

Box 4

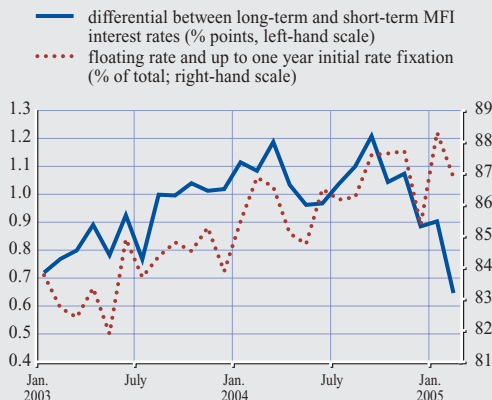
INTEREST RATE SENSITIVITY OF DEBT RAISED BY NON-FINANCIAL CORPORATIONS IN THE EURO AREA

Low short-term interest rates, together with the progressive steepening of the euro area market yield curve observed in recent years, appear to have encouraged non-financial corporations (NFCs) to make increasing recourse to short-term and/or floating rate-based debt financing. To the extent that this has made corporate sector balance sheets more sensitive to rising short-term interest rates, this could have implications for the credit quality of banks. Against this background, this Box examines the short-term interest rate sensitivity of the outstanding bank debt and debt securities issued by firms.

Whereas non-financial corporations in general have tended to lengthen the maturity of their debt, the share of new business loans taken at short-term rate fixation, or even at floating rates, has increased in recent years (see Chart B4.1), which most likely implies an effective shortening of their duration. The growing share of corporate bank loan financing at variable or short-term fixed rates over the past two years mirrors a progressive steepening of the term structure of bank interest rates, although in late 2004 this trend reversed to some extent. Hence, companies seem to have taken advantage of low financing costs at the short end of the yield curve, thereby reducing their overall costs of bank financing. As a result, there was a decline in the overall bank interest rate costs of firms between January 2003 and December 2004 (see Chart B4.2).¹ This occurred despite cumulative growth of around 8% in the amounts of loans outstanding over the same period, indicating that the decline in net interest payments after early 2003 was due to declines in MFI interest rates over the period and, in all likelihood, to the increasing use of short-term/floating rate loans as well. The fall in the net interest payment burden, together with the concomitant strength of corporate profits, significantly resulted in an overall improvement in firms' abilities to service their debts.

1 The bank interest rate cost may be calculated by multiplying the outstanding amounts by their corresponding rates.

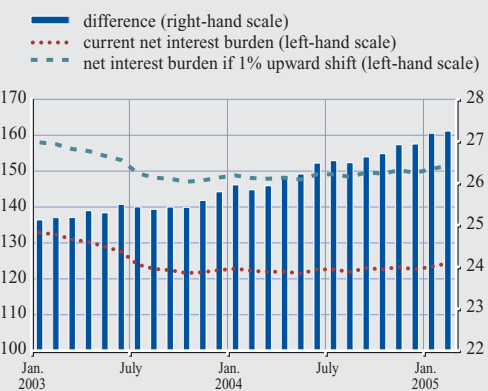
Chart B4.1 New business loans to euro area non-financial corporations with short-term interest rates and term spreads



Source: ECB.

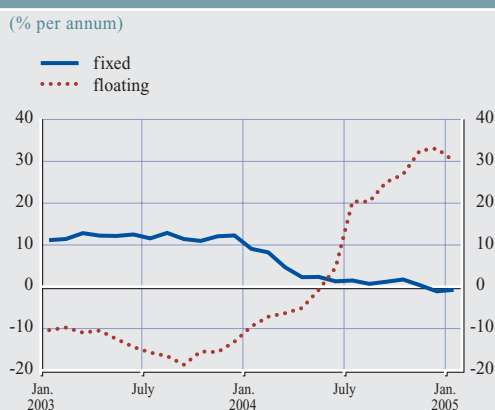
Chart B4.2 Net interest payments on bank debt by euro area non-financial corporations

(EUR billions)



Source: ECB.

Chart B4.3: Debt securities issued by euro area non-financial corporations



Source: ECB.

corresponded to roughly 60% of total amounts outstanding, or 25% of GDP. Moreover, thanks to the cumulative growth of loans outstanding, a 1% parallel upward shift of the term structure of bank interest rates would have had a larger effect on net bank interest payments at the end of 2004 compared with early 2003. A 1% parallel shift would have resulted in an increase of 22% in the interest burden by the end of 2004, compared with an increase of around 18% in early 2003 (see Chart B4.2). While acknowledging the uncertainty surrounding these estimates, it is nonetheless an indication that the short-term interest sensitivity of euro area non-financial corporations is far from negligible.

While bank borrowing is the predominant source of debt financing for euro area non-financial corporations, “direct” financing through the issuance of debt securities has gained in importance in recent years. With regard to short-term interest rate sensitivity, by end-December 2004 the share of outstanding variable rate long-term debt securities, taken together with short-term debt securities issued by non-financial corporations, amounted to 29% of the total amounts outstanding of non-financial corporate bonds. Assuming an average maturity of five years for the amounts outstanding with maturities over one year implies that 20% of these (or 14.2% of the total) would be refinanced within one year. Overall, around 43% of the total amount outstanding of debt securities issued by non-financial corporations is estimated to be subject to short-term interest rate risk. Since the second half of 2004, non-financial corporations have made increasing recourse to long-term debt securities with floating interest rates (see Chart B4.3). This may indicate that many firms have lengthened the maturity of their debt while continuing to take advantage of the low level of interest rates at the short end. Recent developments therefore suggest that the short-term interest rate sensitivity of the market-based debt of non-financial corporations in the euro area has also risen somewhat since mid-2004.²

² Some non-financial corporations also raise market-based capital indirectly through financial subsidiaries or other financial vehicles included in the non-monetary financial corporate sector. While a major part of the issuance of the non-monetary financial corporate sector is at floating and/or short-term rates, this probably primarily reflects the issuance activity of MFIs. Examples of the types of securities issued include mortgage-backed securitisation to finance an increasing share of variable rate mortgage lending to households. Overall, therefore, it is likely that the short-term interest sensitivity of non-financial corporations is not significantly affected by the strong floating rate issuance activity by this sector.

Notwithstanding the overall improvement in the debt servicing burden of firms, an increasing recourse to floating rate and short-term rate loans is likely to have somewhat heightened short-term refinancing risks (here defined by loan contracts where interest rates are reset within one year) of firms, which might therefore have adverse implications for net interest payments in a scenario of rising short-term interest rates. Under certain assumptions regarding the maturity structure of outstanding loans, it is possible to derive a reasonable estimate of the short-term refinancing risk facing non-financial corporations in the euro area. It is estimated that by end-December 2004, outstanding MFI loans due to be reset within one year

To conclude, there are indications that the interest rate sensitivity of balance sheets in the non-financial corporate sector has on balance increased in recent years, especially bank-based debt as well as, more recently, market-based debt. As a result, some firms might have to service significantly higher net interest payments if short-term interest rates rise unexpectedly, which might expose pockets of vulnerability in the non-financial corporate sector.