

Problem set 2
266: Fi. Markets and Institutions
Spring 2014
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Directions. You are to do this problem set alone.

Due Date/time. Your work is due by beginning of class (10:30am) April 22. You can hand the work in to me at the beginning of class. If you put the work under my office door, it must be in before I leave for lecture at about 10:20 am.

Questions. If you have questions, email me or one of the TAs, raise them in class, or come to office hours.

Grading. All parts have equal value.

Note: Be sure to note the proper units (e.g., millions, billions, etc.) in the following answers.

1 Screwing up, perhaps in criminal manner. Provide a brief answer to each of the following. (Hint: you should be able to find these answers easily using standard web search tools.)

1.1 Firms in a strong position screwing up:

1.1.1 What market did Overend, Gurney, and Company develop and dominate? How did they go broke?

Answer/comment

Founded in London in 1800; collapsed 1866. Innovated by promoting large scale trade in discounted bills. This was highly profitable, but began engaging in aggressive and foolish investments and went broke.

1.1.2 What market did Salomon Brothers dominate for many decades? What scandal was part of its downfall?

Answer/comment

Salomon Brothers: Started in 1910, effectively disbanded in the late 1990s. Became one of the most prominent investment

banks in the U.S. for much of the 1900s and was particularly known as a major player and innovator in bond markets. Began using aggressive and arguably illegal methods in the 1990s (such as attempting to corner the Treasury market). Swallowed by Travelers and effectively disbanded.

- 1.1.3 What market did Drexel Burnham Lambert help develop and then dominate? What scandal played a large role in its downfall?

Answer/comment

Formed out of three more venerable firms in 1976, the firm was a major player in creating the high yield (junk) bond market. This was immensely profitable. Due to aggressive, arguably unethical and illegal behavior, the firm got into lots of legal trouble and declared bankruptcy in 1990.

Note: These are just 3 of many good examples from history of major and highly profitable financial firms that had some incredibly lucrative “nitch” blowing themselves up through foolish, aggressive, unethical, and/or illegal activity.

- 1.2 More general mischief

- 1.2.1 What was Barings Bank and why did it fail?

Answer/comment

One of the oldest merchants’ bank based in London. It was founded in 1762. Collapsed in 1995 due to unauthorized (but poorly monitored) trading of a “rogue trader,” Nick Leeson.

- 1.2.2 What is Libor? And the Libor Scandal? (hint: google libor scandal)

Answer/comment

LIBOR is the London Interbank Offered Rate. It reflects the rate that major banks pay to borrow from each other on the London interbank market. The “published” interest rate comes from a survey taken of a panel of banks and is used as a reference rate for many other contracts. It was recently discovered that many banks were manipulating their answers to the survey in order to favor their positions. Detail: Barclays

was the first bank fined in the scandal, but many others were apparently involved. Reform of the LIBOR reference rate setting is a major priority of the private and official financial community.

1.2.3 What is HSBC? How did it aid drug cartels? (hint: google HSBC drug cartels)

Answer/comment

HSBC is the Hong Kong Shanghai Banking Corporation. Recently paid a \$1.9 billion fine in the U.S. for helping aid Mexican Drug cartels launder money arguably in violation of good business, good ethics and money laundering laws.

Note: These are three examples (of many we could cite) of firms not paying close attention to what some employees are doing, and those employees choosing to do something foolish, unethical, and/or illegal and costing the firm greatly.

2 Reading a 10-k report.

Obtain the latest 10-k report for JPMorgan Chase (covering 2013). (Hint 1: i) go to <http://www.sec.gov/>, ii) Under ‘filings’ in the top bar, choose ‘Company Filings Search’, iii) In the Fast Search box, put JPM and search; iv) in the Filing Type box put 10-k and hit search.)

(Hint 2: If the question has a phrase in ‘single quotes,’ searching for this phrase in the 10-k may help you.)

2.1 Find the table summarizing business segments (search for ‘BUSINESS SEGMENT RESULTS’ repeatedly until you see the table. What 4 business segments does JPM report?

Answer/comment

4 Business segments (p.85): (1) Consumer & Community Banking, (2) Corporate & Investment Banking, (3) Commercial Banking, and (4) Asset Management.

2.2 From same table as previous part, what 3 business lines are reported under ‘consumer and community banking’?

Answer/comment

3 business lines (p.86): (1) Consumer and Business Banking, (2)

Mortgage Banking, and (3) Card, Merchant's services and Auto

- 2.3 What was the total net revenue of the 'Corporate and Investment Bank' segment in 2013? What segment had the highest total net revenue?

Answer/comment

Corporate and Investment bank: \$34,225 (million)

Highest total net revenue: Consumer and community banking (\$46,026 million)

- 2.4 What does JPM report it must do regarding a 'resolution plan' under the Dodd Frank Act?

Answer/comment

Firms¹ must report followings regarding the resolution plan:

- (1) Strategies to resolve the Firm under the Bankruptcy Code in the event of material distress or failure,
 - (2) Recommendation to the FDIC and the Federal Reserve about the Firm's proposed optimal strategy to resolve the Firm (under the special resolution procedure provided in Title II of the Dodd-Frank Act) (p.1 and 10)
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Note: you just needed to summarize the basics here.

- 2.5 What does JPM report at 'return on common equity' for each of the last 5 years?

Answer/comment

9,11,11,10,6 (%) (p.62)

- 2.6 What does JPM report at 'return on assets' for each of the last 5 years?

Answer/comment

0.75, 0.94, 0.86, 0.85, 0.58 (%) (p.62)

- 2.7 Name three functions listed for the 'country risk management group.'

¹such that (1) bank holding companies with assets of \$50 billion or more, (2) companies designated as systemically important by the FSOC a plan for resolution under the Bankruptcy Code, and (3) insured depository institutions with assets of \$50 billion or more (JPM is in this category)

Answer/comment

(1) Developing guidelines and policies consistent with a comprehensive country risk framework, (2) Assigning sovereign ratings and assessing country risks, (3) Measuring and monitoring country risk exposure and stress across the Firm, (4) Managing country limits and reporting trends and limit breaches to senior management, (5) Developing surveillance tools for early identification of potential country risk concerns, and (6) Providing country risk scenario analysis (p.149)

3 Value at Risk (VaR).

- 3.1 If a firm says that its 1-day 95 percent value at risk is \$100 million, what does this mean?

Answer/comment

Maximum one-day loss that a financial institution could incur with probability of 5% (p.144)

- 3.2 According to the JPM 10-k examined above, on how many trading days in 2013 did trading losses exceed the 95 percent one-day VaR computed by the firm? (Hint: Search for ‘value-at-risk’ repeatedly until you find the info.)

Answer/comment

2 days

- 3.3 Of the 260 trading days reported for 2013 on how many did JPM report trading gains? (Hint: read the VaR discussion.)

Answer/comment

177 days

4 Mutual funds. Get the ICI factbook

(http://www.icifactbook.org/pdf/2013_factbook.pdf). You should be able to find the following by searching sensible terms in this pdf document.

- 4.1 Describe in general terms the investment strategy of an ‘index fund’

Answer/comment

Index fund: a type of mutual fund, which is constructed in the way that its return matches some indices in the financial market, such as S&P 500 or Dow Jones.

- 4.2 At year end 2012, what proportion of all money in ‘index funds’ was in mutual funds with returns indexed to the S&P 500?

Answer/comment

33% (p.37)

- 4.3 What share of U.S. households held mutual funds in the following years: 1980, 1990, 2000, 2010?

Answer/comment

5.7, 25.1, 45.7, 45.3 (%) (p.90) (Note that the question asks *share* of households, not numbers.)
