

**FIN 7400: Financial Risk Management**  
**Spring 2011**  
**Monday & Wednesday, 3:10 – 4:30, 3142 P. F. Taylor**  
(Syllabus version: January 3, 2011)

**Instructor:** Don M. Chance

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<http://www.bus.lsu.edu/academics/finance/faculty/dchance/>

**Course web page:** On Moodle

**Office hours:** Monday, 1:30 – 2:30 & Thursday, 1:30 – 3:00; I am available most every afternoon and can meet in the mornings if you make an appointment.

**Catalog Description:** *Risk management of corporations, financial institutions, governments, and non-profit organizations; characteristics of financial contracts and markets and applications of these contracts to risk management problems; the value of risk management, measuring exposures, financial contracts for managing risk, the enterprise risk management industry, and the accounting and regulatory framework. Market and credit risks are the primary focus, but some attention is also given to operational and other sources of risk.*

In this course we will examine different types of domestic and global financial risks facing corporations and financial institutions. The focus, however, is mostly on risk management in corporations, though much of what you learn will apply in financial institutions, government agencies, and nonprofit organizations. These risks arise from changes in interest rates, foreign currency rates, commodity prices and stock prices. The emphasis is on interest rate and foreign currency risk. The course takes the approach of identifying the risks and developing the financial contracts, often in the form of derivatives, that provide solutions. The course is taught at an applied, non-mathematical level. Several cases will be used to put you in the position of a firm with a financial risk management problem.

Here are some quotes from previous students in this course:

“Just thought you might want to know that yet again, I am using the skills I learned in your class.”

“I enjoyed your class thoroughly. I thought it was one of the most informative and useful courses I took during my graduate studies. ... I am working as a Financial Analyst for \*\*\*\*. It is going very well so far and just today I was doing some work with swaps for a client.”

“I recently accepted a position at a valuation and forensic accounting firm and sure enough swap valuation has already come up.”

“It’s probably the most beneficial class I have taken in college.”

“It's encouraging to know that I'm able to put my course material to work!”

**What You Will Get from this Course**

- A solid introduction to the practice of managing financial risk
- Knowledge of when to use risk management tools properly and how to avoid disaster
- A basis for further study

**What You Need for this Course**

- Completion of the first year of the MBA program or equivalent coursework.
- One graduate level course in finance or an equivalent course as approved by me

- The usual technology resources (calculator, email, spreadsheet, etc.). Please note: you must check your email daily as I will sometimes communicate by email.

Second-year MBA students and students in the MS program in finance, accounting, or economics have sufficient preparation. *First-year MBA students cannot take this course if they are currently taking BADM 7090. Students in non-business fields must see me for approval before continuing in this course.*

### Course Materials

(No) Text: There is no formal textbook. Your text, as such, is a set of lecture notes in pdf format and Powerpoint slides, both of which are available from the Moodle site. You do have a secondary book, which is a small casebook:

*Risk Takers: Uses and Abuses of Derivatives*, 2<sup>nd</sup> ed. by John Marthinsen. We will be using the cases called Orange County, Proctor and Gamble, and Barings. You will also need to download some appendices from the book web <http://www.aw-bc.com/marthinsen/> (Do not purchase the first edition.)

I cannot emphasize how important it is to get this book now. Do not wait until shortly before the case is due. You might find it not available. I will not be able to help you obtain these materials if you wait until the last minute.

The following case can be downloaded from Moodle.

*State of Wisconsin Investment Board* (CaseNet)

These cases will involve in-class discussion. Handouts containing guidelines, questions and issues are available on the Moodle site. You are responsible for questions from the cases and their appendix materials on the mid-term and final exams.

Teaching Notes: These are short write-ups that are available from links on Moodle.

- TN07-01: The Bernoulli Paradox (optional)
- TN97-01: Basic Concepts in Valuing Risky Assets and Derivatives
- TN01-01: Zero Coupon Bond Prices and Interest Rate Quotation Conventions
- TN97-12: Calculating the Black-Scholes Value
- TN97-01: The Normal Probability Distribution (optional)
- TN96-03: Monte Carlo Simulation
- TN09-02: Understanding the Cash Flows in Collateralized Debt Obligations (optional)

There are some pdf files of articles to read that are posted on Moodle:

