

INVESTING IN CERTIFICATES OF DEPOSIT

THE BASICS



SIA and The Bond Market Association
thank the SIA Ad Hoc Brokered Deposit
Committee for their thoughtful review and
contributions to *Investing in Certificates of
Deposit*.

Illustrator: Giora Carmi

This brochure provides you with basic information about investing in certificates of deposit ("CDs") issued by banks, savings associations and other depository institutions whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC").*

THE BUILDING BLOCKS OF A PORTFOLIO

Before choosing any investment, you should put together a financial plan: outline your goals, clarify your tolerance for risk, and set savings targets that make sense given your income and living expenses. A successful investment strategy requires a long-term perspective and staying on course – even when the financial markets are declining. When developing and implementing your strategy, consider choosing an investment professional who can help you make the right financial decisions.

The basic building blocks of any portfolio are **stocks, bonds or notes, mutual funds, and interest-earning cash deposits**. Typically, your investment plan should include a healthy mix of all four. Deciding how much money you should allocate to each type of investment depends on your age and goals, and the amount of risk that you can accept. The important principle to remember is diversification – don't put your entire savings into just one basket or one type of investment. Depending on the features, CDs may be an appropriate investment for your portfolio.

CDs are available from several sources, including the bank in which you deposit your money, securities brokers and other financial institutions. Institutions such as securities brokers that offer CDs are sometimes referred to as deposit brokers.

WHAT ARE CERTIFICATES OF DEPOSIT?

CDs are time deposits – you agree to place your funds on deposit with the bank for a stated period of time. During the term of the CD your funds earn

**For purposes of this brochure, all FDIC-insured institutions are referred to as banks.*

interest at a stated interest rate or based upon an agreed method of calculating the rate, such as the percentage increase in the stock market.

Because you agree with the bank to keep your funds on deposit for a period of time, CDs may offer you a higher rate of interest than other types of deposit accounts that allow you more immediate access to your funds, such as checking and savings accounts. Generally, the longer you are willing to let the bank keep your funds, the higher the rate you will receive on your CD.

Most banks are members of the FDIC, a government agency that insures bank deposits. You are eligible for \$100,000 of deposit insurance for all the deposits you own at one bank in each recognized ownership capacity. For example, all the deposits (CDs, checking accounts, etc.) you own at one bank in your own name are insured up to a total of \$100,000. You are eligible for an additional \$100,000 for all deposits you own at one bank in joint accounts and another \$100,000 for Individual Retirement Accounts.

The FDIC's brochure "Your Insured Deposit" explains deposit insurance coverage in more detail. You can obtain the publication from the FDIC and from most banks and securities brokers. You can contact the FDIC by mail (550 17th Street, N.W., Washington, D.C. 20429), by phone (800-276-6003) or by e-mail (publicinfo@fdic.gov). You can also visit the FDIC Website at www.fdic.gov.

WHAT ARE THE FEATURES OF CDs?

All CDs do not have the same features. Banks are free to offer CDs with different maturities (i.e., three months, one year, five years), methods of determining interest and payment features. Banks are not required to permit you to withdraw your funds prior to the CD's maturity, even if you were to pay a penalty. If early withdrawal is permitted, there are no strict guidelines governing the penalty that a bank may impose.

When selecting a CD you should carefully review its terms and conditions. The *Federal Truth in Savings*

Act requires all FDIC-insured depository institutions and deposit brokers to disclose certain information to you when advertising the rate on a CD. The information must include the “Annual Percentage Yield” or “APY” (the rate that reflects the amount of interest you will earn on your deposit), the maturity, the minimum required deposit and whether there is a penalty for early withdrawal. Other significant features, such as the right of the institution to redeem or “call” the CD, must also be disclosed.

The Federal Reserve Board’s brochure, “Making Sense of Savings,” explains the APY and other disclosure requirements. You can obtain the brochure from the Board by writing to: Publications Services, MS-127, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (or calling 202-452-3244) or on the Website of the Federal Consumer Information Center, www.pueblo.gsa.gov.

INTEREST FEATURES

Fixed Rate

Many CDs pay interest at a fixed rate for the term of the CD. The interest may be compounded or simple. Interest may be paid to you periodically during the term of the CD or at maturity.

Variable Rate

CDs may offer rates that change periodically during the CD’s term. With such CDs you need to understand how the interest rate is calculated and how often the rate can be re-set.

