Accounting Issues Related to Market Risks of Loan Products

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Abstract

This scientific paper aims at an empirical study of some brief aspects of credit in the current stage of the Romanian economy . A potential reduction in population lending in Romania is believed to have a huge impact on consumption, production , investments and on the state budget. Thus, a 10 % reduction in amounts of credits will have a negative impact on GDP of 4 %. The new draft laws allow the creation of a space of unconfirmed provisions. All these proposals come with losses for the banking industry, including image, and, paradoxically, is happening in the Romania where financial intermediation occupies a low level - more than a quarter - 26.4%. The large differences in the regulatory laws adopted by the Member States contribute to the differences in the flows of the European market .

Key words: bank loans, accounting, trends
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1. Introduction

Romania has a number of disadvantages in relation to older EU Member States which breaks down integration efforts and leads to a number of adverse effects such as reducing net wealth and widening the gap between social classes, increasing migration, etc. (www.bnr.ro):

- Negative demographic growth.
- The massive disappearance of the existing industrial base from the 1980s years and consequently the forced cancellation of a huge number of jobs.
- Romania faces a vulnerability in the labor market caused by the demographic problem, given the fact that emigration has reached a worrying level, about more of 20 % of the country's population and 35 % of the active population.

2. Theoretical background for accounting related to marked risks of loans products

A financial asset can be classified at fair value by profit or loss account only if it meets one of the following two conditions (IASB , 2018):

1. It is classified as held for trading: a financial asset is classified as held for trading if it is:

- acquired or generated primarily for the purpose of sale in the near future;
- included at the time of initial recognition as part of a portfolio of specific financial instruments that are administrated jointly and for which there is evidence of a recent pattern of short-term profit tracking; and
- a derivative, except for a derivative that is a financial collateral or derivative instrument designated as part of an effective hedging relationship.

2. At initial recognition is designated by the entity as being measured at fair value through profit or loss. The option to designate at fair value is permitted only if :

- The proposed instrument to be designated at fair value through profit or loss is a hybrid contract that includes one or more embedded derivatives;
- The designation significantly eliminates or reduces a measurement or recognition inconsistency (sometimes referred to as "accounting mismatch") that would otherwise result from the valuation of assets or liabilities or the recognition of gains and losses associated with them on

different bases;

- A group of financial assets and / or financial liabilities is managed and its performance is measured on a fair value basis in accordance with a documented risk management or investment strategy of the entity and the information is provided to key management personnel on that basis.

3. Evolution of the banking market risks - empirical aspects of research

The banking system registered a positive development mainly driven by the favorable macroeconomic framework, which led to an acceleration of lending. The forecasted annual growth of non-government credit is 6.4% for the year 2018 according to banking strategies, given that in 2017 the advance of the non-governmental credit was 5.6% . The balance of non-government credit returned to EUR 50 billion, at the beginning of the crisis, despite the fact that in the meantime we witnessed total repayments, principal reimbursements, the sale of non-performing loans, etc. The structure of non-governmental lending by segment is divided as follows: 53% are loans to the individuals and 47% to companies (www.bnr.ro).

The year 2018 brought the change in the structure of credit to the private environment. As a result, at the end of first quarter, the share of RON loans accounted for 63.8% of the total loans - the highest level since 1998. In the context in which in 2017 we witnessed the trend change in the evolution of interest rates, the ROBOR index, the Romanian Association of Banks analyzed the possibility of wider use of fixed interest in the lending activity of individuals. Thus, consumers could be further protected against the risk of interest rate variation by creating mechanisms that would allow broader incentives for fixed-rate loans. There was an increase in new loans with fixed interest, 27% of mortgages and 79% of consumer loans granted between January and March 2018 being fixed interest rates . By comparison, only 6% of the mortgages granted in the similar period of 2017 were fixed interest rates . As a result of the constant efforts of the banking system, the rate of bad loans fell from the alert threshold to the signal threshold. The rate of non-performing loans declined to 5.71% in June 2018 (compared with 8.32% a year ago), the decrease being almost 4 times over 2014. As regards the component failure rate published by The National Bank of Romania for March 2018, summed up a percentage of 11.44% on the companies sector, where the rate of non-performance on the SME area was 12.7%, while the indicator was 5.68% on the individuals (www.bnr.ro). In Romania, the coverage ratio with non-performing loans is high, 57% (www.arbc.ro). Banking lending in Romania has a high potential for growth, especially on the corporate area, with beneficial effects on the economy as a whole, but joint efforts of the banking industry, supported by decision-makers, through the projects they promote

4. Survey of the specific developments in the credit market risks in Romania

In Romania a potential reduction in population lending is estimated to have a significant impact on consumption, production and investment, and with effects on the state budget. Thus, a 10 % reduction in lending will have a negative impact on GDP of 4 % (www.bnr.ro).

The first quarter of 2019 was marked by a significant tightening of lending standards for both housing and land purchase loans and consumer credit to households. On non-financial corporations, banks maintained credit standards steadily as compared to the previous quarter.