- B. Boulton. "Defining a Strategic Risk Management Approach." *Risk Professional* (August, 2010), 38-42.
- B. Boulton. "Defining a Strategic Risk Management Approach: Part 2." *Risk Professional* (October, 2010), 48-51.
- P. Carrel. "Repurposing Risk Management: How to Implement a Corporate Culture." *Risk Professional* (August, 2009), 60-62.
- D. Cintioli. "Modeling the Source of Liquidity Risk." *Risk Professional* (October, 2010), 59-60.
- M. Harner. "Barriers to Effective Risk Management." Research Paper, University of Maryland College of Law (2010).
- G. Holton. "Defining Risk." *Financial Analysts Journal* (November-December, 2004), 19-25
- C. Ma. "A Tale of a Two-Sided Coin." *Risk Professional* (June, 2010), 34-37.
- PRMIA. "Principles of Good Governance." Professional Risk Managers International Association (September, 2009).
- F. Salmon. "Recipe for Disaster: The Formula that Killed Wall Street." *Wired* (February 23, 2009).

- P. Satish. "The Art and Science of Today's Risk Management." *Risk Professional* (August, 2009), 50-53.
- E. Vozian, "Value-at-Risk." *Risk Professional* (August, 2010), 46-50.
- T. Wilson, "Did Risk Management Cause the Financial Crisis?" *Risk Professional* (August, 2009), 18-22.

In addition, from time to time there may be current articles on topics related to this course. I will make an announcement post these articles on Moodle.

## Exams

There will be one in-class mid-term exam of 1 hour, 20 minutes and one comprehensive final exam. The exams are closed-book, but you can bring to the exam one 8 ½ x 11 sheet of paper with anything you want written on it (both sides). Also bring a calculator, but use of the text storage feature will be violation of the code of the Code of Student Conduct (see below).

If you miss the exam, you must have a legitimate, reasonable, and verifiable excuse and must inform me in advance. If you miss the exam with an accepted excuse, your final will count for your mid-term exam. Otherwise, you will get a zero.

Copies of old exams and solutions are available on Moodle. Note, however, that in some cases there were errata on the exam that were either corrected during the class period or after grading. These errata have not necessarily been corrected on the copies posted. If you see something, you cannot figure out, this may be the reason. Just ask me.

## Your Grade: the Universal Question

Your grade is determined as follows:

Mid-term exam	100
Final exam	100
Group project	100
Class participation*	<u>100</u>
	400

\*Class participation will include specific in-class case discussions and general class participation on non-case days. If you miss class when a schedule case is discussed, you can make it up by turning in a short written analysis of the case. This offer is, however, not to be abused. It is not intended as an alternative to attending class on case discussion days but is designed to accommodate legitimate absences.

I have a simple grading system. Pretend the course has only two grades, a 100 point mid-term and a 100 point final. Assume an A is 90 on the mid-term and 85 on the final. That means you would need  $90 + 85 = 175$  points to get an A. Repeat that procedure to determine the minimum number for a B, C, D, etc. I do not compute averages. A 90 and an 85 may average to 87.5, but I do not look at averages. My system will produce the same results as one based on averaging and it cuts out one step, calculation of the average.

There are no possibilities for extra credit.

## Group Project

The class will be divided into teams of (hopefully) no more than five. Each team will create a fictional company, write a report, and make a 20-30 minute Powerpoint presentation in the SMART Lab that will make the case to the Board of Directors that the company faces certain risks and should implement a risk management program. A few days before the presentation, one of the other teams will be assigned the role of the Board of Directors. That team will be given advance information on the company, will be required to ask questions during the presentation, and will provide an evaluation. The report will be graded on the basis of the oral presentation, the written report, the evaluation of the "Board," and the

evaluations of the team members by each other. Each group will be required to turn in the presentation and report at the same time. A write-up with more detail is available on the Moodle site.

Your grade on this project is very subjective and at my complete discretion. I will give you feedback, but there will be no negotiating. My decision is final.

Note: Before writing anything, read “The 10 Most Common Writing Mistakes,” which is available at <http://www.bus.lsu.edu/academics/finance/faculty/dchance/Instructional/TenMistakes.htm>.

Do not make these mistakes, and your writing will be better, both in here and on your job.

### **Class Schedule and Assignments**

The course is divided into four parts:

- I: Concepts of Risk Management
- II: Tools and Applications of Market Risk Management
- III: Managing Non-Market Risks
- IV. Implementing a Risk Management Program

The week-to-week schedule is as follows. See the item below the table for the assigned readings for each unit. This schedule is subject to change. I expect that we will be a little ahead of the schedule but cases and the exam are expected to be on the scheduled dates.

