



Rotman Commerce UNIVERSITY OF TORONTO

Course Outline

RSM 428H1 F

Analysis of Financial Institutions and Financial Instruments

Fall 2015

Course Meets: Thursday 2-4 PM, Location WO20

Instructor: Jeffrey L. Callen
E-Mail: callen@rotman.utoronto.ca
Webpage: <http://www.rotman.utoronto.ca/facbios/viewFac.asp?facultyID=callen>
Phone: 416-946-5641
Fax: 416-971-3048
Office Hours: Wednesday 3:00-4:00 PM, RT 523C or by appointment. To schedule an appointment, please send me an e-mail (callen@rotman.utoronto.ca) in advance to let me know what you would like to discuss. My phone is: 416-946-5641.

Teaching Assistant: TBA

Course Scope and Mission

This course focuses on the:

- 1) financial analysis of commercial banks, thrifts, and mortgage banks; and the
- 2) accounting and disclosure rules for financial instruments, transactions and risks including interest rate and income risk, credit loss risk, fair value accounting for financial instruments, securitizations, special purpose/variable interest entities, derivatives, hedging and market risk.

The primary goal of the course is to give you an understanding of how bank financial reports provide detailed but imperfect information about their net worth, and risks, particularly in today's world of complex, structured, value- and risk-partitioning financial instruments and transactions. 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. Specifically, bank-like financial institutions' financial reports reflect a "mixed attribute" accounting model in which the measurement basis is fair value for some positions (e.g., trading instruments), amortized cost for some positions (e.g., deposits), various versions of impaired amortized cost for some positions (e.g., loans), and various hybrids of fair value and (impaired) amortized cost for some positions (e.g., available-for-sale securities). While this accounting model exists for various understandable reasons, the model reduces the interpretability of summary accounting measures, such as book value and net income, by accounting for these institutions' interrelated positions differently. In part to mitigate this problem, these institutions' financial reports include extensive risk and estimation sensitivity disclosures. In my experience, careful joint analysis of recognized accounting numbers and these disclosures invariably yields important clues about these institutions' net worth, performance, and risks.

While this course is most relevant to students interested in financial institutions, 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.

As is evident in the attached course schedule, I interweave the financial analysis of different types of bank-like financial institutions with the accounting and disclosure rules that most directly affect those institutions. This sequence of sessions reflects my belief that a good understanding of an institution's economics is a prerequisite for evaluating its recognized accounting numbers and financial report disclosures. 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 (especially derivatives and hedging) are inherently complex, and I do not avoid complexity when it is necessary for a good understanding of the topic.

Course Prerequisites

RSM 219H1, RSM 222H1, RSM 333H1

Required Textbook

Stephen Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, Second Edition, John Wiley & Sons, 2007

Evaluation and Grades

There will be five assignments that will be done in groups of four (or possibly five). In addition, there will be a final take home exam to be done by each student individually. You will have three days to complete the final take home exam. The take home exam has to be submitted via blackboard. The faculty of Arts & Science will set the date that the exam has to be submitted.

	Due Date	Percentage
Group Assignments		
1. Interest rate risk	October 15	12%
2. Credit risk	October 22	12%
3. Amortized Cost and Fair Value	November 5	12%
4. Securitization and VIE	November 26	12%
5. Derivatives, market risk, hedging	December 3	12%
Final Take Home Exam	TBD	40%
Total Marks		100%

*Depending upon the course time line, the fourth assignment may have to be rolled in with the last assignment in which case the combined assignment will be worth 24%.

Group Work

Learning to work together in teams is an important aspect of your education and preparation for your future careers. That said, project-based teamwork is often new to students; to work well in teams, it helps to follow a set of core expectations to best succeed at your team projects.

1. Read the document entitled, “Working in Teams: Guidelines for Rotman Commerce Students” which is available on the RC portal under the Academic Services tab.

2. When working in a team, Rotman Commerce students are expected to:

- Treat other members with courtesy and respect;
- Honour the ground rules established by the team;
- Contribute substantially and proportionally to the final project;
- Ensure enough familiarity with the entire contents of the group project/assignment so as to be able to sign off on it as original work;
- Meet the project timeline as established by the team.

3. Resolving conflicts:

Conflicts are part of the team’s process of learning how to work together. When handled well, it can generate creativity and bring-multiple perspectives to the solution.

Student teams are expected to work through their misunderstandings as soon as they arise (and prior to submission of the final project). When teams are unable to arrive at a solution that works for all members, the team must meet with the Rotman Commerce Team Coach** as soon as possible. The Coach will listen to the team and help develop options for improving the team process. All members of the project team must commit to, and, utilize their action plans.

