Sophia Bank IFRS9 ECL Case I.

PART I.

On 1 January 20X1, the Bank of Sophia (hereinafter also referred to as Sophia or Bank) originated a 9-year bullet corporate loan with the value of CU 1,000,000. The effective interest rate (EIR) related to the loan was 3%. (The contractual interest rate was also 3%). The loan agreement did not include additional transaction costs or special features (e.g., prepayment or call options). There were also no bank related charges (e.g., premiums or discounts, additional fees). The loan is redeemable at the end of the maturity and interest is payable annually.

At the end of 20X1, there were no signs of a significant increase in credit risk since the initial recognition of the loan. After careful consideration of the characteristics of the loan and the macroeconomic situation, the Bank defined the related probability of default (PD) as 0.13%. The lifetime PD at the origination date was estimated to be 2.7%. Based on an assessment of the collateral and the related discounted cash flows, the Bank believes that in case of default the credit loss (loss given default, LGD) would be 25% of the loan.

At the end of 20X3, the Bank does a reassessment of the debtor and decides that the credit risk has increased significantly since the initial recognition date. As a result, the loan is reclassified as Stage 2.

The bank internal analysis at Stage 2 yields the following data as of 31 December 20X3:

Stage	2
12-month expected PD	1%
Lifetime expected PD (2 Years)	2.2%
Lifetime expected PD (3 Years)	3.72%
Lifetime expected PD (4 Years)	5.77%
Lifetime expected PD (5 Years)	8.02%
Lifetime expected PD (6 Years)	10.06%
Lifetime expected PD (7 Years)	11.8%
LGD	27%
EIR	3%
Years to maturity	7

The cumulative lifetime expected PD shows the probability of the default of the debtor by <u>the end of the given period</u>.

Currently, the borrower is making all regularly scheduled interest payments.

At the end of 31 December 20X4, even though the interest for 20X4 was paid by the debtor, the economic circumstances have changed so dramatically that the debtor is, for all practical purposes, in default on the loan. Specifically, based on a detailed sensitivity analysis of the debtor's situation after liquidation of the collateral, it is estimated that 55% of the contractual cash flows cannot be recovered. It is further estimated that the conversion of the collateral into cash does not take a significant amount of time. Subsequently, the loan is terminated by the bank and the recovery process starts. The process is finished on 30 July 20X6 and 40% of the original claim is recovered.

If necessary, the Bank, discounts certain values to "mid-year".

TASKS

- For the years 20X1, 20X3 and 20X4, calculate the loan impairment (if any) and show the resulting effects of the loan presentation on the financial statements of the Bank.
- Show the detailed calculations for each year and justify by referring to the relevant IFRS reporting rules.
- Your response should be in the form of a high-level management presentation (if the time permits).

PART II.

The Bank of Sophia originated a 5-year mortgage loan to another company. The loan has a 50% LTV (loan-to-value) ratio and is secured by a first mortgage on real estate owned by the company. The loan was not credit-impaired at the date of initial recognition.

Following the disbursement of the loan, there was a significant deterioration of the debtor's income and economic circumstances due to various pandemics in the country. After a further analysis of the legal situation, it was estimated that a further deterioration could be expected and that this trend was expected to be both significant and permanent. The Bank concludes that the repayment of the loan is in danger. However, during this time, the client continues to pay both the principal and the interest on the loan as agreed in the loan documentation. At the same time, the property market starts to improve so that there is an increase of 20% in the value of the collateral pledged for the loan.

TASKS

- Calculate the ECL of the loan.
- How do you assess the necessary parameters?
- Your recommendations must be based on the relevant IFRS rules.
- Your response should be in the form of a high-level management presentation (if the time permits).

PART III.

The Bank of Sophia originated a loan to Kitty Holding (the Parent Company). The Parent Company plans to pay back the loan from dividends received from subsidiaries. At the time that the loan was originated, Kitty Holding operated successfully and there were expectations that global demand would increase. The conclusion was that the cash flow generation ability of the Holding was excellent. However, because the prices of the Holding's products were very volatile (which created risk), the Holding's policy was to grow continuously and to acquire a majority ownership in new companies. As a result of this strategy, the structure of the Holding became very complex, and the analysis of the group has become very complicated.

When the loan was originated, the gearing for the company was appropriate and the Holding was not over-leveraged. However, as the pandemic increased, the Bank of Sophia has uncovered more and more problems. First, there is the problem associated with the repayment of the loan because the expected dividend flow might not come from the subsidiary companies. Second, the sales volume of the three most important subsidiaries (out of five) has decreased, although this trend is expected to reverse during the next quarter and thereafter this sales volume is expected to grow dramatically. (The decrease of the sales volume most probably can be attributed to the pandemic.) The operation of the other two subsidiaries is stable. Kitty Holding has announced that it is planning to restructure the whole group and divest the underperforming companies.

TASKS

- Define the relevant stage of the loan. The definition must be based on an analysis of the current IFRS standards.
- Your response should be in the form of a high-level management presentation (if the time permits).