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APPLICATION AND REPORTING OF HEDGE ACCOUNTING IN BANKING SECTOR OF TURKEY – 2018*

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Abstract

The widespread use of derivatives in the Turkish Banking sector started since the beginning of 2000's, although their initial use was during 1980's. The use of derivatives was limited with a few transactions before 2000. However, the banking crises and adoption of free currency system led the Turkish banks to use derivatives actively. The purpose of this study is to examine the use of derivatives and hedge accounting practices in banks that are operating in the Turkish banking sector. In this context, the audited 2018 IFRS-Financial Statements and their disclosures of 42 banks (commercial, participation, development and investment banks) was investigated. In this study, data about the use of derivatives and reporting of hedge accounting practices is collected and analyzed. This work was supported by Scientific Research Projects Coordination Unit of Istanbul University. Project number 47160.

Keywords ***:*** *Banking Sector, Accounting, IFRS, Derivatives, Hedge Accounting*

Jel Codes ***:*** *G20, M41, M48*

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RİSKTEN KORUNMA MUHASEBESİNİN TÜRKİYE'DEKİ BANKALARDA UYGULANMASI VE RAPORLANMASI – 2018

Öz

Türk bankacılık sektöründe türev ürün kullanımı 1980'li yıllara dayanmasına rağmen bu ürünlerin aktif bir şekilde kullanımı 2000'li yıllardan itibaren başlamıştır. 2000 yılı öncesine kadar birkaç işlemle sınırlı kalan türev ürün kullanımı, meydana gelen bankacılık krizleri ve serbest döviz sistemine geçiş sonucunda bankaları aktif bir şekilde türev ürün kullanımına yöneltmiştir. Çalışmada, Türk Bankacılık sektöründe faaliyet gösteren bankaların türev ürün kullanımı ve riskten korunma muhasebesi uygulamalarının araştırılması amaçlanmıştır. Bu kapsamda Türkiye'de faaliyet gösteren ticari, katılım ve kalkınma ve yatırım bankaları olmak üzere toplam 42 bankanın Türkiye Finansal Muhasebe Standartlarına göre hazırlanmış ve bağımsız denetimden geçmiş 2018 yılı finansal tabloları ve dipnotları incelenmiştir. Çalışmada bankaların sözleşme bazında türev ürün kullanımı ve riskten korunma muhasebesi uygulamalarının finansal tablolarda raporlanması hakkında bilgi toplanmıştır. Bu çalışma İstanbul Üniversitesi Bilimsel Araştırma Projeleri Koordinasyon Birimi tarafından desteklenmiştir. Proje numarası 47160.

Anahtar Kelimeler: *Bankacılık Sektörü, Muhasebe, TFRS, Türev Araçlar, Riskten Korunma Muhasebesi*

Jel Sınıflandırılması: *G20, M41, M48*

INTRODUCTION

In Turkish banking sector, the active usage of derivative contracts are in the 2000s, although its dates back to the 1980s. The first regulation on derivative contracts in banking sector was made in 1983. With this arrangement, banks were allowed to make forward transactions. To be allowed swap contracts between banks and TCMB and between commercial banks was the other important development about usage of derivative contracts in 1985. The first swap contract was made between commercial banks and Central Bank of The Republic of Turkey (CBRT) at this date. However, despite these regulations, the use of derivative products in the Turkish banking sector has been limited to only a few transactions until 2000s (İncekara, 2017: 40-41). The banking crisis that took place during 2000s and uncertainties about the future as a result of the transition to the free exchange system led the banks to actively use derivative contracts.

