

Structure for swings

Ways issuers of, and investors in, structured products can navigate rate volatility

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Structured products in times of interest rate volatility

Structured products are primarily zero-coupon bonds with embedded market-linked derivatives component, making their valuation and risk management more challenging in an evolving financial landscape.

Worries around elevated inflation, economic stability and growth are compelling central banks to adjust their monetary policies. Such moves have stoked volatility in interest rates that, in turn, is having a material impact on structured products already in the market as well as new offerings.

This paper examines how interest rate fluctuations affect the construction and performance of structured products, with focus on capital protection, yield enhancement and participation configurations.

We highlight the challenges and opportunities that issuers and investors face in navigating the changing environment and provide strategic recommendations to enhance resilience and align product structuring with the interest rate cycle.

Our findings include:

- Rising interest rates compress valuations of capital-protected structures, but may enhance coupon offerings in yield-oriented products
- Interest rate volatility increases hedging complexity and model sensitivity, particularly for path-dependent and long-dated instruments
- Investor demand is shifting towards shorter-dated, hybrid and inflation-linked products, prompting issuers to innovate in terms of product design and risk transfer

The prevailing interest rate has the biggest influence on the valuation and performance of structured products. It affects not only the discounting of future cash flows but also the pricing of embedded derivatives, particularly options and swaps. As a result, interest rate fluctuations can significantly alter the attractiveness, risk profile and performance outcomes of structured products.

The six aspects of interest rate dynamics



1. Monetary policy shift and market response

Since 2022, major central banks, such as the Federal Reserve, the European Central Bank and the Bank of England have embarked on aggressive tightening cycles to subdue inflation. This has led to sharp repricing of assets across fixed-income markets and increased volatility in interest rates, driven by uncertainties around the terminal rate, elevated inflation and recession risk.



2. Yield curve behaviour and inversion trends

The shape of the yield curve — whether normal, flat or inverted — has significant implications for structured products. Inverted curves create challenges in modelling forward rates and pricing embedded derivatives, increasing the risk of negative carry and disincentivising duration exposure of new issuances.



3. Rate volatility and market indicators

Interest rate volatility, measured by instruments such as the ICE BofA MOVE Index, has surged to levels not seen since the Global Financial Crisis of 2008. This affects option pricing, hedging strategies and product timing, necessitating more real-time risk tools and simulations.



4. The shift away from the dollar and countermeasures by the US

Many countries are trying to find alternatives to the US dollar as an international settlement currency. Consequently, the preference for dollar-denominated debt as a form of foreign reserve holding is reducing among central banks. This is altering the dynamics of demand and supply of dollars and sovereign debt issuance in other currencies as well.

The US is taking measures to defend both its currency and the stature of its treasuries, resulting in a swinging scale and impact on markets — sometimes to its advantage, sometimes otherwise.



5. Where interest rate is an underlying asset





Assessed through vega (volatility) and as well as impact on discounting factor.






6. Where interest rate is not an underlying asset

Impact through discounting factor, cost of carry. Extended periods of volatility will have a steeper interest rate curve compared with shorter spells of volatility.

The impact on structured products by type

1 Capital protected	2 Yield enhancement	3 Participation	4 Credit-linked notes
 <p>Rising rates reduce the cost of zero-coupon bonds, enhancing the upside potential. Falling rates compress participation and increase the product cost. Issuers may shift to partial protection or shorter tenures.</p>	 <p>High-rate volatility boosts option premiums, improving coupons, but increases the risk of knock-in events and valuation swings. Product appeal is sensitive to the underlying asset behaviour and interest rate direction.</p>	 <p>Rising rates and volatility improve option values, but the rho (rate sensitivity) and vega sensitivity increases. Dynamic hedging becomes more complex, particularly for exotic payoffs.</p>	 <p>These products are linked to the creditworthiness of a reference entity. While primarily driven by credit risk, interest rate movement can influence their valuation, particularly the fixed-income coupon payments and the overall market sentiment towards fixed-income instruments.</p>

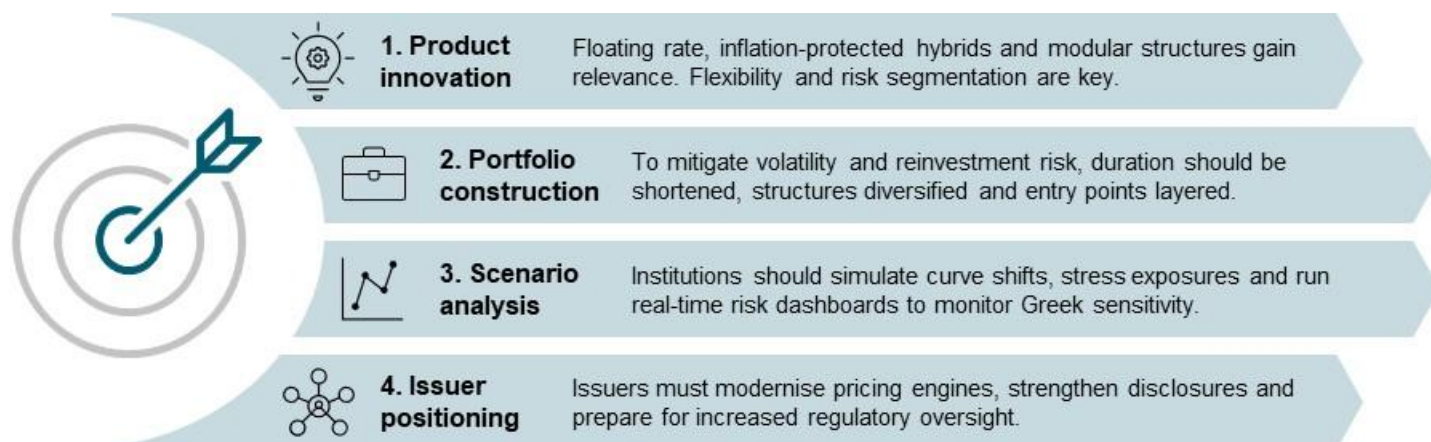
Three risk and valuation considerations

<p>1</p>  <p>Sensitivity to the Greeks</p> <p>Products are increasingly exposed to rho, vega and cross-Greek risks as market uncertainty grows.</p>	<p>2</p>  <p>Hedging complexity</p> <p>Path dependency, liquidity constraints and gamma exposure make hedging structured notes more challenging in a volatile rate environment.</p>	<p>3</p>  <p>Model risk and valuation uncertainty</p> <p>Frequent recalibration is needed. Smile and skew effects must be priced into the contracts. Regulators require robust model governance and fair value disclosures under IFRS 13/FRTB.</p>
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Five implications for issuers and investors



The altering components of strategic outlook



The road ahead for issuers and investors

Interest rate volatility has become a defining feature of today's financial markets and structured products are feeling the impact of this. Rising rates and changing yield curves are reshaping how they are priced and structured.

For investors, this means shifting towards shorter duration, floating rate and inflation-linked products to be aligned with the uncertainties. For issuers, this demands innovation, stronger risk controls and greater transparency.

Future-proofing structured products will require scenario-led thinking, real-time risk management and alignment with emerging regulatory standards

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