How Do CDs Work?

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Certificate of deposit (CD), savings account, money market, high-yield savings, what's the difference? Let's dig in to CDs and just what they are, how they work and whether this is the right savings vehicle for you. Here, we're talking about traditional CDs. There are other types, but here we stick to the traditional.

What Is a Traditional CD?

A traditional CD or certificate of deposit is a type of savings account. They can also be called time deposits, fixed deposits or term deposits.

Unlike a traditional savings account that lets you withdraw money from at any time, a CD has a fixed term and:

- Requires a minimum deposit amount that is higher than a savings account.
- Allows you to withdraw money at the end of the term, or maturity date. Earlier withdrawals can be made only by paying a penalty.
- Don't let you add money after your initial deposit.

In other words, by opening the CD, you agree to leave your one-time deposit in the account for a fixed amount of time. In an emergency, you can withdraw funds early, but you will pay a penalty to do so. In exchange for agreeing to a set term length, you get a fixed interest rate, typically one higher than a traditional savings account. The longer the term length, the higher the interest rate you earn.

Like traditional savings accounts and money market accounts, traditional CDs opened at a bank or credit union are protected by the Federal Deposit Insurance Corporation (FDIC) or National Credit Union Administration (NCUA) for up to $250,000 per person.

Many analysts consider CDs to be one of the safest forms of investment offers. They also pay higher interest rates than money market accounts and savings accounts making a CD a more lucrative low-risk option for investors.

Just How Do CDs Work?

A traditional CD is essentially a time-bound deposit. In exchange for a higher interest rate, you enter into an agreement to let the bank use your money for a fixed period of

The bank rewards you by paying you a higher interest rate than it does for a savings account or money market account. You make a higher annual percentage yield (APR) on the money you deposit in the CD. Some CDs compound interest daily. The bank pays more to you because you're giving them money for a longer period of time. They then can use your money to earn more money. For example by extending other customers long-term like loans.

Some CDs allow you to choose to take the monthly interest earned out. Others require you cash out the CD only at the end of the term length.

When opening a CD, you choose how long you want to give our money to the bank, known as the term length. Common term lengths for traditional CDs include 6, 12, 18, 24 and 30 months and 3, 4, 5 and 6 years. Some banks and credit unions will also offer a custom term length.

Considerations Before You Open a CD

By now, you are probably thinking of opening a CD with the longest term possible. But having a very long-term may not be the best thing to do. For example, you may need your money before the time period is up and if you choose to remove your money before that happens, you can be penalized by the bank or credit union. Some don't allow you to make partial withdrawals and require you withdraw the full account balance. When you do, you can put two or more months of interest.

Bottom line, before you invest in a CD, either make sure you're confident that you won't need the money before the maturity date or that you're comfortable paying a penalty if you need the money earlier. If you're not sure, consider choosing a savings account or money market instead.

When Your CD Matures

When your CD reaches the end of its term, it matures. Toward the end of your term, your bank will inform you about its impending maturity and present you with options, including taking your money and walking away or renewing for another term length. Normally, if you don't withdraw your money, the bank will automatically reinvest your balance into another CD with the same term length as the first.

How to Open a CD

Opening a CD is relatively easy. You can apply online or at your bank or credit union. When researching online options or talking to your bank, ask questions, know your investment rationale and find out about withdrawal penalties and possible alternative products.

CD Options

Longer CD term lengths can be more attractive than shorter term lengths. If you purchase a CD when interest rates are low though, you end up with a lower APR for the rest of your term. A shorter term length may actually allow you to renew for a higher APR.

A CD ladder—or CD laddering—is a common CD tactic used to help maximize returns on CDs. Laddering is using multiple longer-term CDs opened at different times and/or for different term lengths. This disbursement strategy gives you access to money at various times and at various rates. You avoid being locked in to any single term, interest rate or maturation date. And can therefore reap the benefits of a CD without need to risk paying penalties if you need money early.

the total of all CDs is only insured up to $250,000.

Are CDs Safe?

CDs are as just as safe as the money you have in your savings or checking account with the bank, assuming none of those accounts—or the combination of accounts owned by you at the same bank—has more than the insured maximum of $250,000. With FDIC or NCUA insurance, you're guaranteed to get your money back—up to the insured maximum—if your bank or credit union goes under for any reason making.

CDs and Your Credit

A bank or credit union may make a hard pull or a soft pull of your credit when you apply for a CD. Most only do a soft pull, but it won't hurt to ask before you apply if a hard pull is a concern.

CDs in themselves won't help you build your credit history. However, some banks offer a CD secured loan if you open a CD. This is a loan that uses your CD deposit as collateral. If you default on your loan payments, your CD will be taken to pay the loan. Making timely payments on the loan can help you build your credit, if your bank or credit union reports your payments to all three credit bureaus. Not all do, so if you chose this path as a way to build credit, ask your bank or credit union. The CD itself won't impact your credit one way or another.

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