CDs that re-set the rate periodically are referred to as “**floating rate**” CDs because the rate “floats” during the term of the CD. These CDs may re-set the rate at pre-determined intervals against any number of common financial references – Treasury securities, the prime rate or some other index. If these indices decline, so will the rate on the CD. The APY will reflect the rate in effect at the time you purchase the CD.

CDs that change to a pre-determined rate at pre-determined times are referred to as “**step rate**” CDs. These CDs will have an interest rate that is fixed for

a period of time and then “step up” or “step down” to another fixed rate. The steps may occur more than once before the CD matures. The APY on step rate CDs will reflect the total interest to be paid during the life of the CD, so it will be less than the highest step rate, but more than the lowest step rate.

Contingent Rate

The rate on some CDs is determined by the outcome of some event or the performance of a financial index. For example, many banks offer CDs that pay interest linked to the performance of the stock market. You receive the percentage increase in the value of the stock market over a period of time. If the value of the stock market does not increase, you may receive no interest. In many cases, a contingent rate CD will have an APY of 0%. This reflects the fact that the CD has no stated interest rate and the interest rate cannot be determined at the time you purchase the CD.

Zero Coupon

Zero coupon CDs are sold at a discount to their face amount and pay the entire face amount at maturity. For example, you may pay \$900 for a \$1,000 CD and receive the full \$1,000 at maturity. At maturity, you will have received \$100 in interest.

REDEMPTION FEATURES

Call Features

Some CDs allow the bank to redeem or “call” the CD at its sole discretion. These CDs are termed “**callable CDs.**” On pre-determined dates, the bank can choose to give you your money back (including accrued interest) and cancel the CD. A call provision does not give you the right to redeem the CD. Call features are typically incorporated in CDs with longer terms and the call feature may be combined with other features, such as a step rate.

Typically, the bank will call your CD when interest rates have declined below the rate on your CD because the bank can attract deposits at a lower rate. If your CD is called you may not be able to

reinvest your money at the same rate as the CD that was called. This risk is termed “reinvestment risk.”

Callable CDs are sometimes referred to in terms of their maturity and the period during which they cannot be called. For example, “15 year, non-call one” means the CD matures in 15 years, but may be called at pre-determined dates or, in some cases, at any time after the first year.

Banks and deposit brokers must inform you that a CD is callable. However, the APY on a callable CD is not required to reflect the call feature. This will be significant if the CD has step rates because the CD could be called before the CD steps to a more favorable rate. In that case you will receive less than the advertised APY. You should be sure you understand both the APY you will receive on the CD if it is held to maturity and the APY you will receive on the CD if it is called.

Early Withdrawal

As stated earlier, banks are not required to permit early withdrawal. You should determine whether early withdrawal is permitted and, if so, the amount of the penalty that the bank will impose if you withdraw your funds. If you think you may need your money before the CD matures, you should decide if the penalty is a reasonable amount to pay for the opportunity to get your money early. If not, you should place your money in a shorter term CD or keep it in a different type of account.

Though not required to do so, banks may permit early withdrawal without penalty in certain circumstances, such as your death or incapacity.

Is The Interest On My CD Taxable?

Yes. You may be able to defer taxes on your CD interest by holding it in an IRA or other retirement account. You may owe taxes when your funds are distributed from those accounts.

You may be required to pay taxes annually on zero-coupon CDs and some contingent interest CDs if you hold the CD outside a retirement account even though these CDs do not pay interest annually. This

tax consequence – referred to as Original Issue Discount – may be significant to you.

If you have questions about the tax consequences of a particular CD, you should consult your tax adviser.

What Are Brokered CDs?

Brokered CDs are CDs issued by banks that are made available to the customers of a deposit broker. Most, though not all, deposit brokers are securities brokers registered with the Securities and Exchange Commission. Other deposit brokers are subject to regulation by different regulatory bodies or may not be subject to regulation at all. This description of brokered CDs is based upon standard practices in the securities industry. You should compare these practices to the practices of any deposit broker offering you a CD.

Brokered CDs are obligations of the bank, not the broker. Brokered CDs generally have the features of CDs available directly from banks and are eligible for the same deposit insurance as CDs purchased directly from banks.

Generally, the CD is sold to you without a fee because the broker receives its compensation from the bank. You have a right to know the amount of the fee paid to the broker by the bank.

