



DEBT MARKET

Credit risk and spreads

What a rating tells you, why company bonds yield more than government bonds, and what a downgrade does

Bond yields as on 1 September 2026; fund assets as on 31 August 2026

For training and education only. Not investment advice.

Credit risk is the chance that a borrower pays late, pays less, or does not pay at all.

Lenders want to be paid for carrying that chance. The extra yield they ask for, over a government bond of the same maturity, is called the credit spread.

The rating scale, from AAA to D

A credit rating is a rating agency's opinion on how likely a borrower is to pay interest and principal on time.

Long-term rating	Risk level in SEBI's mapping	Where it sits
AAA	Lowest credit risk	Investment grade. An opinion, not a guarantee.
AA+, AA, AA-	Very low credit risk	Investment grade. '+' and '-' rank within a band.
A+, A, A-	Low credit risk	Investment grade.
BBB+, BBB, BBB-	Moderate credit risk	Investment grade. BBB- is the lowest.
BB+ and below, down to D	BB: moderate risk of default. B, C and D: high to very high risk of default.	Below investment grade. D: in default, or expected to be soon.

Sources: SEBI circular of 7 Oct 2026 (Credit Risk-o-Meter, for listed bonds, not MF schemes); SEBI Master Circular, 20 Mar 2026; a rating agency's scale (for D).

A spread, and what happens when it widens

THE SET-UP

Two bonds, each with ₹1,000 face value and three years left.

A government bond yields 7.00%.

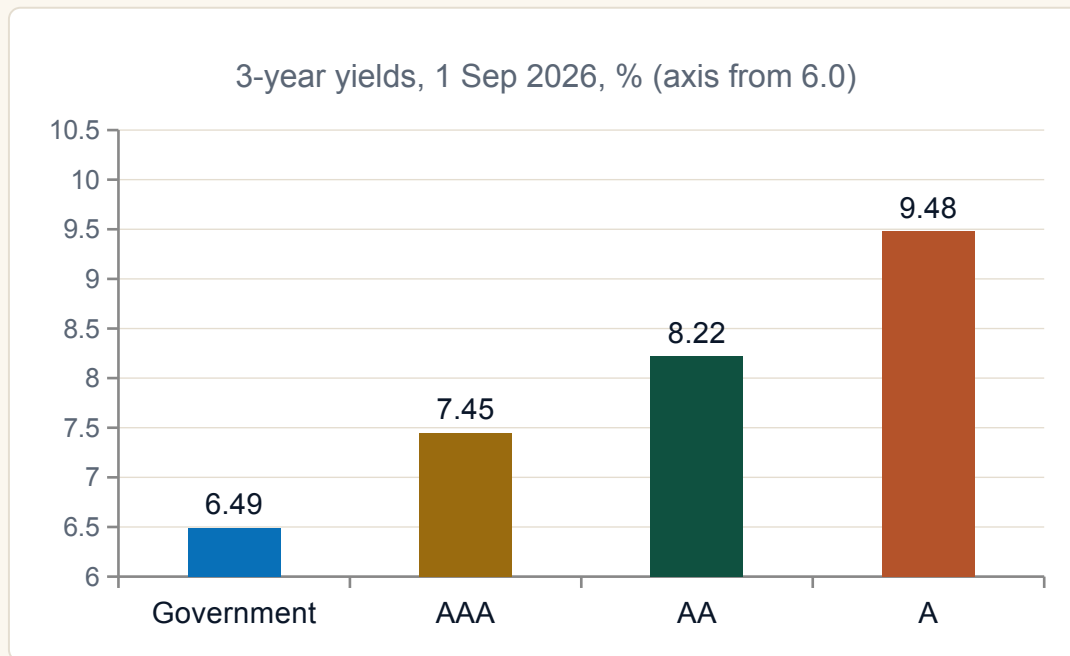
A company bond pays an 8.5% coupon once a year and trades at ₹1,000, so it yields 8.50%.

- 1 Credit spread = $8.50\% - 7.00\% = 1.50$ percentage points. Markets call this 150 basis points (1 basis point = 0.01 percentage point).
- 2 Bad news about the company arrives. Buyers now want 9.50% from it. The government bond still yields 7.00%.
- 3 New price of the company bond: $₹85 \div 1.095 + ₹85 \div 1.095^2 + ₹1,085 \div 1.095^3 = ₹974.91$.
- 4 The spread is now 250 basis points. The bond is worth ₹25.09 less, a fall of 2.51%, and no payment has been missed.

A wider spread means a lower price, even while the borrower is still paying on time.

Illustration with assumed figures. Not a forecast.

What lenders ask for, rating by rating



Read the chart

- Spread over the 3-year government bond: AAA 96 basis points, AA 173, A 299.
- 100 basis points make 1 percentage point.
- The steps down the scale are not equal: government to AAA 96 basis points, AAA to AA 77, AA to A 126.
- Spreads move every day. A year earlier the 3-year AA spread was 139 basis points.

Source: indicative corporate and government bond yields for 1 Sep 2026, from a fund-house fixed-income tracker dated 2 Sep 2026 (secondary source).

Why spreads widen

1

Trouble at the borrower

Weak results, a missed payment or a rating downgrade makes buyers ask for more yield from that borrower.

2

Trouble in its sector

When one borrower in a sector fails, lenders often become wary of similar borrowers, including sound ones.

3

A weaker economy

When growth slows, more borrowers are expected to struggle, so spreads tend to widen across ratings.

4

Cash becomes scarce

When money is tight or funds face redemptions, lower-rated bonds are hard to sell and buyers want a bigger discount.