** For an appointment with a Rotman Commerce Team Coach, please contact Elaine Zapotoczny at elaine@nikoletaandassociates.com. Elaine is highly skilled at facilitating team dynamics and

collaboration. Note that the Team Coach's role is to provide guidance, support and advice on team matters – not to formally evaluate or assess teamwork for academic purposes.

Missed Assignments

Students who miss a test or assignment for reasons entirely beyond their control (e.g. illness) may submit a request for special consideration. Provided that notification and documentation are provided in a timely manner, and that the request is subsequently approved, no academic penalty will be applied.

In such cases, students must notify Rotman Commerce on the date of the missed test (or due date in the case of course work) and submit supporting documentation (e.g. [Verification of Student Illness or Injury form](#)) to the Rotman Commerce Program Office within **48 hours** of the originally scheduled test or due date. Students who do not provide Rotman Commerce or the instructor with appropriate or sufficient supporting documentation will be given a grade of 0 (zero) for the missed test or course deliverable.

Note that the physician's report must establish that the patient was examined and diagnosed at the time of illness, not after the fact. Rotman Commerce will not accept a statement that merely confirms a report of illness made by the student and documented by the physician.

In the event that one assignment is missed, the student's marks will be re-weighted. In the event that two or more assignment are missed, the student will be required to write a supplemental assignment for each missed assignment.

ACCESSIBILITY NEEDS

The University of Toronto is committed to accessibility. If you require accommodations for a disability, or have any accessibility concerns about the course, the classroom or course materials, please contact Accessibility Services as soon as possible: disability.services@utoronto.ca or <http://www.accessibility.utoronto.ca/>.

ACADEMIC INTEGRITY

Academic Integrity is a fundamental value essential to the pursuit of learning and scholarships at the University of Toronto. Participating honestly, respectfully, responsibly, and fairly in this academic community ensures that the UofT degree that you earn will continue to be valued and respected as a true signifier of a student's individual work and academic achievement. As a result, the University treats cases of academic misconduct very seriously.

The University of Toronto's Code of Behaviour on Academic Matters

<http://www.governingcouncil.utoronto.ca/policies/behaveac.htm> outlines the behaviours that constitute academic misconduct, the process for addressing academic offences, and the penalties that may be imposed. You are expected to be familiar with the contents of this document. Potential offences include, but are not limited to:

In papers and assignments:

- Using someone else's ideas or words without appropriate acknowledgement.
- Submitting your own work in more than one course without the permission of the instructor.
- Making up sources or facts.
- Obtaining or providing unauthorized assistance on any assignment (this includes collaborating with others on assignments that are supposed to be completed individually).

On test and exams:

- Using or possessing any unauthorized aid, including a cell phone.
- Looking at someone else's answers
- Misrepresenting your identity.
- Submitting an altered test for re-grading.

Misrepresentation:

- Falsifying institutional documents or grades.
- Falsifying or altering any documentation required by the University, including (but not limited to), medical notes.

All suspected cases of academic dishonesty will be investigated by the following procedures outlined in the *Code of Behaviour on Academic Matters*. If you have any question about what is or not is permitted in the course, please do not hesitate to contact the course instructor. If you have any questions about appropriate research and citation methods, you are expected to seek out additional information from the instructor or other UofT resources such as College Writing Centres or the Academic Success Centre.

EMAIL

At times, the course instructor may decide to communicate important course information by email. As such, all UofT students are required to have a valid UTmail+ email address. You are responsible for ensuring that your UTmail+ email address is set up AND properly entered on the ROSI system. For more information please visit <http://help.ic.utoronto.ca/category/3/utmail.html>

Forwarding your utoronto.ca email to a Hotmail, Gmail, Yahoo or other type of email account is not advisable. In some cases, messages from utoronto.ca addresses sent to Hotmail, Gmail or Yahoo accounts are filtered as junk mail, which means that important messages from your course instructor may end up in your spam or junk mail folder.

BLACKBOARD AND THE COURSE PAGE

The online course page for this course is accessed through Blackboard (the Commerce Portal). To access the course page, go to the UofT Portal login at <https://portal.utoronto.ca/> and log in using your UTORid and password. Once you have logged in, look for the My Courses module where you'll find the link to all your course websites. If you don't see the course listed here but you are properly registered for the course in ROSI, wait 48 hours. If the course does not appear, go to the

Information Commons Help Desk in Robarts Library, 1st floor, for help, or explore the Portal Information and Help at www.portalinfo.utoronto.ca/students and review the Frequently Asked Questions.

