Considerations on Hedge Accounting of Bank Loans

Nicolae Traian Cristin
„Ovidius" University of Constanta, Faculty of Economic Sciences
traian.nicolae.profesor@gmail.com

Abstract

The credit brokerage market in Romania exceeds 1.5 billion lei, or 5-6% of the total retail loans granted by banks. However, if we withdraw from this total the loans granted through the First Home Program, the share of loans granted by brokers rises to 9-10%, according to market data, one of the most active brokers on the market. In other countries, this share rises to 60% for the UK and the Netherlands, or 14% for Belgium. The volume of loans brokered by intermediary brokers was in excess of 700 million lei in 2016, according to the most recent estimate of the Romanian Credit Brokers Association (ARBC). As the members of the association account for about half of the market, the total volume of the market reached about 1.5 billion lei in the same year, ie 5-6% of the total retail loans granted by banks.

Key words: bank loans, hedge accounting, trends
J.E.L. classification: M41, G32

1. Introduction

During the financial crisis banks turned less to credit brokers for the brokerage industry to return to pre-crisis brokerage volumes (www.arbc.ro).

Noteworthy is that during the financial crisis the banks have appealed less to credit brokers for the brokerage industry to return to the pre-crisis brokerage volumes. In the crisis, the brokerage business followed the trend imposed by banks, with brokers specializing more and more in refinancing.

2. Theoretical background of hedge accounting of bank loans

Brokers and banks have become preoccupied not only with the sales target, but also trying to become a financial consultant for the customer, delivering tailor made products, which involve a minimum risk on both sides (debtor-lender). Against the backdrop of rising sales on a healthier basis, and the confidence of banks in credit brokers has returned. In 2009, the brokerage market declined almost 6 times compared to the previous year, amid the slowing of credit The volume of intermediate loans fluctuated in the period 2009 - 2012, so that in 2012 it will grow steadily (www.arbc.ro). Year 2016 was the best year for credit intermediaries. The figures in the table below are estimates of Credit Bonus on the brokerage market starting from ARBC reporting and the results reported by market leaders during the crisis, results that were corroborated by the share they held constantly in the market (www.arbc.ro).

It should be borne in mind, however, that over the past years, about 4-6 billion lei of the new loans were loans through the First Home Program. If we withdraw these loans (First Home), it can be estimated that credit brokers hold about 9-10% of all new retail loans offered by banks (ie consumer loans and standard mortgages) (www.arbc.ro).

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

Although the brokerage market as a whole accounts for only about 9-10% of total retail sales, banks do not cooperate in proportion to brokers. Some lenders rely heavily on this sales channel, taking the model of Western European banks (www.arbc.ro).

In the years of the boom in real estate lending in Europe, with 3 before the financial crisis (2005), in the largest European states, credit brokers and financial advisors (representing the banks' indirect sales channels) accounted for about 40% of total mortgage retail sales, according to reports by financial management consultancy firms (KPMG, 2014). Thus, the brokerage industry was expected to grow in Europe by 10 percentage points over five years (2010), thus reaching a share of 50% of the total mortgage loans sold by European banks. At the same time, the report estimated that the share of mortgages sold through indirect channels, particularly through credit brokers, will reach 60% of the total in 2020 (www.arbc.ro).

With the onset of the crisis, the brokerage business has fallen in tune with the credit market, with banks focusing mainly on their own sales channels in order to mitigate the risk. As the banking and brokerage industry aligned with the new risk prevention requirements, we witnessed a revival of these markets in Europe, but also in Romania. An example of the evolution of the European brokerage market during the crisis is the United Kingdom, where credit intermediaries hold the largest share of total mortgages traded. Market data showed how the brokerage market went into rebound, suffering a fall of about 67% on the back of the crisis, so that brokers would come back with the lending industry. In 2012, most of the loans were contracted through bank branches (www.arbc.ro).

Against the backdrop of the prolonged crisis, many banks have reduced their sales networks, and new regulations on the real estate lending market have become almost prohibitive for prospective borrowers. Following the implementation of the new credit granting rules imposed by the Financial Services Authority, an interview for accessing a real estate loan takes just two hours. Many potential borrowers failed to break the new requirements barrier. However, brokers centralized most of the mortgage offerings on the market (Nicolae, 2010).

By appealing to the broker and not directly to the bank branch, the client was more likely to find an affordable credit. That's how it is that in 2014, UK loan brokers again came to intermediate about 60% of mortgages. After one year, the percentage exceeded for the first time 70% of total new mortgages, reaching 71% in the second quarter of 2015, with a loan volume of 28.8 billion pounds, according to reports available on market, 67% of the 164,000 clients who approached a credit broker during this period qualified for a loan (www.arbc.ro).

