

A Guide to Certificates of Deposit (CDs)

A certificate of deposit (CD) is a type of savings account that pays a fixed interest rate on your deposit for an agreed-upon period. The best CD rates may be higher than those of the best traditional savings accounts, but you lose withdrawal flexibility—if you withdraw your CD funds early, you'll typically be charged a penalty fee.

CDs come in a variety of terms, generally ranging from 3 months to 10 years. Learn more about how CDs work and their advantages and disadvantages.

How Certificates of Deposit Work

Opening a CD is similar to opening any standard bank deposit account. When you shop around, consider these factors:

1. **Interest rate:** Most CD interest rates are fixed, so you'll know exactly how much you'll earn by the end of the term. This is a good way to lock in a high annual percentage yield (APY) if rates in general are expected to fall, but on the other hand it could leave you missing out if rates rise after you're locked in. There are also some variable-rate CDs that can earn a higher return if rates rise, but they usually provide a lower return overall than the best CDs.
2. **Term:** This is the length of time that you agree to leave your funds deposited (6 months, 18 months, 2 years, 5 years, etc.). The term ends on the maturity date, when you can withdraw your funds penalty-free.
3. **Principal:** This is the amount that you deposit when you open the CD.
4. **Financial institution:** The bank or credit union you choose will set policies such as early withdrawal penalties (EWP) and whether your CD will default to being automatically reinvested at the time of maturity.

You'll have either monthly or quarterly statement periods, with paper or electronic statements. Interest payments will be deposited into your CD balance, and the interest will compound, usually daily or monthly.

Pros and Cons of CDs

CDs can be a good idea in several situations. A CD may be a good option if you have cash that you don't expect to need for some time. Investing in a CD can help you save for a specific upcoming event or expense, like a vacation, a new home, or a car.

A CD may be a good idea if you want some of your savings invested conservatively. It can help you achieve lower risk and volatility than investing in the stock and bond markets.

The primary downside of CDs is that your money is tied up in the investment. However, that can be a benefit for some savers who worry that they will be tempted to withdraw from their savings. The fixed term of a CD and the penalty for early withdrawal provide a deterrent to spending.

What Happens to My CD at Maturity?

Leading up to your CD's maturity date, the bank or credit union will notify you of the impending end date. You will receive instructions on the actions to take with the maturing funds.¹

Typically, they will offer you three options.

1. **Roll over the CD funds into a new CD:** Generally, it would be into a CD that most closely matches the term of your maturing CD. For example, if you have a 1-year CD, it would likely roll into a new 1-year CD. This may be a poor choice because the rate on the new CD may be much lower than the best available rate for that term.
2. **Transfer the funds to an account at the same institution:** Options include savings, checking, and money market accounts (MMAs).
3. **Withdraw the proceeds:** Proceeds can be transferred to an external bank account or mailed to you as a paper check.

In many cases, if you don't make a decision in time the bank will default to rolling your proceeds into a new CD.

Which CD Term Should I Choose?

Once you decide that you won't need a certain amount of money for some time, you'll have to determine the CD term that is right for you.

Consider your plans for the money. If it's for a specific goal or project, the expected start of that project will help determine your ideal CD term length. If you're just socking away cash with no particular goal, you may opt for a longer term and higher interest rate.

Also, consider what's expected to happen with the Fed's rate. If it's anticipated that the Fed will raise rates—and CD rates will likely rise as well—then short- and mid-term CDs will make more sense than long-term CDs (or high-yield savings accounts). You don't want to commit to a relatively low rate for five years, for example, when new, higher rates will shortly become available.

Conversely, if you expect rates to decrease in the near term, you may want long-term CDs (like 3-year CDs or even 5-year CDs) so you can lock in today's higher rates for years.

Another way to invest in CDs when interest rates are rising is to purchase a variable-rate CD or a bump-up CD.

