DIPCAT Case 1
Sophia's Dream Case Study – classification of financial assets

Sophia's Dream is the leading manufacturer and retailer in *eco-fashion* - custom lines of sustainable and organic clothing. The lines are currently available online and through high-end department stores in various countries.

The Group have developed a technique in which their clothing is manufactured through 3-D printing, with the main ingredients being tomato vines, tulips and deconstructed (up-cycled) natural fiber clothing.

As the group is a multinational organization, and due to the volume of it's activity it established a bank – Sophia's Bank (hereinafter also referred to as Sophia or Bank) – recently to be more flexible with financial matters. Thus it has quite complex financial instruments.

Task:

1. Look at the following contracts! Decide whether these are financial instruments and then classify them, stating which category/categories of IFRS 9 Financial instruments apply to the given item! You are required to do contract I.-XI., if time permits do the following

2. Be prepared to make a memo! You are going to be asked to explain one or two of your classification in written format by clear reasoning and making appropriate reference to the regulation! (The academic working together with your team will tell you at a later stage which case you need to explain!)

THE TRANSACTIONS/CONTRACTS

I.

Sophia sold one of business segments and received 100 000 CU. So far Sophia did not find an appropriate investment possibility in the recycling industry, therefore purchased short-term government securities with 6-month maturity. Because of the present market situation, it is not likely, that a good investment opportunity will arise in the business field, but if it will, Sophia is going to sell the government securities and make the investment. Otherwise the securities will be held until maturity.

II.

Sophia intends to acquire a new chain of fashion shops in three years. To be able to fund the capital expenditure Sophia invest the surplus cash into different financial assets. Many of the financial assets have a longer maturity term that exceed Sophia's expected investment period.

The aim of the management to achieve the maximum return on these financial assets The motivation and the remuneration of the portfolio's managers are based on the overall return from the portfolio.

III.

Sophia provides a loan worth 100 000 CU to one of its business partners. The five-year loan has a variable interest rate linked to the existing market interest rate capped at 7%. The loan is repayable in five years. Sophia has no intention to dispose the loan before maturity.

IV.

Sophia holds a portfolio of debt instruments worth CU100. CU10 of the portfolio is sold and reinvested once a year or even more often, while the remaining CU90 investments are typically held to near their maturity.

V.

Sophia provides a loan worth 100 000 CU to one of its business partner Company C. The five-year loan has a fixed interest rate of 5%. Company C intends to build a new-wave clothing factory using the Sophias' funds. In exchange for providing the loan Sophia can also expect 10% share of net profit (EBIT) of the project.

VI.

Sophia holds inflation linked government bonds worth 100 000 CU. The interest rate is linked to past inflation so that the bond is protected against inflation by a formula regulated by the Central Bank and the government of the county.

VII.

Sophia's Bank holds financial assets to collect the contractual cash flows until maturity and sells some of these assets as part of sale and repurchase agreements (repos). Under repos the entity agrees to repurchase the financial assets at a later date before their maturity at a fixed price.

During the term of the repos, the transferee is required to remit to the entity an amount equal to any payments received from the transferred assets. The sold assets remain on the entity's statement of financial position, because the entity retains substantially all risks and rewards of the assets.

VIII.

Sophia's Bank originates mortgage loans for young families. A loan contract stipulates that during a time period of first seven years the interests are very low compered to the market rates. However the difference between the market rate and the actual rate is paid by the State Treasure. After the first seven years the interest is paid fully by the borrower (ie. young families). The principal must be redeemed by the borrower. The loans are granted on the arm's-length basis and there is no intention to transfer these before maturity.

IX.

Several loans of Sophia's Bank includes a "special" agreement: under certain market conditions a bank is allowed to perform a unilateral amendment[1] of the margin of a variable loan contracts. The unilateral amendment may only be made if there is a so called tigger event: significant changes in the refinancing conditions of the market like strong and unexpected increase in reference rate or liquidity breaks or if reference became unavailable or cannot be determined. The loans do meet the held to collect business model requirements.

Sophia's Bank exercised this only once, during the financial crisis.

X.

Sophia's Bank gives loans to people employed at least for five years with a favorable rate as long as the private client agrees to have his/her salary sent to the bank account administered by Sophia. A loan contract stipulates an increase in the interest margin (1% to 3%) in case if the private client no longer receives his or her salary in the bank's account. Otherwise the agreement is standard, there is no intention to sell the loan before maturity.

XI.

Sophia's Bank offers for elderly people a reverse mortgage product. A reverse mortgage is a loan that allows older homeowners to withdraw the investment in their houses in the form of a loan with a balance that increases over time.
Reverse mortgage lenders [ie. the Bank] make regular monthly payments to borrower until the certain trigger event occurs (such as selling of equity or death). Borrowers do not have to repay the loan (principal and interest) until that triggering event occurs.
The interest rate is fixed during the whole lifetime of the loan and is added to the loan balance each month. After the trigger event occured, the proceeds from the sale of the property are used to repay the principal and accrued interest to the bank. Sophia will not have direct access to the property, it will be handed over as part of the heritage together with the loan liability.

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[1] Meaning: the borrower do not need to agree the modification and will not be able to cancel the loan agreement on the basis of the change.

IF TIME PERMITS do as many of the below questions as possible.

BI.

Sophia sold one of the business segments and received 100 000 CU. So far Sophia did not find an appropriate investment possibility in the clothing industry, therefore purchased long-term government securities with three-year maturity. It is likely, that a good investment opportunity will arise before the maturity and in that case, Sophia is going to sell the government securities and make the investment. Otherwise the securities will be held until maturity.

BII.

Assume a loan of Sophia's Bank that bears a contractually fixed interest rate of 10% (including credit spread). The loan meets the hold-to-collect business model. The loan can be prepaid at the amount that is equal to the remaining cash flows, discounted with a discounting rate (e.g., 1%). The discounting rate is fixed at the origination of the loan and is significantly lower than the interest rate. In some extreme cases, the discounting rate is even fixed at nil. (Result: the prepayment amount will be always much higher than par amount + accrued interest.)

BIII.

An entity holds financial assets with the aim to collect contractual cash flows. Simultaneously the entity is required by the regulator to routinely sell a portion of these assets to demonstrate that they are liquid. In the past, these sales were frequent and significant in value. This activity is expected to continue in the future.

BIV.

Sophia has an investment in convertible bonds. Under the contractual terms Sophia has an option to convert these into a fixed number of equity shares of the issuer. The convertible bonds as a portfolio are analysed for classification in its completeness.

BV.

Sophia provides a short-term interest free loan without fixed maturity to one of its subsidiary company. The loan is repayable at the first call by Sophia.