

The Influence of the Development of Reference Interest Rates in Choosing Financial Tools for Corporations – Case of the Czech Republic

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Abstract

This paper focuses on the evolution of corporate debt financing in the Czech Republic. Investment-grade companies have become more reliant on direct financing and less reliant on intermediated financing. This is due both to reluctance by banks to extend credit facilities to high-grade corporates as they search for more lucrative returns on capital, and by the growth in the supply of capital by institutional and other non-bank investors. This growth in direct financing has been predominately in the form of unsecured and unregistered commercial paper issues. The relatively high volatility of Czech reference interest rates in the late 1990's influenced the development of company debt financing, forcing companies to become more sophisticated and dynamic in their use of debt instruments and hedging tools as they attempt to manage the subsequent interest rate risk.

Key words

Commercial papers, reference interest rates, interest rates hedging tools, transaction-driven banking.

1 Introduction

Over the past two and half decades, institutional investors in financial markets worldwide have begun to fill the role commercial banks have been gradually vacating. Costly mandatory reserve requirements and regulatory impositions have consigned bank credit to blue-chip companies to a decidedly uncompetitive position. Banks' added value remains in the case of credit facilities to low-visibility, privately-held or unseasoned corporates containing a high level of non-market, idiosyncratic risk, which the bank may be more adept at evaluating than institutional investors.

Although few relationship bankers would readily admit it, relationship banking is, little by little, giving way to transaction-driven banking, where transactions are approved on a case-by-case basis according to clear and unequivocal risk-return, ROE/ROA criteria. Faced by the continuing threats of disgruntled shareholders and hostile takeovers, banks have been making a concerted effort to curtail loan outstandings, particularly in the area of tightly-priced credit facilities for investment-grade clients with few prospects for auxiliary business. Banks are also more inclined to invoke 'material adverse change' or other escape clauses in order to extricate themselves from unprofitable credit commitments.

The excess capital released from liquidated bank assets is often distributed to shareholders as dividends or stock repurchase proceeds. For example, in 1997 Barclays

Bank repurchased 10 per cent of its outstanding equity. However, banks may continue to leverage their client relationships, acting in the capacity of facility arrangers, intermediaries

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and advisors, especially in the area of structured transactions. All these developments have prompted banks to devise financing structures that reflect where real liquidity resides today: with institutional and other non-bank investors.

Whether through securitization, asset decomposition, credit derivatives, collateralized loan obligations (CLOs) or secondary loan sales, debt assets (funding and/or risk) are being offloaded by banks onto investment funds, insurance companies, pension funds and hedge/crossover funds as part of increasingly sophisticated transactions.

2 The rush to financial markets

Lately, the debtors themselves have been spearheading the rush to financial markets. As international banks scramble to cancel unused credit lines and raise rates and margins, premium-risk companies are bracing themselves for what the future holds. In lieu of bank credit, they are increasingly turning to fixed-income securities markets to meet such mundane requirements as working capital funding. A favourite instrument for raising short-term funds is the commercial paper (CP) programme.

In the Czech Republic, these global trends have been making themselves dramatically felt since the mid-1990s. As companies, banks and investors grew more sophisticated, experienced and transaction-driven, the cooperation of institutional and corporate investors was enlisted in order to secure financing for major corporate clients in increasing volumes across a range of maturities. In 1992, the banking community started introducing CP programmes based mostly on promissory notes to accommodate the working capital demands of some of their high-profile clients.

Because of the special status of promissory notes under Czech law in terms of legal protection in the event of default, this instrument is frequently applied as security in a wide variety of trade and financial transactions. Promissory notes are certificated, unlisted debt securities in bearer form. While prom notes remain beyond the reach of many regulated institutions (insurance companies, investment and pension funds are prohibited by law from committing their cash reserves to unlisted securities), their redeeming features include cost-effectiveness (no registration fees), flexibility, investor familiarity and absence of a Security Exchange (SEC) approval procedure. In comparison, CP programmes based on short-term bonds are more cumbersome due to a complicated, time-consuming and costly registration procedure.

