

Not all that glitters is gold – not all foreign currency is what it seems? – a perspective of financial institutions

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The financial recession started in Hungary in the fall of 2008, resulting in the deterioration of the financial market due to hectic exchange rates and higher loan payments in consequence of the weak Hungarian Hungarian Forint. The majority of loans in Swiss Frank and Japanese Yen diminished, the conditions of applying for loans in foreign currency (exclusively the Euro) became strict, and the existing portfolios also decayed. Therefore the booked provisions increased and the loss derived from the above became higher due to the new regulations introduced in year 2010 and 2011 in order to make relief for households indebted in foreign currency.

The article introduces different definitions of foreign currency items included in accounting rules and other books, and shows that these definitions are not standardized/unified.

It is proven that the same handling of foreign currency and foreign currency-based transactions do not distort the true and fair picture. However, the direct application of it in the determination of the foreign currency position of an enterprise could be misleading – regarding the impairment of foreign currency-based transactions.

The article introduces the impact of “home safety package” on FX-positions and outlines some technical problems to overcome.

Keywords: accounting, foreign currency position, impairment, banks, loan loss allowances

1. Introduction

The financial recession started in Hungary in the fall of 2008 resulting in the deterioration of the financial market due to hectic exchange rates and higher loan payments in consequence of the weak Hungarian Hungarian Forint. The majority of loans in Swiss Frank and Japanese Yen diminished, the conditions of applying for loans in foreign currency (exclusively the Euro) became strict and the existing portfolios also decayed. Therefore, the booked provisions increased and the loss derived from the above became higher due to new regulations introduced in year 2010 and 2011 in order to make relief for households indebted in foreign currency. It means that there is a limited choice of applicable FX-rates for financial institutes when they convert receivables from or to a foreign currency¹, and also there is the possibility of paying installments at a maximized FX-rates for a limited period of time, and the possibility of paying the whole sum of the outstanding obligation at a maximized rate².

According to the accounting approach, there is no difference between foreign currency and foreign currency-based transactions, meaning that regulations are the same regarding activation and evaluation. The same stands for loan loss allowances calculated through evaluation and qualification processes. In the essay, I present the magnitude of this problem through statistical data, introduce the definitions found in different related acts and other rules, (e.g. the accounting act and government decrees for accounting rules and capital requirements of financial institutions). In this section I highlight inconsistencies found in

¹ 2010. XCVI. Act „Egyes pénzügyi tárgyú törvényeknek a nehéz helyzetbe került lakáscélú hitelt felvevő fogyasztók megsegítése érdekében szükséges módosításáról (A hitelintézetekről és a pénzügyi vállalkozásokról szóló 1996. évi CXII. törvény módosítása).

² 2011. CXXI. Act “az otthonvédelemmel összefüggő egyes törvények módosításáról (A hitelintézetekről és a pénzügyi vállalkozásokról szóló 1996. évi CXII. törvény módosítása)”.

these prescriptions and show the importance of the above by describing the most common contractual framework of FX-denominated deals in Hungary.

The importance of impairment resulting from foreign currency or foreign currency-based assets is significant and raises numerous questions, which I explain by a quantitative presentation of two different solutions. In this matter, I emphasize the order of different tasks to be fulfilled during the annual report preparation and the effects on business' earnings based on the differences of provisions in foreign currency or foreign currency-based transactions, including foreign currency position and its impact on the profit disclosed.

Finally, I shortly describe the impact of the new acts on the FX-position and on the comprehensive income statement.

2. The importance of foreign currency loans in the light of statistical data

There is basically no heading in balance sheets that would not contain any foreign currency or foreign currency-based assets. The most frequent ones are foreign currency deposits, liquid assets, foreign currency claims and liabilities, especially loan debts and marketable securities. Foreign currency evaluation problems could also arise in Provisions, accrued incomes and expenses, and in the Tied-up provision within the Equity Capital's unit, as well. The most significant is undoubtedly the foreign currency credit so next we present its order.

The balance sheet asset value of credit institutions, operating as public limited companies, increased by 35% from 21,944 billion HUF to 27,520 billion HUF between December 31 of 2006 and December 31 of 2010. The amount of the outstanding loans for the same period increased by 32% from 14,419 billion to 18,983 billion, meaning that the weight of outstanding loans slightly decreased.

The amount of loans in Hungarian Hungarian Forint decreased by 5%, while the amount in the case of foreign currencies, including foreign currency-based loans grew by 84 %, reflecting the increased ratio of foreign currency loans.

The fact that the ratio of foreign currency loans made up 41% of the total amount of the outstanding loans in 2006 and 57% at the end of 2010 corresponds with the above-mentioned. Obviously/Without any questions/Undoubtedly this change is greatly influenced by the increase in exchange rates along with the growth calculated in foreign currencies, which enhances the dynamics and ratio of foreign currency loans calculated in Hungarian Hungarian Forint.

