New York University  
Stern School of Business

B10.3321.20, Spring 2006  
Analysis of Financial Institutions and Financial Instruments  
Professor Stephen Ryan (10-87 KMC, 998-0020, Fax 995-4004, sryan@stern.nyu.edu, Office Hours TR 4-6 and by appointment)  
KMC 5-75, TR 3-4:20

This course focuses on the:

1) financial analysis of financial institutions, primarily banks (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, and market risk disclosures).

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 financial institutions. 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 financial institutions’ risk and performance in today’s world of complex, structured, value and risk-partitioning financial instruments and transactions. While financial institutions 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 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.

Notice from the attached course schedule that I interweave the financial analysis of different types of financial institutions with the accounting and disclosure rules that most directly affect these institutions. This sequence of sessions reflects my belief that a good understanding of a financial institution’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 three take-home problems (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  35%
2. securitizations             25%
3. derivatives, hedging, and market risk    40%

Each take-home problem will be handed out when I finish the relevant topic, 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 institutions. 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)

1/24-1/26 Course Overview and Background on Depository Institutions

*Read: Ryan, Preface and Chapters 1 and 2*
*“Fair Value Accounting”, November 18, 2004 Speech by Federal Reserve Board Governor Susan Schmidt Bies*
*J. P. Morgan Chase regulatory capital disclosures from Y-9C filings*

I will primarily discuss the structure of the course and regulatory capital requirements in this session; while these items constitute a fraction of the material covered in the above readings, you should read them all as they contain relevant background information for the course.

1/31-2/2 Thrifts

*Read: Ryan, Chapter 3*
*Excerpts from Golden West’s 2004 Annual Report and Form 10-K filing*
*“Banking and Credit Cards: Putting it on Plastic,” The Economist, June 11, 2005*

We will walk through Golden West’s report slowly on the second day of this session discussing what the report contains. This exercise will be most useful to you if you have previously read through the report and identified what does and does not make sense to you.
a) repricing gap  
b) analysis of net interest income  
c) rate/volume analysis  

Read: Ryan, Chapter 4  
Exercises for Chapter 4  
Yield curves from 2004  
“Historical Yield Curve”, fixedincome.fidelity.com  
“Narrow Interest Rate Gap is Squeezing Retail Banks,” New York Times, September 20, 2005  
Interest rate risk and net interest earnings disclosures from various financial institutions  
Bring Golden West’s financial report to class  

Prepare for class discussion: Evaluate and compare the net interest earnings and interest rate risk of Golden West and the other financial institutions with disclosures included in the reading package
Credit Risk and Losses

a) loss contingencies (SFAS No. 5)
b) impaired loans (SFAS Nos. 114 and 118)
c) transfers of troubled debt instruments (SOP 03-3)
d) SAB 102

Read: Ryan, Chapter 5
Exercises for Chapter 5
“Bank Loans in America: Shell Game”, The Economist, March 24, 2001
“Banks’ Contingent Liabilities: Holding the Bag?” The Economist, March 2, 2002
“Credit Markets: Even Keel?” The Economist, June 18, 2005
Loan loss disclosures from Washington Mutual and J. P. Morgan Chase
Bring Golden West’s financial report to class

Prepare for class discussion: Evaluate and compare the credit losses and risk of Golden West and the other financial institutions with disclosures included in the reading package

“SunTrust Banks – After the Restatement” case in Appendix 5A of Ryan
2/23-2/28    Fair Value Accounting for Financial Instruments: Disclosures and Investment Securities

a) fair value disclosures for financial instruments (SFAS No. 107)
b) partial fair value accounting for investment securities (SFAS No. 115) as amended (regarding other-than-temporary impairments) by FSP FAS 115-1 and FAS 124-1
c) proposed or final standard on fair value measurements
d) proposals for fair value option

Read: Ryan, Chapter 6
Thought question for Chapter 6
“Private Equity: Parting the Veil,” The Economist, December 20, 2003
Excerpts regarding fair value hierarchy and required disclosures from proposed accounting standard, “Fair Value Measurements” (Final standard is scheduled for first quarter 2006)
Bring Golden West’s financial report to class


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 3/1), and it will be due by the end of class two weeks later.
Read: Ryan, Chapter 7
Countrywide Financial Corporation’s 2004 annual report
“Mortgage Banks: Double WaMu,” The Economist, August 21, 2004
“The Art of Unhatched-Chicken Accounting,” Forbes, February 26, 2004
“Teaser Rates on Mortgages Approach 0%,” Wall Street Journal, February 15, 2005
“The Housing Market: The Seven Deadly Sins,” The Economist, November 29, 2003
“Property Prices: Shaky Foundations,” The Economist, November 29, 2003
“Subprime Mortgage Lending: Benefits, Costs, and Challenges,” Speech by Federal Reserve Board Governor Edward Gramlich, May 21, 2004
Statement by SEC Chief Accountant on Fannie Mae Accounting, December 15, 2004
SAB 105

We will walk through Countrywide’s report on the second day of this session discussing what the report contains. This exercise will be most useful to you if you have previously read through the report and identified what does and does not make sense to you.
3/9-3/23  Securitizations

a) main rules (SFAS No. 140)
b) proposed standards on transfers and servicing of financial assets

Read: Ryan, Chapter 8
“High Risk Lenders Land with a Thud”, Business Week, February 16, 1998
“Credit Derivatives: Russian Doll,” The Economist, September 25, 2003
“Steal Industry”, The Economist, February 3, 2001
SEC Press Release regarding PNC Financial transfers of troubled assets, July 18, 2002
Bring Countrywide’s financial report to class

Prepare for class discussion: “Aames Financial in the Hedge Fund Crisis Case” in Appendix 8A of Ryan, and “Doral Financial’s Interesting Interest-Only Strips”

There are no classes on March 14 and 16 (spring break).

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 3/24), and it will be due by the end of class one week later.

3/28  Features of Structured Finance Transactions

a) consolidation of special purpose/variable interest entities (FIN 46(R))
b) balance sheet presentation of transactions subject to netting agreements (FIN 39)
c) accounting for transactions engaged in contemporaneously and in contemplation of one another as a unit (EITF 98-15, DIG K1, DIG F6)
d) hybrid instruments (FAS 150, proposed standard)
e) financial guarantees (FIN 45)

Read: Draft of new chapter for second edition of Ryan
3/30 Commercial Banks

*Read:* Ryan, Chapter 9
Excerpts from J P Morgan Chase’s 2004 Annual Report

4/4-4/25 Derivatives, Hedging, and Market Risk

a) Main accounting rules for derivatives and hedging (SFAS No. 133, 138, and 149)
b) SEC market risk disclosure requirements

*Read:* Ryan, Chapters 10 and 11
Derivatives, hedging, and market risk questions, problems, and cases
“Financial WMD?” *The Economist,* January 24, 2004
“Credit Derivatives: Pass the Parcel”, *The Economist,* January 18, 2003
“Too Clever by Half,” *The Economist,* January 24, 2004
“The Scorpion’s Tail,” *Investment Dealer’s Digest,* June 14, 2004
“Risk Transfer and Financial Stability,” Speech by Federal Reserve Board Chairman Alan Greenspan, May 5, 2005
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 and “SunTrust Bank’s Derivatives, Hedging, and Market Risk Case.” It is worthwhile working through all of the questions, problems, and cases in the reading package, however.

The third take-home problem (derivatives, hedging, and market risk) will be handed out on 4/20, and it will be due on 5/5 at 5 pm.

4/27 Discussion of Current Financial Reporting Issues