While some domestic banks previously showed a tendency to warehouse most of the notes, downplaying the distribution aspect while seeking to appease the issuer, subsidiaries of international banks took a different approach. Instead of buying the notes for their own portfolios, these banks devoted time and effort to building distribution channels and gaining access to domestic and foreign investors, or in some cases utilizing existing placement capabilities of their parent. Reportedly, many of the notes issued under programmes arranged by foreign bank branches eventually wound up in the possession of international investors in various offshore vehicles.

3 Legislation framework

The legal norms of this case are established in the Bonds Act, number 530/1990 Coll., and the Promissory Notes and Cheques Act, number 191/1950 Coll.

The issue of commercial papers can take place in two ways:

Short-term bonds issues programs, in accordance with the Bonds Act, where the issuer can ask the SEC to approve the terms of issue, which should be the same for the previously undetermined number of bonds to be issued. In his request, the issuer is required to set the

maturity of the bond program and the highest volume of outstanding bonds delivered within the framework of the program.

In the event that the issuer wishes to deliver the securities in accordance with the Bond Act, he must, with respect to §2, request that the SEC approve the issue terms of the bonds, bond prospects, and bond marking with an International Securities Identification Number (ISIN). In approving the bond program, the SEC commits to impose a plenty of fees on the issuer, and undertake a relatively long term approval process – the Bond Act requires the SEC to issue a decision of the terms of issue and prospectus within two months of the application.

Unsecured short-term promissory notes issue program, in accordance with the Promissory Notes and Checks Act. The program is not subject to the regulatory and fee imposing control of the SEC.

Just as with the issue of Euro commercial papers, Czech issues of so called dealer's commercial papers, in accordance with the Promissory Notes and Checks Act, are required to:

- sign a mandate letter with the dealer-bank for the provision of legal and economic inspection (so called due diligence) of the issuer, as well as a dealers contract and paying agency contract;
- prepare and publicise an information memorandum for the investors with the dealer-bank.

This process is much less time and money consuming than the short-term bond programs. In the Czech Republic, a dealers contract is signed, as is an paying agency contract and information memoranda agreement normally within 3-4 weeks of the signing of the mandate letter. Under Czech conditions, almost all commercial paper issues have so far been carried out as promissory notes in accordance with the Promissory Notes and Checks Act. The main reason for the effort is to avoid the relatively expensive and complicated approval process set up by the SEC.

This parallels the trends seen in the 1990's in the largest commercial papers market in the world, the United States of America. Over the past few years, the majority of programs were not registered with the Securities and Exchange Commission. It addressed three categories of commercial papers. Section 3 (A) (2) Paper, Section 3 (A) (3) Paper, a Section 4 (2) Paper. These issue programs must be secured with back-up credit facilities, or bank guarantees. In addition, the market is used to having issuers of such non-registered commercial papers on the American market rated by one of the two biggest rating agencies (S&P, Moody's).

Investment ratings are not so strictly required in Czech companies. Among the most notable past issuers on the Czech market have been companies from the utility and telecommunications sectors, led by CEZ, a.s. (Czech Power Plants), Severomoravská energetika, a.s. and Dalkia Morava, a.s. as well as companies with strong foreign owners, including Unilever and Coca-cola. At the same time, there are only a few dealers for such programs coming from the ranks of important banks operating in the Czech Republic. Almost all issues have been made by CSOB, a.s., the Prague branch of ING Barings, Credit Lyonnais Bank Praha, and Komercní banka.

It must also be noted that, although it is not a condition here as it is with non-registered American and Euro commercial papers, issues in the Czech Republic are made with back-up credits equal to the amount of the bond issue. These credit facilities serve to ensure short-term liquidity, and for refinancing the issued papers. This sends a strong signal to the investment community that the issuer will not have a problem paying the nominal value of the bill at maturity.

In concluding this section, we can see that the original intent of the lawmakers for issuing commercial papers according to the Bond Act has come to naught. The main reason is the time and expense incurred during the approval process. On the other hand, the market itself limits the issue of commercial papers according to the Promissory Notes and Checks Act,

with the strict requirement for the issuer to have a top credit rating. It has to be said that, even when we are talking about unsecured commercial papers, issuers are limited to top companies, better yet, those with quality foreign owners. On top of that, most commercial paper issues are carried out through back up credit facilities provided by the best banks on the Czech market.

