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CONTENTS

Borovcová Martina, Richtarová Dagmar Performance Evaluation of the Manufacturing Industry of the Czech Republic According to Multi-Criteria Decision-Making Methods	5
Horák Josef, Strouhal Jiří, Kadak Tarmo, Gurvitsš-Suits Natalie A. Implementation of ESG Reporting in Czechia	17
Jarczok-Guzy Magdalena Restrictiveness of environmental policy in European Union countries and revenues from environmental taxes	25
Kořená Kateřina Evaluating Gold as an Investment: Perspectives on Long-Term and Short-Term Investing	34
Maidiya Bahate, Kresta Aleš Impact of Investor Sentiment on Stock Characteristics in Big vs. Small Companies	45
Pěta Jan, Srbová Pavla Employing Creative Accounting Methods – Motivations, Risks, and Identification	58
Sedláková Michaela Coordination of Expectations in Multi-Asset Pricing Experiment	66
Solilová Veronika, Brychta Karel, Ištók Michal An Approach for Setting a Safe Harbour for the Loans Based on Freely Available Data: A Reasonable Way or Just Virtue Out of Necessity	73
Xiong Jialei Evaluating the Effect of Market Attention on Portfolio Optimization	81

An Approach for Setting a Safe Harbour for the Loans Based on Freely Available Data: A Reasonable Way or Just Virtue Out of Necessity

Veronika Solilová¹, Karel Brychta², Michal Ištók³

Abstract

With regards to strict laws outlined in the Income Tax Act and the lack of specific methodology/guidelines in the OECD Transfer Pricing Guidelines, taxpayers are experiencing significant legal ambiguity and high compliance costs when determining the transfer price of intercompany loans (i.e. transactions between associated persons). For this reason, a number of states have implemented simplified measures, known as “safe harbours“, which offer substantial advantages both for taxpayers and tax authorities. The purpose of this paper is to introduce a potential safe harbour strategy by assessing the predictive capabilities of the Bloomberg and Czech National Bank (CNB) databases in order to establish a safe harbour considering the conditions of the Czech Republic.

Key words

Comparative study, financial transactions, safe harbour, transfer pricing, Bloomberg, Czech National Bank

JEL Classification: H25, K34.

1. Introduction

In 2022, special standards for financial transactions such as cash-pooling, hedging, financial guarantees, captive insurance, and loans were introduced by the recent OECD Transfer Pricing Guidelines update. This update was eagerly awaited since it introduces important factors that need to be taken into consideration when determining the arm’s length price. One important factor to consider is the assessment of the creditworthiness of the borrowers, which refers to their ability to repay the principal amount borrowed plus the accrued interest. The credit rating assigned by rating agencies, based on their qualitative and quantitative analyses, is the most common tool used in practice to assess creditworthiness. The evaluation of the borrower’s credit rating is therefore the key feature of the transfer pricing analysis (Gabelle In Bakker & Kale, 2021).

In practice, a building block approach (the so-called “build-up model”) is a widely employed in order to determine the arm’s length price of a particular financial transaction. This approach is based on a core concept where a risk premium is assigned to the credit rating to account for the risk of the creditor not being repaid the owned amount, including interest, due to the potential default risk of the borrower. Subsequently, this value is added to the risk-free interest rate (OECD, 2022, chapter X, par. 10.105). Nevertheless, data on assigned

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ratings for European companies is scarce, with most available ratings being for North American companies. As a result, methodologies are typically based on data from North America (e.g. Damodaran, 2024). As a result, establishing transfer pricing for financial transactions based on ratings or creditworthiness poses a major challenge for European companies, leading to considerable uncertainty when addressing tax matters, particularly during audits. Moreover, the rating is a crucial factor that is essential for determining the arm's length price of interest in a financial transaction. Without it, it would be nearly impossible to accurately assess compliance costs related to transfer pricing and corporate income taxation, which are already substantial. For this reason, many tax administrations are attempting to provide some simplification to taxpayers (e.g. Pate, 2021 and Butani, 2021), which can be viewed as a reasonable measure, particularly for fundamental types of transactions.