A variable-rate CD has an APY that changes based on an index rate—it can go up or down, so it might make sense if you expect rates to rise. A bump-up CD allows you to increase the rate at one time of your choosing, and the rate cannot go down.

Important

Variable-rate CDs and bump-up CDs typically have lower rates than the best available CDs. You'll need to weigh that when considering these products.

How Much Do I Need to Open a CD?

Each bank and credit union establishes a minimum deposit required to open a CD—these can be as low as \$100 in some cases. Sometimes, a bank will set a minimum deposit policy across all CDs. Some offer rate tiers with a higher annual percentage yield (APY) for those with higher minimum deposits.

You may expect that larger deposits will earn higher APYs. In practice, this is not always the case. Many of the best accounts in each CD term can be opened with modest investments of just \$500 or \$1,000. And the majority of top rates are available to anyone with at least \$10,000. A \$25,000 deposit is only occasionally required for a top rate.

Tip

Jumbo CDs (which require a minimum deposit of \$50,000 or \$100,000) can pay more, but not always.

Where Can I Get a CD With the Best Rate?

Many banks, credit unions, and brokerages offer CDs. However, many CDs offer very low rates.

Tip

When opening a CD or choosing your term, pay attention to the Fed's rate. If rates are expected to fall in the near future, locking in a high rate now could be smart. But if rates are expected to rise, you may want to opt for a short-term CD or park your cash in a high-yield savings account.

Are CDs Safe?

CDs are one of the safest ways to invest your money. First, their rate is fixed and guaranteed, unlike accounts with variable rates that can change at any time. Second, CD investments are usually protected by the same federal insurance that covers other deposit products.

The Federal Deposit Insurance Corporation (FDIC) insures bank accounts, and the National Credit Union Administration (NCUA) insures credit union accounts. In both cases, up to \$250,000 of your funds (and sometimes more) are protected in the rare event that the institution were to fail.

Just be sure that you're working with an FDIC-insured bank or an NCUA-insured credit union; all of the institutions on our list of the best CD rates offer FDIC or NCUA insurance.

CDs vs. Savings and Money Market Accounts

CDs are like savings or money market accounts in that they allow you to put money away for a set period and earn interest. You can save toward a specific goal like a down payment on a house, a new car, or a vacation. Or you can use a CD to just earn a guaranteed return on cash you won't need for a while.

Savings and money market accounts allow you to make additional deposits as well as withdrawals. But with CDs, you make one initial deposit that stays in the account until its maturity date. In return for giving up access to your funds, certificates of deposit may pay higher interest rates than the best savings or money market accounts.

What If I Need to Withdraw My Money Early?

Opening a CD involves agreeing to keep the funds on deposit for the duration of the term, but that doesn't mean you lack options if your plans change.

The most common way financial institutions accommodate premature termination is by assessing an early withdrawal penalty (EWP) on the proceeds before they are distributed, according to the specific terms and calculations outlined in your deposit agreement when you first opened the certificate. This means that you can determine, before agreeing to the CD, whether the EWP is acceptable to you.

Tip

Always check a bank's early withdrawal policy before committing to a CD. If it's especially aggressive—or if you can find another CD with a similar rate and a milder term—then you'll be wise to stay away from the toughest penalties.

Most typically, the EWP is charged as several months' interest, with more months for longer CD terms. For instance, a bank's policy might be to deduct three months' interest for all CDs with terms up to 12 months, six months' interest for terms up to 3 years, and a full year's worth of interest for its long-term CDs. These are just examples, of course—every bank and credit union sets its own EWP.

However, some particularly onerous penalties exist in the marketplace, where a flat percentage penalty is applied. Depending on your APY and how long the money sits in the account, this percentage may outweigh what you earn on the CD. That means the penalty could cut into the initial principal you deposited, *leaving you with less than you started*. As a result, these EWP types are best avoided.

CD Ladders: Why Should I Build One?

