First Union, Undeterred by Headlines, Peddles Derivatives to Midsize Firms

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GREENSBORO, N.C.—As some 30 local businesspeople finish a breakfast of grits, scrambled eggs and coffee at the well-appointed City Club here, Steven W. Kohlhagen takes the podium and dishes up a heavy chaser: derivatives.

As First Union Corp.'s senior vice president of derivatives marketing, Mr. Kohlhagen is on a mission to bring the sophisticated financial instruments to Main Street. It's a hard sell these days. Many in his audience — officers of medium-sized companies, most of whom have never used derivatives — are mystified and distrustful of the instruments.

"I looked it up in the dictionary" upon receiving First Union's invitation, says Roger E. Rodolphe, controller of South Atlantic Lumber Industries, a local wholesaler. His first reaction: "They're trying to sell me something."

Another guest at Mr. Rodolphe's table offers some insight: "That's a dirty word these days, derivatives. People have lost millions."

But despite news of huge derivatives losses at Procter & Gamble Co., Gibson Greetings Inc. and others, First Union is pushing hard to expand its fledgling derivatives operations. What's more, the bank holding company is targeting what seems like an unlikely group of customers: medium-sized businesses that typically shun arcane instruments, companies with annual revenue as low as $10 million.

"We're explaining to middle-market businesses the way derivatives work, the same way dealers did 10 years ago with Fortune 500 companies," says Terry L. Turner, First Union's senior vice president and manager of derivatives products.

Derivatives are financial arrangements whose returns are designed to track changes in interest rates, currencies or other assets. A common type is an interest-rate swap, where one party commits to pay a fixed rate on, say, $1 million of notional capital, in exchange for floating-rate income on the same notional amount.

First Union's venture reflects a trend: As the derivatives industry matures, use of these instruments is spreading downward from the nation's largest corporations to increasingly smaller concerns. Such smaller companies are finding that they can use derivatives to hedge against adverse interest-rate moves and other risks, just as the largest companies do. Banks, meanwhile, see a new source of revenue.

Other banks, too, offer derivatives to middle-market businesses. What distinguishes First Union is its aggressiveness. The bank has set up a trading floor at its Charlotte, N.C., headquarters that resembles a midsize Wall Street operation. Its derivatives staff is to expand to 45 people in early 1995 from 30 currently. From a standing start in April 1993, First Union has accumulated a customer portfolio with a notional value of $4 billion. Its typical deal is $5 million, but it will do a contract for as little as $1 million, a lower limit than most rivals offer.

At first, First Union's selling job meant educating middle-market executives about how derivatives can add flexibility and predictability to their finances. But as more companies report losses linked to derivatives, the bank faces the added task of dispelling widespread fears about the products and distinguishing what it calls its "plain-vanilla" deals from the exotic and speculative instruments that have grabbed headlines.

"If you're a company thinking of using them for the first time and all the chairman has read is negative publicity, it's bound to slow sales," says Paul Spraos, publisher of Swaps Monitor, an industry newsletter.

Adds First Union's Mr. Kohlhagen: "We're spending a lot more time talking about risk."

The core of First Union's derivatives business is selling simple interest-rate hedges, in the form of swaps, caps and floors. It also offers derivatives to protect against swings in currency, energy, and metal prices — products that it expects will grow.

As First Union accumulates a series of small customer deals, it typically hedges its own risk by entering into offsetting positions in the futures market or with other dealers. The bank profits as long as its own hedges are cheaper than those it sells to its customers. The small size of its clients' transactions and its relative lack of competition means First Union can typically reap fatter spreads than it could selling similar products to large firms.

To bring potential new customers up to

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