The first regulation on hedge accounting in the banking sector in Turkey was published "The Guideline No.1 Regarding Accounting Practices Regulation: Accounting Standards for Financial Instruments" by The Banking Regulation and Supervision Agency at 22.06.2002 and numbered 24793. This regulation was abolished with "The Guideline on the Regulation of Consolidated Financial Statements of Banks by The Banking Regulation and Supervision Agency at 8.11.2006 and numbered 26340. The accounting of banking operations were adopted Turkish Accounting Standards, issued by Turkish Accounting Standards Board established in 2002, with "Principles and Procedures for Safeguarding and Documents Accounting Applications" to be published by The Banking Regulation and Supervision Agency at 1.11.2006 and numbered 26333. The authority of Turkey Accounting Standards Board was transferred to Public Oversight, Accounting and Auditing Standards Authority established with "Public Oversight, Accounting and Auditing Standards Agency of the Organization and Duties of Decree Law", published on 11.02.2011. Today, Banks recognize financial instruments and prepare financial statements according to Turkish Accounting and Financial Reporting Standards issued by Public Oversight, Accounting and Auditing Standards Authority. Today, Banks are adopted accounting standards to be published by Public Oversight, Accounting and Auditing Standards Authority.

I. LITERATURE REVIEW

There have been several studies regarding the usage of derivative contracts, reporting of hedge accounting and its reasons in Turkish banking sector.

Selvi (2000: 224-225) examined 56 commercial banks and 13 development and investment banks that were operated in 1996. In this study, it was aimed to reveal the usage of derivative instruments on instrument base and accounting of these instruments in Turkish banking sector. It was observed that banks prefer mostly foreign exchange based contracts foreign Exchange risk more than derivative contracts based on interest risk. Also, it was found that the banks mostly follow the transactions related to these instruments in the off-balance sheet accounts and do not subject them to any valuation on the financial reporting date. On the reporting date, it was determined that half of the other banks subject to the valuation process made an explanation about the purpose they were involved in the derivative contracts and the other half did not provide sufficient explanations.

Türel and Selvi (2007: 110) reviewed as of 31 December 2005 financial reports and disclosures related with financial reports 13 banks registered on Istanbul Stock Exchange. They found that 12 banks to be parties to the derivative contracts. Also, only 2 of these banks were considered to be parties to the derivative contracts and to make reports. On the other hand, despite of the fact that the other banks were mainly hedged, the purpose of becoming a party to the derivative products contract was reported to be hedged as a derivative financial instrument since they could not fulfill the requirements of hedge accounting. However, according to hedge accounting, there was not enough information about the risk management.

Türel (2008: 105; Türel&Selvi, 2010: 666-669) examined 33 commercial banks that was operated in Turkey. It was observed that only 28 of the banks were parties to the derivative contracts and the item on which the derivative contracts were based mainly exchange rate risk and interest rate risk, and small amount of stock index risk. Although the purpose of being a party to the derivative product contract of the banks, which are party to the derivative contract agreement, is hedged, only 4 of them are reporting to hedge accounting and the other 20 banks are parties to hedging against the derivative as reported.

Çiftci (2019; 80-85) examined 22 commercial banks, 5 participation banks, and 12 development and investment banks that were operated in Turkey. It was observed that 39 banks were parties to the derivative contracts to mainly manage exchange rate risk and interest rate risk. Also, the purpose of being a party to the derivative product contract of the banks, which are party to the derivative contract agreement, is hedged, only 13 of them are reporting to hedge accounting and the other 26 banks are parties to hedging against the derivative as reported.

In addition to these studies, there are various studies about use of derivative contracts in non-financial institutions. However, there studies were excluded because these studies did not allow for comparison in terms of development of derivative products in Turkish banking sector and they were not suitable for research purposes.

II. RESEARCH METHODOLOGY

The aim of this study to find out the usage of derivative contracts and applications of hedge accounting in Turkish banking sector. For these purpose as of December 31, 2018 audited financial statements and disclosures related to these financial statements of 24 commercial banks, 5 participation banks, and 13 development and investment banks were examined. There are 25 commercial banks, 5 participation banks, 13 development and investment banks, 5 foreign banks opened a branch office in Turkey and 2 banks be transferred Saving Deposit Insurance Fund, which are operated in Turkey (www.tbb.org.tr). However, due to inaccessibility to the financial reports 5 foreign banks opened a branch office in Turkey and 2 banks be transferred Saving Deposit Insurance Fund was excluded from the study. In addition, Citibank A.Ş. was excluded because of lack of the financial statements.