The chart above reflects the distribution of FX and FX-denominated loans in currencies in the last 4 years, and it shows that – although the ratio of loans in Euro are important – the amount of loans provided in CHF are much higher.³

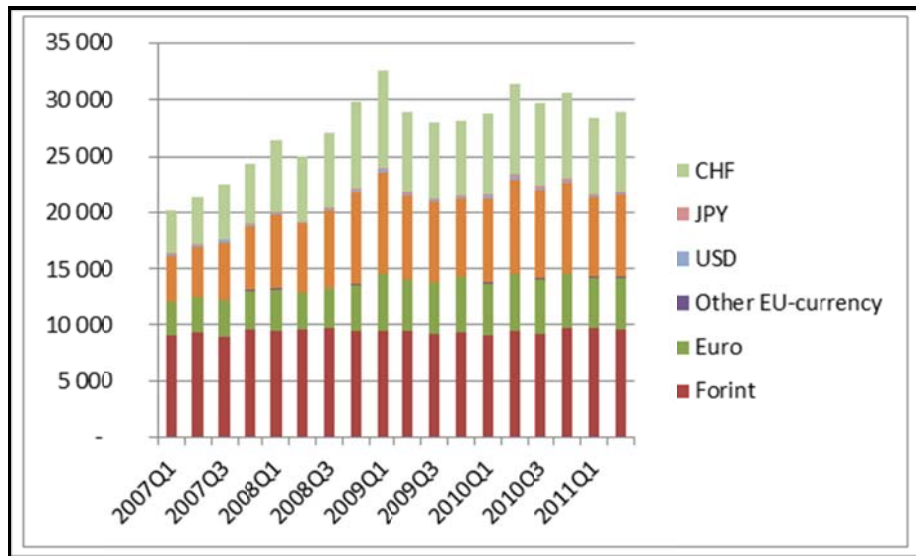
The sum expressed in Euro of the Euro and the Euro-based loans increased by 42% between 2006 and 2010, while the FX-rate grew by 5 % resulting in 50% increase in the Hungarian Hungarian Forint sum of these loans.

The increase of Swiss Frank-based loan portfolio calculated in the original currency was 33% in the same period, parallel with 40% increase in the FX-rates, hence the Hungarian Hungarian Forint amount of these loans grew by 86%.

In the case of the Euro and the Euro based loans, the above-mentioned analysis shows that while the amount of the Euro loans denominated in Euro increased by 10% between Dec 31 of 2006 and Dec 31 of 2010, the currency rate increased by 39%, which raised the Hungarian Forint amount of Euro loans by 54%.

³ <http://www.mnb.hu/Statisztika/statisztikai-adatok-informaciok/adatok-idosorok>

Figure 1. Loans provided to domestic clients in original currency; billion HUF

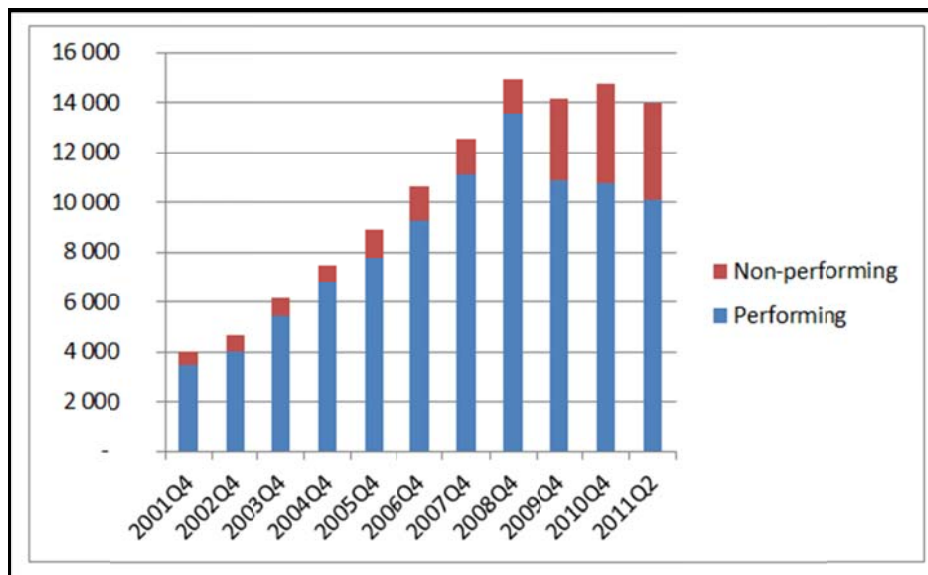


Source: own construction based on mnb.hu⁴

It can be clearly stated that it would be necessary to analyze foreign currency amounts to demonstrate the significance of foreign currency loans, but since most of the debtors can only pay in Hungarian Forint, the change to Hungarian Forint is also relevant⁵.

