Understanding brokered CDs

E*TRADE from Morgan Stanley 06/12/24

***Summary:** Brokered CDs offer more flexibility to investors who want to add a lower-risk, short-term investment to their portfolio. But it's important to understand the potential risks.*

Investors often use certificates of deposit (CDs) to inject stability to a portfolio during times of market volatility. Fixed-income investors often invest in CDs because compared to many other types of investments, they can offer shorter terms, competitive yields and FDIC insurance.

Brokered CDs vs. Bank CDs

While purchasing a bank CD is the most straightforward way to add CDs to a portfolio, CDs purchased through a broker (brokered CDs) offer more versatility and potentially higher returns—although they also come with additional risks[1]. Brokered CDs are similar to bank CDs in several ways, but they also have some features that resemble more traditional investment products. Here's what you need to know:

What are certificates of deposit?

CDs are "cash equivalent" bank accounts, opened as either an individual or a joint account, in which you deposit a certain amount of money with a bank upfront, and they agree to pay you back at a set annual percentage yield for a set period, no matter what happens to interest rates during that period.

At the end of that term, which can range from one month to several years, you can either cash out the CD or roll it over into a new CD with market terms. If you need to cash out before maturity, you may have to pay an early withdrawal penalty, typically a few months' interest.

What are brokered CDs?

If you have a brokerage account you can also use it to purchase a brokered CD. In that case, you can:

- Choose from newly issued CDs from banks throughout the country and purchase that CD with funds in your brokerage account.
- Also purchase a brokered CD on the secondary market and potentially sell your brokered CDs on the secondary market before they reach maturity.

One other important difference between bank and brokered CDs: Bank CDs pay compound interest and brokered CDs pay simple interest.

Like all financial products, there are pros and cons to brokered CDs.

What are the benefits of brokered CDs?

One of the biggest advantages of brokered CDs is that they may provide more flexibility to investors than bank CDs. Rather than having to choose a CD from the handful offered by your bank, you can select a CD from the many banks, nationwide, that have made their CDs available for purchase through brokerages. That means, you can often find brokered CDs with more competitive rates, different maturities (up to 20 years long), and variable interest rate structures.

Other advantages include:

- *Potential for broader insurance coverage:* FDIC insurance covers up to $250,000 in CDs per depositor at a given bank. However, if you purchase brokered CDs issued by different banks, you are eligible for FDIC insurance up to $250,000 per bank.
  - You must aggregate all deposits that you maintain with the bank by account ownership, including those that you hold at the bank through other intermediaries. There are conditions for obtaining FDIC insurance coverage held through such intermediaries.
- *Liquidity:* Rather than paying early withdrawal fees to cash out a CD before it reaches maturity, brokered CD owners may be able to sell their CD in the secondary market, subject to market conditions.
- *Survivor's options:* Most brokered CDs offer estate protection, meaning that if the CD owner dies, their heirs can redeem the CD at face value, regardless of the current market price.
- *Streamlined management:* If you have multiple brokered CDs through one brokerage account, it's easy to see and track them all at once, without having to log into multiple accounts.

What are the risks of brokered CDs?

Brokered CDs involve more complexity than bank CDs. So before investing in brokered CDs, it's important to understand the risk involved. These include:

Liquidity Risk

While you may be able to sell brokered CDs on the secondary market, there is no guarantee that you will be able to sell brokered CDs prior to maturity. If interest rates have gone up since you bought the CD, you may need to sell at a discount to what you paid, leading to a loss on your investment.

Interest rate risk

The market value of a brokered CD may decrease if prevailing interest rates go up.

Credit risk

There is a possibility that the bank issuing your CD could default.

Call features

Some brokerage CDs are callable, meaning that the bank issuing the brokered CD can buy it back from you before it matures, which may reduce your total return. (Callable brokered CDs typically pay slightly higher rates.)

> "While brokered CDs offer many advantages to investors, they also involve more complexity than bank CDs."

To help mitigate the above risks[1], consider purchasing brokered CDs with a plan to hold them until maturity, and to keep your holdings at any given bank below the $250,000 insurance limit.

With predictable returns, brokered CDs are one way to diversity a portfolio using fixed income, especially in times of market volatility. Whether they make sense as an investment for you will depend on several factors, including the amount you want to invest, your risk tolerance, and your personal financial goals.

*[1]Link to recent SEC Investor Bulletin on brokered CDs, 2024; Link to E*TRADE's CD disclosure statement*

How can E*TRADE from Morgan Stanley help?

Open a Brokered CD

Brokered CDs can help investors find competitive interest rates for their cash that includes FDIC coverage from hundreds of banks all over the country.

Learn more →

Consider a retirement account

Invest in the future, with retirement accounts from E*TRADE.

Learn more about our retirement accounts →

What to read next...

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Because saving and investing are in some ways similar, many of the same ideas apply to both, including the risk of losing money, how easy it is to access your funds, and potential gains. But there are significant differences in exactly how those ideas apply and in how you actually go about saving versus investing. Let's break down the details.

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