The OECD Transfer Pricing Guidelines introduce suitable transfer pricing methods for financial transactions, including the still preferred comparable uncontrolled price (CUP), yield or cost approach, credit default swaps, economic modeling, and others. However, there are no specific standards/recommendations for financial transactions safe harbour regimes in the OECD standards. Safe harbour standards specifically for financial transactions as a simplified procedure have never been introduced. A globally accepted standard has not been established, so existing practices (concepts) vary significantly among countries. According to Ištók, Solilová & Brychta (2023), about 15 countries (such as Austria, Luxembourg, New Zealand, or South Africa) have implemented simplified procedures to determine the interest rate for financial transactions between associated entities, while 12 countries (including Australia, India, Korea, Serbia, Slovenia, Switzerland, and the United States) have directly introduced safe harbour provisions for such transactions. Chapter IV of the OECD Transfer Pricing Guidelines, which focuses on the Safe Harbour approach, currently only offers it for low value-added transactions. According to the authors of this paper, this Chapter and the standards included within it are not considered suitable, i.e. sufficient, for safe harbour in the area of financial transactions.

2. Aims and methodology

This paper aims to establish and evaluate a potential simplified regime approach for setting an interest rate for loans, known as the “safe harbour“, while utilizing alternative available data. These data include particularly statistics from the Czech National Bank and denomination for Czech crowns being considered. The main focus of this paper is to analyze the data obtained from the Bloomberg database and compare it with publicly available information from the Czech National Bank regarding interest rates on debt transactions denominated in Czech crowns.

The data sources used were the Bloomberg (2023) and CNB-ARAD (Czech National Bank, 2023) databases. Bloomberg was selected due to its common application in practice, while the CNB-ARAD database was used as a publicly available database, since it provides data from the Czech region. In the Bloomberg database, we concentrate on the bond bid option-adjusted spread (OAS) for monthly membership of the forward Bloomberg US Corporate Bond Index (LUACSTAT). This refers to the month-end spread for this forward index, which can be broken down according to sector, rating bucket, and maturity bucket. In practice, the OAS represents a robust indicator of the level of interest rate margin considered by third-party lending institutions. Furthermore, based on the Czech tax authority's preference, only the 5-year maturity bucket was analyzed.

The CNB-ARAD database contains comprehensive credit statistics for non-financial entities and other entities. To achieve the goal of the paper, our focus is on non-financial

entities and detailed credit statistics related to loan transactions. Additionally, we only considered data from the year 2022.

3. Results and discussion

Based on the analysis of safe harbour regimes in the world, it is clear that the most common form of safe harbour is a build-up model. This model typically includes a risk-free interest rate plus a risk premium, which is set for different currencies (usually EUR, USD, and domestic currency) and lengths of the transaction (usually categorized as short-term or long-term). The varying position of the taxpayer in the transaction, whether as a debtor or creditor, and the associated different risk premium, is not frequently utilized in practice, nor is the distinction of the taxpayer's size. Additionally, the safe harbor is typically restricted to the maximum amount of the financial transaction(s) and is always established as an optional system. Furthermore, the OECD Transfer Pricing Guidelines emphasize the importance of creditworthiness and rating in transfer pricing. However, only one country (India) has implemented a safe harbor provision taking into account this key aspect, setting applicable spreads of risk premium based on the rating range from AAA to D. Moreover, only a handful of countries establish particular requirements for the implementation of this system, such as excluding financial transactions with "low-tax countries" (i.e. tax havens – countries with a preferential/harmful tax system), taxpayer shall not generate long-term losses or be in restructuring period during the year of the application of the safe harbour (e.g. Australia) (Ištók, Solilová and Brychta, 2022).

When establishing a safe harbor, there are several approaches to consider. However, it is important to emphasize that a safe harbor (simplified regime) does not meet the requirement of determining prices based on the arm's length principle. However, there is a requirement for a reasonable setting that enables the replication of results as market conditions evolve and adhere to economic principles (rationality in decision-making). In general, a standards-making authority should decide whether to establish safe harbor rules based on the credit rating of the borrower, as highlighted in the OECD Transfer Pricing Guidelines, or to focus on general safe harbor criteria such as currency, transaction length, and setting limits for loan amounts. When determining a safe harbor, freely and regularly available data should be prioritized over commercial data if the results are comparable in order to consider availability and cost. In the case of the Czech Republic, the key factors influencing the final decision are the predictive accuracy of Bloomberg and the Czech National Bank (CNB) database, as well as their impact on the compliance cost of taxation. As mentioned above, if the results provided by both databases are similar, it is preferable to use a concept based on publicly available data. Utilizing publicly available databases does not increase the compliance cost of taxation and administrative expenses.