The quality of foreign currency and foreign currency-based loans worsened due to the recession.

Figure 2. Assets to be classified of credit institutions working as public companies; billion HUF



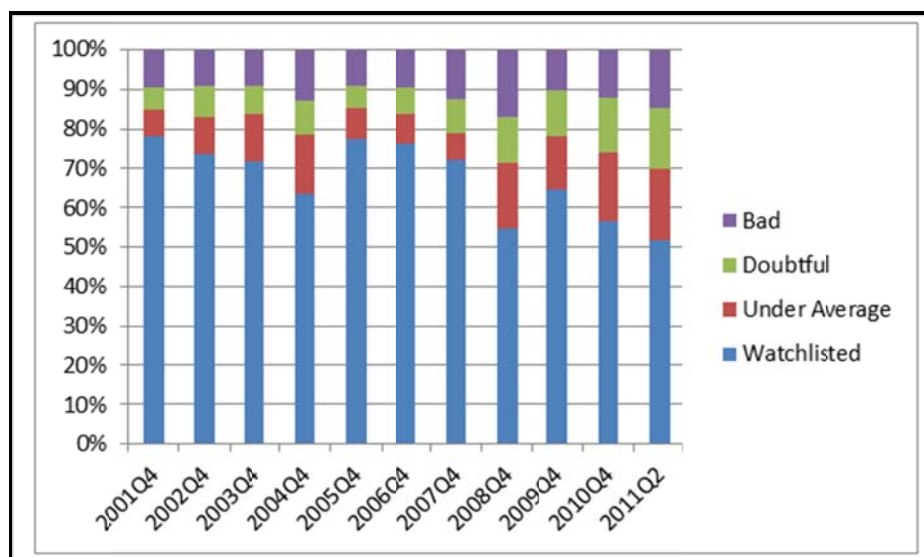
Source: own construction based on PSZAF time lines of credit institutions

Figure 2 shows that the rate of non-performing loans has been continuously increasing in the last 10 years, while these loans added up to only 14 % of the total loan portfolio in 2001, those rate went up to 28% by June 2011.

⁴ http://www.mnb.hu/Kiadvanyok/mnbhu_stabil/mnbhu-stab-jel-201111

⁵ http://www.pszaf.hu/bal_menu/jelentesek_statisztikak/statisztikak/hiteladat_bev.html

Figure 3. The distribution of the problematic portfolios of corporate credit institutions



Source: own construction based on PSZÁF time lines of credit institutions⁶

The ratio of the watchlisted, least wrong loans among the non-performing portfolios decreased from 78% to 52% during the same period, while the distribution among other categories was changing, but Figure 3 above unambiguously indicates the worsening/declining of the portfolios.

The above facts are reflected in the amount and the rate of the provision booked and summarized in the next Table.

Table 1. Loan loss allowances at credit institutions working as public companies; million HUF

Description/Year	2005	2006	2007	2008	2009	2010
Provision booked (loss)	-35 392	-75 016	-104 093	-148 250	-459 900	-418 570
Average loan portfolio	11.022.413	13.238.759	15.744.979	18.890.832	19.923.361	19.059.250
Average provision % on loan portfolio	-0.32%	-0.57%	-0.66%	-0.78%	-2.31%	-2.20%
Average total asset	17.109.563	20.225.572	23.704.602	27.972.558	30.459.661	30.026.678
Average provision % on total asset	-0.21%	-0.37%	-0.44%	-0.53%	-1.51%	-1.39%

Source: own construction based on PSZÁF Golden books, 2004-2010⁷

We can only have an approximate picture of the quality of the portfolio of financial institutes working as public companies, but the trends and the magnitude of changes shown by those are true⁸. Provisions booked were almost irrelevant in 2005, but increased gradually in the observed period. The major change happened in 2009 when the rate of provision booked tripled and this level did not change in 2010.

⁶ http://www.pszaf.hu/bal_menu/jelentesek_statistikak/statistikak/pszaf_idosorok/idosorok

⁷ http://www.pszaf.hu/bal_menu/jelentesek_statistikak/statistikak/aranykonyv_cikk.html

⁸ Although the table contains changes in the total amount of provisions booked each year as the exact amount of the base of provisioning, I took into account both the total loans and the total asset value in order to calculate ratios.

All these data/figures clearly show the significance of a proper economical handling of foreign currency assets and sources.

3. Definition of items in foreign currency

In this chapter I. introduce and compare the most important definitions of foreign currency items, collected from relevant laws/acts, other regulations and related professional items, in order to draw the attention to the contradictions embedded in these definitions, however, I do not make suggestions for their dissolution.

According to Jozsef Roth (*Adorján et al 2010*) “those items can be treated as foreign currency ones, where there is a need for booking also in a foreign currency in the analytics. It is needed because these items will be changed to a foreign currency in the future, going hand in hand with FX-risk.”