In the coming period (T2 2019), credit institutions anticipate a marginal tightening.

lending standards for real estate and moderate lending in consumer credit for the population sector. In the case of non-financial corporations, banks' expectations for the next quarter are a tightening of credit standards.

Initial potential risks to the sector of the legislative framework have been diminished over the course of time. Credit institution strategies include long-term commitments to lend to the real economy.

We can refer to the challenges posed by the recently promoted laws during the pre-election period, the Paying Law and the Law on the conversion of Swiss francs into a historical course, but the Constitutional Court has already expressed its opinion and brought the necessary clarifications (www.cdep.ro).

Analysis of the decision published by the Constitutional Court related to Law no. 77/2016 on payment shows that the institution was considering applying the law on social cases by invoking the principle of imprevision (www.ccr.ro).

Imprudence (those exceptional credit events that led the client to have major difficulties in repaying the loan) will be a rather exceptional situation than a frequent one.

The banking community has stated from the outset that the substantive solution to all these issues is related to communication between the bank and its client and that each bank has tried to find a solution in one form or another in the social cases we are discussing. The problem we have is a problem setting expectations.

The Constitutional Court motivated the decision by which it rejected the law on the conversion of credits into Swiss Francs (CHF), stating that the law violated [the principle of bicameralism, in the sense that it was radically altered by the Chamber of Deputies, the first form imparted by the Senate, objectives of initiators (www.ccr.ro).

Otherwise, a single Chamber, namely the Chamber of Decision Makers, has legislated exclusively, and this contradicts the principle of bicameralism. The payment difficulties encountered by some debtors in Swiss francs (but also in other currencies) were addressed always at banks, offering customized solutions (www.cdep.ro) .

By the end of August 2016, 78% of customer requests were approved and, as such, restructured and / or converted into national currency tens of thousands of CHF loans (www.arbc.ro).

The banking system is in a position to rebuild confidence that has been affected by public debates in recent years.

5. The observation of the risks associated with credits to companies in Romania

Small and medium-sized enterprises account for about 90% of all enterprises globally and cover over 50% of the workforce . These are essential for the development of economies, playing an important role in creating jobs and developing innovative systems.

Credit standards had a steady evolution in the first quarter of 2019, compared with the previous quarter. With respect to Q2 2019, credit institutions expect a moderate tightening of credit standards for companies, irrespective of their size, for both long-term and short-term loans.

Credit terms did not fluctuate significantly in Q1 2019, except for the spread of the average interest rate on credit to ROBOR 1M, which experienced a marginal relaxation (www.insse.ro) .

Credit demand from companies has moderated at a moderate level. Large companies have significantly reduced their demand for funding, both for short-term and long-term loans, while for small and medium-sized companies, demand declined moderately.

Rejected credits, as a share of total requested loans, have fallen marginally, especially for large companies seeking to attract long-term funding.

The risks associated with companies classified by their size have been assessed by moderately growing banks in Q1 2019 in the mid-sized and corporate segment. Increases in credit risk were of significant magnitude in the case of energy and transport companies and moderate in real estate companies.

In Romania, the share of SMEs is 99.7% in the total number of companies compared to an average of 99.81% in the EU, covering 66.4% of the total labor force, similar to the European average (66, 63%), according to Eurostat data for 2016 . Taking into account the crucial role that SMEs play for employment, given that at national level, 2 out of 3 employees work in SMEs, it is essential to ensure access to finance viable, supporting their expansion, invoicing and development projects (www.insse.ro) .

A large part of the Romanian companies are not bankable, as they have negative equity. Credit institutions have the resources to support lending, with solvency and liquidity ratios at high levels, but for the corresponding expansion of lending to the corporate sector it is necessary for them to be bankable. There are a number of vulnerabilities, such as the high indebtedness or the high debt recovery period, which hampers the banks' lending effort. With regard to the average debt recovery period, small and medium-sized businesses are able to recover their claims in 1/3 of the year, making it clear that commercial credit is being used. The top three most pressing problems faced by businesses are still high taxation, the implausibility of the tax environment and competition (www.insse.ro) .

Studies show that a culture of SMEs is not yet rooted in Romania, with more than half of the companies set up disappearing within 10 years of registration. For companies, loss in case of default (LGD) estimated by banks for non-repayable loans in Q4 / 2017 was 42% up from 40% a year ago (www.arbc.ro). In a general local climate characterized by a high degree of unpredictability, business plans are deferred, re-evaluated, and investment appetite is low.

Demand for loans from non-financial corporations recorded a moderate decline at aggregate level in Q1 2019, contrary to the expectations of credit institutions. Based on the size of the firms, the magnitude of the decline was more pronounced in the case of very large companies, both for long-term and short-term loans. For the next quarter, demand for company financing is expected to have a relatively steady development across the sector, while moderate growth is projected for small and medium-sized companies.

