A Self-Learning Resource From MSU Extension

Investing in Certificates

by Marsha Goetting, Ph.D., CFP®, CFCS, Professor and Family Economics Specialist and Joel Schumacher, Extension Assistant

Savings certificates can offer higher interest rates than savings accounts, if you're willing to leave the certificate untouched for a specified period of time. This MontGuide will help you compare a range of saving certificates that are available from a variety of financial institutions.

MONTANA STATE UNIVERSITY EXTENSION

MontGuide

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AN ALTERNATIVE TO A REGULAR SAVINGS ACCOUNT is a savings certificate, also known as a certificate of deposit (CD) or time deposit from a bank, savings and loan, brokerage firm or as a share certificate from a credit union. In addition to paying a higher rate of interest, CDs differ from a regular savings account in other ways. First, savers agree to leave their money with the savings institution or brokerage firm for a specified period of time. A penalty is applied if the funds in the CD are withdrawn before the maturity date. Second, savings institutions may require a larger minimum deposit than the amount required for a regular savings account.

This MontGuide provides information to help Montanans compare certificates of deposits that are available from banks, savings and loans, brokerage firms and share certificates from credit unions. While this MontGuide focuses on the more traditional CDs, the basic comparision information can be used for other types such as brokered CDs, variable rate CDs, inflation-linked CDs, and stock market CDs.

Deregulation

The deregulation of interest rate ceilings, minimum deposits, and length of maturities has resulted in a competitive spirit among financial institutions. The ability of the consumer to make informed decisions regarding savings accounts and certificates of deposit has been strengthened because of the Truth-in-Savings Act 1993. The law provides for uniformity in the disclosure of terms and conditions of savings instruments, such as regular savings accounts and certificates of deposit.

Interest Rates

The Truth-in-Savings Act requires financial institutions to reveal the annual percentage yield (APY). The APY measures the effect of an institution's compounding and crediting policy. An institution that advertises an identical annual percentage rate and an annual percentage yield is crediting the interest earned on a CD once a year. An institution that advertises a higher annual percentage yield than the annual percentage rate is crediting interest to the account more often. Compounding monthly or quarterly is common. The national average annual percentage yield for 90-day CDs as of August 2005 was 1.29 percent; 1-year was 3.62 percent; and 5-year was 4.09 percent.

Maturities and Minimum Deposits

Typical lengths of maturities for CDs are seven to 31 days, three, six, 12, 18, 24, 36, and 48 months. Many Montana savings institutions also offer investors the opportunity to name a maturity date to meet their specific needs. For example, a parent may have a large tuition payment to make in 49 days. The parent could invest in a 49-day CD rather than a regular savings account. This alternative allows the parent to receive a higher interest rate than would have been available if the funds had been placed in a regular savings account.

The key with time deposits is planning so that maturity dates arrive about the time the funds are needed such as when the children approach college age or when a major purchase is planned. Many investors make the most of short-term plans (i.e. a 90-day certificate) in anticipation of paying property taxes or insurance premiums. Retired individuals may time maturity dates of CDs to supplement their monthly Social Security and pension incomes.

Financial institutions offer fixed rates (that remain constant until maturity) or variable rates (that are based on an index and change bimonthly, monthly, or weekly). Each institution, not the federal government, sets minimum amounts for certificates of deposit; $500 is typical. Many institutions have established annual percentage yields based on the average 1½-year yield for U.S. Treasury Securities. Most financial institutions publish a sheet that provides effective dates for annual percentage rates, annual percentage yields, minimum balance requirements, and maturity lengths for certificates of deposit they offer.

Certificates sold by brokerage firms sometimes pay higher interest rates than do banks, savings and loans, or credit unions. Such CDs can be cashed in before maturity without any penalty. However, if interest rates have risen since the certificate was issued, the investor will take a loss because the principal is reduced by an amount sufficient to make the yield competitive with rates on newly issued CDs. A brokerage firm may also charge a processing fee.

Table 1 provides the typical rates of return on savings certificates in August 2005.

Table 1. Average Rates of Return for Certificates of Deposit (August 2005)

CD Maturity Length	Annual Interest Rates	Annual Percentage Yield
3 months	2.29%	2.32%
6 months	2.93%	2.98%
12 months	3.62%	3.69%
24 months	3.82%	3.88%
36 months	3.92%	3.99%
60 months	4.09%	4.17%

Source: Yahoo Finance (August 25, 2005) http://banking.yahoo.com

Insurance Coverage

Certificates of deposit from most banks and savings and loans are insured for up to $100,000 for each depositor by the Federal Deposit Insurance Corporation (FDIC). The FDIC is an independent agency of the U.S. Government established by Congress in 1933 to insure bank deposits, help maintain sound conditions in the banking system, and protect the nation's money supply in case of financial institution failure.