The first part of the definition would not give a clue to grasp the substance, but the second part gives an important factor according to which the key is the future change in the amount of the foreign currency, which can result either in profit or in loss due to changes in FX-rates.

These definitions are in line with the government decree on definitions of capital requirements (244./2000.). However, the same conclusion can be drawn not from the given definition of foreign currency but from the prescribed method of calculation of FX-position.

According to the 2.§ 6. of the above mentioned government decree, “foreign currency: receivables for foreign currency and gold.” Literally this would mean that only those receivables could be treated as foreign currency receivables whose related cash inflow is expected also in foreign currency. Hence, cash in hands and foreign currency based receivables and liabilities – where cash inflow is expected in Hungarian Forint, even if they are FX-denominated – would not be foreign currency ones.

The intention of the lawmakers was probably different, which can be traced from the 40.§ 1.a): “ net balance sheet position (total asset booked in the given foreign currency decreased by the total liabilities in the same currency)”.

While calculating the FX-position, not only the amount of assets, but also the liabilities should be taken into account when they are registered in foreign currency.

The government decree I refer to above deals with the foreign currency definition in the 8. § (1) sentence also as part of the valuation of FX-positions: “Net positions of financial items denominated in other currencies than Hungarian Forint should be valued at the official rate of the National Bank of Hungary (NBH).”

Based on this we can conclude that all assets and liabilities should be treated as foreign currency ones, whose amount is defined not in Hungarian Forint but in any other foreign currency, notwithstanding the currency of expected cash inflow.

In the minority of the cases it means that the amount of the receivable or that of the liabilities is denominated in a foreign currency together with cash settlement which is expected in the same foreign currency. These kinds of contracts are irrelevant to loans provided to domestic households, in the case of these loan types, the clients are usually companies (FX-loans).

Household debts are mainly denominated in a foreign currency, but their installments are due in Hungarian Forints. These FX-denominated loans are treated differently by banks:

- a) in the majority of the cases – loans provided usually by commercial banks – the debt is registered in foreign currency until it is paid in. There is no translation/conversion to Forint before this point, even in the case of late payment.

- b) in other cases – some loans, but almost all financial leasing contracts – debt is registered in foreign currency by the lender until the due date. At that point the due foreign currency amount will be automatically translated/converted to Hungarian Forint, hence, a part of the debt will be still denominated in foreign currency – due in the future -, but the previously due part of it will be expressed in Hungarian Forint.

Financial institutions should take into account both of the above mentioned loan types, but in the case the latter one (b), only the part which is still registered in foreign currency.

Act C, 2000 on accounting lays down in its §60 (7) that “if the law allows for domestic foreign currency users to define considerations and their installment on the basis of foreign currency in their contracts, then according these contracts, paragraphs (1)–(6) have to be applied in registration and at the year-end evaluation”.

All in all we can conclude that Act C on accounting and the government decree on calculation of capital requirement basically apply the same definition for foreign currency items.

In the case of financial institutions, there is one more government decree to be observed (250./2000.) ruling the speciality of financial statements of these institutions.

According to 2.§ 5. of this decree, from the valuation point of view, “foreign currency bank accounts, securities and shares of foreign currency and receivables, where the offset is foreign currency”, are foreign currency assets.

Point 7. within the same paragraph defines foreign currency liabilities, whereas Point 10 defines the off-balance sheet foreign currency receivables along the same logic. Their result is the fact that the prescription of the accounting government decree equals to the “narrower” definition described in the capital requirement decree. However, while the (last one) capital requirement decree generalizes the definition, the accounting decree remains at this level, hence it does not reflect reality. Since the accounting decree is only a supplementary regulation of the accounting act, we can conclude that they both define foreign currency and foreign currency-denominated items as foreign currency ones.

All items where the amount is defined in foreign currency should be treated as foreign currency ones, notwithstanding whether cash offset are expected in Hungarian Hungarian Forint or in any other foreign currency.

4. Foreign currency or foreign currency - based?

The law does not distinguish the valuation of exclusive foreign currency or foreign currency-based transactions in the financial statement. In this section, I analyze how strong/accurate/distinct this approach is, how the report prepared accordingly could show a true and fair picture of the enterprise which made it.

In the case of foreign currency-based deals, liabilities of a company are denominated in foreign currency in spite of the fact that the creditor expects the payments in Hungarian Forint not in a foreign currency. At this point, the enterprise has foreign currency receivables but it is not able to pay its foreign currency-based liabilities directly after conversion to Hungarian Forint. This is a double burden for the enterprise: the conversion to Hungarian Forint is on buying rate and the payment is on selling rate, so the created difference is clearly the burden of the enterprise. It means that the enterprises had to and still have to make responsible decisions about the foreign currency type of their financial liabilities in their calculations and payments. In case they have actual foreign currency income, it is recommended to apply for real foreign currency loan, which is calculated in foreign currency and requests the payment in Hungarian Forint the same currency. If they do not follow this, they will have open position in both cases of receivables and liabilities of the same amount denominated in the same

foreign currency. consequently they could have even exchange earnings. I explain this through the next example:

Based on the consideration above, foreign currency and foreign currency-based items should be separated when calculating the accounting FX-position, as in the latter case the goal is not the zero position but a slight surplus on the asset side in order to reach economic zero position.