4 Influence of the reference interest rates evolution on corporate sector

Unlike the relatively stable rates of Eurozone markets, the Czech Republic has in recent years experienced a precipitous decline in the inter-bank rate PRIBOR. During the period of relatively high interest rates (1997 and 1998), Czech companies scrambled to find alternative sources of financing to be able to avoid expensive short- and long-term bank loans. The range of alternatives included CP programs for short-term and bonds for long-term financing.

As Figure 1 illustrates, the reference interest rate in the Czech Republic declined sharply since 1997. As a result, Czech corporations were forced to operate in a relatively unstable interest rate environment until 2000, in comparison with their Eurozone counterparts. The average 3-month Dutch AIBOR (since 1999 the EURIBOR, as a result of the introduction of the Euro currency) is presented for comparison.

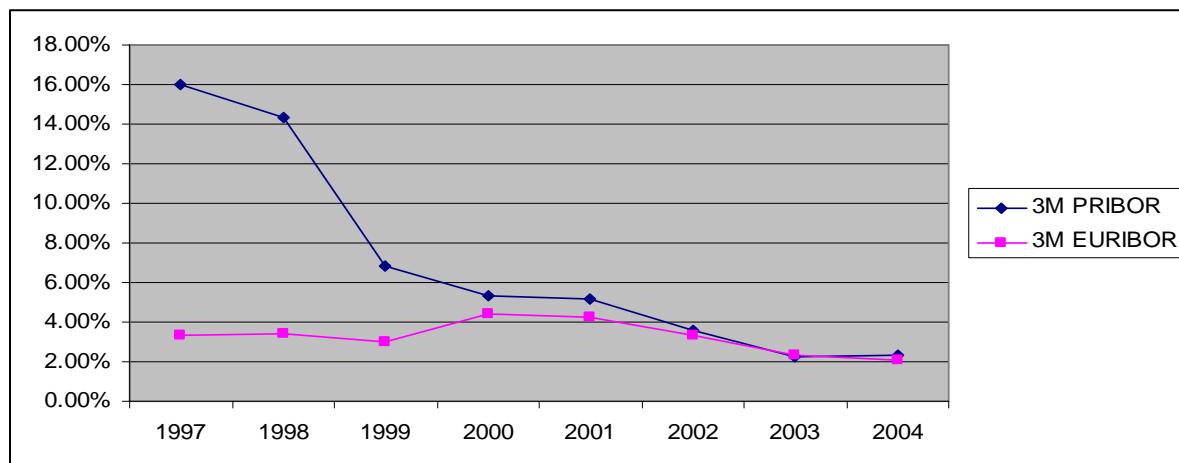


Fig. 1. Comparison of the development of the 3M reference interest rates for Czech and Dutch (i.e. since 1999 Euro) markets, yearly averages in % p.a.

Source: Czech Central Bank, De Nederlandsche Bank N.V.

The unstable interest rate environment at the end of the 90's forced Czech businesses to choose differing strategies during periods of high and low interest rates, and even expand the tools used to eliminate risk caused by such interest rate variation. During periods of relatively high reference rates (particularly 1997 and 1998, and in terms of EURIBOR rates, even 1999 and 2000), businesses seeking financial resources looked for alternatives to short and long-term credits. In the Czech Republic, such alternatives include most notably, commercial papers issues for short and mid-term financing. For long term financing, there are alternatives to loans, namely the issue of corporate bonds. As Tables 1 and 2 show, corporate bond issues are not very wide spread, despite the inverted profile of IRS yield curve (in the years 1997-1998) for attracting fixed coupons under the appropriate PRIBOR rate. The reasons behind this include a lack of confidence from the side of investors, and at the same time, a lack of willingness from the issuers to go into long-term commitments in an environment of high and volatile interest rates.

Table 1 Advancement in volume of loans provided to the clients of Czech based banks, in billions of CZK, as at the end of respective year

	1997	1998	1999	2000	2001	2002
Loans	1 149,6	1 135,4	1 085,7	952,4	974,5	949,8
from that loans provided to corporations in bln. of CZK	986,4	917,4	851,2	720,0	631,5	555,6
in %	85,8%	80,8%	78,4%	75,6%	64,8%	58,5%
from that long term loans provided to corporations in bln. of CZK	327,5	335,8	336,2	316,8	289,2	236,1

Source: Czech Central Bank.

