

# CZECHING OUT TREASURY

WITH JUST ONE YEAR UNTIL IT JOINS THE EU, **PETR POLAK** AND **KAMIL KOCUREK** FOCUS ON THE KEY ISSUES FACING TREASURERS OF COMPANIES BASED IN THE CZECH REPUBLIC.

**T**reasury is still in its infancy in the Czech Republic. It was not until the country's currency crisis in 1997, which crippled a number of major companies, that the treasury function really took off in finance management, dealing particularly with foreign exchange and interest rate hedging. Seven years later, a number of treasury departments have been set up and treasury professionals have become more active in the financial management of companies. Here, we explore the various areas in which developments have been the most prolific.

**INTERMEDIARIES IN THE CZECH REPUBLIC.** The financial sector in the Czech Republic – as it applies to banking structure and non-bank financial intermediaries – is, by volume of its total assets, the most developed within the Central and Eastern European (CEE) candidate countries, and is continuing to develop rapidly.

The banking sector controls about 80% of the financial sector's assets. At the end of 2002, its assets, as a proportion of gross domestic product (GDP), stood at 109% in the Czech Republic, as opposed to 61% in Poland, 70% in Hungary and 95% in Slovakia.

Non-bank financial intermediaries in the Czech Republic have started to play a more important role in the financial sector since the second half of the 1990s. At present, life insurers and pension funds together control about 10% of the assets in the financial sector and insurance companies, in particular, are among the key institutional investors in the Czech Republic. Česká pojistovna, the oldest and largest insurance company in the country, for example, is one of the biggest local institutional investors in government and corporate bonds.

Their progress is also aided by the Insurance Act of 1999, which allows insurance companies registered in the Czech Republic to invest in foreign securities, as well as domestic securities, registered at the public capital market in any member country of the European Union and OECD.

**FOREIGN EXCHANGE AND INTEREST RATE HEDGING.** Banks have been at the forefront of treasury developments in the region, offering their corporate clients a whole range of treasury products, including options. They also play a big role in keeping clients up to date about currency and interest rate risks.

Since the Czech economy depends heavily on foreign trade (exports in 2002 were 55% of GDP, with almost 60% of this to the euro zone), mostly with the euro zone countries, exporters in particular have had to adjust their approach towards hedging instruments because of the

reinforced Czech koruna. The most frequently used product in foreign exchange (FX) assurance is the currency forward option, which, thanks to its low interest rates differential, offers the ability to hedge export or import FX needs.

The market in currency options in koruna has developed over the past five to six years. At first, the main trading was in plain vanilla options, but gradually the offer was extended to include barrier and exotic options.

*Figure 2* shows how the main CEE currencies have developed against the euro. The biggest strengthening over the period 1999-2002 has been achieved by the koruna, at 19.7%, with the other CEE currencies showing the same trend, if not to the same degree.

To hedge interest rate risk operations, companies tend to use forward rate agreements (FRA) and interest rate swaps (IRS), in addition to instruments based on interest rate facilities, such as cap and floor options. The high volatility of reference interest rates has influenced enormous progress in using such tools since 1997.

**INTEREST RATE RISK MANAGEMENT IN PRACTICE.** The development in interest rate risk management practices in the Czech Republic is best shown by the approach taken by Severomoravska energetika (SME), the largest electricity distributor in the Czech Republic.

In March 1998, SME decided to issue CZK1bn worth of bonds. The interest rate was based on the float rate – six-month Prague Interbank Offered Rate (Pribor) plus a margin of 0.40% per annum. The deal was the first corporate issue with a float coupon rate. However, there was the risk that the interest rate could rise significantly – in May/June 1997, interest rates had been rising (up to 30% for very short-term rates, ie those up to two weeks) and the level at the time of the issue was at about 15%. SME covered the opened position by taking the derivative route, buying an interest rate 'cap', structured as follows:

- Strike price: 11.60%.
- Premium: CZK50m.
- Start date: March 1998.
- Expiry date: March 2001.
- Number of possibilities to call the cap option: five.
- Current level of six-month Pribor: 15.82%.

The cap structure was not offered by banks but by insurance companies. It was an original structure in the Czech Republic at the time and SME used International Swaps and Derivatives Association (ISDA) agreement as the basis for the deal.

TABLE 1  
TOTAL ASSETS IN THE BANKING SECTOR IN CEE  
COUNTRIES, AS OF THE END OF 2002 (€bn)

	Czech Republic	Poland	Hungary	Slovakia
Banking sector assets in €bn	78.6	116.3	44.3	24.0
Population in million	10.2	38.6	10.2	5.4

*Source: Central banks of respective countries*

TABLE 2  
FX RATES DEVELOPMENT IN CEE COUNTRIES, YEAR  
AVERAGES AGAINST EURO

	1999	2000	2001	2002
CZK	36.88	35.61	34.08	30.81
SKK	44.12	42.59	43.31	42.70
HUF	252.80	260.04	256.68	244.50
PLN	4.23	4.01	3.67	3.76

