UNTANGLING THE DERIVATIVES MESS THEY DIDN'T MELT DOWN THE FINANCIAL SYSTEM. BUT THESE RED-HOT INSTRUMENTS PROVED TOO TEMPTING FOR BOTH BUYERS AND SELLERS. THIS IS THE STORY OF HOW LIES, LEVERAGE, IGNORANCE-- AND LOTS OF ARROGANCE-- BURNED SOME BIG PLAYERS.

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(FORTUNE Magazine) – It was the year of the derivative. From last spring on, as if a blockade of ice had suddenly given way, bad news about these exotic financial innovations started to flow, and victims, corporate and public alike, began to wash ashore. In the wake of billions of dollars in losses since then, opinions about these new-age instruments have drastically hardened. "Derivatives," observes Richard Syron, chairman of the American Stock Exchange, which trades the species called puts and calls. "That's the 11-letter four-letter word."

The words' elevation to pejorative status is probably justified, but not simply because wild market swings turned many derivatives players into big losers last year. What magnified those losses and sent a troubling message to regulators was disturbing instances of managerial blindness, desperate behavior, even outright fraud. Among the most spectacular misadventures were those of Gibson Greetings, the Cincinnati card and wrapping paper company, which was the victim of lies that were subsequently exposed. Watergate style, by a taped conversation, which we'll listen in on in a bit. The preeminent purveyor of leading-edge derivatives, Bankers Trust, was censured and fined by regulators for its role in Gibson's loss. Enormous complexities delayed investigators in that case, just as the general confusion of derivatives has kept the world unsure of exactly what transpired in most of the other derivatives calamities. Only lately have the arresting details come to light.

The thread running throughout last year's disasters was the misuse of derivatives, now standard equipment in the financial quarters of many companies. When they are employed wisely, derivatives make the world simpler, because they give their buyers an ability to manage and transfer risk. But in the hands of speculators, bumbling, or unscrupulous peddlers, they are a powerful leveraged mechanism for creating risk. Last year the worst sort of crowd grabbed hold of the tool and took over the plant.

Like Gibson, Procter & Gamble was chewed up by derivatives that incorporated astounding leverage and confounding complexity. It is currently engaged in a court fight with Bankers Trust, which sold it the derivatives. Other large companies publicly acknowledged losses, and behind the scenes there were undoubtedly more slips and falls that never came to light. Then there was the nightmare of Orange County, California, which brought to life the dread of many Wall Streeters, a major loss of public money linked to derivatives. Many of these derivatives bear the fingerprints of Merrill Lynch.

In a way that the corporate disasters had not done, Orange County, with its mean effects on millions of citizens, triggered alarm in Washington. But at Senate Banking Committee hearings on derivatives in early January, a troop of top-level regulators were largely reassuring. In particular, they noted the absence of systemic risk last year. That is, no deep problem—extreme distress, say, at a major derivatives dealer—clutched the financial market and, by chain reaction, choked off the liquidity on which the system lives. Fears of such a crisis have ballooned with the prodigious growth of customized, over-the-counter derivatives. But a meltdown obviously didn't happen in the otherwise wretched year of 1994, and that has left regulators feeling relief. At the hearings, they went on to say they did not see themselves as needing new authority to deal with the hazards at hand. Good thing, since most of the committee's Republicans, newly ascended to power, were in no mood for legislation.

But to the ranking Democrat, Paul Sarbanes of Maryland, the Senate committee's attitude, in the wake of this dramatically troubled year, smacked too much of "complacency." Holding up a ten-month-old Fortune cover article about over-the-counter derivatives (March 7, 1994), he read its warnings, among them the fact that these things "make leverage all too easy to come by" and turn existing accounting rules into "hash." He stressed the article's title, "The Risk That Won't Go Away," and read out the subhead that followed: "Like alligators in a swamp, derivatives lurk in the global economy." What, he said in effect to the regulators, are you going to do about this?
Thanks for the plug, Senator, and we will readily accept some credit for our timing. Right after that article was published, the alligators crawled out of the swamp and got their jaws going. But if we may also offer an update, Senator, the add-on news is that horrendous trouble has, as usual, sped change. For one thing, those banking, securities, and commodities regulators who were sitting before you have emphatically toughened up their act. For another, new rules about disclosure have just gone into effect and will be adding a mixture of density and light to 1994 annual reports. On the clarity side, corporations must now state their purpose in using derivatives, a directive that just by its existence may deter speculation.

