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# Explaining the Czech interbank market risk premium



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### ABSTRACT

This paper focuses on the development of the interbank market risk premium in the Czech Republic during the global financial crisis. We explain the significant departure of interbank interest rates from the key monetary policy rate by a combination of different factors, including liquidity risk, counterparty risk, foreign influence, interbank relations, and strategic behavior. The results suggest a relevant role of market factors and some importance of counterparty risk.

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## 1. Introduction

The interbank markets play an important role in many aspects in almost all economies. They serve as a source of funding and a venue for the liquidity management of banks. Moreover, interbank markets play a key role in the monetary policy transmission mechanism and represent one of the main channels through which the official interest rates set by central banks are transmitted further to commercial bank rates and to the real economy. Finally, interbank market rates reflect the actual

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situation of demand for and supply of liquid funds in the market and play an important role as reference rates for a number of financial products – be they selected derivatives, bank loans or deposits.

During the global financial crisis which started in the US sub-prime mortgage segment in 2007, interbank markets worldwide experienced an increase in volatility and decrease in liquidity. While interbank market rates usually closely mirror the monetary policy rate in normal times, a rather strong departure of interbank rates from the key central bank rate has been observed since the onset of the global financial crisis. This increase in risk premium and a parallel significant decrease in interbank market liquidity also occurred in the Czech interbank market despite the fact that Czech banks were not directly hit by losses from subprime-related structured products.

The objective of this article is to identify individual components of the interbank risk premium in the Czech interbank market during the global financial crisis period. We consider credit and liquidity risk as potentially significant determinants of the interbank risk premium in the Czech Republic. However, we also examine other factors that might significantly influence interbank lending conditions in the Czech Republic. Specifically, we examine the role of other bank-specific characteristics (e.g., market share, interbank lending relations, portfolio composition of the bank) and the situation in the relevant domestic as well as international markets.

The article is structured as follows. The following Section 2 describes the Czech interbank market, while Section 3 is devoted to a review of relevant literature and introduces the hypotheses that are tested. Section 4 describes the data used for the analysis and Section 5 explains the methodology. Section 6 discusses the results and Section 7 concludes.

## 2. The Czech interbank market and the role of PRIBOR

The Czech banking sector consisted of 18 banks, 21 foreign bank branches and 5 special-purpose building societies in 2012, with total assets amounting to roughly 120% of GDP. A distinct feature of the Czech banking sector is that the majority of banks are foreign owned, a result of large-scale privatizations of previously state-owned banks in the early 2000s as well as of subsequent mergers and acquisitions.<sup>1</sup> The Czech banking system exhibits favorable values of key indicators such as profitability and solvency (capital adequacy exceeding 15%), a relatively low level of non-performing loans, and, unlike Hungary or Poland, no household FX loans. Moreover, there is an overhang of deposits over loans, leading to a structural excess of liquidity in the sector. This contributes to a favorable liquidity position of most banks and no dependence on interbank market funding or funding from abroad, unlike in many other Central and Eastern European banking sectors (Frait et al., 2011).

The structural excess of liquidity in the domestic banking sector is regularly absorbed by the central bank (Czech National Bank, CNB) via its repo operations, unlike in the euro area, where the ECB injects liquidity into the banking sector.<sup>2</sup> In October 2008, following a liquidity crisis in the Czech government bond market, the CNB launched a temporary liquidity-providing facility, in which Czech government bonds can be used as collateral.<sup>3</sup> This facility proved to be of great importance, since around 15% of banking assets consist of government bonds, and helped to calm the government bond market despite its rather limited use by the banks (CNB, 2012).

The Czech interbank market was always relatively illiquid due to the structural excess of liquidity in the banking sector, with mostly unsecured lending heavily concentrated at the shorter end of the maturity curve (O/N trading usually represents around 80% of daily trading volumes). However, Czech banks are quite active in trading interest rate derivatives linked to interbank market rates, especially forward rate agreements (FRA) and interest rate swaps (IRS).

The reference interbank market rate called PRIBOR (Prague Interbank Offered Rate) is calculated for a certain maturity as a trimmed mean out of individual quotes provided by a panel of reference banks (CNB, 2006). In addition to PRIBOR, the reference interbank market rate is also quoted for the bid

<sup>1</sup> The development of the Czech banking sector is discussed, for example, in Bárta and Singer (2006).

<sup>2</sup> In total, roughly 10% of aggregated banking sector assets were deposited with the CNB in 2012 as a result of these repo operations.

<sup>3</sup> See Geršl and Komárková (2009).

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