



Rotman Commerce UNIVERSITY OF TORONTO

Course Outline

RSM 428H1 F

Analysis of Financial Institutions and Financial Instruments

Fall 2018

Course Meets: Thursdays 9:00-11:00 AM, Location RT142

Instructor: Jeffrey L. Callen, RT523c
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Office Hours: Thursday 11:15-12:15 AM, 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.
Teaching Assistant: TBA

Course Scope and Mission

This course focuses on the:

- 1) financial analysis of commercial banks; and the
- 2) accounting and disclosure rules for bank 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

Recommended Textbook:

There is no up-to-date textbook on our subject matter. Although outdated and focused on US GAAP, the following textbook will prove helpful on many topics: Stephen Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, Second Edition, John Wiley & Sons, 2007. This book is available as a pdf file.

Evaluation and Grades

Grades are a measure of the performance of a student in individual courses. Each student shall be judged on the basis of how well he or she has command of the course materials.

<u>Work</u>		<u>Due Date</u>
1. Weekly Assignments	30%	Weekly
2. Group Assignment	30%	November 29
3. Final Exam	40%	During Faculty of Arts & Science Final Examination period

There will be weekly individual assignments almost every week that are due in the following class. There will also be one group assignment that is due at the beginning of class on November 29. There will be a final exam during the normal exam period (December 8-21, 2018).

Course Format and Expectations

For Written Assignments

Please note that clear, concise, and correct writing will be considered in the evaluation of the assignments. That is, you may lose points for writing that impedes communication: poor organization, excessive wordiness, hard-to-follow sentence structure, spelling mistakes and grammatical errors. Bullet point answers are in fact preferred. Students who require additional support and/or tutoring with respect to their writing skills are encouraged to visit the Academic Success Centre (<http://www.studentlife.utoronto.ca/asc>) or one of the College Writing Centres (www.writing.utoronto.ca/writing-centres). These centres are teaching facilities – not editing services, where trained staff can assist students in developing their academic writing skills. There is no charge for the instruction and support.

For Group Work

The group project requires students to work in teams of three or four (preferably). 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 Nouman Ashraf at nouman.ashraf@rotman.utoronto.ca Nouman 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.

Policy and Procedure

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 **2 business days** 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.

Documentation submitted in support of petitions for missing tests and assignments must be original; no faxed or scanned copies will be accepted

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 later report of illness made by the student to a 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.

LATE ASSIGNMENTS

The weekly assignments are due at the beginning of the next class (in class). Late assignments will not be marked. Assignments should NOT be submitted as an e-mail attachment except in special circumstances and with the express permission of the instructor.

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: accessibility.services@utoronto.ca or <http://www.studentlife.utoronto.ca/as..>

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.

Quercus and the Course Page

The online course page for this course is accessed through Quercus. To access the course page, go to q.utoronto.ca and log in using your UTORid and password. Once you have logged in, you will be at the Quercus Dashboard. On this page you will see all of the courses you are presently enrolled in. If you don't see the course listed here but you are properly registered for the course in ROSI, wait 48 hours.

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, Quercus materials, etc.

If permission is granted by the instructor (or via Accessibility Services), it is intended for the individual student's own study purposes and does not include permission to "publish" them in anyway. It is absolutely forbidden for a student to publish an instructor's notes to a website or sell them in any other form without formal permission.

CONDUCT OF CLASSES

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.

Class attendance is mandatory. Students are required to sign in for each class session. Students who miss more than two classes will be penalized up to 15% of the final course mark.

Course Schedule

The tentative sequence of class sessions is attached. Note that there will not be a scheduled class on the fall reading week (November 8).

Note: The first session contains readings that I may 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.

Throughout the course we will discuss relevant portions of the Bank of Montreal 2017 annual report beginning with traditional banking activities. We will defer discussion of non-traditional banking activities such as securitizations, variable interest entities, and derivatives until later in the course. We will ignore non-financial or otherwise extraneous topics throughout the course. (For an electronic copy of the 2017 annual report, google Bank of Montreal Investor Relations and download the report.)

September 6: Course Overview

- a) Financial institutions
- b) Bank statement basics-BMO
- c) Repos and security sales

Readings:

Canadian Financial System-Power Point Presentation
Canadian Banking System-Power Point Presentation
Bank of Canada, Financial System Review-June 2015
Bank of Canada “Canadian Repo Market Ecology” August 2016
Ryan, Chapters 1, 2 and 10.
Class slides

September 13: Interest Rate Risk

- a) Interest rate risk basics
- b) Interest rate swaps
- c) Duration

Readings:

Ryan, Chapters 4
Class slides

September 20: Interest Rate Risk and Bank Statements

- a) Yield curves
- b) Analysis of net interest income
- c) Rate/volume analysis
- d) Repricing gap
- e) Interest rate sensitivity disclosures

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>

September 27 Amortized Cost and Fair Value Basics

- a) Amortized cost basics
- b) Fair value defined-IFRS 13
- c) fair value hierarchy

Readings:

Ryan, Chapter 4.

Class slides.

October 4 Accounting for Financial Instruments

- a) fair value versus amortized cost
- b) fair value option
- c) fair value income statement
- d) gains trading
- e) financial instrument classification-IFRS 9
- f) impairments
- g) reclassifications

Readings:

Ryan, Chapter 6

Class slides.

October 11 Credit Risk and Losses

- a) Loan Impairments-expected loss model
- b) Loan commitments and guarantees
- c) Impaired loans acquisition

Readings:

Ryan, Chapter 5.
Class slides.

October 18 More Credit Risk

- a) Loan Portfolio Quality
- b) Loan Loss Reserves

Readings:

Ryan, Chapter 5.
Class slides.

October 25 Securitizations

- a) Securitizations
- b) Variable interest entities

Readings:

Ryan, Chapters 8 and 9.
Class slides.

November 1 Mortgage Banking

- a) Mortgage banking
- b) Prepayment Risk
- c) Mortgage servicing rights

Readings:

Ryan, Chapter 7.
Class slides.

November 15 and 22 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.

November 29 Banking Regulation

- a) Basle accords
- b) What's new in Basle 3

Readings:
Ryan, Chapter 2.
Class slides.