The question is how we can calculate the amount of a necessary surplus, whether it can be calculated at all. As the example shows, we can define the liabilities which can be settled off as the result of the conversion of foreign currency receivables using the actual buying and selling rates ($250/260 \times 100 \text{ euro} = 96.15 \text{ euro}$), hence, we can calculate the amount of loss, as well.

This calculation cannot be made so easily since the maturity break down of receivables and liabilities are not the same, the relation between selling and buying rates are not constant, hence, there is an inherent uncertainty in the calculation above.

We can also meet the opposite of the above described case: in the case of foreign currency- based receivables and purely foreign currency liabilities, the difference between FX-rates used for the conversion of receivables to Hungarian Forint and the rates applied by the bank results in FX-risk.

The avoidance of this risk usually happens not with accounting, but with contractual methods – it is worth applying for the same FX-rate of the bank in the contract of the receivables.

Example 1. Problems with foreign currency-based receivables

An enterprise has 100 EUR receivables from a client who will balance it in Hungarian Forint. It will finance it from a loan, which has to be paid off in a foreign currency.

At both the asset and the liability sides of the balance sheet, the enterprise has 100 EUR so according to the rules there is no exchange earning expected.

According to the contract, the client is obligated to balance the liabilities on buying rate of the financing bank, which is 250 HUF/EUR. The enterprise converts this incoming 25,000 HUF ($=100 \text{ EUR} \times 250$) to foreign currency on selling rate (260 HUF/EUR) of the financing bank and it will become 96.16 EUR which does not cover the settlement of the foreign currency debt.

To settle the whole amount to the creditor the enterprise needs $100 \text{ Euro} \times 260 \text{ HUF/EUR} = 26.000 \text{ HUF}$, which could be available if the payable Hungarian Forint amount is assigned by the application of foreign currency selling rate in the contract⁹.

Notice that there is no exchange risk in Example 1, not even when the refinancing liability is exclusively in a foreign currency. This way the proper amount of foreign currency for payment could be obtained from the Hungarian Forint amount on selling rate for the liabilities.

In the previous chapter, enterprises with open foreign currency positions, according to their balance sheet, were analyzed, typically having surplus at the side of the liability, meanwhile having continuous foreign currency income in the future according to their contracts.

⁹ These types of contracts are signed typically by those financial enterprises that finance their outsourcings not from their own incoming Cash Flow – since they do not have the right for cash collection – but from the refinancing loans they received from commercial banks. Since the effective financing and installment happens in Hungarian Forint, even if they are foreign currency based, the financial enterprise applies for the same loan from the financing bank.

In this chapter, we analyze the same situation with the difference of having future income not in foreign currency, but on foreign currency basis, in Hungarian Forint¹⁰.

The possible solution of realizing the certain amount of expected exchange gain in advance described in the previous chapter is also applicable here, with the restriction that this solution assumes the definition of income conversion on selling rate in the contract, as well.

5. Annual report and impairment

Connected to the foreign currency liabilities, beyond usual questions regarding loss in value, the exchange rate to apply and the priority of annual foreign currency evaluation have to be defined in the annual evaluation.

According to the accepted, widely taught and published view¹¹, the first step is to determine the loss in value in foreign currency in the case of foreign currency liabilities, which is followed by registration on book rate. The last step is the revaluation of foreign currency amounts including both the original receivables and the registered impairment.

These are analyzed in the following example:

Example 2. Problems with foreign currency based receivables – Solution#1

An enterprise has 100 EUR receivables from a client who will balance it in foreign currency. The receivable was registered in the books in the current year on 250 HUF/EUR book rate. At the year-end evaluation the applied rate is 255 HUF/EUR, but there is no 10% return from the receivable.

According to the recommended solution, 10 EUR impairment has to be registered on book rate, so 2,500 HUF (=10 EUR×250 HUF/EUR) appears under other operating expenses. Following this the net bookvalue of receivable will be 90 EUR, the revaluation difference will be 450 HUF (=90×(255-250)), which appears under another income from financial transactions, if the summarized exchange rate result is a gain. Although, under other expenses the summarized exchange rate can result as a loss.

In the next year the value of receivables in foreign currency does not change, therefore the booking of 50% impairment is necessary and the rate is 260 HUF/EUR at the end of the year.

Consequently the sum of additional impairment: 10,200 HUF (+40×255 HUF/EUR, so we define increment in EUR on book rate, in this case the one used at revaluation at the end of previous year). Next step is the revaluation of the remaining net foreign currency receivable (50 EUR) resulting in the appearance of additional 250 HUF exchange gain.

