Indexed CDs offer safety, but there's still risk

By Suzanna de Baca • Bankrate.com   Print   E-mail

With the global economy still on uncertain footing, consumers are on the lookout for investments that limit downside risk.

One such product is an indexed CD, or ICD, a hybrid that couples the principal protection of a plain vanilla certificate of deposit with the upside promise of the equity markets.

"The average consumer will be hearing a lot more about these instruments if the markets stays volatile," says Karen Maloney Stifler, president of True Wealth Advisors in Hudson, Ohio.

Despite the fact that indexed CDs have Federal Deposit Insurance Corp., or FDIC, protection, she cautions that "consumers hear 'FDIC' and assume safety, but it is not the same as a regular CD."

How do indexed CDs work?

"An investor in equities is directly subject to the volatility of the marketplace and is at risk for loss of principal," says Michael T. Sherzan, president of Bankers Financial Services Corp. in Johnston, Iowa, a major provider of indexed CDs to banks nationwide. With ICDs, he says, "the depositor not only has an investment that is principal protected but also has the potential return of the corresponding index."

Unlike their conventional CD cousins, indexed CDs offer investors exposure to a specific equity index such as the Standard & Poor's 500 or the Dow Jones industrial average. Still not widely available, indexed CDs are sold primarily by community banks in a variety of maturities, typically in the three- to five-year range. Minimums are generally $1,000, with additional investment available in increments of $1,000. If the indexed CD is held to maturity, the principal and earned interest is guaranteed up to $100,000 per taxable account, or $250,000 for retirement accounts, in accordance with FDIC rules and regulations.

Joe DiNuzzo, counsel to the FDIC, notes that while principal up to the FDIC limits is insured, interest income must be considered separately. "If the interest is based on an outside factor like an index," he says, "then it depends on how each bank credits that interest."

While the terms vary, indexed CDs typically pay interest at maturity; some guarantee a set rate of interest even if the market does not rise, and other issues offer only the returns of the linked index, and that performance may be capped.

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Who is offering them?

Indexed CDs vary considerably. First State Bank in Gothenburg, Neb., recently closed an issue of 4-1/4 year non-callable indexed CDs with no cap or floors and a 4 percent minimum interest rate for the full term.

Minnesota-based Merchants Bank National Association has just launched two ICDs in the Winona branch, both linked to the Dow Jones industrial average: a three-year product with a guaranteed 1 percent annual percentage yield, or APY, and a 75-percent participation rate; and a five-year product with 85 percent participation. According to Sue Hovell, director of sales and marketing at Merchants, these products are not suitable for everyone, but may be right for depositors "who don't like to lose money but still would enjoy a little upside."

Hovell says that in light of current uncertain economic conditions, Merchants expects this product might appeal to individuals who feel jittery about the markets.

Read the fine print

"There is no investment decision that does not involve some sort of risk," says Maloney Stifler, adding that as with any investment, a consumer interested in indexed CDs should "do a lot of digging and read the fine print."

Potential risks of indexed CDs:

- **Lost opportunity.** The typical consumer for a traditional CD wants safety of principal plus a guaranteed rate of interest, but depending on the terms of the indexed CD, you might not earn any interest at all. "If the market doesn't do well, the consumer might end up with just the principal and no return," says Maloney Stifler. "That is lost opportunity cost."
- **Liquidity.** Like their traditional counterparts, indexed CDs must be held until maturity or the consumer may be hit with penalties. Since most indexed CDs are typically offered in greater than three-year maturities, the depositor must be certain that these funds will not be needed in the short term.
- **Participation rates or caps.** While ICDs claim to offer returns of the corresponding index, the actual return that the depositor receives may be capped at a certain percentage depending on the issuer. Sherzan recommends looking at the participation rate. "If it is capped, it can negatively affect your investment return."
- **Taxes.** If the money you deposit into an indexed CD is taxable, you will owe taxes annually on the earnings, even if you don't receive the actual interest until maturity, so you may have to come up with funds to pay the tax bill out of another pool of assets. Hovell stresses that these may not be appropriate for retirement accounts held by individuals who are nearing or past age 70½, as liquidity restrictions prevent withdrawal of funds to pay the minimum required distribution to the IRS. Additionally, says Maloney Stifler, "This is going to be taxed as interest income, a higher rate than a capital gain."
- **Bank credibility.** The FDIC's DiNuzzo says that "as with any deposit, it's advisable to make sure you're dealing with a reputable institution."

Consider all options

Depending on your perspective, an indexed CD is an equity investment with downside protection or a CD with potential risks. According to Maloney Stifler, "if you're looking for ways to manage downside risk, you should consider all the options to accomplish that goal."

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