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

Romania has proved to be an avid residential real estate market in recent years, although we have one of the highest ownership rates in terms of number of homes in the EU. Demand for housing is high, however, given the relatively poor quality of living spaces. There are all prerequisites for this demand for housing to exist in the coming years, given the relatively low house prices and accessibility of loans, with interest rates on loans still low. In addition, real estate loans have associated a minimum risk and therefore banks are interested in crediting this segment. In Romania, the credit brokerage market is constantly changing, with credit brokers currently accounting for around 9-10% of all new loans granted by banks (www.arbc.ro) .

Both banks and customers are increasingly appealing to these intermediaries, especially for mortgage / mortgage lending. Banks are attracted by these collaborations due to the prospect of lowering sales force costs, but especially to increase sales. There are already banks on the local market for which 30-50% of total retail sales come from alternative channels. On the other hand, potential borrowers have understood that if they call a broker they will have free access to the best loan on the market, giving brokers a comparative analysis of current offers (Nicolae, 2015).

Until 2008, the overwhelming share of loans to households accounted for personal loans (around 75% of the total), with mortgages accounting for only a few tens of percent of the total. Throughout the crisis, loans backed by real estate collaterals have increased steadily, being the only product whose hip increased by more than ten percent from year to year. Evolution is explained by the fact that banks have focused on these safer products, wanting to eliminate some of the credit risk. In 2008, the balance of mortgages was 20.89 billion lei, in order to reach almost three times the value of 58.44 billion lei in 2016 (www.bnr.ro).

Between 2007 and 2016, there is only one year in which mortgage credit rose by less than ten percent - 2014. In the years to come, increases were between 10 and 19 percent. Currently, in the case of major players in the banking market, such as BCR and BRD SocGen, mortgages have significant percentages in the total volume of loans, with the net balances reported by the two banks at the end of 2016 being 12 and 10 billion of lei, both of which had a significant share of loans at First House (65% - BCR and 70% - BRD) (www.bnr.ro). As a matter of fact, the launch of First House program has allowed sustained housing credit growth during the crisis, with clients applying for a 5% down payment, while being the cheapest mortgage loan. But we are talking about a product that generates small earnings for banks due to small margins, and also a product that the state will give up gradually, as the level of guarantees granted was lower.

Year 2016 was the peak year for First House Program supported by the Government, with guarantees amounting to more than 3.2 billion lei. 2017 is already the first year in which the initial ceiling of 2.5 billion lei was not supplemented in the autumn, although it was exhausted and the demand was overwhelming. For 2018, the state announced that it will provide guarantees of only 2 billion lei, which would reduce the total volume of loans that can be accessed up to 4 billion lei, the lowest level in the last 6 years. To meet high demand, players in the real estate market will have to increasingly rely on their own mortgage lending (www.bnr.ro).

5. The observation of the risk associated with mortgage loans is the most healthy segment of bank portfolios

The brokerage companies focused on the intermediation of real estate loans, which are intended for the purchase of dwellings. These loans have proved to be a healthy segment of banking portfolios along the crisis, generating an insignificant rate of bad loans. In the years 2013-2014, when the average share of non-performing loans at the level of the Romanian banking market was 15-20%, the share of non-performing real estate loans represented less than one third of this percentage (www.bnr.ro). Over the crisis, the highest non-performing loans rates were generated by consumer loans with or without collateral. The difference between the evolution of the two types of loans is evident when we analyze the banking outcomes of the crisis years. According to the data provided by the National Bank in its reports on financial stability, unsecured consumer credits have generated much higher rates of non-performing loans in relation to real estate loans. In the last five years, the rate of non-performing consumer loans was between 8.5 and 13.6%. Over the same period, nonperformance generated by real estate loans accounted for between 2.6% and 4.9% of the portfolio (www.bnr.ro). The decline in bad credit spending rates in recent years has mainly occurred on the backdrop of outsourcing, while real estate loans have remained in bank portfolios. Between 2014 and 2016, the value of outsourced consumer credits was around 3.5 billion euro (www.bnr.ro). Also, real estate loans generated far fewer bad loans than mortgage consumer loans. Between December 2008 and June 2010, the mortgage-backed consumer credit default rate rose from 0.8% to 5.9% to reach 10-15% in 2011, 2012 (www.bnr.ro). During this period, the rate of non-performing real estate loans was below 6%. At the same time, at the end of 2015, the non-performing rate of mortgage-backed consumer loans was 12.43% and real estate loans only 2.64% (www.bnr.ro). The difference was noted by the National Bank of Romania (NBR) in its stability reports, which pointed out that the gap between the mortgage-backed mortgage-backed mortgage loan and real estate loans ratio reached 4.8 percentage points in June 2011, from 1.5 percentage points in December 2009 (www.bnr.ro). The evolution led to the approval by the NBR of Regulation 17/2012 imposing stricter conditions for the granting of consumer mortgages by setting an advance of at least 40%. Banks such as BRD have taken out these loans on the offer, focusing on lending (www.bnr.ro).

