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Fancy Footwork

Bankers Trust Thrives Pitching Derivatives, But Climate Is Shifting

Losses by Clients Like P&G May Crimp Plan to Move To Relationship Banking

Some Intense Pressure to Sell

The folks at Bankers Trust New York Corp. haven't been bankers in the classic sense for years. And now, corporate financial executives are beginning to wonder how much they can trust them.

In just two weeks, three companies that bought sophisticated financial-derivative products from Bankers Trust have had to report big losses on those investments. Two – Procter & Gamble Co. and Gibson Greetings Inc. – are threatening to sue Bankers Trust. The third, Mead Corp., is taking its lumps without talk of legal action, at least so far.

By Wall Street Journal staff reporters Steven Lipin, Barbara Donnelly Granito and Leslie Scism.

It isn't clear yet whether in each case corporate executives were willingly taking big risks to earn big rewards, or whether they might have been induced by Bankers Trust salespeople to buy products they didn't understand. What is clear from interviews with former Bankers Trust executives and with corporate treasurers and other financial officials is that Bankers Trust has been unusually aggressive in selling the products as well as in using them to its own advantage, even at the expense of its clients. People close to the bank say that its "take-no-prisoners" approach has even driven away dozens of ambitious employees who grew uncomfortable with that style.

"It's a tough culture. If they find a weakness, they'll exploit it," says a former Bankers Trust official who left to run a derivatives operations for a rival bank.

"If you look around at the Street, you find a lot of ex-Bankers Trust people," says J. Thomas Allen, president of Advanced Investment Management, a Pittsburgh-based firm that manages $3.5 billion through derivatives.

Of course, Bankers Trust isn't the only big investment firm peddling sophisticated derivative products to corporate America. In a recent regulatory filing, Dell Computer Corp. said it suffered a $500,000 paper loss on a derivative transaction. Separately, the company said the deal was not with Bankers Trust. Dell warned that it could take additional paper losses on derivatives during its current first fiscal quarter ending May 1; some analysts project the quarterly loss at between $5 million and $15 million.

In addition, senior consultants at big accounting firms warn that some of their other corporate clients soon will be reporting derivatives-related losses, too, the result of products sold by some of Bankers Trust's biggest rivals.

Big Chunk of Its Business

And senior consultants at big accounting firms warn that some of their corporate clients soon will be reporting derivatives-related losses, too, the result of products sold by some rivals of Bankers Trust.

But Bankers Trust is far more dependent upon the sale and trading of derivative products than any other U.S. financial institution. Over the past decade, it has become a derivatives juggernaut, constantly striving to create sophisticated new products on which it can earn big fees or trading profits. Last year, 31% of its bottom line was the result of selling risk-management products, while a stunning 56% came from proprietary trading. In the first quarter, the bank said this week, 70% of its earnings came from the sale of derivatives to clients. The bank's ability to stay on the cutting edge of financial innovation earns the highest accolades from some financial executives.

"They're extremely innovative and extremely aggressive," says Michael Flagg, the former treasurer of AM International. "You could sit down with them and say 'I want to hedge a risk of having too many blue giraffes,' and they would be able to help you do that.

Bankers Trust officials say that the blowups at three companies that bought products from Bankers Trust are isolated incidents that don't reflect the vast majority of clients that use derivatives. Doug Kidd, a managing director at Bankers Trust, says, "We believe we've acted completely ethically, honestly and with the highest standards of professionalism."

Bad for Relationships

Still, the clients well-publicized losses, and the likelihood that more will be forthcoming, threaten at the very least to undermine Bankers Trust's efforts to rebuild the corporate relationships it willingly abandoned years ago.

"We believe there will be a slowdown as client policies tighten," Timothy Yates, the bank's chief financial officer, said earlier this week. "But in the long term we see that as good."

Beyond the immediate effects on Bankers Trust's profits and revenue, the problems that are cropping up threaten to slow the growth of the entire derivatives business, including the standard risk-management products on which many corporations, pension funds and even credit unions routinely rely.

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Fancy Footwork: Bankers Trust Did Well Pitching Derivatives, but Clients' Losses Sting the Bank, Too

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maybe futile task in this environment," says Narayan Ramachandran, managing director for research at Rogers, Casey & Associates, a large pension-fund consultant. "It's not necessarily rational, but it's practical for a customer to say 'Why mess with this stuff now? Let somebody else take the heat.' "

What's more, the problems open new doors for nervous regulators and ambitious legislators who already are moving to crack down on more exotic derivatives and the proprietary trading of financial instruments by U.S. banks.

"It is bad for everybody," says an executive at one of the leading dealers.

Bankers Trust executives concluded as early as 1979 that traditional commercial banking was a dying business, fraught with too many competitors fighting over a shrinking commercial loan pie. Led by its chairman, Charles Sanford, a former bond trader from Georgia, Bankers Trust had the vision to invest heavily in capital markets when some other banks were trying to be all things to all people, in effect, financial supermarkets. Today that early thrust into the world of derivatives seems especially prescient as competitors have had to scramble to catch up.