3.1 Bloomberg database evaluation

According to our analysis of the Bloomberg database, we can conclude that it provides highly detailed information for the North America region. However, there is a significant lack of data for the European region when it comes to classification based on rating grades. Because of this, we utilized data from the North America region for our analysis. Additionally, following the OECD Transfer Pricing Guidelines and recommended methods for determining transfer pricing for loans, we specifically looked at the month bid option-adjusted spread (OAS) for the forward index. This is a reliable indicator of the interest rate margin level taken into account by third-party lending institutions. The OAS is available for sector categories, ratings bucket option (i.e., investment grade and speculative grade of ratings group) and for maturity buckets (i.e., 3, 5, 7, 10, 20 and 30-years). We chose a maximum

transaction length of 5 years maturity bucket, which appears to be the preferred option in this regard. The analysis results are shown in Tables 1- 4.

Table 1: 5-year maturity spread for all sectors and available rating grades

Spread 5YR		All sectors			
		Average	Median	1. Quartile	3. Quartile
2022					
AAA	Investment grade	34.53	33.78	29.24	39.49
AA		74.98	78.26	61.90	83.35
A		80.94	80.58	72.38	87.43
BBB		130.81	131.89	121.58	145.08
BB	Speculative grade	244.20	237.74	212.25	267.51

Source: own processing using (Bloomberg, 2023).

If we focus only on the creditworthiness, the Bloomberg database introduces the OAS spread breakdown according to the credit rating grade. As it is obvious from Table 1 above, the median values raise between 0.33 up to 1.31 % at investment grade, and up to 2.37 % at speculative grade. However, results can differ based on the industry where the borrower operates its business activities.

The Bloomberg database covers OAS results disaggregated by rating grade, industry, and maturity. However, the automatic breakdown is only available from an industry, rating, or maturity perspective, and not all-together. To obtain such a detailed breakdown, individual data processing is necessary. Therefore, the three-sided view is not readily accessible, which we see as a major drawback. If the standard-setting body wishes to establish safe harbors with such a detailed breakdown, it would raise administrative and compliance costs for taxation.

Table 2: 5-year maturity spread for individual ratings in investment grade and non-financial sector

2022	YR	Rating	Average	Median	1. Quartile	3. Quartile
Non-financial sector	5	AAA	35.69	31.51	21.84	45.04
		AA+	39.28	40.86	34.71	45.68
		AA	43.45	31.86	25.00	44.05
		AA-	51.30	47.22	37.80	61.06
		A+	77.77	63.92	52.11	86.45
		A	69.60	68.50	51.47	81.42
		A-	84.40	82.12	66.20	99.11
		BBB+	108.16	103.24	87.32	129.57
		BBB	120.21	120.73	100.47	141.39
		BBB-	174.98	174.81	143.63	202.03
Total		A - BBB-	96.15	87.51	60.10	123.85
		min	7.67			
		max	320.12			

Source: own processing (Bloomberg, 2023).

Furthermore, the OAS spread differs significantly in individual rating grades and industry sectors. The highest spreads were identified in the junk rating grade, which is not surprising (see Table 3 below). Entities with such credit rating are considered very risky with high default probability. Therefore, lending institutions expect higher interest margins. Median value of spread is approximately 10 %, although average value is more than 17 %, in comparison with just only 0.87 % (resp. 0.96 % in average) in case of investment grade. Additionally, the disparity between the median and the mean increases significantly as the rating grades decrease. The values from the lowest rating grades have a substantial impact on

the overall median value when all rating grades are taken into account. The median value of all rating grades without junk grade is significantly lower, particularly at 1.72 % in comparison with 2.45 % covering junk grade.

Table 3: 5-year maturity spread for non-financial sector and ratings

2022	Average	Median	1. Quartile	3. Quartile	Min.	Max.
All rating grades	500.65	245.82	94.54	506.95	7.43	18884.40
All rating grades without junk grade	243.32	172.92	84.15	355.90	7.67	1549.59
Investment grade	96.15	87.51	60.10	123.85	7.67	320.12
Speculative grade	416.21	373.87	283.68	504.00	144.66	1549.59
Junk grade	1762.17	1019.21	709.92	2117.96	313.89	18884.40

Notes: Speculative grade represents credit rating BB+, BB, BB-, B+, B, B-. Junk grade represents credit rating CCC+, CCC, CCC-, CC, C and D.

Source: own processing using (Bloomberg, 2023).

