

**University of Toronto
Rotman Faculty of Management**

**Analysis of Financial Institutions and Financial Instruments:
The Accounting Disclosure-Risk Perspective**

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Office Hours: Tuesday 11:15-12:15 or by appointment

Course: MGT 414H1F
Lecture Room: W0 30
Time: Tuesday 9-11

This course focuses on the:

- 1) financial analysis of firms in the financial services industries (thrifts, trusts, mortgage banks, commercial banks, and property-casualty insurers); and the
- 2) accounting and disclosure rules for financial instruments (interest rate risk disclosures, loan loss disclosures, fair value accounting for financial instruments, securitization, derivatives and hedge accounting, market risk disclosures, and insurance accounting).

The main goal of the course is to give you an in-depth understanding of how financial reports provide unusually accurate and detailed (but not perfect) information about the risks and performance of firms in the financial services industries. These firms' financial statements increasingly are based on fair value accounting and their financial reports typically include extensive risk and estimation sensitivity disclosures. Both fair value accounting and risk and estimation sensitivity disclosures are necessary ingredients for financial reports to convey the risk and performance of financial services firms in today's world of complex, structured, and risk-partitioning financial instruments and transactions. While financial services firms often apply fair value accounting and risk and estimation sensitivity disclosures imperfectly (or worse), careful joint analysis of the information they do provide invariably yields important clues about their risks and performance.

While this course is most relevant to students interested in the financial services industries, much of the accounting material also pertains to varying extents to other types of firms. For example, many firms securitize their accounts receivable or hedge their commodity, interest rate, or foreign exchange risk using derivatives.

Notice from the attached course schedule that I interweave the financial analysis of financial services industries with the accounting and disclosure rules that most directly affect these industries. This sequence of sessions reflects the belief that a good understanding of a firm's economics is a prerequisite for evaluating its accounting and disclosures and thus analyzing its financial reports. Throughout the course, I emphasize the use of financial reports for financial analysis purposes rather than technical accounting issues. I note, however, that some of the accounting and disclosure rules that we will cover (in particular, derivatives and hedging) are inherently complex and that I do not avoid complexity when it is necessary for a good understanding of the topic.

Requirements and Grading: There will be quizzes and exercises worth a minimal amount (10% in total) to make sure you are keeping up with the material. Your grade is primarily based on five take-home problems (usually cases based on public financial report information) with the following weight in determining your grade.

Activity	Due Date	Course Weight
Quizzes-Exercises	Ongoing	10%
Take-home Assignments:		
1. Securitization	10/5	20%
2. Derivatives, hedging	10/19	20%
3. Interest rate risk	11/9	15%
4. Credit risk	11/16	15%
5. Fair value accounting	11/30	20%
Total		100%

Time permitting, there may be a separate sixth problem on market risk disclosures or the problem may be rolled in with the fifth assignment. Course weights will be adjusted accordingly.

Since 90% of the course weight is based on take-home problems, the instructor will NOT answer substantive questions regarding these assignments. Clarifying questions are most welcome.

Assignment solutions are to be typed and handed in at the end of the relevant class. Solutions sent by e-mail or fax without prior approval of the instructor will not be marked. Solutions handed-in after the due date without prior approval of the instructor will not be marked.

Required Text and Other Materials: The required text is Stephen Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, John Wiley & Sons, 2002 (hereafter Ryan).

I will also assign various other readings, most importantly, the financial statements of representative financial services firms; I highly recommend reading these reports critically from cover to cover as they provide considerable insight into the firms and their financial services industries. In contrast, the readings from the popular press can usually be skimmed. I will endeavour to put all lecture materials, solutions and readings on the portal in a timely fashion. I will also assign exercises and problems (usually with answers) for the financial analysis and technical accounting topics. While I only go over a subset of these exercises and problems in class, I highly recommend working through them all, looking at the answers only after you have made your own attempt.

Course Schedule: The tentative sequence of class sessions is attached. Some of the readings and assignments may change over the course of the term.

Course Schedule

Self-study-Part 1 The Canadian Financial and Banking System

Readings:

Canadian Financial System-Power Point Presentation
Canadian Banking System-Power Point Presentation

C. Freedman, "The Canadian Banking System" Bank of Canada, March 1998
C. Freedman and C. Goodlet "The Financial Services Sector: Past Changes and Future Prospects"
Bank of Canada, March 1998
C. Freedman and C. Goodlet "The Financial Services Sector: An Update of Recent Developments"
Bank of Canada, March 2002

Self-study-Part 2 The US Banking System

Readings:

Ryan, Chapter 2 (excluding the section on bank regulation, pp.22-32)
Ryan, Chapter 3

"Profit and Balance Sheet Developments at U.S. Commercial Banks in 2001", *Federal Reserve Bulletin*, June 2002
"Implementing the Gramm-Leach-Bliley Act: Two Years Later", speech by Federal Reserve Governor Mark W. Olson
"Strengthening the Financial System of the 21st Century through Sound Financial Reporting, speech by Federal Reserve Governor Susan Schmidt Bies
"Accord Reached on Lifting of Depression-Era Barriers among Financial Industries", *New York Times*, October 23, 1999
"Merrill Lynch is Set to Move into Banking", *New York Times*, February 1, 2000
"Few Banks or Insurers Capitalize on their New Freedom to Merge", *New York Times*, December 18, 2000
"Bolstered by Rate Cuts, S.& L.'s Are on the Rise", *New York Times*, October 7, 2001

I will not lecture directly on this material. You will be quizzed on the main issues. The quiz on the Canadian material will take place at the beginning of the second lecture September 21. The quiz on the US material will take place at the beginning of the third lecture September 28.

