

Certificates of Deposit (CDs)

Overview

Certificates of Deposit (CDs) are promissory arrangements between a depositor/investor and a bank, whereby the issuing bank agrees to pay a predetermined rate of interest in exchange for the investor agreeing to deposit funds for a fixed period of time. Typically, CDs offer a higher rate of interest than savings or money market deposit accounts, and are widely considered to be relatively low-risk investments because of the availability of deposit insurance by the FDIC.

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 in response to The Great Depression. As a result of the Depression, more than 9,000 banks closed between the stock market crash in October 1929 and March 1933. In June of 1933, Congress created the FDIC to help restore order to the banking system. The FDIC protects a wide range of deposits, including Certificates of Deposit (CDs), and insures deposits up to a predetermined limit based on account category.

On July 21, 2010, the standard maximum FDIC deposit insurance amount was permanently increased to \$250,000 per depositor, per insured bank, for each ownership category. Additional information about federal deposit insurance is available by visiting the FDIC web site, www.fdic.gov, or by calling FDIC's Central Call Center at 1-877-ASK-FDIC (1-877-275-3342) from 7 a.m. to 7 p.m. ET.

The FDIC deposit insurance coverage limits refer to the total of all deposits that an accountholder (or accountholders) has at each FDIC-insured bank.

- \$250,000 Single Accounts (owned by one person)
- \$250,000 per owner Joint Accounts (two or more persons)
- \$250,000 per owner IRAs and certain other retirement accounts
- \$250,000 per owner Trust Accounts, subject to specific limitations and requirements

CDs generally pay interest periodically (for example, every six months) with the principal amount being returned to investors at final maturity. However, it should be noted that the specific terms of a CD often vary from one issue to another. Interest income from CDs is generally subject to income tax and offered in denominations of \$1,000. There are two basic types of CDs: those traditionally offered at the local bank and brokered CDs.

Bank CDs vs. Brokered CDs. Investors today may choose to acquire CDs either directly from a bank or through a brokerage account. Because there are many similarities and significant differences between bank CDs and brokered CDs, investors should carefully consider the risks and benefits of each structure in order to determine the most appropriate selection for their individual circumstances.

Bank CDs. The basic business of banks is to gather deposits to make loans. They earn a profit by receiving a higher rate of interest on loans than they pay on deposits. If a bank CD is redeemed before it matures, investors may incur an "early withdrawal" penalty – usually, a forfeiture of some or all of the interest earned, or instead a portion of the principal balance.

Brokered CDs. Many banks have begun to utilize the nationwide brokerage community for distribution of CDs. In order to purchase CDs through a financial advisor investors first must open a brokerage account. Through brokered CDs, investors can choose from a broad selection of maturities and coupon frequencies to find those CDs best-suited to their particular requirements. Unlike other types of investment securities typically offered by brokerages (which are not covered by FDIC insurance), brokered CDs are subject to the same FDIC coverage requirements as Bank CDs.

Because federal deposit insurance is limited to a total aggregate amount of \$250,000 for each depositor in each bank or thrift institution, it is very important that to know which bank or thrift issued the CD. In other words, find out where the deposit broker plans to deposit the money. It is important to note that all CDs sold by Morgan Keegan are FDIC insured. However, not all CDs that are issued have FDIC insurance.

Brokered CDs and the Secondary Market

CDs are most suitable for purchasing and holding to maturity. However, investors may find it necessary to dispose of CDs prior to maturity. An important distinction between Brokered CDs and Bank CDs is the different means for early redemption. Bank CDs typically allow investors an option for early withdrawal by charging an early withdrawal penalty when redeemed before maturity. By contrast, Brokered CDs are traded in the secondary market, which provide an opportunity for investors to sell their CDs at the prevailing market levels. As a result, the value of a Brokered CD sold in the secondary market may be worth more or less than the original amount invested, depending on market conditions.

Before considering the purchase of a CD from a bank or brokerage firm, make sure to fully understand all of its terms. Carefully read the disclosure statements, including any fine print. Investors should be cautious of CDs offering yields substantially higher than those being offered elsewhere in the marketplace. Ask questions - and demand answers - before investing.

Structure

Variable-Rate CDs. With variable-rate CDs, the rate of interest is adjusted periodically in relation to some benchmark, such as the prime rate or a stock index. Some feature a multi-step or bonus-rate structure in which interest rates increase or decrease over time, according to a preset schedule.

Fixed-Rate CDs. Considered the simplest (and most common) type of callable CD structure, the interest rate on a fixed-rate CD is set and remains constant until maturity or called.