6. The observation of the brokerage activity in financial intermediation

The brokerage activity in financial intermediation has already been around 15 years in Romania, in 2003 being founded the first such company, Gemini, which later became Kiwi Finance (www.arbc.ro). Prior to the financial crisis, during the crisis and afterwards, credit brokers constantly provided clientele to commercial banks. The service, which facilitates a potential borrower's access to a bank loan, is offered to borrowers free of charge, and the lender has to pay a modest commission once the client is accepted in the portfolio (IASB , 2014) . In the broker-credit collaboration, the client's risk degree is analyzed based on the same parameters as if the client had co-opted through the bank's sales force. Practically, the client goes through the same risk filters as a potential debtor who addressed the bank directly, the credit being granted after applying the scoring and checking the client's eligibility by the bank (IASB , 2014). The main benefit of a credit broker's collaboration with a credit broker is the increase in sales and the prospect of lowering the cost of its own sales force in the retail segment (www.arbc.ro).

In this way, branch staff can focus on loan analysis for SMEs or micro-enterprises. In the US, retail credit sales were almost entirely outsourced to credit brokers, with around 90% of retail clients in the bank's portfolio coming through this indirect sales channel. In Western Europe, the percentage is about 40%, and in Romania only 9-10%, but steadily increasing (www.arbc.ro). The higher degree of financial education of the population in Western Europe and the US determines potential borrowers to turn to credit brokers, which can offer them a comparative offer of all products on the market. Unlike in Romania, where the service is offered free of charge to potential debtors, most Western European states and the US pay a commission. In the UK, for example, the amount of the commission is around 0.35% - 0.4% of the loan (www.arbc.ro).

The activity of brokers is supervised by the National Authority for Consumer Protection. GEO 52/2016 on credit agreements for real estate consumers, an ordinance transposing European directives in the field of credit intermediation, stipulates the conditions that brokers have to fulfill in order to carry out their activity. The regulatory act stipulates that a credit broker must meet the minimum knowledge and competence requirements, respectively to have adequate knowledge of credit products and accessories normally provided with them; adequate knowledge of consumer credit legislation, including in the field of consumer protection; adequate knowledge of the process of acquiring real estate and understanding it; adequate knowledge of the valuation of guarantees; adequate knowledge of the organization and operation of land registers .

The same ordinance imposed on brokers the conclusion of professional liability insurance with a coverage of EUR 460,000 for each individual damage and EUR 750,000 for all claims for damage in a calendar year (www.arbc.ro).

7. A case study of accounting aspects of equity instruments classified as financial assets at fair value through profit or loss (FVTPL)

On November 20, 2018, an entity purchases 1,000 shares at the price of 8,000 m.u. (monetary unit) per share. Trading costs represent 1% of the value of the purchased shares (Nicolae, 2010).

According to the entity's policies, it intends to trade the shares in the near future, aiming at achieving short-term profit from these operations, and classifies the shares acquired in the financial assets at fair value through profit or loss **(**FVTPL) category (Nicolae, 2010). The accounting account used (as proposed in the IFRS accounting plan) to exemplify the accounting records was 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 records
(Author processing)

Registration of the acquisition of shares :

Debit *Quoted shares held for trading* 8,000,000
Credit *Payments to be made for other short-term financial investments* 8,000,000

Record of transaction costs:

Debit *Expenses on fees payable for securities trading on the regulated market* 80,000
Credit *Payments to be made for other short-term financial investments* 80,000

Payment of expenses:
Debit *Payments to be made for other short-term financial investments* 80,000
Credit *Bank account* 80,000

Payment of debt on purchased shares:

Debit *Payments to be made for other short-term financial investments* 8,000,000
Credit *Bank account* 8,000,000

Accounting records as at 31 December 2018
At December 31 2018, the share price dropped to 6,000 m.u. , and the fair value of the stake was 6,000,000 m.u. . The registration is:

Debit *Losses related to financial assets and liabilities held for trading* 2,000,000
Credit *Quoted shares held for trading* 2,000,000

Accounting records on January 31, 2019
On January 31, 2019 the share price increased to 12.000 m.u. . As a result, a gain of fair value differences on the share of the shares held will be recorded, amounting to m.u. 6,000,000 :

Debit *Quoted shares held for trading* 6,000,000
Credit *Gains on financial assets and liabilities held for trading* 6,000,000

Accounting records on 29 February 2019
On February 29, 2019, the entity signs a share sale contract at a price of 13,500 m.u. . The selling price is equal to the market share quote valid for the date of sale.
Recording of the valuation at fair value:

Debit *Quoted shares held for trading* 1,500,000
Credit *Gains on financial assets and liabilities held for trading* 1,500,000

Registration of sale of shares:

Debit *Debtors from transactions for own-account transactions on the regulated market* 13,500,000
Credit *Quoted shares held for trading* 13,500,000

Subsequent collection of due amounts:

Debit *Bank account* 13,500,000
Credit *Debtors from transactions for own-account transactions on the regulated market* 13,500,000

This example illustrates the two-step sale (fair value measurement followed by actual sale). 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. Conclusion

In my opinion, the hedge accounting is an important tool for bank / credit 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 bank 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.

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