6. The observation of the main destinations of the loans

Most Romanians say they take into account loans from banks or non-bank financial institutions mainly when they want to make improvements in the home (31%), unexpected spending that may affect their financial situation (29%) or medical expenses (18%), when looking to consolidate their debts (23%), but also to invest in children's education (5%) (www.arbc.ro).

On the other hand, 29% of Romanians say they are concerned about the possibility of rising living costs in the coming year and 15% are worried that they might lose their jobs. Also, 21% of them are concerned about the evolution of the economy over the next period .

The increase in the cost of living in the next period is set by 29% of Romanian clients due to the increase in utilities spending, above the European average of 17%, of housing costs, whether rents or bank installments for the purchase of a housing (15%) and food expenditure (12%). By comparison, for respondents in Europe, the main reason for the increase in the cost of living is represented by rents or house purchase (19%) and food expenses (19%) (www.arbc.ro).

At the same time, retirement is a factor that 12% of respondents in Romania consider could affect their standard of living, as opposed to the average of only 6% at European level, and 7% of them consider the possibility that the next period to receive less money from abroad and thus the living standard to be affected (www.arbc.ro).

7. A case study of the accounting records of equity instruments classified as financial assets at fair value through the statement of comprehensive income (FVTPL)

On May 15, 2019, an entity purchases 5,000 shares at the price of 5,000 m.u. (monetary unit) per share. Trading costs represent 0.75% of the value of the purchased shares (Nicolae, 2010).

Under accounting policies adopted by the entity, the target pursued by the entity is to sell long-term shares with the purpose of obtaining the long-term profit from these operations and classifies the shares acquired in the category of the items in the statement of comprehensive income (FVTPL) at the value of the financial assets (Nicolae, 2010). The recording accounts used (as proposed in the IFRS accounting plan) for the exemplification of these accounting records were selected based on the formulated assumptions (Nicolae, 2010).

The acquisition is quoted on a regulated market and the entity has concluded, according to its policies, that the market is active and that it is also the primary trading market, in accordance with IFRS 13 (Nicolae, 2015).

Accounting data
(Making entries by the author)

Registration of the acquisition of shares :

Debit *Long-term financial investments* 25,000,000
Credit *Payments to be made for long-term financial investments* 25,000,000

Record of transaction costs:

Debit *Expenses on fees payable for securities trading on the regulated market* 187,500
Credit *Payments to be made for long-term financial investments* 187,500

Payment of expenses:

Debit *Payments to be made for long-term financial investments* 187,500
Credit *Bank account* 187,500

Payment of debt on purchased shares:

Debit *Payments to be made for long-term financial investments* 25,000,000
Credit *Bank account* 25,000,000

Accounting records as at 31 December 2019

At December 31 2019, the share price dropped to 4,500 m.u. , and the fair value of the stake was 22,500,000 m.u. . The loss caused by keeping titles = 25,000,000 m.u. - 22,500,000 m.u. = 22,500,000 m.u. The registration is:

Debit *Losses related to long-term financial assets and liabilities* 2,500,000
Credit *Long-term financial investments* 2,500,000

Accounting records on May 31, 2020

On May 31, 2020 the share price increased to 6.000 m.u. . As a result, a gain of fair value differences on the share of the shares held will be recorded, amounting to = 5,000 shares x (6.000 m.u - 4,500 m.u.) = 7,500,000 m.u. :

Debit *Long-term financial investments* 7,500,000
Credit *Gains on long-term financial assets and liabilities* 7,500,000

Accounting records on 31 May 2022

On May 31, 2022, the entity signs a share sale contract at a price of 10,500 m.u. . The selling price is equal to the market share quote valid for the date of sale = 5,000 shares x (10.500 m.u - 6,000 m.u.) = 22,500,000 m.u.

Recording of the valuation at fair value:

Debit *Long-term financial investments* 22,500,000
Credit *Gains on long-term financial assets and liabilities* 22,500,000

Registration of sale of shares = 5,000 shares x 10.500 m.u = 52,500,000 m.u. :

Debit *Debtors from transactions on the regulated market* 52,500,000
Credit *Long-term financial investments* 52,500,000

Subsequent collection of due amounts:

Debit *Bank account* 52,500,000
Credit *Debtors from transactions on the regulated market* 52,500,000

This example illustrates the periodic update of long-term financial investments at fair market value by recording the gains or losses generated by the fluctuation in fair value on the current profit and loss for the year.

When implemented in practice, entities may also consider other accounting records alternatives as long as there is a fair presentation of the results in profit or loss and in the statement of financial position.

8. Conclusions

In my opinion, the use hedge accounting for the risks associated with credits is an important tool for bank entities in the Romanian economy. In the actual period, the chances of a sustained increase in the operations thru hedge accounting is a modern alternative for credit entities.

I consider that accounting for hedge operations of credit institutions resulting from the sale or purchase of equities with a fair value recording is a complex chapter in continuous development under the influence of global financial and banking volatility.

9. References

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