Step-Up CDs. Step-up CDs feature coupons that increase at intervals according to a pre-determined rate schedule until maturity or called.

Zero-Coupon CDs. Issued at a deep discount to par, zero-coupon CDs gradually accumulate interest due until they reach par at maturity and are retired. Investors who don't need current income may prefer zero-coupon CDs.

Market-Index-Linked CDs. With market-index-linked CDs, interest is paid based on the performance of a market index, rather than a fixed interest rate. The principal is protected by FDIC insurance when held to maturity. No interest is earned or credited for these securities until maturity. Due to the unpredictable nature of markets, only one interest payment is made in a lump sum at final maturity. Examples of market indices are the S&P 500 and NASDAQ 100. The maturity for index-linked CDs usually ranges from 5-10 years, allowing for short-term market volatility.

Estate Feature. A valuable feature common to most Brokered CDs is the survivor's option, which is designed to protect estate assets. Upon the death of at least one of the beneficial owner, this provision allows the surviving heir (or estate) the right to redeem the CD from the issuer at par value plus accrued interest prior to the stated maturity date, regardless of the market value at the time the survivor option is exercised. It is important to note that very few fixed-income investments offer this feature and that the specific terms of an estate option may vary widely from one issue to another. Before exercising the survivor's option, investors should determine whether CDs are trading at a premium in the secondary market. If secondary market value is above par, then it may be more beneficial to sell CDs at a higher price rather than redeem from the issuer at par.

Callable. Callable CDs allow for the issuer to redeem, or call, a CD prior to its final maturity. When CDs are called, investors are paid principal, along with interest earned through the call date. It should be emphasized that the option to redeem a CD prior to maturity resides with the issuer, not the investor. Because the call option is likely to be exercised when interest rates have declined (when reinvestment conditions are comparatively unfavorable), callable CDs typically offer higher interest rates than non-callable CDs in order to compensate investors for the possibility that their deposit will be retired early.

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Not FDIC Insured | Not Bank Guaranteed | May Lose Value | Not a Deposit | Not Insured by Any Government Agency

Non-Callable. Most CDs are non-callable, meaning that the issuer is precluded from redeeming the deposit prior to its final maturity.

Benefits

Bank CDs. These are the most broadly known form of certificates of deposit.

Brokered CDs. Brokered CDs offer an investor the potential for higher yield by providing a wide range of issuers, and through the rich variety of payment structures. Another important distinction between a bank-purchased CD and a brokered CD is that the early withdrawal mechanism does not apply to Brokered CDs. Brokered CDs may be sold in the secondary market, meaning the investor is subject to market conditions for pricing, but not to an early withdrawal penalty. There are two types of Brokered CDs: non-callable and callable.

Risks

Price Risk. Brokered CDs are priced similar to bonds and have an active secondary market. Like bonds, CD prices are inversely related to interest rates. If interest rates increase, CD prices fall and vice versa. A CD's price is only certain at maturity (barring default or call). If an investor chooses to redeem a bank CD before it matures, he/she may have to pay an early withdrawal penalty or forfeit a portion of the interest earned. Brokered CDs do not have early withdrawal penalties. Instead, they are sold to dealers in the secondary market at prevailing market levels. Investors who sell a CD prior to maturity in the secondary market are subject to market pricing, and may not receive full principal value.

Reinvestment Risk. Uncertainty about possible shifts in the yield curve creates uncertainty about future returns from coupon reinvestment. If future reinvestment rates are different from a CD's calculated yield to maturity (YTM), the investor's total return will not equal its YTM at the time of the transaction.

Call Risk. Issuers often are allowed to retire a CD issue prior to its scheduled maturity. As a result, investors are uncertain that coupon and principal payments will be made as scheduled in the indenture agreement. Call risk applies to callable CDs only.

Market Risk. Market risk is the exposure to changes in a CD's price as interest rates change. As rates go up, a CD's principal value will decline and vice versa. An investor who holds a CD to maturity may not be overly concerned with market risk, because the principal amount invested will be returned at final maturity.

Prepayment Risk. Prepayment occurs when an issuing bank decides to prepay a CD's interest in full through the original scheduled maturity date. In an instance where prepayment occurs, CD investors would receive all interest payments and principal balance prior to maturity. Prepayment can occur with both callable and non-callable CDs. While prepayment occurs infrequently, it is a possibility. The primary risk involved with prepayment is that it may increase the investor's tax burden in the year the prepayment occurs. Because investors receive all scheduled interest in a prepayment, it offsets the adverse tax consequences.

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