In terms of the number of entities with ratings and available OAS, the majority are from non-financial sectors with investment and speculative grade ratings. The marginal portion consists of entities with a low credit rating, specifically only 101 entities. The financial sector also shows a significant decrease in entities with a speculative or low rating, with only 61 entities being the exception (see Table 4).

Table 4: Number of entities having rating at 31 December 2022, for 5-year maturity

Credit rating grade	Non-financial sector	Financial sector	Total
Investment	799	502	1 301
Speculative	564	51	615
Junk	101	10	111
Total	1 464	563	2 027

Source: own processing using (Bloomberg, 2023).

This outcome would validate the transfer pricing viewpoint in the event of a financial transaction involving a loan. Generally, companies with junk credit ratings are unable to secure financing from financial markets for their preferred forms of funding due to the high risk of default they pose. If they are granted access, it is typically subject to certain specific conditions that restrict their activities (such as limitations on asset disposal). Similarly, when dealing with related parties, it is important to assess whether the entity is a key part of the group's strategy and whether there is a high risk of default. However, once the financial transaction is finalized, it is important to review all terms and determine if it is still classified as a loan or if it should be considered a capital contribution. The tax authority should also take a similar stance on this matter. However, as is evident, this reclassification of financial transactions should be done on a case-by-case basis, as some institutions that provided financing chose to lend to these entities despite the high probability of default. To take such a significant risk, they requested a very high interest margin (the 3rd quartile value is 21%), as shown in Table 3 above.

3.2 ARAD database evaluation through the CNB

Based on the analysis of the CNB database, specifically the ARAD database, several statistics can be taken into account for the creation of a safe harbour. The ARAD database not only includes general statistics, but also provides detailed credit statistics for non-financial entities. This includes data on interest rates for new contracts, contracts lasting up to 1 year, contracts lasting 1 to 5 years, and contracts lasting over 5 years. It also includes information on existing loans, loans up to CZK 30 million, loans over CZK 30 million, all on a monthly

basis. It also offers information on the overall cost of borrowing for these entities, monitors both short-term and long-term expenses, and total costs for loans provided to them (on a monthly basis).

The index monitors the yields of Czech government bonds ranging from 1 to 10 years, as well as it tracks the daily interest rate swap (IRS) for 1 to 10 years and monthly basis for 1 to 15 years. It also keeps an eye on the interest rate differentials between PRIBOR/EURIBOR and PRIBOR/LIBOR on a daily basis, as well as forward rate agreements (FRA CZ) for standard periods of 1, 3, 6, 9 months to 3 months. Additionally, it offers daily statistics for PRIBOR (2W, 1M, 3M, 6M, 12M), Repo rates, Lombard rates, and Discount rates.

However, all of this information could serve as a crucial foundation for establishing a safe harbor. Unfortunately, the database is lacking data on the credit ratings assigned to non-financial entities (such as issuer credit ratings) or issue-specific ratings that take into account specific financial obligations, classifications of financial obligations, debt seniority, as well as the creditworthiness of the guarantor, currency, and other factors. If the need for credit rating data is eliminated, the ARAD database offers valuable and detailed information that is worth considering.

3.3 Safe Harbour

When it comes to the Czech Republic, we assess the possible safe harbour options using various data sources such as Bloomberg and ARAD provided by the CNB. The main factors taken into account include OAS spread for various rating grades, 5-year maturity, currency, and loan amount.

Table 5: Safe Harbour for non-financial sector, USD bond - 1Y ago

Safe harbour for 5yr - Bloomberg database (in %)			Average	Median	1Q	3Q
A) all rating without junk grade - OAS spread, 5YR			2.43	1.73	0.84	3.56
B) rating in investment grade - OAS spread, 5YR			0.96	0.87	0.6	1.24
5YR USD bond, at 09/2023, 1Y ago	3.317					
Safe harbour for USD loans	variant A)	fixed rate	5.75	5.05	4.16	6.88
	variant B)		4.28	4.19	3.92	4.56
Differential PRIBOR/LIBOR	3.15					
Safe harbour for CZK loans	variant A)	fixed rate	8.90	8.20	7.31	10.03
	variant B)		7.43	7.34	7.07	7.71

Source: own processing (Bloomberg, 2023).