RECORDING LECTURES

Lectures and course materials prepared by the instructor are considered by the University to be an instructor's intellectual property covered by the Canadian Copyright Act. Students wishing to record a lecture or other course materials in any way are required to ask the instructor's explicit permission, and may not do so unless permission is granted (note: students who have been previously granted permission to record lectures as an accommodation for a disability are, of course, excepted). This includes tape recording, filming, photographing PowerPoint slides, blackboard materials, etc.

CONDUCT OF CLASSES AND EXPECTATIONS

Classes will begin at ten minutes after the hour, in accordance with university policy. Students are expected to arrive on time so as not to disrupt the class.

Course Schedule

The tentative sequence of class sessions is attached. Some of the readings may change over the course of the term.

Note: The first two sessions contain readings that I will not cover in class but that provide highly relevant background for the course. You will get more out of the course if you read this material in the first week or so.

September 17: Course Overview

Readings:

Canadian Financial System-Power Point Presentation
Canadian Banking System-Power Point Presentation
Bank of Canada, Financial System Review-June 2015
Ryan, Chapters 1 and 2.

September 24: Thrifts and Commercial Banks

Readings:

Class Slides
Ryan, Chapters 3 and 10

We will walk through and discuss those portions of the Bank of Montreal 2014 annual report that pertain to traditional banking activities (Note: We will analyze this report throughout the course. For an electronic copy, google Bank of Montreal Investor Relations and download the report. I will indicate the sections to read as we go along. I will also hand out a hardcopy of this report to each of you in class.) We will defer discussion of non-traditional banking activities such as securitizations, variable interest entities, and derivatives until later in the course. We will tend to ignore non-financial or otherwise extraneous topics throughout the course. You should read through this material on your own after we go through it in class.

October 1 and October 8 (first half): Interest Rate Risk and Amortized Cost Net Interest Earnings

- a) repricing gap and interest rate sensitivity
- b) amortized cost interest
- c) analysis of net interest income
- d) rate/volume analysis

Readings:

Ryan, Chapter 4.

Class slides.

<http://www.investingforme.com/historical-yield-curves>

“Historical Yield Curve”, <https://fixedincome.fidelity.com/ftgw/fi/FIHistoricalYield>

See also the nice US yield curve generator at <http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx>

BMO net interest earnings disclosures and interest rate sensitivity disclosures

October 8 (second half)-October 15 Credit Risk and Losses (Primarily on Loans)

- a) loss contingencies and the related literature on the “incurred loss model”
Note: The IFRS 9 will replace the incurred loss model for loss contingencies and other existing financial instrument credit impairment accounting rules (see below and in the next course session) with an expected loss model effective 2017/8.
- b) impaired loans
- c) mortgages held for sale
- d) other loans held for sale
- e) transfers of troubled debt instruments
- f) concentration of credit risk disclosures

Readings:

Ryan, Chapter 5.

Class slides.

Loan portfolio, credit risk, and credit losses disclosures in BMO’s 2014 annual report

October 22-October 29 (first half) Fair Value and Impairment Accounting for Financial Instruments: Disclosures and Investment Securities

- a) Fair value disclosures for financial instruments
- b) Accounting for investment securities, including impairments of AFS and HTM securities and treatment of economic reversals of impairments
- c) Fair value option for financial instruments

Readings:

Ryan, Chapter 6.

Class slides.

Fair value disclosures in BMO’s 2014 Annual Report

October 29 (second half) Mortgage Banks

- a) Mortgage banking
- b) Fees and costs

Readings:

Ryan, Chapter 7.

Class slides.

Mortgage banking disclosures in BMO's 2014 Annual Report

November 5-November 12 Securitizations

- a) main rules
- b) servicing rights

Readings:

Ryan, Chapter 8.

Class slides.

BMO's 2014 Annual Report securitization footnote

November 19 Consolidation of Variable Interest Entities

- a) main rules
- b) We will not discuss balance sheet presentation of transactions subject to netting agreements, accounting for related transactions as a unit, hybrid instruments, project on liabilities and equity) or financial guarantees, other topics that are covered in Chapter 9 of Ryan

Reading:

Ryan, Chapter 9.

Class slides.

BMO's 2014 Annual Report variable interest entity footnote.

Nov 26- Dec 3 Derivatives, Hedging, and Market Risk

- a) Main accounting rules for derivatives and hedging
- b) market risk disclosure requirements

Readings: Ryan, Chapters 11 and 12.

Class slides.

BMO's 2014 Annual Report derivatives footnote