III. RESULTS

Information on the usage of derivative contracts bank operating in Turkey were examined. As a result of the examination, it was seen that 39 banks were parties to the derivative products contract. Iller Bankası A.Ş, Standard Chartered Bank Turkey Investment Inc. and İstanbul Takas ve Saklama Bankası A.Ş. have not clarified explanations on the use of derivative contracts. Therefore, it is concluded that these banks are not parties to the derivative contracts. Distribution of the usage of derivative contracts of banks by contract types is presented on Table 1.

Table 1: Distribution of Derivatives Used in Banks According to Contract Types

Contract Types		Commercial Banks	Participation Banks	Development and Investment Banks	Total
Forward Contracts	Foreign Currency	23	5	10	**38**
	Interest	-	-	-	**0**
TOTAL		**23**	**5**	**10**	**38 (26%)**
Swap Contracts	Foreign Currency	23	4	9	**36**
	Interest	19	-	6	**25**
	Precious Metal	2	-	-	**2**
TOTAL		**44**	**4**	**15**	**63 (42%)**
Option Contracts	Foreign Currency	21	-	4	**25**
	Interest	7	-	1	**8**
	Precious Metal	-	-	-	**0**
	Securities	-	-	-	**0**
TOTAL		**28**	**0**	**5**	**33 (22%)**
Future Contracts	Foreign Currency	3	-	1	**4**
	Interest	1	-	-	**1**
TOTAL		**4**	**0**	**1**	**5 (3%)**
Other Contracts	-	**8**	**1**	**2**	**11 (7%)**
GRAND TOTAL		**107**	**10**	**33**	**150**

Table 1 also shows the distribution of the components on which the derivative contracts used by banks by type of derivative contracts. When the results are evaluated as a whole, it is seen that banks are a part to derivative contracts mainly based on foreign currency and interest rate as a result of their activities. Banks are also parties' precious metal and securities based derivatives contracts, which are classified as goods/prices based on relatively small amount. According to this, we can conclude that banks are a party to derivative contracts in order to hedge interest rate risk arising from interest rate-based products and foreign exchange risk arising from foreign currency transactions. In order to hedge the exchange rate risk from foreign currency transactions, the most commonly used derivative instruments are foreign currency swap contracts, foreign currency forward contracts and foreign currency option contracts. Interest rate swap contracts are mainly used to hedge the effects of interest rate risk.

Banks can parties to derivative contracts for two purpose; hedging and trading. However, in order to report according to hedge purpose banks are required to meet the requirements of TMS-39.

On the table 2, the manner in which the derivative contracts of the banks parties are reported in the financial statements.

Table 2: Financial Reporting For Derivatives Contracts Used in Banks According to Intended Purpose

	Commercial Banks	Participation Banks	Development and Investment Banks	Total
Reporting According to Hedge Purpose	11	2	2	15 (36%)
Reporting According to Trading Purpose	13	3	11	27 (64%)
TOTAL	24	5	13	42 (100%)

When the disclosures about the purpose of being a party to the derivative contracts and their reporting preferences are examined; a total of 15 (36%) banks that are parties to the derivative instruments are reported according to hedge purpose and the other 27 (64%) banks are reported according to trading purpose. The disclosure titled "The Disclosures on Forward, Option and Derivatives Contracts", which the accounting policies regarding the use of derivative contracts are disclosed are analyzed, these 27 banks are also parties to derivative contract to hedge purpose. Although these derivative contracts provide economic hedge, they are reported for trading purpose under the condition of TMS-39: Financial Instruments: Recognition and Measurement. Also, the banks that report according to hedge accounting classify the derivative contracts that cannot be fulfilled the necessary conditions as trading derivative contracts. These derivatives contracts reported in this scope are classified as fair value through profit of loss financial asset or fair value through other comprehensive income financial asset.

Banks can report in accordance with hedge accounting for three types of hedging; fair value risk, cash flow risk and net investment risk. On the table 3, according to hedge accounting, it is presented that the banks, which report on the types of hedging relationship, are reported. The table 3 is based on as of December 31, 2018 audited financial statements and Off-Balance Sheet Items Statement.

