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RISK MANAGEMENT

IN-HOUSE

CASE STUDY SERIES

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Case Study 17 Answers

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Bankers Trust Case Study

Multiple Choice Questions

Answer

1. **C is correct.**

   Disaster due to conduct of customer business

   "The classic case of this type [i.e., disasters due to the conduct of customer business] is the Bankers Trust (BT) incident of 1994, when BT was sued by Procter & Gamble (P&G) and Gibson Greetings. Both P&G and Gibson claimed that they had suffered large losses in derivatives trades they had entered into with BT due to being misled by BT as to the nature of the positions. These were trades on which BT had little market or credit risk, since it had hedged the market risk on them with other derivatives and there was no credit issue of P&G or Gibson being unable to pay the amount they owed. However, the evidence uncovered in the course of legal discovery for these lawsuits was severely damaging to BT's reputation for fair business dealing, led to the resignation of the firm's CEO, and ultimately had such negative consequences for the bank's ability to do business that it was forced into an acquisition by Deutsche Bank, which essentially amounted to a dismemberment of the firm.

2. **B is correct.**

   The transaction at issue was a complex interest-rate derivative

   The "sheer complexity" of the transaction was at the heart of the dispute and appears to generally not be in dispute.

   - *In regard to (A), P&G "had been entering into such trades for several years prior to 1994 with good results.*
   - *In regard to (C), P&G was seeking to REDUCE FUNDING COST (consequently that had directional exposure to a rise in interest rates) and "the derivatives were not tailored to any particular needs of P&G or Gibson*

- *In regard to (D), BT asserted that it was NOT acting in an advisory (fiduciary) role to P&G, since the firm had retained its own outside experts to create interest rate forecasts.*

3. **D is correct.**

   Some transactions are sufficiently complex that their costs outweigh their benefits

   - *In regard to (A), (B), and (C), these are all lessons learned.*
   - *In regard to (D), please note COMPLEXITY is fundamental to the case. However, the lesson was not that complex transactions should be avoided but rather that the scandal caused firms "to tighten up their procedures for dealing with customers, both in better controls on matching the degree of complexity of trades to the degree of financial sophistication of customers …" … so this is rather an issue of complexity with regard to client suitability.*

4. **B is correct.**

   Procter and Gamble and Gibson sued Bankers Trust over the latter's failure to tailor negotiated derivative trades to meet their individual needs. P & G and Gibson actually used phone records of BT staff as evidence in lawsuits. In particular, some of the employees were on record bragging about how badly they'd fooled clients with complex, unfathomable structures. The case study highlighted the need to exercise caution when "wire-tapping" staff.