Table 2 Advancement in volume of corporate bonds (in nominal value) registered at the Prague Stock Exchange, in billions of CZK, as at the end of respective year

	1997	1998	1999	2000	2001	2002
Corporate bonds in NV	8,65	17,95	40,00	53,01	53,04	57,04

Source: Reuters, ABN Amro Bank N.V.

In terms of commercial papers issues, there are no central statistics. This is because such securities issues needn't be approved by the SEC. Besides this, in the Czech Republic, this program is only for debtors who belong to companies with prime credit risk ratings (particularly companies in the utility sector, or with strong foreign owners).

4.1 The marked ambivalence of interest rates on the Czech market since 1997 has led companies to behave more cautiously and use hedging tools

Table 3 Advancement in volume of main interest rate hedging tools used by clients of Czech banking sector in the years 2000-2003, in billions of CZK

	31.12.2000	31.12.2001	31.12.2002	31.3.2003
Forward rate agreement	487,3	925,7	973,0	1012,6
Interest rate swap	398,6	760,7	1020,6	1067,9
Interest rate futures	4,1	0	0	0
Total of IR hedging tools	890,0	1686,4	1993,6	2080,5

Source: Czech Central Bank.

Table 4 Advancement in volume of main interest rate hedging tools used by clients of Czech banking sector in the years 1997-1999, in billions of CZK – rounded estimation from CNB graphs

	as of 31.12.1997	31.12.1998	31.12.1999
Forward rate agreement	132	337	423
Interest rate swap	180	220	294
Interest rate futures	31	26	4
Total of IR hedging tools	343	583	721

Source: Czech Central Bank.

As Tables 3 and 4 show, a marked yearly increase in interest rate hedging tools for bank clients in the Czech Republic is evident for the years 1997-2002. During the periods of high PRIBOR a PRIBID reference rates in 1997 and 1998, businesses tried first and foremost to take advantage of the negative inclination of FRA and IRS rates of return (which means that long term annual interest rates were lower than short term rates). This effort is especially clear in the issue of corporate bonds in 1997 and 1998. Bond issues in 1997 had fixed interest rates, which means that on the day of issue, an interest rate swap was placed on the entire amount of the issue, where the original floating PRIBOR + margin p.a. was exchanged for a fixed rate. In 1998, just two companies in the utility sector chose different paths. On March 5th, 1998, Severomoravská energetika, a.s. (SME) issued 1 billion CZK in bonds at a floating 6M PRIBOR + 0,40% p.a. In June of the same year, and under the same conditions, Jihomoravská

plynarenska, a.s. (JMP) issued 700 million CZK in bonds. Both of these companies bet on the future decline in the PRIBOR rate, and they were proven right. However, at the time of their issue, they were going against market forecasts. Nonetheless, SME ensured itself against a potential rise in the 6M PRIBOR purchase cap with a strike price of 11,60% p.a. All in all, five caps were purchased on semi-annual coupons, however with premium payment requirements. Of these caps, only one was called, the very first coupon in September 1998, when the 6M PRIBOR was at 14.51% p.a., and the company actually paid 11.60% p.a.

The period since 1999 is characterised by the sharp continual decline of the PRIBOR rate, and in comparison with the previous two years, the positive slope the IRS curve (which indicates that annual interest rates for the longer term were higher than for the short term) and a noticeable growth in the issue of corporate bonds. But even at this time, there were companies that hedged against interest rates by issuing IRS bonds. The above-mentioned SME conformed to this trend, by exchanging its original floating interest rates from its 1998 issue for a fixed interest rate swap in 2001. In addition to that, Belgian owned company Glaverbel issued 3 billion CZK in bonds in 2000, and Skoda auto in the same year issued 50% of its 10 billion CZK with floating coupons. After 1999, corporations feared again that floating coupons would suffer from return of rising interest rates in the near future. This forecast did not come true; interest rates continued their falling trend.

