CREDIT SPREADS

Understanding Credit Spreads

– By Prof. *Simply* Simple

CREDIT SPREADS

- A credit spread refers to the difference in interest rates between a corporate bond and a comparable Government bond.
- Assume that the interest rate on a five-year corporate bond is 6 per cent and that on a similar five-year Government bond is 5 per cent.
- This means that the interest on a corporate bond consists of a risk-free rate of 5 per cent plus a credit spread of 1 per cent.

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- Different securities in the market have different risk profiles.
- Therefore, compensation is paid to investors proportionately according to the risk taken by the investor in selecting a particular security.

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- There will be a spread between two different kinds of papers due to the following reason:
  - Credit quality – Lending money to the Govt. is any day safer than lending money to a corporate because the Govt. will never default. Hence, one is willing to park one's money at a lower yield.

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To sum up…

- **The difference in yields between two different kinds of debt papers in the market is known as credit spread.**
- **For example, if the Govt. security is giving an yield of 5% while a corporate paper is giving an yield of 8%, the difference between them is 3% - which is the credit spread.**
- **However, the spread between a Govt. and good quality corporate papers is usually around 1.5%.**

COMMERCIAL PAPER

Hope you have now understood the concept of Credit Spreads

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