<b>Date</b>	<b>First Half Material</b>	<b>Second Half Material</b>
W 1/19	Course Overview	Unit IA: What is Risk?; article by Harner; TN07-01 (optional); article by Holton
M 1/24	Unit IA (continued)	Unit IA (continued)
W 1/26	Unit IB: Basic Concepts of Financial Risk; TN09-01; articles by Wilson & Satish	Unit IB (continued)
M 1/31	Unit IC: The Risk Management Environment	Unit ID: The Value of Risk Management; article by Ma
W 2/2	Unit ID (continued)	Unit IIA: Basic Concepts in Measuring Risk; TN01-01; TN96-03; article by Vozian
M 2/7	Unit IIA (continued)	Unit IIA (continued)
W 2/9	Unit IIA (continued)	Unit IIA (continued)
M 2/14	Unit IIA (continued)	Unit IIB: Forward and Futures Contracting
W 2/16	Orange County case (Marthinsen, Ch. 6 and	Appendices 6.1, 6.2, 6.3, & 6.4 online)
M 2/21	Unit IIB (continued)	Unit IIB (continued)
W 2/23	Unit IIB (continued)	Unit IIC: Swap Contracting
M 2/28	Unit IIC (continued)	Unit IIC (continued)
W 3/2	Unit IID: Option Contracting; TN97-12; TN97-01 (optional)	Unit IID (continued)
M 3/7	Mardi Gras (no class)	
W 3/9	Unit IID (continued)	Unit IID (continued)
M 3/14	Mid-term exam (through IIC)	
W 3/16	Unit IID (continued)	Unit IID (continued)
M 3/21	Unit IID (continued)	Unit IIIA: Credit Risk
W 3/23	Proctor & Gamble case (Marthinsen, Ch. 5 and	Appendices 5.1, 5.3, 5.4 & 5.5 online)
M 3/28	Unit IIIA: Credit Risk	Unit IIIA: Credit Risk; TN09-02 (optional); article by Salmon
W 3/30	Unit IIIA (continued)	Unit IIIA (continued)
M 4/4	Unit IIIA (continued)	Unit IIIB: Operational and Other Risks; article by Cintiola

W 4/6	Barings case (Marthinsen, Ch. 7)	
M 4/11	Unit IVA: Accounting and Disclosure of Risk Management Activity ; download Appendix 5.2 of Marthinsen and UPS 2009 Annual Report (see below)	Unit IVA (continued)
W 4/13	Unit IVB: Corporate Governance; two articles by Boulwood; article by Carrel; article by PRMIA	Unit IVB (continued)
M 4/18	Spring Break (no class)	
W 4/20	Spring Break (no class)	
M 4/25	State of Wisconsin Investment Board case	
W 4/27	Group Project Presentations	Group Project Presentations
M 5/2	Group Project Presentations	Group Project Presentations
W 5/4	Group Project Presentations	Group Project Presentations
Sat 5/14	Final Exam (7:30 – 9:30 am)	

Unit IVA: The UPS 2008 Annual Report is available at

<http://www.investors.ups.com/phoenix.zhtml?c=62900&p=irol-reportsannual>

We will use the sections called “Item 7A,“ pp. 49-50, and “Note 14: Derivative Instruments and Risk Management,”pp. 100-105.

### Practice Problems

This course contains a mixture of conceptual and quantitative material. Students typically require practice problems for the quantitative material. There are practice problems at the end of each unit of the lecture notes. Working these problems will help you prepare for the exams.

### Conduct Expectations

*Cell Phones.* Cell phones are one of the greatest conveniences but one of the greatest annoyances as well. A classroom setting requires uninterrupted concentration. Your cell phone must be turned off or on vibrate in class unless you would prefer to write an essay on the annoyances of cell phones.

*Classroom behavior.* Consider a class meeting to be a business meeting. Participation is important. Professional and respectful behavior toward your classmates and me is expected. Although it is common in the business world to arrive “fashionably late” for or leave early from a meeting, it is not acceptable in this class, barring an outright emergency, for which you should clear it with me. I also expect the utmost in professional behavior at all times, which means that whining, complaining, and arguing with me are inappropriate and immature. Treat me as you would your boss.