4.2 In periods of lower, especially short term, interest rates (the significant decrease in rates in the period from 1997 to today), corporate investors were forced to look for more sophisticated ways to use their available monetary funds

From the evaluation of the state of available funds on the Czech financial markets shown in Table 5, it can be seen that in 1997 and 1998, bank deposits formed a relatively high share of investment instruments on the financial markets. In 1997 in particular, simple and very short (from overnight to 2 weeks) deposit instruments were commonly used. This was a result of their high rate of interest during the currency crisis in the Czech Republic in May and June, 1997. In 1998, a new VAT Act was passed, and regulations concerning short term bonds were loosened, especially those concerning bank deposit promissory notes, which were first offered that same year. This became evident in the decrease of the absolute value of business deposits in banks, and a more than 40% year on year increase in deposit promissory notes.

Table 5 Advancement in Czech money market investment tools amounts, in billions of CZK, as at the end of respective year

	1997	1998	1999	2000	2001	2002
Bank's deposits	1112,5	1205,3	1314,6	1408,1	1474,8	1627,9
- from that corporations	482,9	327,8	304,8	342,2	426,2	493,3
Participation certificates	11,5	16,8	53,05	76,1	84,2	99,9
CDs	1,4	2,0	3,2	2,2	0,1	0,1
Bank's P/N	80,0	115,0	130,0	159,3	127,8	92,2
T - bills	130,0	215,0	282,0	332,0	418,0	340,0

Source: Czech Central Bank, Czech Ministry of Finance.

In January 1999, a new Income Tax Act was passed that addressed the issue of taxing income from bonds. This led to an increase in investments in bank deposits as well as participation certificates of open end unit trusts. This was especially thanks to the favourable 15% withholding tax. A sharp growing trend could be seen in open end unit trusts, which by the end of 2002 had brought in 99.9 billion CZK. At the same time, the Czech Central Bank (CNB) estimates that Czech residents invested another 30 billion CZK into foreign open end unit trusts. In 1999, the CNB concluded a process of gradually lowering the mandatory minimal reserve rate to 2%, which conforms to the rate established by the European Central Bank for banks operating within the Eurozone. In addition to this, beginning on July 12th,

2001, reserves on clearing account with CNB were interest-bearing by a two-week repo rate. For this reason, mandatory minimal reserves no longer have an influence on the level of the gross interest yield of term deposits and current accounts. Since 2001, we can see an increase in bank deposits over all, including corporations deposits.

A host of T-bills are here only to supplement investment opportunities on the financial markets, a predominant part of which was held by the banking sector. From the tables above, it is clear that periods of lower reference interest rates are accompanied by a rise in the volume of more sophisticated instruments. Since 1998 it was predominantly because of higher yield from bank deposit promissory notes, and from 1999 as well as a result of changes to the tax code. With almost equal yields from these notes and term deposits in 2001, there was a shift towards participation certificates of open-end unit trusts, with similar favourable yield taxation applied, but with even higher yields attained.

5 Conclusion

Evolution in Czech corporate debt financing been driven by changes in the requirements of suppliers of capital, with institutional and other non-bank investors replacing traditional banks. Investors have become increasingly sophisticated, favoring less regulated instruments. Increased volatility in the reference interest rate has also influenced capital raising decisions, and increased the use of hedging instruments to manage the resulting interest rate risk.

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Summary

Vliv vývoje referenčních úrokových sazeb na výběr finančních nástrojů podnikem – případ České republiky

Příspěvek se zabývá vývojem dluhového financování v podnikové sféře České republiky. Nejbonitnější podniky se staly více odkázanými na přímé financování a současně méně závislými na zprostředkování financování. Důvodem byla jednak neochota bank rozšiřovat úvěrové linky pro podnikovou sféru v situaci, kdy tato bankovní sféra hledá výnosnější zhodnocení svých volných finančních prostředků, jednak na druhé straně i růst nabídky kapitálu ze strany institucionálních a dalších nebankovních investorů. Tento růst objemu přímého financování se v České republice především projevil ve formě nárůstu objemu emisí komerčních papírů v případě krátkodobého dluhového financování. Relativně vysoká volatilita CZK referenčních úrokových sazeb ve druhé polovině 90. let 20. století ovlivnila změny v dluhovém financování podniku a donutila tyto podniky využívat sofistikovanější dluhové nástroje, jakož i nástroje zajištění úrokového rizika.