In 1989, the FDIC was given the additional responsibility of insuring deposits in savings and loans. As a result, the FDIC insures deposits in banks, using the Bank Insurance Fund (BIF), and insures deposits in savings and loans, using the Savings Association Insurance Fund (SAIF). Both BIF and SAIF are backed by the full faith and credit of the United States. CDs sold through brokerage firms are usually insured by the BIF and SAIF as well. Similar coverage is provided for credit union share certificate holders through the National Credit Union Administration (NCUA), which administers the National Credit Union Share Insurance Fund (NSUSIF).

Deposits maintained in different categories of legal ownership are separately insured. In the case of a married couple, each spouse could have $100,000 coverage on a CD in his/her name and another $100,000 in a joint tenancy with right of survivorship CD for a total coverage of $300,000. Check with your financial institution for the specifics about your account.

Money Market Certificates, Mutual Funds, Money Market Deposit Accounts

Some savers confuse money market certificates, money market mutual funds, and money market deposit accounts.

Money market certificates were first offered at savings institutions in 1978. Though the interest rate paid varies each week, once money market certificates are purchased, that rate is locked in for the period of maturity selected. Just as with a regular CD, money market certificates at insured financial institutions are insured up to $100,000.

A money market mutual fund is an investment whose rate of return and assets are not guaranteed. When an individual buys into a money market fund, the money is pooled with other investors just as with any mutual fund. Instead of investing in stocks and bonds, the fund manager buys short-term securities on the money market such as Treasury Bills, corporate loan paper, or $100,000 or more in bank certificates of deposit.

Money may be added to a money market mutual fund account any time, usually in increments of $100 or more. Interest paid varies daily, depending on changes in the money market. If interest rates are increasing, this can be an advantage over the fixed interest rate of the money market certificate. Of course, the opposite also is true. Money market mutual funds are not federally insured.

Money market deposit accounts (MMDAs) are interest-bearing accounts available at banks, savings and loans, and credit unions. Typically MMDAs have a limit of six withdrawal transactions allowed per statement cycle, three of which may be checks. Some institutions allow unlimited deposits and withdrawals in person or by mail.

Penalty for Early Withdrawal

A CD may be cashed before maturity, but a penalty is typically due. For example, the disclosure statement at one financial institution stated that "a penalty equal to 90 days interest on the amount of principal withdrawn will be charged on certificates of deposits with a term of three or six months." However, for one-year certificates of deposit, the "penalty is equal to 180 days interest on the amount of principal withdrawn. If the early withdrawal penalty is greater than the interest earned, the difference will be deducted from principal."

Example: Kevin purchased a $5,000, three-year CD earning 3.82 percent from a local bank on September 1, 2005. A month later, he cashed it in because of a family financial emergency. The interest earned in one month was $16.33. The penalty was 180 days of interest ($98.00), leaving Kevin $4,918.33 of his $5,000 CD.

An investor faced with a sudden need for cash may want to consider borrowing against a savings certificate rather than withdrawing the funds and incurring the interest penalty. Certificate owners may want to ask a lender to calculate whether borrowing against or cashing in the CD will cost less in the long run.

Individuals who make early withdrawals may deduct the interest loss from gross income on their federal income tax returns if deductions are itemized and they have previously reported the interest as income.

All interest earned from CDs is subject to federal and Montana income taxes during the year earned unless the CD is in an Individual Retirement Account (IRA). The interest is reported to the Internal Revenue Service (IRS) by the Social Security number on the account.

The value of a certificate of deposit is also subject to federal estate taxes upon the death of the owner. For further information, ask for MSU Extension MontGuide "Federal Estate Tax" (MT 199104 HR).

A certificate of deposit placed in another individual's name is subject to the federal gift tax in the year that person cashes the CD if the amount is more than the annual exclusion amount of $11,000 (in 2005).

Financial institutions generally allow certificates to be cashed in without a penalty in the event of the owner's death or, upon request by a conservator if the owner of the CD has been declared incompetent or incapacitated by a court.

Certificates in an IRA or Keogh plan may be cashed in early without an IRS penalty when the owner of the certificate reaches age 59½ or becomes disabled. MSU Extension MontGuide 200208 outlines conditions under which individuals may have access to their IRA dollars for medical expenses without incurring an IRS 10 percent excise tax on the distribution. Penalty-free distributions are also available for the purchase of health insurance if the IRA owner is unemployed for a certain period of time. Another provision permits penalty-free withdrawals from an IRA for qualified education and first-time homebuyer expenses.