*Source: Central banks of respective countries*

TABLE 3  
3M PRIBOR AND PRIBID DEVELOPMENT, YEAR AVERAGES  
IN %, PER YEAR

	1997	1998	1999	2000	2001	2002
3M PRIBOR	15.97	14.33	6.84	5.36	5.18	3.55
3M PRIBID	14.15	13.94	6.62	5.23	5.08	3.46

*Source: Czech central bank (CNB)*

## 'EXAMINING LIQUIDITY, FOREIGN EXCHANGE, INTEREST RATES AND CREDIT RISKS HAS BECOME IMPORTANT FOR CZECH CORPORATE TREASURERS SINCE 1997'

From 1998 onwards, the situation in the Czech financial markets stabilised, the Czech central bank (CNB) was able to cut interest rates more quickly than anticipated, and the interest rate curve started to decrease significantly. As a result, the option became out of the money. Although SME called the option only once, the cap had been considered worthwhile, as a necessary insurance against interest rate rises.

After the cap option expired in March 2001, SME was again concerned about the possibility of an unpredicted rise in interest rates, as happened in 1997. This time, SME chose to use a different hedging tool – an IRS. The Czech hedging market had become far more developed than when SME had bought its initial cap option. There was a competition among banks established in the Czech Republic and so there were no problems in obtaining an appropriate price for the IRS for up to 10 to 15 years. In the end, SME signed two contracts for IRS with two different banks that offered the best conditions.

**CASH MANAGEMENT.** In the Czech Republic, as with most countries around the world, cash management is one of the most extended treasury department areas. These activities comprise corporate finance, debt administration (loans, bonds, commercial paper and the like), good banking relations, payments systems to suppliers and collections from customers, controlling foreign currency and interests positions to meet the company's needs, and the technical and reporting support of the above mentioned areas.

Cash pooling has very quickly become a part of the Czech corporation's consciousness. Beside domestic notional and zero balancing cash pooling, Czech banks now offer cross-border pooling, both notional and real, for accounts in Czech koruna, euro, US dollar, CEE currencies (such as in Slovak koruna, Hungarian forint and Polish zloty) and sterling.

**ACCOUNTING, TAX AND LEGAL MANAGEMENT.** Treasury structured products (such as different types of so-called high-yield deposits) and certain money market tools (such as bank deposit promissory notes and participation certificates) are becoming some of the Czech Republic's main tax optimisation instruments and are contributing to the rise in accounting and tax management practices. At the moment, a number of companies, especially those with foreign capital invested, are solving the problem with derivatives such as currency forward options, FRAs, IRSs or facilities that adhere to international accounting standards such as IAS 39, IAS 32 and FAS 133.

**RISK MANAGEMENT.** Risk management is the most important and complex area in Czech treasury. Companies assess a broad range of risks but prefer to focus on market, operational and credit risks. In contrast to banks and other financial institutions, local companies tend not to deal with risk management in a department

established purely for that reason. But the number of companies that understand the importance of risk control (which normally means measurement, creating risk exposure limits and risk reporting) has grown rapidly.

The role of analysing liquidity, FX, interest rate and credit risks has become crucial for Czech corporate treasurers, especially since the currency crisis of 1997. Policies can include a list of permitted tools and banks, methods of hedging, limits on deal size and approval procedures.

In common with best practice in companies all around the world, Czech businesses have to prepare documentation for all their departments which sets out job descriptions, responsibilities and management reporting structures. Those involved in risk management teams will have a risk management policy, similar to the treasury policy documentation, which is approved by the management and shareholders, which lays down risk procedures and risk methodology.

**TREASURY MANAGEMENT SYSTEMS.** Trailing way behind global trends, integrated treasury management systems (TMS), a compound of treasury and electronic banking systems, are at a crucial stage in the Czech Republic. According to the Czech Association of Corporate Treasurers (CAT), domestic corporations are predominantly in the position where TMS support systems are able to deal with:

- separate applications based on Excel: 58% of participating companies;
- in-house integrated applications: 7%;
- integrated TMSs (such as SAP modules and Kondor+): 21%; and
- unspecified: 14%.

**SLOWLY BUT SURELY EVOLVING.** The role of corporate treasurers in the Czech Republic has evolved rapidly since 1997-1998. In addition to the banking relationships and cash management, treasury managers have to keep themselves informed about developments in electronic payment systems, e-commerce, risk management and relevant software for modelling and evaluating risks, credit management and accounting standards tax optimisation. However, with less than one year to go before the country joins the European Union, there is still much work to be done before Czech treasury reaches the same standards as their European counterparts.

Petr Polak is teaching Finance and completing his PhD at the Technical University of Ostrava. He was previously Financial Manager and Treasurer at two leading Czech companies. Deza, a.s. and Moravskoslezske teplarny, a.s. (Moravian-Silesian Power & Heating Plants). Petr is Vice-President of the Czech Association of Corporate Treasurers (CAT).

**petr.polak@vsb.cz**

[www.czechtreasury.cz](http://www.czechtreasury.cz)

Kamil Kocurek is Financial Analyst in the Strategy Department of Severomoravska energetika, a.s., which became a member of the CEZ Group this year.

**kamil.kocurek@sme.cz**

*Note: The authors would like to thank Ivan Haco, President of the Czech Association of Corporate Treasurers, for his opinions and ideas.*