Table 6: Safe Harbour for non-financial sector, USD bond – range 52W

Safe harbour for 5yr - Bloomberg database (in %)			Average	Median	1Q	3Q
A) all rating without junk grade - OAS spread, 5YR			2.43	1.73	0.84	3.56
B) rating in investment grade - OAS spread, 5YR			0.96	0.87	0.6	1.24
5YR USD bond, 52W range, 09/2023						
range 3.204-4.875						
Safe harbour for USD loans	variant A)	fixed rate	5.63-7.31	5.05-6.61	4.04-5.72	6.76-8.44
	variant B)		4.16-5.84	4.07-5.75	3.80-5.47	4.44-6.12
Differential PRIBOR/LIBOR	3.15					
Safe harbour for 5yr - Bloomberg database (in %)			Average	Median	1Q	3Q
Safe harbour for CZK loans	variant A)	fixed rate	8.78-10.46	8.2-9.76	7.19-8.87	9.91-11.59
	variant B)		7.31-8.99	7.22-8.9	6.95-8.62	7.59-9.27

Source: own processing using (Bloomberg, 2023).

In order to determine a fixed interest rate for the country through Bloomberg database that introduces OAS spread for the North America region via credit rating, the government bond yield is to be taken into consideration. In September 2023, 52wk range of USGG5YR Index (i.e., United States 5-Year Bond Yield) was between 3.204 and 4.875 %, with 3.317 % for 1 year ago (i.e. in 09/2022). Furthermore, if we consider two rating grades, the first one including all ratings except for junk grades and the second one consisting of investment-grade ratings, we can identify two different safe harbors for fixed interest rates. Additionally, all OAS spreads were calculated for USD currency, so by using the differential between PRIBOR and LIBOR, the next safe harbor for CZK loans will also be determined (Tables 5 and 6 above).

The results show that the safe harbours fixed rate for USD loans could be around 5% (median) for all ratings except junk grade, and approximately 4% for investment grade ratings. Additionally, **the fixed rate for CZK loans in safe harbours could be higher, reaching approximately 8% for all ratings above junk grade and 7% for others.** However, when determining a transfer price, it may be more practical to consider using an interval in many situations. Table 6 shows the fixed safe harbours rate range based on the 52-week range of the USGG5YR Index. For USD loans, the rate could be between 5% and 7% for all ratings without junk grade, and between 4% and 6% for investment grade ratings. **For CZK loans, fixed rates are higher, approximately 8 to 10% for all ratings except junk grade, and between 7 to 9% for investment grade ratings, which is similar to the previous case.**

Table 7: Safe Harbour for non-financial sector, CNB, ARAD database (in %)

Data – credit statistics, average in 2022	Interest rate	Safe harbour Range*
Interest rate for 1-5 years maturity loans	7.52	6.52-8.52
Interest rate for loans	7.57	6.57-8.57
Interest rate for loans over CZK 30 mil.	7.69	6.69-8.69
Interest rate for loans up to CZK 30 mil.	6.93	5.93-7.93
Total cost of loans	7.72	6.72-8.72
Cost of borrowings	7.01	6.01-8.01

Note: * Add to each side of the range one percent point.

Source: own processing using (Czech National Bank, 2023).

To calculate the fixed interest rate using the ARAD database by the CNB for safe harbour purposes, we make one assumption. Since the database does not include information on ratings, we adjust the selected data for credit statistics by one percent point on each side of the range (Table 7 above). Based on our assumption, the safe harbour's individual ranges would be between 6 to 8.7%, depending on the specific criteria, which closely aligns with the results obtained from the analysis of the Bloomberg data. Brychta et. al. (2023) provides more detailed information about potential approaches of setting the safe harbour in the Czech Republic in their Summary Research Report.

4. Conclusions

The purpose of this study was to assess the safe harbour determination using alternative data from the CNB in its statistics, specifically through the ARAD database. Another objective was to compare the findings with those from the commonly used Bloomberg database. The findings indicate that while the Bloomberg database offers detailed information, the results from the publicly accessible CNB statistics yield similar results for the periods examined. The suitability of the CNB database is due to certain simplifications, which form

the foundation of the safe harbour. Additionally, the use of safe harbour applies to reducing both administrative costs and compliance costs related to taxation. Moreover, taking into account that the data from the Bloomberg database pertains to the North America region, where credit rating data for the European region is lacking, the publicly accessible data specific to the Czech environment becomes even more valuable. It can be assumed that this data is better suited for local conditions. The body establishing safe harbour standards and its parameters should reflect many aspects, including the availability of data and the reproducibility of results on which the safe harbour standards are based. These aspects are of crucial importance. We believe that the data provided by the CNB is highly relevant, reasonable, and suitable for determining an appropriate safe harbour.

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