A CD ladder is a strategy that allows you to invest in CDs while maintaining periodic access to your funds and still getting high yields from multi-year CDs.

Let's consider how to build a CD ladder ramping up to 5-year CDs.

At the outset, take the amount of money that you want to invest in CDs and divide it by the number of CDs you will invest in. Let's say you have \$25,000; in this case you'd invest in five CDs to build the ladder. You put one-fifth of the funds into a top-earning 1-year CD, another fifth into a top 2-year CD, and so forth up to a 5-year CD. That would give you five CDs with varying term lengths, with a value of \$5,000 each.

Then, when the first CD matures in a year, you take the resulting funds and open a top-rate 5-year CD. A year later, your initial 2-year CD will mature, and you'll invest those funds into another 5-year CD.

You continue doing this every year with whichever CD matures until you end up with a portfolio of five 5-year CDs, all earning high APYs, but with one of them maturing every 12 months.

Tip

CD ladders make your money more accessible than if it were all locked up for a specific term.

How Are CD Rates Determined?

The Federal Reserve's benchmark rate range plays a large role in the rates banks and credit unions pay on deposit accounts. In general, as the Fed rate goes up or down, rates on deposit accounts (and loan and credit products) tend to go up or down. Here's how it works.

No more than eight times a year, the Federal Open Market Committee (FOMC) decides whether to raise, lower, or hold its federal funds target rate range. This rate range determines the interest rates that banks charge to lend their excess reserves to each other overnight.

Each morning, rates are weighted, averaged, and published. The resulting rate becomes a benchmark that influences what banks and credit unions are willing to pay consumers for their deposits in savings, money market, and CD accounts. The higher the federal funds rate, the higher the interest rate you can generally earn on a CD.

This is why it's important to check the rate outlook before committing to a CD, especially a long-term CD. Take a look at our list of the best CD rates, and keep an eye on the FOMC to help make the right decision.

Frequently Asked Questions

How Are CD Earnings Taxed?

When you hold a CD, the bank will apply the earned interest to your account at regular intervals. This is usually done daily or monthly and will show up on your statements as earned interest.

Just like interest paid on a savings or money market account, this interest is taxable income. It will be reported to you in the new year as interest earned. Then, you must report it as income when you file your tax return.

For tax-reporting purposes, your CD earnings are taxed when the bank applies them to your account, regardless of when you withdraw your CD funds.

Can You Lose Money on a CD?

It is nearly impossible to lose money on a CD for two reasons. First, certificates of deposit are guaranteed by the bank or credit union that offers them, meaning they are legally required to pay you exactly the amount of interest and principal agreed upon. Second, CDs are generally also insured by the federal government for up to \$250,000. That means that even if the bank or credit union went bankrupt, your principal would still be repaid.²⁵

Should I Let My CD Roll Over?

As a general rule, letting your CD roll over into a similar CD term at the same institution is unwise. The rate you'd get is often far lower than the best available rate for that term. Shopping around is important if you want to earn the top APY on your certificates of deposit.

Can I Add Additional Funds to My CD?

No, you typically cannot add funds to your CD during its term, but you may buy other CDs. Some banks may allow you to add funds during a grace period, which can vary depending on the issuer.

Is There an Early Withdrawal Penalty for CDs?

Yes, you will usually face an early withdrawal penalty when you take your money out of a certificate of deposit before the term ends. However, some issuers offer CDs with no early withdrawal penalty, although these tend to have low rates.

The Bottom Line

Certificates of deposit offer a way to earn more on your money without the risk inherent in stocks and bonds. Their fixed rates let you lock in a high rate, without worrying about the variable interest rates of high-yield savings accounts. Although interest rates may be higher than those of savings and money market accounts, read the fine print carefully.

Understand the early withdrawal penalty, and be aware that you may lose out on higher interest returns if the federal funds rate increases. Know the limitations and benefits of any investment and consider consulting a financial professional for more guidance on your situation.

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