ANOTHER RISK MEASUREMENT TOOL – THE TED SPREAD

Over the past few years we have continually researched risk measurement tools and brought the more interesting ones to our readers. The latest tool we have added to our tool box is the TED Spread. The TED Spread is the difference between the interest rates on interbank loans and short-term U.S. Government debt (“T-bills”). TED is an acronym formed from T-Bill and ED, the ticker symbol for the Eurodollar futures contract.

Initially, the TED Spread was the difference between the interest rates for three-month U.S. Treasuries contracts and the three-month Eurodollars contract as represented by the London Interbank Offered Rate (LIBOR). However, since the Chicago Mercantile Exchange dropped T-bill futures, the TED Spread is now calculated as the difference between the three-month T-bill interest rate and three-month LIBOR.

The size of the spread is usually denominated in basis points (bps). For example, if the T-bill rate is 5.10% and the ED trades at 5.50%, the TED Spread is 40 bps. A rising TED Spread often presages a downturn in the U.S. Stock Market, as it indicates that liquidity is being withdrawn.

The TED Spread is an indicator of perceived credit risk in the general economy.¹ This is because T-bills are considered risk-free while LIBOR reflects the credit risk of lending to commercial banks. When the TED Spread increases, that is a sign that lenders believe the risk of default on interbank loans (also known as counterparty risk) is increasing. Interbank lenders therefore demand a higher rate of interest, or accept lower returns on safe investments such as T-bills. When the risk of bank defaults is considered to be decreasing, the TED Spread decreases.²

The long term average of the TED Spread since the mid-1990’s through March 31, 2011 (see the accompanying chart) has been approximately 60 basis points.

During 2007, the subprime mortgage crisis ballooned the TED Spread expanded to of 150-200 bps. On September 17, 2008, the TED spread exceeded 300 bps, breaking the previous record set after the Black Monday crash of 1987.³ Some higher readings for the spread were due to inability to obtain accurate LIBOR rates in the absence of a liquid unsecured lending market.⁴ On October 10, 2008, the TED Spread reached another new high of 465 basis points. The lowest mark occurred in 2001 – 6.75 basis points.

Source: Parts of this article were excerpted from the article entitled “TED Spread” originally written for wikipedia.org.

¹ Bloomberg.com Financial Glossary
⁴ Bloomberg - Libor Jumps as Banks Seek Cash to Shore Up Finances