Brokers may provide certain services to you that would normally be provided by the bank. The broker will hold your CD as your custodian and keep a record of your holdings. The broker will include your CD holdings in the periodic account statements you receive concerning the assets you have with the broker. Tax information concerning the amount of interest you should include in your income for tax purposes will also be provided by the broker.

Unlike banks, securities brokers are required to provide you with an estimated market value of your CD on your periodic account statement. This is an estimate of the amount you might receive if you were able to sell your CD prior to its maturity. You may not be able to sell your CD for the amount listed on the statement. Also, the amount on the statement

does not affect your deposit insurance, which is based on the outstanding principal amount of your CD, not the estimated market value.

When you hold your CD through a broker you have certain rights, including the right to dismiss the broker as your agent and move the CD to an account at another broker or establish the CD directly with the bank. Once you establish the CD directly with the bank your broker has no further obligation with respect to the CD.

Within a few days of your CD purchase, a securities broker will provide you with a trade confirmation that sets forth the terms of your CD. In addition, the broker will send you a CD disclosure document describing your rights with respect to the CD, the availability of deposit insurance coverage and other important considerations. The disclosure document will usually be sent with the trade confirmation, but is also available upon request. You should review these documents carefully and ask your broker if you do not understand the terms and conditions of your CD or if the terms and conditions are different than you were told when you placed your order.

Liquidity

Though not obligated to do so, some securities brokers may be willing to purchase, or arrange for the purchase of, your CD prior to maturity. The broker may refer to this activity as a secondary market. This is not early withdrawal. The price you receive for your CD will reflect a number of factors, including then-prevailing interest rates, the time remaining until the CD matures, the features of the CD and compensation to the broker for arranging the sale of the CD. Depending on market conditions, you may receive more or less than you paid for your CD. The broker is free to discontinue offering you this service at any time.

Early Withdrawal

Banks usually limit early withdrawal of CDs offered through brokers. You may not be permitted to withdraw your funds even if you are willing to pay

a penalty. Banks generally permit early withdrawal of brokered CDs without penalty upon the death or adjudication of incompetence of the depositor.

Information About Your Broker

You can find out if your broker is a registered or licensed securities broker by contacting your state securities regulator or the Public Disclosure Program of the National Association of Securities Dealers. Call 800-289-9999 or log on to www.nasdr.com and click on “Know Your Broker” to verify a broker’s license or registration and obtain a background report on the broker detailing any existing legal or regulatory problems.

WHAT QUESTIONS SHOULD I ASK BEFORE BUYING A CD?

- Does the CD meet your investment objectives?
- What are its terms, i.e., APY, maturity, early withdrawal, call features, etc.?
- What are the terms offered on other available CDs?
- Is the interest paid to you periodically throughout the term of the CD, or at maturity?
- Will you need your funds before the CD matures?
- Are your total deposits at the bank within the FDIC’s \$100,000 limit?
- If the CD is callable, what is the first date the bank can call it and how frequently after that can it be called?
- Do you understand the tax consequences associated with the CD?
- If purchasing a CD from a broker, are you familiar with the broker’s reputation and comfortable with your salesperson’s advice?
- Have you asked for copies of the disclosure materials available from the bank or the broker?

November 2001

The Bond Market Association is the trade association representing the largest securities markets in the world, the \$17 trillion debt markets. Its membership includes securities firms and banks that underwrite, trade and sell debt securities. The Association acts as an advocate for industry positions and informs and educates the public about the role of the bond markets and the global economy. The Association publishes newsletters and education materials, presents seminars and conferences and publishes bond markets-related statistics. These efforts are aimed at increasing the level of professionalism in the industry and raising public awareness of the importance of the bond markets. More information about the Association is available on its Web site: www.bondmarkets.com.

The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans, and generates \$358 billion of revenue. Securities firms employ approximately 760,000 individuals in the United States. (More information about SIA is available on its home page:<http://www.sia.com>.)



40 Broad Street
New York, NY 10004
(212) 440-9400 • Fax (212) 440-5260

1399 New York Avenue, NW
Washington DC 20005-4711
(202) 434-8400 • Fax (202) 434-8456

St. Michael's House
1 George Yard
London, EC3V 9DH
44-20-77-43-93-00 • Fax 44-20-77-43-93-01
www.bondmarkets.com



Securities Industry Association

120 Broadway, New York, NY 10271-0080
(212) 608-1500, Fax (212) 968-0703

1401 Eye Street, NW, Washington, DC 20005-2225
(202) 296-9410, Fax (202) 296-9775
info@sia.com, www.sia.com