To sum up the above:

Table 2. Summary of result on Example 2 – Solution #1

Category	1 st year	2 nd year
Impairment (other expense)	-2,500	-10,200
Exchange gain	450	250
Summarized effect on profit and loss	-2,050	-9,950

Source: own calculation

¹⁰ These enterprises are typically e.g. the office buildings, which can pay their installment of foreign currency-based loans taken for the construction, from their future Euro based rental incomes.

¹¹ This opinion appears in the 1.4 Chapter of Chamber of Hungarian Auditors accounting educational publication, as well. Author: Jozsef Roth Dr.

The method considers impairment as a foreign currency item, just like the receivable itself that is impaired.

In my opinion, this consideration is well established from the side of financial reality, as well: when the payment of a receivable becomes doubtful/indefinite/uncertain/unsure, we “waive” - not legally - the estimated unpaid part by booking impairment, so we realize it as a loss. In conclusion is also means, that in the future we do not wish to have further losses concerning this impairment - in the example concerning 10 and additional 40 Euros. Exchange rate change would cause such a loss, that we would like to exclude this, so we take into calculation this impairment at the asset side of the balance sheet decreasing the position.

The solution above only partially reflects the latter way of thinking. On the one hand, it is according to the principle since only the net receivable is revalued after registering the impairment, so additional exchange earning does not appear in the books.

On the other hand, impairment is booked according to a previous book value, which contradicts the principle of true and fair view: the impairment loss is born on the day it is registered - at least based on the financial thinking - so according to this, the registration of it should not be at a past rather at a present rate.

At the same time, I have to point out that applying past exchange rate absolutely suits the principle of going concern as the basis of the Act on Accounting. The evaluation on cost value of assets is the consequence of this principle and as result, we register assets on their original value until canceling. This approach is overruled at several points by the law even in the case of enterprises not applying fair value measurement. On one hand, it allows to “appreciate” assets by value correction, on the other hand, it makes booking of impairment obligatory not only in the case of receivables but that of the tangible assets and inventories, as well, if their book value permanently and significantly exceeds their market value.

However, the law makes an exception in the case of the foreign currency asset parts because of their nature, the volatility of exchange rates and the handling method of risks in them. It prefers the principle of true and fair views meaning the application of due date rate.

Since marking impairment is a duty related to the periodical closing, the cost value should be the due date exchange rate. The analysis of the effect of recommended method through the above mentioned Example 3. follows:

Example 3. Problems with foreign currency based receivables – Solution#2

According to the proposed solution, first the gross receivable has to be revalued, as a result of a revaluated difference of 500 HUF ($=100 \times (2550 - 2500)$) appears in the earnings of the financial transactions. After this the 10 EUR impairment could be accounted, now on due date rate, so that 2,550 HUF ($=100 \text{ EUR} \times 255 \text{ HUF/EUR}$) appears under other expenses.

In the next year the value of receivable in foreign currency does not change, because of that the accounting of 50% impairment is necessary, and the rate is 260 HUF/EUR at the end of the year.

As result, in the new annual revaluation there is an additional 450 HUF ($=90 \times (260 - 255)$) exchange gain marked, and the sum of impairment to mark is 10,400 HUF ($+40 \text{ EUR} \times 260 \text{ HUF/EUR}$).

To sum up the above:

Table 3. Summary of result on Example 2 – Solution #2

Category	1 st year	2 nd year
Impairment (other expense)	-2,550	-10,400
Exchange gain	500	450
Summarized effect on profit and loss	-2,050	-9,950

Source: own calculation

It is clearly pointed out, that although certain factors of the result changed, the solution above leads to the same conclusion as the commonly accepted method.

In my view, the second solution reflects the situation better and it is more consistent since according to it the impairment is always booked at daily exchange rate, while in the first case either at original rate or at any balance sheet rate dated later, if the receivable is still in the books for more than a year¹².

Reserve due to the uncertainty of receivables has to be booked as negatively signed item – impairment – on the asset side of the balance sheet. This method has not always been followed, even in the history of the Act on Accounting. There was a solution that required not the reduction on the asset side, but the appearance of a new item, called provision, on the liability and equity side of the balance sheet. In this case, the exchange rate of creating a provision was obvious since it was about booking a new passive, which had to be registered not at the exchange rate of an already existing asset, but at the actual daily rate.

Impairment booked at foreign currency receivables is also in the same currency, hence, it is taken into consideration at the determination of foreign currency positions – this way the creation of impairment affects the position, which also reflects in the books.

The question is that whether this point of view should be applied also in the case of the foreign currency-based transactions.