Even so, there remain plenty of reasons to worry. High on the list is the bedeviling variety and complexity of over-the-counter derivatives, a continuing pain for the accounting crowd and a true mind-bender for anyone trying to value these instruments. Commonly, the tools for valuations are complicated mathematical "models" that factor in, say, estimates of what interest rates will do and with what degree of volatility. The dealers who sell derivatives are customarily the experts on valuation, and many customers—including Gibson, to its sorrow—have simply taken the dealers' word as to what their derivatives are worth.

Then, of course, there is the tendency of markets to do what they wish, including becoming turbulent on occasion, and that means derivatives disasters will multiply. The bad guy last year was interest rates, which rose with a force and suddenness beyond the expectation of the treasurer of P&G, the treasurer of Orange County, and most of the world. The severe drop in the value of the Mexican peso (almost 40% as of late February) has already produced a few derivatives problems, and more are likely to surface. Do you think, perhaps, that the stock market could crater as it did in 1987? Equity derivatives were troublesome back then, and their numbers have since multiplied greatly.

Simon Lorne, general counsel of the Securities and Exchange Commission, recently spoke optimistically about all the steps that regulators have taken to get a grip on the derivatives market. But he also agreed the progress might not match the intensity of the problem: "That's the point Fortune made a year ago. This is the risk that won't go away."

The wrecks at Gibson, P&G, and Orange County point up everything about the risks, including the complexity and confusion of derivatives and their seeming determination to get out of control. But these incidents also raise the definitional problems that have to come to both fuzz up this game and add to its mystery.

As the term is most commonly used, derivatives are contracts. They are written between two parties (the "counterparties") and have a value that is derived—that's the key word—from the value of some underlying assets, such as currencies, equities, or commodities; from an indicator like interest rates; or from a stock-market or other index. The options and futures traded on exchanges are derivatives contracts. So are the over-the-counter options and forwards sold by dealers (such as Bankers Trust) and bought by end users (such as Gibson and P&G). All of these instruments are "off balance sheet," a fact that tends to obscure the leverage and financial might they bring to the party.

The cousins of these contracts are derivatives securities, which show up on the balance sheet. In a pure sense, a security of this type has some sort of derivatives contract embedded within it—an option, for example. But as the notoriety of derivatives has increased, this pure definition has been extended to the point that all manner of securities that do not incorporate derivatives contracts are often referred to as derivatives. In short, if it's complex, it's apt to get the name.

To the extent that the Orange County mess was about derivatives, the villain was securities. (For an account of what happened there, see box.) But the agent of doom at Gibson Greetings and P&G was totally derivatives contracts, sold in each instance by Bankers Trust, the seventh-largest bank holding company in the U.S. Over the years, Bankers has made itself a specialist in complex, "proprietary" derivatives, turning these into a highly lucrative business. In ads, Bankers has said, "Risk wears many disguises. Helping you see beneath its surface is the strength of Bankers Trust."

Those lines are quoted bitterly in the lawsuit that P&G has brought against Bankers, which has in turn launched a counterclaim against P&G. In another, still more dramatic set of legal actions, the Federal Reserve, the SEC, and the Commodity Futures Trading Commission have all levied penalties on Bankers Trust because of its behavior in dealing with Gibson.

The CFTC's order against Bankers describes the way in which Gibson gorged on a derivatives' diet. Between November 1991 and March 1994, the company entered into 29 derivatives transactions and amendments, managing in the process to deliver $13 million in revenues to Bankers. Many of the contracts, usually because they contained options, incorporated leverage that caused Gibson's losses to increase dramatically in response to small changes in interest rates. Many, according to the CFTC, also had lingo names, among them "the ratio swap, periodic floor, spread lock 1 and 2, Treasury-linked swap, knockout call option, Libor-linked payout, time swap, and wedding band 3 and 6."

"What is a wedding band?" Fortune recently asked Charles S. Sanford Jr., 58, chairman of Bankers Trust and a onetime trader. He suggested we get an answer from one of the bank's technical experts. Next day the company's investor relations director called to relay an expert's statement that a wedding band "was a swap containing a series of barrier options."

