Callable Bonds

Vocabulary

- Callable bonds are issued with a call provision that allows the issuer to repay the debt earlier, i.e., before maturity
- The dates at which the debt can be repaid early are called call dates and for each of them, a particular redemption value is specified
- The initial period before the first call date is called the lockout period
- European option ... single call date before maturity
- Bermudan option ... multiple (discrete) call dates before maturity
- American option ... all dates before maturity are call dates

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Optimal exercise

- At a discount:
  If a bond is bought at a discount and it has a Bermudan option with call dates at coupon dates and redemption amount C independent of the time it is called, then the smallest yield occurs if the bond is **not called before maturity**
- At a premium:
  If a bond is bought at a premium and it has a Bermudan option with call dates at coupon dates and redemption amount C independent of the time it is called, then the smallest yield occurs if the bond is **called at the earliest call date**

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Putable bonds

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- Additional terminology and conventions apply in analogy to the callable bonds

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