Categorization Exercise

For the following examples, please answer:

- Does the event represent an operational failure?
- How would you categorize the event?
- What was the nature and magnitude of the loss?

Case I

A U.S. property and casualty insurance firm reported that as part of a class action lawsuit it had been ordered to pay approximately five million policyholders $1.2 billion in aggregate because it had required repair shops to use generic rather than original equipment manufacturer parts when conducting vehicular repairs. The jury ordered the firm to pay $456 million to policyholders whose cars had been repaired with the cheaper parts, and the judge later slapped the insurer with an additional $730 million judgment, mostly in punitive damages, for committing consumer fraud.

Case II

The back office operations of a European brokerage firm discovers that as a result of a miscommunication between the front office and the back office they have processed a buy instead of a sell, which has resulted in a loss of €600,000. The back office manager decides not to reveal this mistake to anyone outside the group, expecting that the position will self-correct in the near future. By the end of the week, the loss amount has increased to €6.7 million. Finally the manager reveals the error and the broker writes down the full amount of the loss.

Case III

A U.S. retail brokerage firm reported that it had written down $350 million in assets after realizing that its fixed income security pricing model had systematically mis-priced an entire portfolio of securities. A bond trader at the firm had for several years knowingly exploited this model error by purchasing exactly those securities that the model was overvaluing. This arbitrage opportunity allowed him to generate an immediate phantom profit. The trader was dismissed by the firm, arrested and charged with fraud, but after a two-year trial was found to be not guilty. One of the trader's arguments was that that it was not his job to determine whether the model was working properly; his job was to generate profits, which he did.

Suppose you had to classify this event before the verdict had been announced. How would you classify it?

Case IV

A U.S. bank lost $155 million in settlement of a lawsuit. It was alleged that the bank had used predatory lending practices in the state of Georgia because it had not properly disclosed the way it had calculated interest on loans. It was further alleged that many borrowers were under the false impression that they were paying a lower interest rate on their mortgage loans than the rate actually charged.

Case V

Two freight trains are approaching a small town at high speed from opposite directions. One of the train operators is text-messaging his sweetheart and fails to realize that both trains are on the same track and fails to stop his train in time. The two trains collide, resulting in $10 million in property damage and the death of 30 train company employees.

Case VI

The mortgage banking division of a bank provides a $2 million loan for the purchase of a residential property. The property is offered as collateral for the loan. After four years the borrower loses his job and defaults on the loan. When the bank initiates foreclosure procedures it discovers a serious error in the loan documentation, which prevents the bank from taking ownership of the property. As a result, the bank is forced to write off the full amount of the loan.

Case VII

A US life insurance firm, reported that it had agreed to pay $357M to settle charges that it had used deceptive sales practices and that it had cheated customers. In a case involving "vanishing premiums", policyholders, usually elderly customers, had been persuaded to buy new life insurance policies using the value of their old policies. The policyholders were told that they wouldn't have to pay premiums after a certain number of years, because dividends on the policies would cover those costs. However, the company failed to disclose that this would only happen if dividends, which were based on interest rates, stayed the same or increased. Instead, both interest rates and dividends fell, leaving policyholders with premium payments they had not expected. The company's salespeople were accused of using deceptive practices, including misleading customers about premium costs and disguising life insurance policies as retirement plans. Customers who had been insured through the company between 1979 and 1996 settled for a total of $350M. Additionally, the firm was fined $6M by Florida regulators and $1M by New York regulators.

Case VIII

A gang of bank robbers learns that a large bank is about to change its security system. Because the bank is likely to be vulnerable on the day they implement the new system, the gang decides to rob five nearby branches on that day during a two-hour period. They succeed. In the process they also vandalize one building, which costs the bank $20,000 to fix. The total loss amounts to $150,000, roughly $30,000 per robbery.

Case IX

On September 11, 2001 two planes crashed into the World Trade Center, completely destroying many of the buildings and killing many people. Several retail outlets in the vicinity lost their clientele and were unable to repay their bank loans. Total losses to the bank from this event amount to $200 million.

Case X

A US insurance company and a subsidiary of an investment group, reported that it had realized a loss of $125M due to embezzlement and fraud committed by one of its principals. The scheme caused the company's collapse. Later, a federal grand jury found the principal guilty of pocketing the funds.