CASE STUDY

## The preferred stock issue

### The story

##### Everything is safe

Life in Banking was pleasant. Sylwia and Grzesiek were living in a small town, those in which you easily know more than half of the people living there. Day after day, they managed to sell some of this new product that recently launched the bank they were forking for: ‘Preferred dividend 6.5%’. Actually, this product was launched in response to a recent campaign led by their direct competitor, who had their ‘Investment Preferred dividend 6.25%’. Both entities were fairly small, focusing on typical retail customers and SMEs, with little activity in other business such as Private Banking, Project Finance, etc.

This was not a bad product, pretty much in line with similar products that other banks were selling. They had been commercializing it for near four years now slightly adjusting the interest rates, always with very good results. Even people was very keen to buy them. The sale sheets[[1]](#footnote-1), sent from the Sales Director and with Top Management signature, including the Board of Directors representative, were something like this:

* It's like a deposit. You make a transfer and then after one year you will receive your money back plus a 6.5% interest payment;
* You can cancel any moment and get your money back. Only you miss the coupon payment;
* At maturity, you can choose to get your money back or to roll-over.

To be honest, it was a very good interest rate, even at some point Sylwia and Grzesiek were wondering why they should advertise the ‘Deposit 3.25%’, as pretty much nobody asked for it. Even more, they were surprised that the biggest banks in the country didn't have any *Preferred dividend* product, only the classical cheap deposits. Actually some days ago this conversation happened in the office with a recently retired customer:

* Hmmm..., something doesn't add up here. If both are deposits, why one gives double the interest than the other? Sylwia, are you sure it is the same?
* Yes Pan Marek, don't worry at all. It is exactly like a deposit.
* I am still not convinced. Listen my dear, I don't know these numbers you do every day, but my mother taught me something that until today has been very useful to me: nobody presents you money for free.

This conversation was rather an exception, as many other retired people massively bought this kind of products in all the banks.

##### The country freezes

Nobody knew what was happening exactly, but the fact is that the unemployment rate was skyrocketing. Many people lost their jobs, and didn't have direct earnings. The banks saw their benefit drop to negative numbers, and almost no entity was able to close the year with positive earnings. People was not especially scared, as during the previous years many people managed to save enough to have deposits in case of a bad situation.

Quite a number of people were coming to the branch, and this dialogue happened one time after another:

* Hi Grzesiek. I want to cancel my deposit. I know we are in September, it's a pity I won't get my interest, but I really need my money.
* Good morning Pani Anna. I am sorry, but it is not possible to get the 100% of the deposit. If you cancelled now, you would get only 60% of your capital.
* I don't understand, you told me that I could cancel any moment, just I would loss the interest. How can it be?
* Yes, but the market conditions do not allow it. We can only sell your deposit for 60% of its value.
* But a deposit is not sold, I don't understand anything. Grzesiek, I have been a good customer for 15 years. Please don't make me come with my lawyer.

Some months later, the nightmare turned even worse: all customers who kept their investment saw that no interest was transferred to their accounts. This time the dialogue looked like this:

* Hi Sylwia. Look, I still don't have my interest payment. Can you please check?
* Yes, Pan Gabriel. Actually the interest for this year has been cancelled due to bad results.
* What?!?! A deposit always has an interest!! Well, at least I want my capital, then we will see what to do.
* Well, Pan Gabriel, the fact is that it will not be possible to recover the capital this year. The bank has decided to continue at least one extra year.
* WHAT?!?!?!?! What kind of deposit does so?!?!?!
* But this is not exactly a deposit, it is a preferred stock.
* Sylwia, you never told me that. I want my money back now.
* Pan Gabriel, given market conditions, you would get in your account 250.000 PLN.
* Sylwia, I invested 1.000.000 PLN. How can you tell me that I get not 106.5% as promised, but 25%? I lost a lot of money. Tomorrow I will come with my lawyer.

##### The reality uncovered

Yes, the ‘Preferred dividend 6.5%’, the ‘Investment Preferred dividend 6.25%’ and other similar products were not deposits by any mean, Pan Marek was right. It was preferred stock, a highly speculative perpetual product. Actually, in July these issues were valued from 90% to 110%, depending on rate and entity. Half a year later, the prices were not higher than 20%.

Cases in court were happening one after the other, mostly always ruling in favor of the customer. The point is that not everybody could afford a lawyer. Sylwia had to see every day the people that lost almost all the money, threating and insulting her, up to a point she could not stand it anymore and decided even to move to another city in which she didn't know anybody. After half a year, Grzesiek had his hair mostly white and seemed to be ten years older. Nobody in the town wanted even to speak to him. Both banks were losing customers every day, as many customers moved their accounts to the big banks, and eventually they disappeared absorbed by bigger competitors. When Grzesiek's branch was closed, he was unable to find any job, having also to move to another city.

### Discussion

Comment and discuss the following questions:

* What are the main risks involved in this case?
* What failed in the Risk Management framework?
* From the identified risks, which are the most important?

1. A Sale sheet is a sort of script the salesforce is given, to be able to explain the product to customers. [↑](#footnote-ref-1)