He went on, but this lunch into "barrier options" had shut down the listener's mind. After further research, Fortune submits this simplified explanation: A wedding band is typically a swap on which the client makes out well as long as interest rates stay within a relatively narrow range—"the band"—but that turns into a loser if rates move much below the band or above it. A gambler could get similar action by placing money on the total points to be scored in the Super Bowl. Gary Gastineau, head of derivatives research at S.G. Warburg, says that given long enough, he might be able to think of a risk management reason for entering into a wedding band swap: "But that's not really their purpose. These things are done by people who think they know better than the market where interest rates are headed."

GIBSON GETS TAKEN ON TAPE

Gibson, which definitely thought it was smarter than the market, has nevertheless described itself in legal papers as "a conservatively managed company." This is also the corporation that William Simon, former Secretary of the Treasury, took private in a 1982 leveraged buyout and remarried to the public a year later, thereby famously adding about $70 million to his net worth. Simon has been out of the company for years, and it is today run by Benjamin Sottile, 57, whose background is consumer products. In 1993, the latest
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year for which figures are available, Gibson had sales of $547 million and was not big enough to make the

Fortune 500. The company's profits that year were $20 million.

In the manner of many other seers, Gibson's financial officers—the boss was then Ward Cavanaugh, now 65
and retired—believed from late 1991 on that interest rates were sure to drop, and they backed their belief by
purchasing derivatives. But because of its small size and avowed conservatism, Gibson felt—and claims to
have told Bankers Trust—that it could not tolerate a derivatives loss greater than $3 million. Originally that
thought was irrelevant, because Gibson's first two derivatives contracts, both closed out within eight months
of their inception, generated $280,000 in profits. Or at least that is the profit accorded Gibson by
Bankers Trust, whose valuation models were the source of all Gibson's knowledge about profits and losses.

After Gibson's initial profits, the question of how much the company was making or losing on its derivatives
becomes murky for two reasons. First, the parties, Gibson and Bankers, began chain-linking transactions, so
that just what was going on in the first vs. the next became obscure. Second, Bankers Trust people began lying to Gibson about how much money it was losing.

According to the CFTC and SEC, the lies began at the end of 1992 and caused Gibson to release inaccurate
financial statements for 1992 and 1993. But more recent evidence of dishonesty is now embellazoned on the
record because two people holding a phone conversation were taped. In fact, by an internal system that Bankers uses to monitor trades. In this smoking-gun conversation, which took place on Wednesday, February 23, 1994—about three weeks after the Fed had first begun to tighten
interest rates—one of the two talkers worriedly discussed misinformation that Gibson was getting from
Bankers and went on to consider strategies for getting out of the problem. Buried among thousands of tapes
that Bankers Trust had been listening to after various derivatives disasters hit the news last spring, this
particular tape did not turn up for months. But when it did, it went to Washington's regulators and became
the cornerstone of their disciplinary moves against Bankers Trust.

The essence of the problem described on the tape was that Bankers' data showed Gibson to have lost
amounts that far exceeded what Gibson had been told was the case. Here, in sentences that include
clarifying, parenthetical phrases inserted by Washington's regulators, is an unidentified managing director of
Bankers Trust Securities discussing the "differential":

"I think that we should use this [a downward market price movement] as an opportunity. We should just call
[the Gibson contact] and maybe chip away at the differential a little more. I mean, we told him $8.1 million
when the real number was 14. So now if the real number is 16, we'll tell him that it is 11. You know, just
slowly chip away at that differential between what it really is and what we're telling him."

Later the same day, the managing director spoke ominously of just what would happen if Bankers, looking at
the large amounts Gibson now owed it, had to tell Gibson that it must stop the bleeding by "unwinding" its
trades. In that case, of course, the truth would come out. Said the managing director: "We gotta try and
close that gap...if the market hasn't changed at all, or was just kind of dottering around within a couple of
ticks, then you know, there's nothing that we can really say...But when there's a big move...and he is down
another 1.3, we can tell him he is down another two. And vice versa. If the market really rallies like crazy,
and he's made back a couple of million dollars, you can say you have only made back a half a million."

