FDIC Consumer News

Spring 2012

Market-Linked CDs: Don't Let the Possibility of Higher Returns Cloud Your View of the Potential Risks

Questions to ask before you sign on the dotted line

Market-linked certificates of deposit (CDs), also known as indexed or structured CDs, have been around since the 1980s but recently are being marketed more aggressively to consumers, including seniors. These CDs have the potential to earn more than traditional, fixed-rate CDs because the return is linked to the future performance of a market index that could include stocks, bonds, foreign currency or other assets. That may sound good, especially in the current low interest-rate environment. But be careful.

"While some of these market-linked products might be right for some consumers, there are definitely potential risks and other issues to consider before investing" cautioned Martin W. Becker, an FDIC Senior Deposit Insurance Specialist. "Indexed CDs have features that are different from conventional, insured certificates of deposit with a fixed rate of interest."

FDIC Consumer News offers questions to ask before you commit to a market-linked CD.

Is the principal amount of my CD guaranteed against loss?
This is crucial to know if you want FDIC deposit insurance coverage for your funds. That's because, to qualify for FDIC insurance coverage, the principal amount you invest must be guaranteed by the issuing bank. "If the principal is subject to loss — other than for an early withdrawal penalty — the product is not insured by the FDIC if the bank were to fail," Becker explained.

When will the CD mature?
Index-linked CDs often are designed for a long-term commitment ranging up to *20 years.* These differ from most traditional CDs that generally require depositors to keep the funds in the account for three months to five years.

What are the restrictions or penalties on early withdrawals?
While most traditional CDs allow for early withdrawal after paying a penalty, most market-linked accounts do not. However, some indexed CDs may allow

a deceased depositor’s survivors to redeem the full value early without penalty. In addition, the contract may or may not provide that the CD can be sold to other investors on the secondary market. If your contract does allow for a sale and if you want your money back before maturity, a deposit broker may be able to find a buyer for your CD. But keep in mind that if current interest rates for new CDs are higher than yours, you may be selling at a loss.

“If you think you may need the funds prior to the maturity date, this product is not for you,” Becker said. “And, if you want your heirs to be able to access the funds early if you die, it is extremely important to read the contract carefully to see what their options are, if any.”

He added, “Even if you may be able to withdraw funds early, you still should ask yourself whether you can afford to wait for your principal and any interest income for a long time. For seniors, this is especially relevant, because if you are 75 years old, are you sure you can afford to wait to have access to the principal of your CD as well as any interest earnings for five, 10 or even 20 years?”

Do I understand how the return on my CD will be calculated?
With market-linked CDs, the formula for calculating the return may be extremely complex. Some banks will offer a return solely based on the performance of the market-linked index while others may also offer an additional minimal guaranteed return.

Start by looking at the disclosures for the CD. You should understand how a particular increase in the value of the underlying index during the full term of the CD, minus any fees (such as sales charges by a deposit broker), would translate into your actual return.

And look carefully at the terms for the CD. “You may find that your share of any uptick in an index will be limited to a certain percentage and subject to a maximum cap,” said Meron Wondwosen, an FDIC Consumer Affairs Specialist. “For example, it’s possible for the market index to increase by 25 percent but your actual return on the CD may be only 10 percent.”

When will interest be added to my account balance?
One of the key components of a market-linked CD is that, unlike most fixed-rate CDs, interest earned might only be accrued (unconditionally added to the account balance) when the CD matures. However, you may be required to include interest income in your taxable income each year that you receive a Form 1099-INT from the issuing bank, even though you were not paid interest during that year but will be paid the interest at the maturity of the CD. Paying tax on interest earned but not paid to you is commonly known as “phantom income.” A tax advisor or CPA can explain the tax implications of “phantom income.”

Is it possible that I might not earn any interest on a market-linked CD, even after many years?
Yes, that is possible. Some indexed CDs guarantee that depositors will earn interest, but some do not. Also, as explained above, interest often is only credited at maturity. So if the index performs poorly enough, when the CD matures you might receive your initial investment back (minus any fees or commissions) but zero interest, even after many years. To learn more about this risk with a particular CD, review the disclosure statements. Also see below about what may happen to the interest if your bank fails before your CD matures.

Can the bank redeem the CD before the maturity date? If so, what does

that mean for me?
Some market-linked and other long-term, high-yield CDs have “call” features in their contract giving the bank — not the depositor — the right to close the account early without paying a penalty. The bank is most likely to exercise this option when interest rates fall, which means a callable CD would limit your ability to lock in an attractive interest rate for a long time.

For example, a bank might decide to call for the early redemption of a 10-year CD after only a year or two if market rates on new CDs have dropped significantly. “You’d get back your money plus accrued interest, but your earnings will likely be less than if the CD had been held to maturity,” Wondwosen said. “Of course, you could turn around and purchase another CD, but most likely it will have a lower interest rate.”

What will be covered by the FDIC if the bank that issued the CD fails?
If the bank has guaranteed that the principal will not go down in value, the FDIC will cover both the principal and any accrued interest, up to the federal insurance limit. But if interest is only credited at maturity, and if the bank were to fail before the CD matured, no interest would be insured because no interest had accrued.

How can I decide if a market-linked CD makes sense for me?
Before purchasing any CD, it’s best to shop around at a few different financial institutions for the best combination of terms and conditions, such as rates, minimum deposit requirements, maturity dates, and early withdrawal provisions. Consider your tolerance for risk and your willingness to commit money for the long term. Then, if you’re thinking about going with a market-linked CD, carefully read the contract agreement and all the associated documents, including the fine print. Make sure you completely understand the main features and the potential risks and that you are comfortable with them.

“Market-linked CDs are not suitable for all consumers,” Becker concluded. “If you are confused about the terms and conditions offered under the product and you are unclear or uncomfortable about the risks you are assuming, a conventional CD might be better for you.”

For additional information about CDs in general, including market-linked products, see resources listed in For More Help or Information Regarding CDs.

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