Callable Bond Introduction

A callable bond is a bond in which the issuer has the right to call the bond at specified times from the investor for a specified price. At each callable date prior to the bond maturity, the issuer may recall the bond from its investor by returning the investor’s money.

The underlying bonds can be fixed rate bonds or floating rate bonds. A callable bond can therefore be considered a vanilla underlying bond with an embedded Bermudan style option. Callable bonds protect issuers. Therefore, a callable bond normally pays the investor a higher coupon than a non-callable bond.

For issuers, callable bonds allow them to reduce interest costs at a future date should rate decrease. For investors, callable bonds allow them to earn a higher interest rate of return until the bonds are called off.

If interest rates have declined since the issuer first issues the bond, the issuer is like to call its current bond and reissues it at a lower coupon. Comparing to a normal bond, a callable bond is a higher cost to the issuer and an uncertainty to the investors.

Reference:

https://finpricing.com/lib/FiZeroBond.html