# Procter & Gamble vs. Bankers Trust






## Summary

- P&G entered into two seemingly innocuous SWAPs
- Within four months, had to charge $157 million to pre-tax earnings.
- This was a minor loss given the net income for P&G was $2.2 billion
- The issue is whether corporate treasuries should be profit centers, or manage liabilities using structured derivatives
- Landmark court ruling on fiscal responsibility and off-balance sheet disclosure
- BT was revealed as “duplicitous weasels”
- P&G appeared to lack risk-management skills





## Why did P&G need the SWAP(s)

- **Entered into two swaps in 1993 and 1994**
- **Wanted to reduce the borrowing to 40 basis points below commercial paper.**
- **Currently at $100 million dollar swap that was set to expire**
- **Entered into a five year floating for fixed swap with BT**
- **What were P&G’ expectations about interest rates?**

## Common Sense Exercise

- **What is the annual saving for a 40 basis point reduction on $100 million notional principal?**
- **What was P&G annual expenses in 1994**
  - $500 million
- **That is a percentage decrease in annual expense of roughly ???**





## Why go German

- **It is not clear why they entered into a German mark-denominated deal in February 1994**
- **200 DM million ($93 million)**





## Why not go to the Exchange

- **They could have gone to the CBOE**
- **However accounting treatment was more favorable for OTC products**
  - Give me some reasons?

## The First SWAP

- **U.S dollar denominated interest swap on 2 November 1993.**
- **$200 million notional principal with a five year maturity**
- **Complicated transaction that contained two parts**
  - A plain vanilla swap and a gamble





## Plain Vanilla Swap

- **BT paid P&G a fixed rate of 5.3% on $200 million**
- **P&G paid BT a floating annual rate tied to the daily yield on 30-day commercial paper**
- **Noticed they have doubled down**
- **What is unusual here?**





## The Side-Bet

- **Here is where P&G lost big**
- **BT essential sold a call option**
- **P&G earned a premium of 75 basis points on the principal**
  - $1.5 million
- **P&G paid BT a fixed rate of interest over the next five years- but was determined in a unique fashion**
  - Spread between the *yield* of a five T-note and the *price* of a 30 year T-Bond.
  - Rates were set on May 4th 1994
- **This is why the swap is referred to 5s/30s Swap.**

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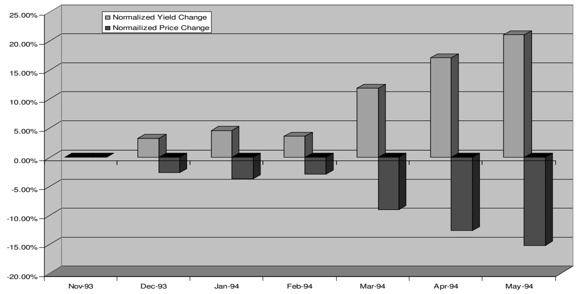
## Yield vs. Price

- **This distinction is crucial**





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$$\text{Premium} = \text{Max}\left\{\frac{\frac{98.5 \times \text{5-Year U.S. T-Note Yield (CMT)}}{5.78\%} - \text{Price of 30-Year U.S. T-Bond}}{100}, 0\right\}$$

- **Implications**
  - What happens if yields rise in tandem?
  - What was the value on
    - Initiation date?
    - The five year note=5.05%
    - The yield on a 6.5% 30 year bond was 6.07%

    - On the Valuation date?
    - The five year note=6.74%
    - The yield on a 6.5% 30 year bond is 7.35%





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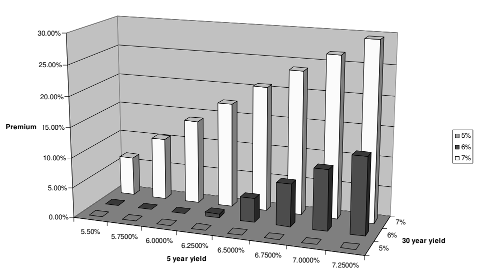
## The Spread



## P&G Response

- **Hedge the exposure in March 1994**
- **Reset the premium to 88 basis points**
- **Spread ended up being 14.12% costing $28.2 million**
- **If the bet was successful P&G could have borrowed for cheaper than the U.S government**





## DM Interest Rate SWAP

- **14 February 1994, entered in 4.75 year interest rate swap**
- **For the first year BT paid the German swap rate + 233 basis while PG paid the swap rate + 133 basis. What?**
- **Starting the second year PG premium depended on whether the four year swap rate was below 4.5% or above 6.01% at any point during the previous year. This was known as the *Wedding Band*.**
- **If the rate crossed the wedding band the premium would equal ten times the difference between four year rate and 4.5%**





## What Happened

- **In early 1995 the swap rate was 5.35%**
- **On February 4$^{th}$, 10 days before the 2$^{nd}$ year initiated, the U.S tightened monetary policy, resulting in a worldwide increase in rates**
- **The swap rate went outside the band and the premium increased to 16.4%**
- **This is a cost of $60.9 million**

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## The Net Effect

- **P&G sued on February 6$^{th}$ 1995**
- **P&G claimed BT withheld information**
- **Settled $35 million**
- **What of BT- how did they hedge?**
- **What was the investor perspective?**