't called early.

Return of the FTSE 100	GBP 300% participation total return including capital
10%	130%
20%	160%
30%	190%

If the return on the index is not positive, then investors will receive their money back providing that it has not fallen below 60% of its strike level (60% European-style barrier).

Callable

At monthly observation dates from 12 months, the issuer is able to "call" the note and bring it to an end early. If they do this, they will return client capital plus a return equivalent to 1% per month.

When might an issuer call the note early?

The callable option is designed to allow the issuer to limit their potential liability on the note in the event the index performs well over the investment term. Their aim would be to call the note if they think that they are likely to pay out less to investors in coupons than they would if they let the product continue to the end of the term. It is unlikely that they would consider calling the product for at least the first 3-4 years as there would be too much uncertainty over the final level of the Index.

Possible Scenarios

If after 4 years, the index is 30% up, the issuer could look at that and worry that if the index stayed at this level for 2 more years, they would be looking at paying out growth of 90%. They could decide to take the opportunity to close the note early and this would mean that they would pay growth of 48%, clearly much less than they would be liable for if they thought that the index was going to stay at the prevailing level for the final two years of the note, or indeed grow further. If they thought the index was likely to fall, they would have less reason to call the investment early.

It is difficult to predict when a call might take place as it is entirely at the discretion of the issuer and they will only do so if they think that the return on the product is likely to be, at the end of the 6-year term, higher than the coupons that they would need to pay out.

The issuer will take account of a variety of factors, but especially the volatility of the underlying index and the value of futures contracts (tradeable instruments that will reflect the market's view of future index movements). Prevailing interest rates will also play a part: for example, if interest rates rose above the level of the coupons (a very unlikely scenario at the moment) the issuer would most likely call the product as late as possible.

Summary

The callable feature is entirely at the discretion of the issuer and is designed so that they are able to limit their liability on the note in the event of the index growing strongly. It is this limitation of their exposure that allows for such a high participation rate, but the high coupon rate if the investment is called early should more than compensate investors. Because of the uncertainty the future always holds, the callable feature is unlikely to come into play until late on in the product's life. For investors with the ability to invest for a period of at least 6 years (or the maximum period of a relevant note) who are seeking a good level of growth on their investment, coupled with strong capital protection, callable notes should deliver excellent returns.