What causes a Zero Coupon Callable Certificate of Deposit to be called?

A ZCD is likely to be called when the issuer determines that it is cheaper to issue a new deposit instrument at prevailing interest rates than it is to continue to accrue interest on the outstanding security. There is no simple way to predict precisely when a call will occur. However, when interest rates decline the probability of the investment being called increases significantly.

Is there a Secondary Market?

An active secondary market exists for most callable deposit instruments. It should be recognized, however, that the relatively small deal size of the issues and their unique characteristics place limitations on the potential liquidity of the product. Therefore, ZCDs are best suited for "buy & hold" investors as there is little likelihood that the securities will ever trade at a significant premium over their redemption value. Accordingly, if these investments are sold in the secondary market prior to maturity or call date, they may be worth less than their original cost or accreted value.

Revised 10/99

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FISN, Inc.
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A Guide to...

Zero Coupon Callable CDs

Zero Coupon Callable Certificates of Deposit

Zero Coupon Callable Certificates of Deposit

Zero Coupon Callable Certificates of Deposit (ZCDs) are Zero Coupon deposit instruments that are sold at a discount from their final maturity value. Interest income is compounded while an issue is outstanding and received as a part of the eventual redemption price. The ZCDs are callable at the option of the issuer only, at scheduled Redemption Prices.

ZCDs are issued by banks and are covered by federal deposit insurance provided by either the Bank Insurance Fund or Savings Association Insurance Fund, in each case administered by the Federal Deposit Insurance Corporation and backed by the full faith and credit of the United States Government, in the maximum amount permitted by law (currently $100,000).

What are the benefits of Zero Coupon Callable Certificates of Deposit?

ZCDs offer higher yields than both non-callable zero coupon investments of similar credit quality and interest paying callable deposit instruments with comparable maturities. Since no interest is paid until the ZCD is called or matures, there is no need to reinvest small amounts of cash. In the event of the death or adjudication of incompetence of the owner, the ZCDs may be redeemed at the then current accreted value, based on the stated Interest Rate and semiannual compounding.

Who invests in Zero Coupon Callable Certificates of Deposit?

Buyers of ZCDs include individuals planning for future income (ie. 401K, IRA, & college planning), as well as pension funds, insurance companies, commercial banks, credit unions, savings banks and other financial institutions. In the case of ZCDs, investors must be aware that these instruments do not bear interest. The Annual Percentage Yield (APY[2]) is achieved through the gradual accretion[1] of the discounted instrument to its final maturity or call value. Thus, the ZCDs are designed for investment strategies that do not require regular cash flow.

Why are the interest rates and APYs so much higher than on other Zero Coupon investments of similar credit quality?

The investor has, in effect, sold to the issuer the right to call the ZCDs prior to maturity. This call feature has considerable value. The issuer is willing to pay the investor a higher interest rate than it would offer on a non-callable Zero Coupon investment in exchange for receiving this right to call the notes.

1 *Accretion is a straight line accumulation of interest on discount bonds in anticipation of receipt of par at maturity. Accreted interest is subject to taxation annually as ordinary income, even though no payments will be received by the investor.*

2 *The Annual Percentage Yield (APY) represents the interest earned through each year-end call period.*

Why are the interest rates and APYs higher than on callable interest paying obligations of the same maturity?

Because interest income on Zero Coupon securities is compounded, rather than being paid out periodically, their value is more sensitive to subsequent changes in interest rates than interest paying instruments of the same maturity. The investor is compensated for this additional price sensitivity with a higher yield on the investment.

How are the redemption prices determined for Zero Coupon Callable Certificates of Deposit?

The Redemption Price is the percentage of the final maturity value the investor will receive if the ZCD is called before maturity. At the time of issue, the issuer calculates a Redemption Price for each potential Redemption Date equal to the ZCD's accreted value as of that date, using the stated Interest Rate and semiannual compounding. Thus, an investor who buys a ZCD at its original offering price and holds it until it is either called (at its accreted value) or matures (at par) will have earned the stated Interest Rate. A schedule of Redemption Prices is included in the Disclosure Statement Supplement for each issue.