Non-Probate Transfers

When an owner dies, the certificate belongs to the surviving parties if a right of survivorship option is selected. The deceased owner's share is divided equally among the surviving joint tenants. A payable on death (POD) beneficiary receives funds in the CD only upon the death of the last surviving party.

Such CDs are considered as non-probate transfers, which means the money in the CD can go directly to the beneficiary without a court procedure. POD beneficiaries have no rights to money in the CD during the lifetime of the owner. If no POD beneficiary survives, the CD passes as part of the last surviving party's estate. For further information on POD accounts, request MSU Extension MontGuide "Non-Probate Transfers" (MT 199509 HR). Examples of POD designations:

- Sole owner, sole beneficiary: Debbie Buczinski POD Bethany Buczinski
- Sole owner, multiple beneficiaries: Debbie Buczinski POD Sara Anderson and Budd Anderson
- Multiple owners, sole beneficiary: Debbie Buczinski and Michael Buczinski, JTWROS,* POD Sara Anderson
- Multiple owners, multiple beneficiaries: Debbie Buczinski and Michael Buczinski, JTWROS,* POD Sara Anderson and Budd Anderson

*The letters "JTWROS" mean joint tenancy with right of survivorship.

Shopping for a Certificate

Because of the Truth-in-Savings Act, an investor can comparison shop for a CD knowing that his or her time is well spent because differences do exist among financial institutions products. Most advertisements or announcements initiated by a depository institution or deposit broker state the following information:

1. The annual percentage yield (APY).
2. The period during which such annual percentage yield is in effect.
3. All minimum account balance and time requirements that must be met to earn the advertised yield.
4. A statement that regular fees or other conditions could reduce the yield.
5. A statement that an interest penalty is required for early withdrawal.

Much of the information listed on the chart can be found by calling the institutions. Be sure to ask for the person who handles certificates because he or she will be more familiar with the institution's most recent rules and federal regulations.

Another method of becoming a more informed saver is to write to the financial institutions to request their Truth-in-Savings disclosure statements for certificates of deposit or share certificates. This was the procedure used in the process of compiling the information in this MontGuide to help investors comparison shop for a CD. The chart at the end of this MontGuide provides a method for summarizing what you discover when comparing CDs at various financial institutions.

Minimum Deposit Amount

When comparison shopping for a CD, ask, "What is the minimum deposit amount required?" A typical minimum requirement is $500 to earn the institution's disclosed interest rate and annual effective yield. However, some savings institutions may require minimum deposit amounts of $1,000, $2,500, $10,000 or more.

Length of Maturity

Typical maturities for CDs are seven to 31 days, three, six, 18, 24, 30, 36, and 48 months. Some institutions offer flexible maturities, allowing investors to select a CD length that matures precisely on the day they have a need for the money. Typically, the longer the maturity and the larger the dollar amount placed in the CD, the higher the yield. For example, one institution advertised a 36-month CD at 3.92 percent, while the 60-month CD was offered at 4.09 percent (August 2005).

Annual Percentage Yield

When deciding where to invest in a certificate, shop for the highest annual percentage yield (APY) possible.

> **Example:** Donna was considering placing $5,000 in a three-year CD at a savings institution paying an annual percentage yield of 3.79 percent. In three years, the balance would be $5,590.32. Then she discovered that her CD could grow to $5,616.21 over the same period if it were in an institution that paid an annual percentage yield of 3.95 percent. Donna made an additional $25.89 by comparing rates.

How Often Compounded and Credited.

Compounding generally means that interest is being accrued on earned interest. So, if your $5,000 CD earns $75 in the first quarter, you will be earning interest on $5,075 for the next quarter, and so on. Crediting interest to the CD may be done annually, semiannually, quarterly, monthly, or daily. A 5 percent annual percentage rate is equal to 5 percent annual percentage yield if the CD is compounded annually; 5.09 percent APY if compounded quarterly; 5.12 percent APY if compounded monthly; and 5.13 percent APY if compounded daily.

Some institutions indicate that interest is compounded every day, but that the interest is not credited until quarterly, at maturity, or even when cashed in. Other institutions do not pay accrued interest if an account is closed before the interest is credited.

Penalty for Early Withdrawal

Institutions often advertise a "substantial penalty for early withdrawal." For example, the disclosure statement from one bank revealed a minimum penalty equal to seven days simple interest on a 3-month certificate while another institution imposed a penalty of one month's interest. On a 24-month certificate of deposit, one institution imposed a penalty of seven days simple interest while another imposed a penalty of three months. If the account does not earn enough interest to cover the penalty, the difference is deducted from the principal of the CD.

