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CASE STUDY SERIES

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Case Study 17 Questions

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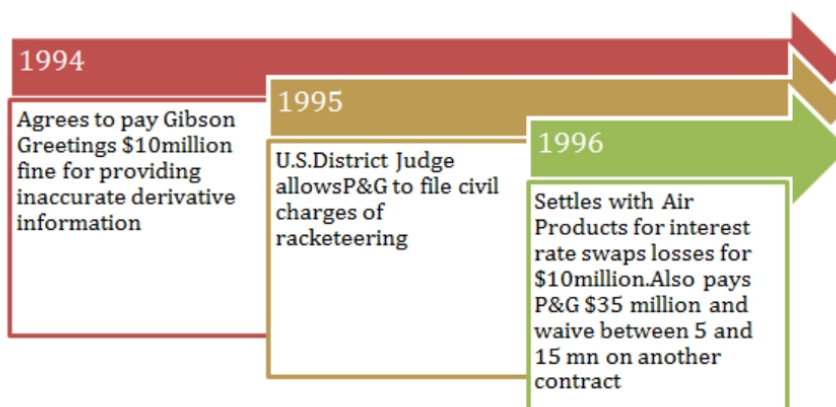
Bankers Trust Case Study

P&G like several other profitable companies was looking at ways to hedge itself from risk. They were also looking at methods at making small gains, where possible. In case the gains turned to be losses, since they were offset by the small gains. They did this by using plain swaps of fixed for floating rate debt or vice versa. They also used futures, options and currency trades to hedge.

P&G decided to go into high risk complex derivatives through Bankers Trust which was known to be a top player in risk management. P&G had discussed hedging by Bankers Trust using vanilla swaps. It entered into two such contracts. These contracts were floating rate notes in Deutsche marks and dollars. The bets were made on the assumption that the interest rates would fall. P&G further upped the stakes by betting twenty to one in favor of an interest rate fall.

There was the buzz that rates would indeed increase at some point and therefore positions must be cleared before it did happen. In 1994, Greenspan went ahead and did what the market was predicting. He raised rates. P&G lost heavily. Its Chief Financial Officer claimed that they had no knowledge of the intricacies of the contract and were thus unaware of the losses that could be made. Bankers Trust on its part had not clearly detailed the underlying risk inherent in their contracts.

P&G sued BT for $195million. BT claimed that P&G had in place its own panel of experts to do interest rates forecasts and that they had not complained when they made handsome gains. Eventually both the parties settled out of court for a net of $78 million. Bankers Trust also settled with Federal Paper Board Company, Gibson Greetings, Air Products and Chemical, and Procter & Gamble for $93 million.



Bankers Trust contended that P&G could have learnt more about the complex derivatives it was channeling funds into. P&G countered by saying BT should have made them fully cognizant of the risks that were involved in these instruments, since P&G had given their funds in good faith. Since the returns were good P&G had no real reason to go into the details of the contract.

A series of recordings among employees at BT were heard out, in which employees discussed how the contracts that P&G had got into were not unlike a keg of gunpowder waiting to explode.

One of the oft quoted excerpts from those recordings (6500 of them) from Newsweeks archives reads as follows:

“It’s Nov. 2, 1993, and two employees of Bankers Trust Co. are discussing a leveraged derivative deal the bank had recently sold to Procter & Gamble Co. “They would never know. They would never be able to know how much money was taken out of that,” says one employee, referring to the huge profits the bank stood to make on the transaction. “Never, no way, no way,” replies her colleague. “That’s the beauty of Bankers Trust.”

P&G claimed that by the time it was fully in the know about how the derivative worked they were asked to fork out $40 million as extra financing costs. They then learnt that BT was using a proprietary model to calculate these costs. Just as the costs the payouts were not fully clear either.

Lessons Learnt

BT suffered from serious reputational risk, lost the trust of its valued clients and laid bare the process lacunas in its system.

BT was dealing with complex derivatives and getting into them with clients who trusted them and considered them to be the best. Instead what transpired was that BT misused this trust by not being transparent in their dealings. If they had clearly explained to their clients all the risks and costs that may need to be borne in the event the hedge went against them, clients would have further investigated them.

BT got over confident and seemed to have bred a culture of deceit and profits at any cost. It also seems to have not placed adequate emphasis on communication between employees regarding client matters. The attitude of it's alright to scam the client by not keeping them fully informed seemed to be rampant within the organization. Perhaps it was more a case of employees having to reach targets at any cost. Unfortunately that pressure translated into the most undesirable form with BT employees not putting their clients on top.

In the case of clients like P&G who while being financially savvy may not have been fully aware of how the more complex derivatives worked, BT could have spent time earlier on making them aware of the risks. P&G went after BT with a vengeance and made several incriminating allegations against them, warning off other valuable customers who might have done business with BT.

If BT employees and management had been more discreet in their internal communication and far more transparent in their conversation with clients it would have done their business and reputation a world of good.

Multiple Choice Questions

1. Where does banker trust slots amongst the following?

A. Disaster due to misleading reporting

B. Disaster due to large market moves

C. Disaster due to conduct of customer business

D. All of the above

2. Which is TRUE about the issue between Bankers' Trust and Procter & Gamble (P&G)?

A. P&G was a new client to Banker's Trust in 1994

B. The transaction at issue was a complex interest-rate derivative

C. The intent of P&G was to implement a tailored hedge

D. Banker's Trust asserted its fiduciary role with respect to P&G

3. The lessons learned from Bankers' Trust included each of the following EXCEPT for:

A. Complex transaction make comparison shopping difficult and make clients more dependent on advisor

B. Provide a means for customers to obtain price quotes from an area independent of the front office

C. People and firms should be cautious about communications (e.g., email) that can later be made public

D. Some transactions are sufficiently complex that their costs outweigh their benefits

4. In the modern business world, it's not uncommon to find organizations recording phone conversations between clients and staff. Which of the following best explains why firms must exercise caution when engaging in such an exercise as highlighted by the Bankers Trust incident?

A. Taping conversations can have a negative impact on the ability of staff to freely and candidly engage with clients

B. The recorded conversations can be used against the organizations as evidence during lawsuits

C. The exercise may not yield significant results and may actually deal a heavy blow to staff/management trust

D. Taping conversations could consume considerable time and energy which could otherwise be channeled into more productive business