Table 3: Hedge Accounting Reporting

	Fairvalue Risk	**Cash Flow Risk**	**Net Investment Risk**
AKBANK	*	*	-
ALTERNATIFBANK	*	*	-
BURGAN BANK	-	*	-
FIBABANK	*	-	-
QNB FINANSBANK	*	*	-
ING BANK	-	*	-
TEB	-	*	-
ODEOBANK	-	*	-
SEKERBANK	*	-	-
GARANTI BANK	*	*	-
YAPI KREDI BANK	*	*	-
KUVEYT TURK	-	*	-
TURKIYE FINANS	*	*	-
EXPORT CREDIT BANK of TURKEY	*	*	-
TURKIYE SINAI KALKINMA BANKASI (TSKB)	*	-	-

When the financial statements of the banks reporting according to hedge accounting are examined, it is seen that almost all of the banks are parties to the derivative product contract in order to be protected from cash flow risk. Otherwise, 7 banks protected from cash flow risk are also parties to derivative contracts for fair value hedges and reporting. Fibabank, Sekerbank, and Turkiye Sınai Kalkınma Bankası (TSKB) are only parties to derivative contracts for fair value hedges according to as of December 31, 2018 audited balance sheet and Off-Balance Sheet Items Statement.

In order for banks to be able to report according to hedge accounting, they have to meet the conditions described in the accounting standards. The most challenging condition to be met under these conditions is to measure the effectiveness of hedging (Kawaller, Koch, 2000: 79). On the table 4, the disclosures on the methods used by the reporting banks to measure the effectiveness of hedging are presented.

Table 4: Disclosures on The Methods Used to Measure The Effectiveness of Hedge

	Commercial Banks	Participation Banks	Development and Investment Banks	Total
Disclosures on The Methods about to Measure the Effectiveness of Hedge	4	1	2	7 (%47)
No Disclosures on The Methods about to Measure the Effectiveness of Hedge	7	1	0	8 (%53)
TOTAL	11	2	2	15

When the disclosures regarding the measurement of the hedge effectiveness are examined, approximately half of the banks according to hedge accounting disclosed the methods used to measure the effectiveness of hedging. According to this, banks mainly used a dollar off-set method This method is thought to be more preferred because of the ease of application.

CONCLUSION

The changes and uncertainties in the economy over time have been led the banks to use derivative products to protect against the risks they face. For this reason, it has been examined the use of derivatives and hedge accounting practices in banks that are operating in the Turkish banking sector. The audited 2018 IFRS-Financial Statements and their disclosures of 42 banks (commercial, participation, development and investment banks) have been investigated. The findings of the study show that there is an increase in the usage of derivative products and the variety of derivative products in the Turkish Banking Sector.

Banks are a part to derivative contracts mainly based on foreign currency and interest rate as a result of their activities. Also, as a result of competitive environment, banks are also parties precious metal and securities based derivatives contracts on relatively small amount. The most commonly used derivative instruments are foreign currency swap contracts, foreign currency forward contracts, and foreign currency option contracts in order to hedge the exchange rate risk from foreign currency transactions. Interest rate swap contracts are mainly used to hedge the effects of interest rate risk.

It is observed that the reporting of these products in the financial statements is not the same as the purposes, although the purpose of banks' being a party to derivative contracts is hedging. It is examined that banks reporting according to hedge accounting rules mainly report cash flow hedges.

It is determined that the banks, which give explanation as a method of measurement of hedge efficiency, prefer the dollar off-set method. According to this, banks may be experiencing difficulties in the application of hedge accounting even though banks are parties to hedging derivative contracts due to the insufficiency of internal systems in terms of the continuous measurement of hedging effectiveness. A scientific study should be done to determine the reasons for this situation.

Although the number of banks reporting under hedge accounting has increased over time, many banks do not report according to hedge accounting rules. It can be said that they cannot report according to hedge accounting due to the failure to meet the application requirements and the failure to establish a system for measuring the effectiveness of hedging.

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