

Bankers Trust

Summary:

Bankers Trust (BT) was sued by four of its major clients - Federal Paper Board Company, Gibson Greetings, Air Products and Chemical, and Procter & Gamble - who asserted that Bankers Trust had misled them with respect to the riskiness and value of derivatives that they had purchased from the bank. The first three cases were settled out of court for a total of \$93 million. The \$195 million Procter & Gamble suit was settled at a net gain to P&G of \$78 million. The most lasting damage, however, was to BT's reputation.

Overview:

In the mid-1990s, Bankers Trust (now part of Deutsche Bank) was one of the leading banks in the marketing of innovative financial products. The bank prided itself on its superior financial abilities and on its leading edge risk management with respect to its derivatives trading. Yet Bankers Trust's reputation took a pounding after the bank was sued by several customers alleging various forms of fraud and racketeering with respect to derivatives transactions they had entered into with the bank. Several of these suits have since been settled both in and out of

court, costing the company millions of dollars in settlement and possibly much more in damage to its reputation.

Why did these problems arise? The root cause appears to have been that BT's clients felt that BT had unfairly exploited their comparative lack of sophistication in handling these sophisticated derivative products. For example, Procter & Gamble (P&G), the client whose case received the most publicity, had entered into complex interest-rate derivatives transactions with the bank. These transactions represented a bet on P&G's part that U.S. interest rates would remain stable, or decline, over the transaction period. If interest rates rose, however, P&G would lose a substantial amount of money. In addition, P&G made its bets more aggressive by leveraging its positions twenty-to-one.

The transactions lost a substantial amount after the US Federal Reserve Board raised interest rates repeatedly in 1994. P&G subsequently sued BT for \$195 million, claiming that the bank had failed to fully inform it with respect to the risk involved in the transactions. BT countered that it was not acting in an

advisory (or "fiduciary") role to P&G, since the firm had retained its own outside experts to create interest rate forecasts. It also claimed that P&G's reputation for using cutting-edge financing techniques cast doubt on its claims to be naive in this matter.

This appears to be an example of poor stakeholder management. In focusing on increasing profits, Bankers Trust didn't pay adequate attention to the fact that its clients were vital to its business. Even if it did nothing dishonest, it failed to serve its clients in terms of making them feel informed and at ease with their deals.

Events:

October 1994: Procter and Gamble Co. sues Bankers Trust for \$195 million (the company recorded a \$102 million charge against fiscal 1994 earnings to cover losses from derivatives transactions), alleging that BT misled it with regard to the value and risks of its derivatives positions.

December 1994: BT signs consent decrees with federal securities regulators and agrees to pay a \$10 million fine over allegations that it wilfully gave Gibson Greetings inaccurate values for its derivatives portfolio, causing

Gibson to violate SEC laws. BT neither admits nor denies guilt.

October 1995: U.S. District Judge John Feikens allows P&G to add civil racketeering charges to its suit, which will allow the company to seek treble damages.

January 1996: Bankers Trust settles with Air Products and Chemicals, Inc. for \$67 million, 63% of the \$107 in losses in fiscal 1994 that Air Products wrote off in connection with interest-rate swaps the company entered into with Bankers Trust.

May 1996: Bankers Trust and Procter & Gamble reach an out-of-court settlement in which P&G agrees to pay \$35 million of the \$195 million it owed BT and will forgo between \$5 and \$14 million in gains on a separate contract. P&G reports a net gain of \$78 million with respect to the issue in its quarterly reports.

Lessons to be Learned:

Give adequate attention to all aspects of risk

An enterprise risk management program must balance the "hard side" of risk management (including policies, limits and systems) and the soft side (including people, culture and incentives). It is ironic that BT, a company that was considered by many to be a leader in risk management and in innovative derivative products, lost so much of its reputation as a result of operational risk (in this case, sales practices).

Honesty is always the best policy

Reputational risk management suggests that in a time of crisis, management should focus on integrity and openness in dealing with customer complaints and public perception: if the allegations brought by P&G had any basis in reality, Bankers Trust did an inadequate job in resolving them.

Align incentives properly

Performance pressure may encourage participation in deals that ultimately backfire, especially if incentives and oversight are not aligned properly. Despite the urgency of the rush to sell a deal or gain a client, proper thought needs to be given to the long-term wisdom of all aspects of the deal.

Practice good stakeholder management

Clients are stakeholders, too! In the rush to create profits for shareholders, attention must still be given to the clients who are integral to the business.

About BancWare ERisk

BancWare ERisk is a leading provider of integrated software and consulting solutions that enable financial organizations to enhance their performance through better risk and capital management. We help senior executives to transform their risk management processes to improve management effectiveness, reduce losses and increase shareholder value. BancWare ERisk is backed by the strength of SunGard, a global leader in integrated software and processing solutions, primarily for financial services. SunGard serves more than 25,000 customers in more than 50 countries, including the world's 50 largest financial services companies.