Bankers Trust's strength as a financial innovator lies in its ability to ~~attract the best and~~ brightest among the mathematics wizards coming out of top schools like the Massachusetts Institute of Technology and Wharton. Those "rocket scientists" are put to work devising sophisticated formulas for creating customized swaps and complex option products.

Swaps and Options

In their simplest and safest use, swaps and options give buyers financial protection against adverse moves in such things as interest rates or foreign currencies. For example, Bertelsmann Inc., the U.S. subsidiary of the German media giant, last year purchased an interest-rate option called a "cap" that, in effect, set a ceiling on the cost of financing the $119 million purchase of a building in New York. If interest rates rise above a certain level, the company's financing needs become fixed at a set rate.

"We wanted peace of mind," says Basil Mavrovitis, the departing treasurer.

But those kinds of deals carry scant profits for the banks and securities firms that sell them. Although Bankers Trust does plenty of this work, its real expertise lies in the area of exotic products such as leveraged swaps. These products differ from plain-vanilla derivatives in that they allow the buyer to make very specific bets on things like the difference between short-term and long-term interest rates. The trouble is they are a particularly volatile form of derivative, and the returns — or losses, if the bet is wrong — are greatly magnified.

The appeal of such exotic instruments is that it takes a certain amount of expertise to craft them, so not every financial firm can compete. Further, they tend to be much more profitable for the seller. For example, the profit for the seller on a typical leveraged swap runs about eight times the level of a traditional interest-rate swap. The more complex and customized the product becomes, the higher the fees the bank can command.

Fee-Driven

"Every bank of any size wants to sell [exotic derivatives] to a corporation," says Christopher Sailer, treasurer of Brown-Forman Corp., a Louisville, Ky., distiller. "They basically will promote it with whatever reasoning a treasurer will accept. They're there to generate transaction fees, and the way to do it is through sales." He says that Brown-Forman hasn't done derivatives business with Bankers Trust and doesn't use leveraged swaps.

Bankers Trust's tight focus on derivatives during the last decade made it the leader in the field. But that came at the expense of the kind of broad-based investment-banking business that firms like J.P. Morgan & Co. and Goldman, Sachs & Co. have nurtured. Not only does the broader business provide a diversified stream of earnings, it also encourages deep relations between the firms and their clients. The lack of those relationships is something that Bankers Trust set out to remedy in recent years. But the latest imbroglio suggests that it has been less than successful in achieving this goal and indeed may now be suffering a big setback.

"If we start to see things of this magnitude with more regularity, it would be worrisome because one major strategic initiative was to rebuild their corporate customer base," says Judah Kraushaar, banking analyst at Merrill Lynch & Co. "A major leg of their strategy could be in jeopardy."

He and others argue that the bank's strategy is to use its derivatives business as a lever into the rest of the client-company's financial needs.

"Derivatives and risk management are their competitive advantages," says Mr. Kraushaar. "They still have a long way to go to catch up with other large commercial banks in terms of depths of relationships. But I would stop way short of concluding that it suffered an irreversible setback."

Rivals Are Ready

But other major banks aren't wasting any time in taking advantage of Bankers Trust's woes. Some New York banks and securities firms are sending out formal letters to their corporate clients saying they don't sell leveraged swaps to corporations.

"I think Bankers will probably see some erosion," said Raphael Soifer, banking analyst at Brown Brothers Harriman & Co. "Bankers Trust might be more vulnerable than some of the other banks because they don't have as many deep banking relationships as, say, J.P. Morgan does." He adds, however, that he believes corporate treasurers will be reviewing their financial relationships in light of the events of the past few weeks.

Former Bankers Trust executives suggest that the big bank's internal culture also has contributed to its lack of strong client relationships. The hard-nosed trading culture that developed over the past decade at Bankers Trust was geared to exploiting short-term market opportunities as they arose, sometimes at customers's expense. That market savvy and appetite for risk plays heavily in Bankers Trust's favor when it comes to making decisions about its own profits or those of clients.

"Knowledge is power," says Mr. Allen of Advanced Investment Management. "These guys see the whole market minute by minute." Because they have all that information and act as principals on both sides of trades involving their products, Bankers Trust, as well as some other investment bankers, are able to overcharge for their products, he contends.

The combination of expertise and sales pressure may have led Bankers Trust to push too aggressively to sell products that weren't suitable for its clients; certainly that's what Gibson Greetings and P&G are claiming after the recent spike upward in interest rates wrecked their bets that interest rates were heading lower.

"It is clear that the company should never have been put in a position like this, as we relied on Bankers Trust to advise us on these transactions," asserted Gibson Chairman Benjamin Sottile in a prepared statement earlier this week.

But Bankers Trust insiders note that clients who in the past earned fat returns from successful bets don't complain about the size of their profits. And some knowledgeable clients say it's not entirely Bankers Trust fault that companies using their products got into trouble.

"I do think Bankers Trust has been more innovative" than other firms, says Stuart Reese, senior vice president of Massachusetts Mutual Life Insurance Co. in Springfield, Mass. "But innovation isn't bad unless you don't understand it. Their innovation gives us more flexibility to do

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