September 14

**Lecture 1 Course Overview
Securitization-Part 1-Finance Issues**

September 21

Lecture 2 Securitization-Part 2- Accounting Issues

- a) main accounting rules (SFAS 140, CICA 3860, IAS relevant EIC's and AcG's)
- b) recent FASB proposals regarding consolidation of non-qualified special purpose entities and guarantees

Reading:

Ryan, Preface and Chapter 1 (read this chapter cursorily)

Ryan, Chapter 8

"Some Analysts Seek Accounting-Rule Change That Would Slash Profits of Subprime Lenders", *Wall Street Journal*, September 29, 1998

"High Risk Lenders Land with a Thud", *Business Week*, February 16, 1998

"Fannie Mae Eases Credit To Aid Mortgage Lending", *New York Times*, September 30, 1999

"Steal Industry", *The Economist*, February 3, 2001

"Bank Regulators Eye Securitizations after Enron's Accounting Debacle", *Wall Street Journal*, February 14, 2002

"A Boom Built upon Sand Gone Bust", *New York Times*, November 25, 2001

"U.S. Seizes Bank Business of Web Credit Card Issuer", *New York Times*, February 12, 2002

"CDO – Not Cash on Delivery", *The Economist*, July 28, 2001

"Wall Street Found Others Willing to Copy Enron's Deals", *New York Times*, February 14, 2002
Bring Countrywide's annual report to class

First take-home problem (securitization) will be uploaded at the end of the second lecture and is due by the end of class on October 5, two weeks later.

September 28

Lecture 3 Derivatives and Hedging-Part 1-Options and Swaps

October 5

Lecture 4 Derivatives and Hedging-Part 2-Other Instruments

October 12

Lecture 5 Derivatives and Hedging-Part 3-Credit Derivatives

- a) Main rules (FAS 133 and 138, CICA 3860, IAS 32 and relevant EIC's and AcG's)
- b) Recent CICA and FASB proposals regarding the definition of derivative

Readings:

Ryan, Chapter 10

Derivatives and hedging questions and problems

"Freddie Mac, Fannie Mae Seem More Volatile As Accounting Rule Highlights Hedging Risks", *Wall Street Journal*, February 7, 2002

"Credit Derivatives: Rites of Passage", *The Economist*, January 12, 2002

"Market That Deals in Risk Faces a Novel One", *New York Times*, November 29, 2001

"Enron Had More Than One Way To Disguise Rapid Rise in Debt", *New York Times*, February 17, 2002

"Enron Hid Big Loans, Data Indicate", *New York Times*, February 27, 2002

Second take-home problem (derivatives, hedging) will be uploaded at the end of the fourth lecture and is due by the end of class on October 19, two weeks later.

October 19

Lecture 6 Banking Capital Regulations 1- The Basle Agreements

October 26

Lecture 7 Banking Capital Regulations 2- The Basle Agreements

Readings

Ryan, Chapter 2 (pp. 22-32)

Altman and Saunders "An Analysis and Critique of the BIS Proposal on Capital Adequacy And Ratings" W.P. New York University, 2000.

Altman and Saunders "Credit Ratings and the BIS Reform Agenda" W.P. New York University, 2001.

For comprehensive information on Basle II, see the Bank of International Settlements homepage: www.bis.org

November 2

Lecture 8 Interest Rate Risk and Net Interest Earnings

- a) repricing gap
- b) analysis of net interest income
- c) rate/volume analysis

Readings:

Ryan, Chapter 4

Exercises for Chapter 4

Yield curves from 2003-2004.

Interest rate risk and income disclosures from various financial institutions

Third take-home problem (Interest Rate Risk and Earnings) will be uploaded at the end of the eighth lecture and is due by the end of class on November 9, one week later.