Perhaps because interest rates pressed ever higher, the gradual return to reality that this conversation
templates did not occur. On the Friday after the Wednesday of the taped conversation, Bankers Trust told
Gibson that its losses had increased from the $8.1 million to $13.8 million. By the following Thursday, the
figure was a remarkable $17.5 million, and Bankers, so says Gibson, was describing the company's losses as
"potentially without limit." Gibson therefore took action: It signed up the next day for one amendment and
one new derivative—the 28th and 29th of its transactions—that capped its loss at a maximum of $27.5 million
but also held out the possibility that it could reduce its loss to $3 million. Grasp the implications of that
move: At that moment, Gibson could have settled with Bankers Trust for less than $27.5 million—perhaps
something close to the $17.5 million. But gripped, no doubt, by desperation, Gibson took the chance of
entering into new transactions that had the potential of increasing its losses. "I tell you," says a director of
another company that reeled into derivatives trouble last year, "it's a lot like gambling. You get in deep. And
you think, 'I'll get out of it with this one last trade.' "

After the new agreements, Gibson's losses in fact rose. As of September 30, 1994, they were up to $20.7
million. But just before that date, Gibson swerved in strategy, suing Bankers Trust in an effort to get out of
paying on the deals. Gibson claimed it had been misinformed and misadvised by Bankers, which Gibson
charged had a "fiduciary relationship" with its client. In October, Bankers denied those allegations and
launched a counterclaim that presented Gibson--a "large and sophisticated corporation," said the legal
papers—as simply the victim of its own rotten judgment.

And then Bankers Trust found the smoking-gun tape. Without knowing of Bankers' discovery, the world soon
got the impression of wheels whirring. To begin with, the news leaked that Bankers was reassigning five
executives, pending an internal investigation into certain derivatives deals. Next, Bankers announced that
Gibson would pay it a settlement amount of $6.2 million, obviously a much-reduced figure.

The names of three of the executives reassigned have never been disclosed. The other two were managing
directors of BT Securities: Jack A. Lavin, who headed the sale of corporate derivatives, and Gary S. Missner,
who reported to Lavin and handled the Gibson account. Lavin, who continues to work for Bankers, was
definitely not a participant in the taped conversation. Missner definitely was. He has left the bank and so has
the other participant in the taped talks. Meanwhile, the internal investigation continues.

The tape's existence became publicly known only when the CFTC, the SEC, and the Fed came down hard
on Bankers Trust in late December. The Fed's "battering in...a serious kind of sanction—requires
Bankers to rework and greatly improve its procedures for selling leveraged derivatives and to hire an
independent legal counsel to consider what disciplinary actions against Bankers' people might be
appropriate. The agreement specifically directs the counsel to inquire into whether management failed to
supervise its employees.

The CFTC's and the SEC's "orders" against Bankers charge it with both giving Gibson wrong information
about its losses and causing Gibson to issue inaccurate financial statements. The SEC throws in a "failure to
supervise" charge, and by its very presence on the scene makes the new point that certain kinds of over-
the-counter derivatives are subject to its jurisdiction. Finally, in an allegation that has shocked
many a derivatives dealer who never wanted to be a fiduciary of any kind, the CFTC finds Bankers to have

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This allegation is tied to still other incriminating tape conversations, in which a Bankers managing director says, "From the very beginning, [Gibson] just, you know, really put themselves in our hands like 95%." The same executive acknowledged that Gibson was no derivatives whiz: "These guys [Gibson] have done some pretty wild stuff. And you know, they probably do not understand it quite as well as they should...And that's like perfect for us."

For all of these misbegotten deeds, the CFTC and the SEC jointly fined Bankers Trust $10 million. That is not a huge fine by SEC standards (its largest was the $300 million levied on Drexel Burnham Lambert in 1989 for insider trading and other violations of securities laws), but it is big stuff for the CFTC. Mary Schapiro, chairperson of the CFTC, says the $10 million "is not unrelated to the $13 million in revenues that Bankers Trust took in from Gibson." Could it also, she is asked, be roughly equivalent to Bankers' profits on the Gibson business? She says she doesn't know but "wouldn't be surprised" to find that true.

The SEC and CFTC orders state that Bankers has consented to the regulators' findings, without either admitting or denying these. Informally, the case has said wrongs were clearly committed. But CEO Sanford tends to believe the problem was simply "two guys" guilty of rogue behavior. In general, he says, "I think our people have been acting very fairly with customers."

He is asked to what extent he thinks top management bears responsibility for what happened with Gibson. "I don't think they-- That would be pretty hard. There's four or five levels of management below. I don't know what people are saying on the phone or doing until it's brought to our attention."

