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Why are T-Bills used when determining risk-free rates?

By [INVESTOPEDIA](#) | Updated Nov 7, 2018

The [risk-free rate](#) is the [rate of return](#) of an investment with no risk of loss. Most often, either the current [Treasury bill](#), or T-bill, rate or long-term government bond yield are used as the risk-free rate. T-bills are considered nearly free of default risk because they are fully backed by the U.S. government.

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The [market risk premium](#) is the difference between the [expected return](#) on a portfolio minus the risk-free rate. The market risk premium is a component of the [capital asset pricing model](#), or CAPM, which describes the relationship between risk and return. The risk-free rate is further important in the pricing of bonds, as bond prices are often quoted as the difference between the bond's rate and the risk-free rate.

Treasury Bills

The risk-free rate is hypothetical, as every investment has some type of risk associated with it. However, T-bills are the closest investment possible to being risk-free for a couple of reasons. The U.S. government has never [defaulted](#) on its debt obligations, even in times of severe economic stress. T-bills are short-term securities that mature in one year or less, usually issued in denominations of \$1,000. T-bills are auctioned at or below their [par value](#), and investors are paid the par value of the security upon [maturity](#).

Since T-bills are paid at their par value and do not have interest rate payments, there is no [interest rate risk](#). Anyone is free to buy T-bills at weekly Treasury auctions. They are a very simple instrument for investors to understand. T-bills are issued by the government to [fund the national debt](#). Yields on long-term government bonds are sometimes used as the risk-free rate depending on the investment being analyzed.

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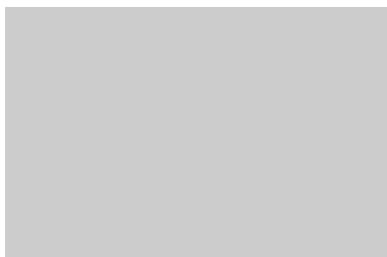




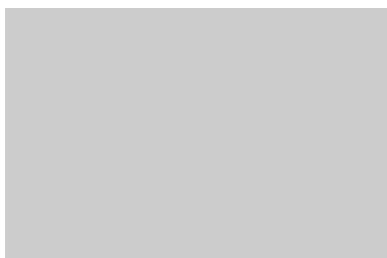
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