November 9

Lecture 9 Credit Risks and Losses

- a) Accounting for loss contingencies (FAS 5, CICA 3290, IAS 37)
- b) Accounting for loan impairments (FAS 114 and 118, CICA 3025, IAS 36)
- c) Recent FASB and CICA decisions and proposals regarding loan commitments and guarantees (FIN 45)

Readings:

Ryan, Chapter 5

Exercises for Chapter 5

“Bank Loans in America: Shell Game”, *The Economist*, March 24, 2001

“Finding Skeletons in Bank Closets”, *New York Times*, February 4, 2001

“2 Banks Struggle with a Single Troubled Debtor”, *New York Times*, November 16, 2000

“Banks’ Contingent Liabilities: Holding the Bag?” *The Economist*, March 2, 2002

“Citigroup and J.P. Morgan Are Left with Bruised Egos and Exposure to Loans”, *New York Times*, November 29, 2001

“Morgan Owed More by Enron than Previously Disclosed”, *New York Times*, December 21, 2001

“How Citigroup Hedged Bets on Enron”, *New York Times*, February 8, 2002

“Credit Agencies Waited Months to Voice Doubt About Enron”, *New York Times*, February 8, 2002

“An Innovative Way to Borrow Started at Enron”, *New York Times*, January 29, 2002

“Many Banks Tightening Up Business Loans”, *New York Times*, February 22, 2001

“Survey Finds Loan Losses Rose Sharply”, *New York Times*, October 9, 2002

Fourth take-home problem (Credit Risk) will be uploaded at the end of the ninth lecture and is due by the end of class on November 16, one week later.

November 16

Lecture 10 Fair Value Accounting for Financial Instruments: Disclosures and Investment Securities

- a) fair value disclosures for all financial instruments (SFAS 107, CICA 3860, IAS 30, IAS 32)
- b) fair values of investment securities (SFAS 115, CICA 3010, IAS 39)
- c) CICA Accounting Standards Board, Exposure Draft “Financial Instruments- Recognition and Measurement” March 2003.

Readings:

Ryan, Chapter 6

- “Oops! Bank Will Write Off \$1.75 Billion”, *New York Times*, September 8, 2001
- “Fuzzy Rules of Accounting and Enron”, *New York Times*, January 30, 2002
- “Through the Enron Looking Glass”, *New York Times*, February 17, 2002
- “Former Officials Say Enron Hid Gains During Crisis in California”, *New York Times*, June 23, 2002

Fifth take-home problem (fair value accounting) will be handed out at the end of the above session and is due by the end of class November 30, two weeks later.

November 23

Lecture 11-Part 1 Mortgage Banks

Readings:

Ryan, Chapter 7

- “Mortgage Rates Are Near Low of Early 1999”, *New York Times*, September 4, 2001
- “In a Shaky Economic Climate, Mortgage Refinancings Have Helped One Segment of Business: Online Lenders”, *New York Times*, October 22, 2001
- “Failing Mortgages Soar in New York”, *New York Times*, March 27, 2002
- “A Wider Loan Pool Draws More Sharks”, *New York Times*, March 24, 2002
- “Easy Credit and Hard Times Bring Foreclosures”, *New York Times*, November 24, 2002
- “Mortgage Company Profits Doubled Last Year, Survey Shows”, *New York Times*, June 25, 2002
- “Can Fannie Mae Make Necessary Repairs?”, *Wall Street Journal*, October 1, 2002
- “How Freddie Mac’s House Stands”, *Wall Street Journal*, October 1, 2002

Lecture 11-Part 2 Commercial Banks

Readings:

Ryan, Chapter 9

- “Investors Feel Some Ripples at J.P. Morgan”, *New York Times*, February 12, 2002

November 30

Lecture 12 Market Risk Disclosures

Readings:

Ryan, Chapter 11

Alternative SEC Market Risk Disclosures Problem

Prepare for class discussion: “Bank One’s Offsetting Swaps?” case in Appendix 11A of Ryan

Time permitting, the sixth take-home problem (market risk) will be handed out at the end of the above session and will be due by the end of class December 7, one week later.

December 7

Lecture 13 Property-Casualty Insurers and Insurance Accounting (Time Permitting)

- a) accounting for short-duration policies (FAS 60, CICA 4210, IAS AcG 3)
- b) SEC-mandated loss reserve development disclosures

Readings:

Ryan Chapters 13 and 14

“Insolvency: Will Historic Trends Return?”, *A. M. Best*, March 1999

“A Trail of Toxic Torts”, *The Economist*, January 27, 2001

“Small Storms May do the Biggest Damage”, *Business Week*, May 12, 1997

“Insurers’ Outlook (Unexpectedly) Good, Despite Big Claims”, *New York Times*, December 17, 2001

“Rethinking Dire Warnings by Insurers After Sept. 11”, *New York Times*, February 27, 2002

“Insurers May Turn to Catastrophe Bonds”, *New York Times*, October 21, 2001

“GEICO Faces Challenges After Grabbing Market Share”, *Wall Street Journal*, January 27, 2000

“The State of Allstate”, *The Economist*, July 22, 2000

“Major Insurers May Pull Out of New Jersey”, *New York Times*, June 21, 2001

“Bermuda Move Allows Insurers to Avoid Taxes”, *New York Times*, March 6, 2000

“Leaving Home, Without Its Umbrella”, *New York Times*, January 6, 2002

“American International Group: Shine a Light”, *The Economist*, March 2, 2002