Some people who have worked at Bankers claim, nevertheless, that the Gibson behavior grew out of a culture that puts an almighty importance on profits. Says a former Bankers managing director who held a responsible position in its derivatives business: "This is very much a management issue. Any sales force is extremely sensitive to management. If you go for several years paying and promoting certain kinds of salespeople, the message gets across that what they do is acceptable behavior."

As of now, new rules about acceptability are in place at Bankers. Under the Fed agreement, Bankers is directed to make sure that its customers know about every wart, wrinkle, and whisker of their leveraged derivatives. Most significantly, Bankers is required to provide "transparency" about prices. If a client, for example, has entered into a highly leveraged contract, it is entitled to know on a daily basis what the contract's value is.

Along the way, that requirement seems likely to provide clients with new information about what Bankers is taking in on its trades. Imagine that a client asks on Day Two of a transaction what the contract's value is--or other words, what it would cost him to undo it. The client would be aware that he buys at an "offered" price and sells at a "bid" price. So when Bankers comes forth with an answer about the derivative's Day Two price, it will in effect, assuming that the market has been quiet, be divulging the "spread," or revenues it booked on Day One. Revenues in this business certainly aren't equivalent to profits, since they must cover compensation and the sometimes sizable costs that a dealer will incur trying to hedge the risk it has just shouldered. But as a rough indicator of Bankers' take on the deal, the figures should be of keen interest to clients.

At the hearings in January, Fed Chairman Alan Greenspan said unequivocally that the Bankers Trust agreement should not be construed as setting general guidelines for the industry. Even so, other big derivatives dealers have been poring over the agreement, trying to understand what it means for them. Will they also be forced, perhaps even by customer pressure, into daily valuations? On a kind of ludicrous level, but with legal problems definitely in mind, should they do more tapping or less tapping? And what about that huge question of their fiduciary responsibility to the corporate clients with which they deal? Most dealers have thought of their customers as sophisticated types not needing handholding. But does the Gibson case suggest that the dealers must get deeply into what's appropriate for customers to own? That is, in fact, a question right now on the plate of Washington's regulators, who have so far not produced an answer.

P&G: A JURY'S NIGHTMARE

Any summation of the Gibson case would have to conclude that this company had no business signing up for leveraged derivatives. Beyond that, a match pitting Gibson against Bankers, with all its erudition in derivatives, was indisputably an unfair fight. But what should indignant when the bout is between P&G and Bankers? Can P&G really be classed a victimized innocent? In a recent speech, Merton Miller, a well-known University of Chicago finance professor, got out the needle and delivered his answer: "You know Procter & Gamble? Procter is the widow, and Gamble is the orphan."

P&G is doggedly claiming, nonetheless, that in late 1993 and early 1994 it was cheated by Bankers into buying two swaps having "huge, concealed risks." One of P&G's complaints is that it was the prisoner of "a secret, proprietary, complex, multivariable pricing model" that Bankers would not share and whose

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derivatives, and he has been an important figure in their regulation. But he concedes a timing problem: "From
the day I got here, I felt I was falling behind what was going on in the market. That doesn't mean we can't
supervise. It just means we're always running to keep up."

Given the range of complications that derivatives present, outside directors cannot possibly achieve close
communion with the contracts their companies hold. Most chief executives won’t master the game, either. In
the end, the choice of what risks to hedge, what derivatives to employ in doing it, and how to draw the bright
line between risk management and speculation will be largely left to financial people down the corridor —
some of whom, recent train wrecks notwithstanding, may think of themselves as running a profit center. And
on the other end of their phones will be derivatives salespeople trying to sell the latest innovation, which
assuredly will not be a plain-vanilla hedge.

It’s not a particularly cheerful picture—not for a problem as big as derivatives. So maybe what we need is new
thinking, a fresh approach, a suggestion so radical it goes off the page. Here’s one: Warren E. Buffett,
chairman of Berkshire Hathaway, says he’d deal with derivatives by requiring every CEO to affirm in his
annual report that he understands each derivatives contract his company has entered into. Says Buffett: "Put
that in, and I suspect you’ll fix up just about every problem that exists." In a market that seems to thrive on
complexity and obfuscation, such a solution won’t happen. It’s too simple. But he’s right.

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