There are foreign currency-based transactions where the applicable exchange rate is laid down in the contract, but the due date of the conversion is not registered, so it could not be determined in advance at what exchange rate should the installment be converted to Hungarian Forint. It means that the particular amount of foreign currency is indeed a foreign currency until it is being paid. The evaluation of this type of foreign currency-based transactions, including the description at the accounting of the impairment, is the same as it is settled at exclusively foreign currency transactions.

During another type of foreign currency-based transactions – as I claimed before – the contract could possibly contain the day when the debtor is obliged to pay the converted Hungarian Forint amount at the given exchange rate. In the case of such foreign currency-based transactions, the Hungarian Forint receivable is to be paid at the exchange rate of the due date, typically on selling rate. This solution results that such receivables are not actually foreign currency ones, at due date or at the end of their term, but rather they are determined to be receivables in Hungarian Forint. Consequently, from their conversion time their impairment is also not in foreign currency but in Hungarian Forint. To prove my statement, here is the following example:

Example 4. Loss in value of foreign currency based receivables

An enterprise gave a 1,000 EUR foreign currency loan to one of its partners. Half of the loan is due October 30, and the other half is due April 30, next year, in Hungarian Forint. The cost value rate is 250 HUF/EUR, the selling rate at the due date in October is 260 HUF/EUR, during the annual evaluation it is 265 HUF/EUR, and at the final due date it is 254 HUF/EUR. The enterprise refinances the transaction from a foreign currency loan, with the same dates as the dates of items on the asset side. The enterprise creates a 20% impairment of 500 EUR receivables, for the future balance sheet date, since the debtor paid the first installment 50 days overdue.

¹² In the first example, the impairment created in the year when the receivable was booked, appeared in the books at rate 250, while the next year impairment appeared after the first revaluation, therefore it reflected the particular daily rate. In case the enterprise choose to make monthly revaluation – which can be done legally, and according to the regulations of its parent company, usually it is obliged to do so – this way we almost reach the second solution.

In case the impairment created in foreign currency, the open position of the enterprise determined by the financial statement according to the Act on Accounting will be the following:

Assets: 500 EUR receivable due in the future - 40 EUR impairment

Liabilities: 500 EUR liability, due in the future.

The enterprise did not have an open position before the creation of the impairment, the value of EUR assets and liabilities was the same. The position virtually was opened by the registering of the impairment, and the enterprise got into the exchange risk that it wanted to avoid. According to the book, that reflects the financial reality, the position has not been opened since it can still expect 500 EUR revaluation difference from the debtor according to the contract. In case the receivable is lost, due to cancellation or factoring, the Hungarian Forint amount due is calculated on actual selling rate. This way there will be no exchange loss, instead, the credit loss increases.

In the case of hedging a seemingly financially open position on due date exchange rate, it means that it fixes the rate of the generated 40 EUR impairment so as to realize a 10,600 HUF loss for certain. In case it converts the receivables to Hungarian Forint on due date at 254 HUF/EUR rate, it becomes obvious that the hedging transaction, according to the year-end impairment estimation, has been unnecessary, because that does not avoid exchange rate risk, but brings it into the operation of the enterprise.

As for the unsettled 500 EUR, the enterprise does not have any exchange risk since the hedge is built into the credit transaction.

The deduction above attracts attention to that basic receivables of foreign currency-based contracts which have to be evaluated in the balance sheet at the determination of foreign currency position, whose starting point is usually the accounting date, in the same way as exclusively foreign currency receivables, and the impairment of these transactions has to be handled separately.

6. Amendments for helping the households indebted in foreign currency and their impacts on the FX-position

Foreign currency loans have resulted in a growing burden on households due to the weakening Hungarian Forint. During the last two years more laws have been enacted with the intention to ease this burden.

In the following I examine the impact of these new features on the FX-position and through this on the P&L of financial institutions.

As the first step in the line of these arrangements the possible applicable FX-rates have been limited. According to the new prescription from 27th November 2010, “if the financial institution settled an FX, or FX-denominated mortgage loan or leasing contract with a consumer, then the

- a) down drawn loan,
- b) monthly installment and
- c) any expense, fee or commission defined in foreign currency should be converted into Hungarian Forint...
- d) using the financial institution’s own average of selling and buying FX-rates, or
- e) the official rate of the National Bank of Hungary.”

The market price of the assets financed by financial institutions is usually defined in Hungarian Forint, but in order to calculate the amount in foreign currency to be financed, an FX rate should be applied. Before enacting the above cited prescription, creditors usually applied buying rates in this case, as they needed to buy the currency in order to be able to finance the asset. On the other hand, installments payable by the clients were converted to Hungarian Forint using selling rates with the underlying idea that the debtor needs foreign currency in order to pay the installment, and this will be sold by the financial institution at selling rate.

Limitation of applicable FX-rates will result in the fact that FX-amount of these loans at the inception of the loan term will be lower as the same Hungarian Forint amount will be converted to foreign currency at a higher rate, and installments in Hungarian Forint will be also lower as those will be converted to Hungarian Forint at NBH to an average rate, which is always lower than the selling rate.