*Integrity.* My heavy emphasis on this matter is motivated by the fact that there has been cheating in graduate courses in business here and where I previously taught. According to a study released in 2008, 56 percent of business school students admit to having cheated, making business the professional school with the most (admitted) cheating. Enron, Arthur Andersen, WorldCom, Tyco, HealthSouth, Refco, ... These names have become synonymous with corporate scandals of the last few years. Regardless of whether these companies and its executives are legally guilty, the hint of dishonesty has stained all involved and the financial world as a whole. Moreover, we cannot expect a financial system to function properly without honesty. If you cheat as graduate business students, you will cheat as business leaders. Others will cheat when dealing with you. Resolve to be honest. Here are a few things to remember about people who cheat:

**People who cheat in school set an example for their children. Do you want your children to cheat?**

**People who cheat in school set an example for the employees who work under them. Do you want your employees to cheat?**

### **Some of today's doctors and lawyers cheated in school. Are you ok with that?**

If you have any questions about the LSU Code of Student Conduct, consult the division of Judicial Affairs at

<http://appl003.lsu.edu/slas/judicialaffairs.nsf/index>

Remember, if you lose your honor, it is almost impossible to get it back.

### **Other Items**

Students with special dispensation from the Office of Disability Services (ODS) should see me immediately to discuss your situation. I will be glad to work with you to help you, but I expect you to be proactive in a very timely manner. Exams will be administered in compliance with their rules, but you will take the exam in our department office, not at ODS.

A class session is a private meeting between the students in this class and me. If you take this course, you are agreeing not to use any electronic recording device in class unless you receive permission from me.

### **About Me**

Since I am going to ask you some things about yourself, here is some information about me.

I was born in and grew up in Alabama and after obtaining my B.S. from the University of Montevallo in Alabama and MBA from Ole Miss, I spent four years in banking for a bank that is now part of Regions Bank. I received my PhD from LSU and joined the Virginia Tech faculty in 1980. I spent 23 years at Virginia Tech in Blacksburg, interrupted only by a semester sabbatical at the University of North Carolina at Chapel Hill and a semester at the Virginia Tech Northern Virginia Graduate Center near Washington, DC. I joined LSU in 2003. My position here is the James C. Flores Endowed Chair of MBA Studies. My specialization is risk management. I teach the MBA core course in financial management (BADM 7090) and an elective on risk management (FIN 7400) in the spring term. My research is on derivatives and risk management, and I have authored three books on this subject. I also hold the CFA charter. I consult and conduct training programs for a number of companies, organizations, and law firms and am frequently quoted in the media. I also work as an advisor to IndexIQ, a New York-based ETF firm, and to The Governance Fund, a Minnesota-based investment management firm. My web site is <http://www.bus.lsu.edu/academics/finance/faculty/dchance/>

## First Assignment

Send me an email (dchance@lsu.edu) with the following information as a *one-page Word file attachment*. Name the file "yournameFIN7400". Give your answer to each item below with the item number shown (do not type the questions). Insert your official Flores MBA photo (or an equivalent) somewhere in the file. Do not send the photo as a separate attachment. The photo does not have to be a portrait-style photo but it should be up close and should have only you in it. If you do not have one, have a friend take one right now. Skip a line between each and do not type the question. If you do not follow these instructions, you will have to re-do it.

Except for obvious questions I have provided my own answers in italics. (Some of this information is in "About Me" above.)

1. Your name (what you want to be called by) and hometown (or wherever you say you're from)
2. Previous degrees held (degree, major field, university, year awarded)
3. Previous work experience
4. The program you are in and any specialty or concentration
5. Why you chose LSU for your graduate program (*It so happens that I too came to LSU for graduate study. I did so because I wanted to stay in the south and also my wife was working for a company that offered her a transfer to Baton Rouge. Unfortunately, they closed down the office about a year after we got here.*)
6. Your current job (employer, title, responsibilities)
7. Your career plans
8. The name of the last book you read other than a textbook or a book required for a course. *"America by Heart: Reflections on Family, Faith, and Flag" by Sarah Palin.*
9. Something interesting or unusual about yourself. This could be an unusual experience in life, a hobby, an unusual goal, or just anything out of the ordinary you're willing to tell me about yourself. *I play guitar (any guitarists should check out my guitar page on my web site) in a band called Capital Gains, which consists of three other business professors and an MBA student (www.capitalgainsmusic.com). In the last year, I started writing music, and the band has recorded several songs I have written or co-written. I also play a little banjo, piano, and mandolin. I also have a physiological quirk in that I have no thyroid gland, a result of its complete removal in 1996 due to cancer.*
10. A statement indicating that you have read the syllabus, agree to its terms, and pledge to abide by the LSU Code of Student Conduct.

Remember: Attach your photo and put all of this in a separate Word file

**This assignment is obviously not hard and will not take much time. It is due by 3:00 pm on the day of your second class period. Otherwise, it is a major inconvenience to me and I will not hesitate to penalize you.**