

**New York University  
Stern School of Business**

B10.3321.20, Spring 2004

Analysis of Financial Institutions and Financial Instruments

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Hours MW 4:30-6 and by appointment)

KMC 4-90, M 6-9

This course focuses on the:

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

The main goal of the course is to provide students with 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 value and risk-partitioning financial instruments and transactions. While financial services firms often report imperfect (or worse) fair value measurements and risk and estimation sensitivity disclosures, 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 my belief that a good understanding of a financial services 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.

Prerequisites: B09.2301 (Financial Accounting: A User Perspective) and either B10.2303 (An Integrated Approach to Financial Statement Analysis) or B10.2302 (Financial Reporting and Analysis), or the equivalent. I assume the student has a working knowledge of basic finance, especially net present valuation and the operation of securities markets.

Requirements and Grading: There will be four take-home problems (usually cases based on public financial report information) with the following weight in determining your grade.

1. interest rate risk, credit risk, and fair value accounting	30%
2. securitizations	20%
3. derivatives, hedging, and market risk	35%
4. leasing	15%

Each take-home problem will be handed out when I finish the relevant topic and will be due either one (problems 2 and 4) or two (problems 1 and 3) weeks later, regardless of whether I am on schedule or not. Class participation of the productive sort is encouraged and will be rewarded by one-quarter of a letter grade increase. I emphasize that productive participation does not require being either an expert or correct; for example, asking good questions is sufficient.

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 hand out various other readings, most importantly, the financial reports of representative financial services firms. While somewhat tedious, I highly recommend reading these reports carefully from cover to cover as they provide considerable insight into the firms and their financial services industries. In contrast, readings from the popular press can usually be skimmed. I will also hand out 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.

Web Access to Materials/Blackboard: While I will hand out all materials needed for the course in class, the materials that are in electronic form will be available on Blackboard. I do not use Blackboard for any other purpose.

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

## Course Schedule (Tentative)

### 1/26 Course Overview and Background on Depository Institutions

*Read:* Ryan, Preface and Chapters 1 and 2

“Profit and Balance Sheet Developments at U.S. Commercial Banks in 2002”, *Federal Reserve Bulletin*, June 2003.

“The Future of Financial Services – Revisited”, October 8, 2003 speech by Federal Reserve Governor Roger W. Ferguson, Jr.

“Effective Market Discipline: The Roles of Auditors, Companies, and Analysts”, October 31, 2003 speech by Federal Reserve Governor Susan Schmidt Bies

“American Banking: Loss Leaders”, *The Economist*, January 11, 2003

**Note: I will not cover much of this material in class, but it is very worthwhile background reading.**

### 2/2 Thrifts

*Read:* Ryan, Chapter 3

Excerpts from Golden West’s 2002 Annual Report and Form 10-K filing

### 2/9 Interest Rate Risk and Net Interest Earnings

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

*Read:* Ryan, Chapter 4

Exercises for Chapter 4

Yield curves from 2002

Interest rate risk and income disclosures from various financial institutions

“As Interest Rates Climb, Must Bank Stocks Fall?”, *New York Times*, September 21, 2003

“Greenspan’s Speech Focuses on Deflation, Not Inflation”, *New York Times*, December 20, 2002

“In a Bad-News Bond Market, Treasuries Can Be the Biggest Loser”, *New York Times*, July 27, 2003

Bring Golden West’s financial report to class

2/16 Credit Risk and Losses

- a) Accounting for loss contingencies (SFAS No. 5)
- b) Accounting for loan impairments (SFAS Nos. 114 and 118)
- c) Recent FASB decisions regarding loan commitments and guarantees

*Read:* Ryan, Chapter 5

Exercises for Chapter 5

“S.E.C. Warns Banks Against Overgenerous Reserve Levels”, *New York Times*, November 14, 1998

“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

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

“Despite Record Defaults on Junk Bonds, Optimism Persists”, *New York Times*, January 2, 2003

Loan loss disclosures from various financial institutions

Bring Golden West’s financial report to class

*Prepare for class discussion:* “SunTrust Banks – After the Restatement” case in Appendix 5A of Ryan

2/23 Fair Value Accounting for Financial Instruments: Disclosures and Investment Securities

- a) fair value disclosures for all financial instruments (SFAS No. 107)
- b) fair values of investment securities (SFAS No. 115)

*Read:* Ryan, Chapter 6

Thought question for 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 20, 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

Bring Golden West’s financial report to class

*Prepare for class discussion:* “T.R. Financial in 1994 – The Downside of Negative Gap” case in Appendix 6A of Ryan

**The first take-home problem (interest rate risk and net interest earnings, credit risk and losses, and fair value accounting for financial instruments) will be handed out in class at the end of the session in which the material above is completed (which may not be 2/23), and it will be due by the end of class two weeks later.**

3/1 Mortgage Banks

*Read:* Ryan, Chapter 7

Countrywide Financial Corporation’s 2002 annual report

“Mortgage Rates Are Near Low of Early 1999”, *New York Times*, September 4, 2001

“Mortgage Company Profits Doubled Last Year, Survey Shows”, *New York Times*, June 25, 2002

“How Freddie Mac’s House Stands”, *Wall Street Journal*, October 1, 2002

“Can Fannie Mae Make Necessary Repairs?”, *Wall Street Journal*, October 1, 2002

“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, 2001

**Note: There are no classes the week of March 15**

3/22 Securitizations

- a) main rules (SFAS No. 140)
- b) recent FASB decisions regarding consolidation of non-qualified special purpose entities and guarantees

*Read:* 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

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

“Bank Regulators Eye Securitizations after Enron’s Accounting Debacle”, *Wall Street Journal*, February 14, 2002

Press release regarding SEC’s cease-and-desist order against PNC

“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

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

“Steal Industry”, *The Economist*, February 3, 2001

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

Bring Countrywide’s financial report to class

*Prepare for class discussion:* “Aames Financial in the Hedge Fund Crisis Case” in Appendix 8A of Ryan

**The second take-home problem (securitizations) will be handed out at the end of the end of the session in which the material above is completed (which may not be 3/22), and it will be due by the end of class one week later.**

3/29 Commercial Banks

*Read:* Ryan, Chapter 9

Excerpts from J P Morgan Chase’s 2002 Annual Report

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

4/5-4/12      Derivatives and Hedging

- a) Main rules (SFAS No. 133 and 138)
- b) Recent FASB proposals regarding the definition of derivative

*Read:* Ryan, Chapter 10

Derivatives and hedging questions, problems, and cases

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

“Credit Derivatives: Rites of Passage”, 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

Bring J P Morgan Chase’s financial report to class

4/19      Market Risk Disclosures

*Read:* Ryan, Chapter 11

Alternative SEC Market Risk Disclosures Problem

Bring J P Morgan Chase’s financial report to class

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

**The third take-home problem (derivatives, hedging, and market risk) will be handed out at the end of the session in which the material above is completed (which may not be 4/19), and it will be due by the end of class two weeks later.**

4/26-5/3      Lessors and Lease Accounting

a) main lease accounting rules (SFAS No. 13 and its amendments)

*Read:* Ryan, Chapter 12

Leasing exercises and problems

Examples from GAAP guide

“The Leasing of Software: Lessons from the Car Lot”, *New York Times*, January 30, 2000

“Favorable Lease Deals may be Fading Fast”, *New York Times*, December 15, 2000

Excerpts from Leasing Solutions’ 1998 Form 10-K filing

GATX’s 2002 Form 10-K filing

**The fourth take-home problem will be handed out on 5/3 and will be due on 5/10 at 6 pm.**