Although this amendment is able to significantly reduce the creditor's profit, it does not have any impact on the FX-position, and the accounting prescriptions can be further applied without any modification.

FX-rate barrier introduced in summer 2011 gives the opportunity to clients indebted in foreign currency to pay the increase of installments – during 3 years starting from the contract amendment – in the future financed from automatic Hungarian Forint loans with maximized interest rates. {Act LXXV. of 2011, 1.§ (1) point 1. and (2)}.

In those cases, where the original contract had the same characteristics – that the installments are converted to Hungarian Forint at the due dates – this modification does not cause any changes from the point of view of the FX-position.

In these cases the creditor's receivables after the due dates up to now will also be denominated in Hungarian Forint, hence loan loss allowances were booked originally in Hungarian Forint, and there is no need for alterations.

Irrespective of the above, there are several problems to be handled by the creditors, as the original FX-based loan should be tied to the Hungarian Forint loans originated by the unpaid FX-differences of the client, and the interest rate of this loan can be capitalized on a quarterly basis, which is probably not the case regarding the general loans.

Due to the above, there will be a change in the position of liquidity also, as the creditor will not have enough amounts of Hungarian Forint to pay the refinancing loan in foreign currency, therefore additional Hungarian Forint sources will be required.

The client will be obliged to repay the accumulated Hungarian Forint receivables together with the original foreign currency loan, causing a potential increase in credit risk despite the partial government warranty.

As I mentioned earlier in Chapter III., in other cases the loan remains in the original foreign currency until it is paid, hence all parts (both past due and undue) of the receivables were registered in foreign currency before applying the FX-rate barrier, as FX-risk was transferred to the clients. In those cases where creditors book loan loss allowances for these loans, they register it in foreign currency causing position-opening. Whenever the creditors hedges this open position, it fixes the rate and the amount of the losses in Hungarian Forint is being born.

After using the FX-rate barrier, FX-rates for all due installments will be fixed during the applying period – therefore these will be converted in all the cases at the rate valid at each due dates. That portion of the loan (maximum the principal part of the installment for 3 years) will receive a different characteristic from the original foreign currency loan, and it will also differ from the ones due after 3 years. Provisions regarding principal payables during the application period of this new rule should be registered in Hungarian Forint in contrast to the principal due after this period.

Due to the above, the position, previously closed accurately, will open again, now in the opposite direction, hence provision booked on this Hungarian Forint principal will be removed from the position. This results in explicit FX-risk to the creditors as this means such changes in the contractual conditions, which affect the calculation of FX-position, as well.

The introduction of the FX-barrier can cause problems from IT point of view as installment payable in the following 3 years should be converted to Hungarian Forint, provisions related to these installments should be booked in Hungarian Forint, but installment due after the 3rd year can be treated as previously.

FX-risk arisen from the applying FX-rate barrier is limited by the law itself, as the application of it is not obligatory for loans with 90 or more days past due, and when applying it in a given contract after reaching the 90 DPD, the obligation of application of fixed FX-rate will be ceased.

Based on such loans – with DPD within 90 days – creditors are obliged to book maximum 30% provisions according to the accounting government decree. Assuming that creditors do not book higher provision than prescribed, we can conclude that the maximum of FX-risk arisen from this modification is the 30% of the principal due in 3 years.

The last resort of the “home safety” package is *the opportunity to repay the total amount of debt at a very favourable rate*, but this does not cause FX-risk, rather a one-off credit loss.

In this case cash inflow to be settled against the receivable will not cover the refinancing sources behind the original FX- receivable, as the FX-rate prescribed by the act is much lower than the actual FX-rates nowadays.

Loss derived from the above can be interpreted as either FX- or credit loss. In the latter case we assume that the Hungarian Forint cash inflow should be converted to the foreign currency at the originally contracted rate, hence not the total FX-amount will be repaid, but the creditor is not eligible to claim the unpaid difference from anyone, hence that amount will never return.

Both approaches clearly show opening of FX-position due to the applied favourable rate, their impact on the magnitude of the profit (loss) is equal, but the structure of the loss will be different.

In my view, interpretation of the loss as credit loss reflects the reality better.

The opportunity to repay the debt at this favourable rate does not have significant impact on impairment-related FX-positions, as early repayment is more probable for performing loans, rather than the non-performing ones.

7. Conclusions

The article introduces different definitions of foreign currency items found in accounting rules and other books, and shows that these definitions are not standardized/unified.

It is proven that the same handling of foreign currency and foreign currency-based transaction does not distort the true and fair picture; however, the direct application of it in the determination of the foreign currency positions of an enterprise could be misleading – regarding the impairment of foreign currency-based transactions.

The article introduced the impact of “home safety package” on FX-positions and outlined some technical problems to be overcome.

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