5

A move to gilts

In a scare, investors move towards government bonds. Government yields can fall while company bond yields rise.

When a bond in a debt fund is downgraded

A debt fund values nearly all its bonds at market-based prices daily, so NAV carries a credit event at once.

- 1 The bond is marked down** Its valuation must reflect the credit event. NAV falls that day, in line with how much of the bond the fund holds.
- 2 A side pocket may be created** If the bond falls below investment grade, the AMC may move it to a segregated portfolio. Trustees must approve.
- 3 Holders get matching units** Each investor on the day of the event gets as many units in the segregated portfolio as in the main one.
- 4 The main fund carries on** Buying and redeeming continue in the main portfolio. Side-pocket units cannot be redeemed; they are listed instead.
- 5 Recoveries go to holders** Recovered money is paid out in proportion to units held. No investment and advisory fee is charged on that portfolio.

Source: SEBI Master Circular for Mutual Funds, 20 March 2026, paragraph 5.5 (creation of segregated portfolio in mutual fund schemes).

Credit stress, and the rules that followed

When	What happened	What followed
2018	A large infrastructure finance group, IL&FS, defaulted on its borrowings. On 1 October 2018 the Government moved the NCLT, which replaced its board.	SEBI permitted segregated portfolios in debt schemes on 28 December 2018.
2019	RBI superseded the board of a housing finance company, DHFL, on 20 November 2019, citing governance concerns and payment defaults.	RBI appointed an administrator for the company.
April 2020	In the Covid-19 shock some debt schemes were closed. RBI said the stress was confined to the high-risk debt fund segment.	RBI opened a ₹50,000 crore special liquidity facility for mutual funds on 27 April 2020.
June 2021	SEBI issued its Potential Risk Class matrix circular on 7 June 2021.	From 1 December 2021 each debt scheme states the most interest-rate and credit risk it may take.

Sources: IL&FS 'Significant developments' page; RBI press releases of 20 Nov 2019 and 27 Apr 2020; SEBI circulars of 28 Dec 2018 and 7 Jun 2021 (effective date per a press report of June 2021).

The Potential Risk Class matrix

Each debt scheme picks one of nine cells. The cell is the most risk it may take, not what it holds now.

Rate risk limit ↓ Credit risk limit →	Class A: relatively low (CRV 12 or more)	Class B: moderate (CRV 10 or more)	Class C: relatively high (CRV below 10)
Class I: relatively low (Macaulay duration up to 1 year)	A-I	B-I	C-I
Class II: moderate (Macaulay duration up to 3 years)	A-II	B-II	C-II
Class III: relatively high (any Macaulay duration)	A-III	B-III	C-III

CRV is the credit risk value, a weighted average: government securities 13, AAA 12, AA+ 11, AA 10, AA- 9 and so on. Source: SEBI Master Circular for Mutual Funds, 20 Mar 2026, para 6.18.

Credit risk funds: the rule and the size

Credit Risk Fund is one of SEBI's 17 debt scheme categories. It is a small part of debt fund assets.

MINIMUM IN AA AND BELOW

65%

Of total assets, in corporate bonds rated AA and below. AA+ bonds do not count.

CREDIT RISK FUND ASSETS

₹21,998 cr

Net assets of all credit risk funds on 31 August 2026.

SHARE OF DEBT FUND ASSETS

1.1%

Of ₹19,33,476 crore in debt-oriented schemes on 31 August 2026.

Sources: SEBI Master Circular for Mutual Funds, 20 Mar 2026, para 3.8.2 (category definition); AMFI Monthly Note, August 2026 (assets). Share computed: $21,998 \div 19,33,476$.

Four things people get wrong



'AAA means it cannot default.'

AAA means the lowest credit risk on the scale, not zero. A rating is an opinion, and it can be cut later.



'A higher YTM means a higher return.'

YTM assumes every payment arrives on time. A higher YTM usually means lower-rated or longer bonds in the portfolio.



'A side pocket means the money is gone.'

It only separates the troubled bond. Recoveries go to whoever holds the side-pocket units, issued on the day of the event.



'Only credit risk funds carry credit risk.'

Any debt fund that holds company bonds carries some. The Potential Risk Class shows the most a scheme may take.

Check yourself

Q1

A 5-year government bond yields 7.10%. A 5-year company bond yields 8.60%. What is the credit spread in basis points?

Q2

A debt scheme is placed in cell B-II of the Potential Risk Class matrix. What is the most risk it may take?

Q3

A bond in a fund falls below investment grade and the AMC creates a segregated portfolio. What does an investor who held units that day now hold?

Sources and disclaimer

SOURCES FOR THE FIGURES IN THIS DECK

- Rating-to-risk mapping: SEBI circular, 7 Oct 2026, Credit Risk-o-Meter for listed bonds (not MF schemes).
- Segregated portfolios (para 5.5), Potential Risk Class (para 6.18), debt categories (para 3.8.2): SEBI Master Circular for Mutual Funds, 20 March 2026.
- 3-year yields, 1 Sep 2026: indicative corporate and government bond yields from a fund-house fixed-income tracker dated 2 Sep 2026 (secondary source).
- Fund assets on 31 August 2026: AMFI Monthly Note, August 2026.
- 2018 to 2021: IL&FS 'Significant developments' page; RBI press releases, 20 Nov 2019 and 27 Apr 2020; SEBI circulars, 28 Dec 2018 and 7 Jun 2021; a press report of June 2021 (1 Dec 2021 date).
- The worked example and the 4% holding in the notes use assumed figures, not quotes for any actual bond or scheme.

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