Method of Interest Payment

Typically, there are four ways for savers to receive interest that is earned on a CD.

1) leave interest in the account and add to the certificate balance so that the interest earns interest at the same rate of the CD;

2) have the interest mailed quarterly or monthly to the saver in the form of a check;

3) have the interest credited to the saver's regular

checking account (in cases 2 and 3, the saver is not receiving the benefit of interest compounding on interest); and

4) have the interest credited to the saver's regular savings account, but the earnings are receiving the lower savings account rate rather than the higher CD rate.

Deposits Insured

If you are concerned about safety, ask if certificates of deposit are insured. The Federal Deposit Insurance Corporation insures deposits in banks, using the Bank Insurance Fund (BIF), and insures deposits in savings and loans, using the Savings Association Insurance Fund (SAIF) for up to $100,000 for each depositor. Similar coverage is provided through the National Credit Union Association for share certificates and through FDIC for brokerage CDs.

Certificate Maturity

Find out the policy of the financial institution when a certificate matures. Is the money rolled over automatically into a new certificate without changing the interest rate? Such action is to the saver's disadvantage if interest rates have increased. Are funds transferred into a lower-paying regular savings account or a checking account if the money is not rolled over? Are the funds renewed at the latest rate? Does the institution provide notification of an upcoming maturity date? Or, is the saver expected to remember it?

Some institutions offer a CD with or without an automatic renewal feature. If the saver does not select the automatic renewal option, the account will not renew at maturity and the deposit will be placed in a non interest-bearing account. Most institutions offer a grace period of seven calendar days after the maturity date for the saver to withdraw the funds without being charged a penalty.

Preferences

Another consideration that may be important to some individuals is whether the financial institution gives preference to savings customers for loan approval.

Other Services

Do the institutions offer other services that may influence the saver's decision to deposit his or her funds with them? Examples of such services could include monthly interest statements, safe deposit boxes, cashiers checks, money orders, coin counting, online banking, wire transfers, fax transmissions, senior citizen discounts, telephone transactions, automated teller machines, open hours that fit the saver's work schedule, "free gifts" (e.g., 4-H calendars), friendly staff or support by the institution for local community projects (e.g., soccer, baseball, hockey clubs). Savers can decide what services are most important to them.

Acknowledgment

This MontGuide has been reviewed by representatives from the Montana Credit Union Network and Montana Bankers Association.

Disclaimer

This publication is designed to provide educational information, not to render legal, accounting or other professional advice. If legal advice or other expert assistance is required, you should seek the services of a competent, professional person.

Related MontGuides available from the MSU Extension Service

Non-Probate Transfers
(MT 199509 HR)

Federal Estate Tax
(MT 199104 HR)

Gifts: A Property Transfer Tool of Estate Planning
(MT 199105 HR)

Custodial Accounts for Kids under Age 21
(MT 199910 HR)

Individual Retirement Accounts
(MT 199807 HR)

Shopping for an IRA
(MT 200207 HR)

Montana First Time Home Buyer Savings Account
(MT 199918 HR)

Montana Medical Care Savings Account
(MT 199817 HR)

Tracking Your Savings Goals
(MT 200303 HR)

Comparison Shopping for a Certificate of Deposit

	Bank	Savings & Loan	Credit Union
1. Minimum Deposit Amount			
2. Length of maturity			
3. Annual percentage yield (APY)			
- Fixed			
-Variable			
4. How often is interest compounded and credited?			
5. Penalty for early withdrawal			
6. Method of interest payment			
7. Deposits insured			
8. Certificate maturity			
9. Preferences for loan approval			
10. Other services (list)			
a)			
b)			
c)			
d)			
e)			
f)			
g)			

Comparison Shopping for a Certificate of Deposit

	Brokerage Firm	Internet Financial Institution	Other
1. Minimum Deposit Amount			
2. Length of maturity			
3. Annual percentage yield (APY)			
- Fixed			
-Variable			
4. How often is interest compounded and credited?			
5. Penalty for early withdrawal			
6. Method of interest payment			
7. Deposits insured			
8. Certificate maturity			
9. Preferences for loan approval			
10. Other services (list)			
a)			
b)			
c)			
d)			
e)			
f)			
g)			

Comparison Shopping for a Certificate of Deposit

Notes about the financial institutions.				
Date	Financial Institution	Phone number	Name of person talked with (if applicable)	Comments

http://www.montana.edu/wwwpb/pubs/mt9801.html

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