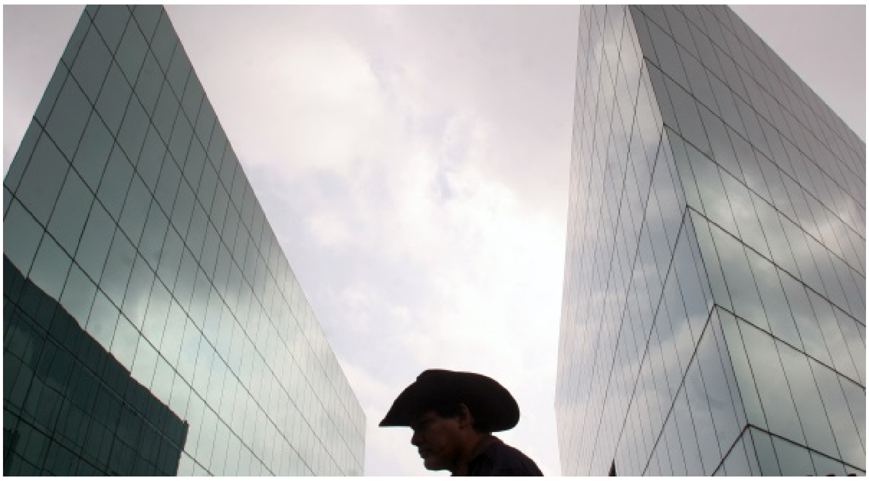
Beware ‘Wild West’ of FX options

by Farah Khalique

Brokers and even the likes of Western Union are finding success in selling complex foreign-exchange options to small to medium-sized enterprises (SMEs) as banks retreat from servicing their smaller customers, but industry figures warn of a new ‘Wild West’ and the need for robust compliance standards.



The global financial crisis, stricter regulation and copious banking scandals have culminated in a partial retrenchment by the banks, as they focus on their strongest clients that generate the most revenue, such as large corporates and ultra-high-net-worth individuals.

They have pulled back from servicing SMEs with turnover of less than £100 million, says Fred Ponzo, managing partner at consultancy, GreySpark Partners.

"But a lot of [these companies] do have treasury and foreign-exchange requirements," he says. "If the banks don’t provide a good service, there are a plethora of independent, niche FX brokers that fill the gap."

Currency brokers such as HiFX and WorldFirst typically offer smaller margins than banks, making them an attractive proposition for customers that feel sidelined by their bank.

"We have seen a shift from banks selling currency derivatives to brokers selling them," says Abhishek Sachdev, founder of independent derivatives consultant Vedanta Hedging.

Wild West

Ponzo describes the surge of FX brokers as "a bit of a Wild West right now".

"Some are really good, others are less good," he says. "Some are playing the long game, others the short game."

Western Union – the money transfer service – even offers a variety of FX options to its customers, detailing complex structures such as knock-out convertibles and leveraged collars on its website.

Its derivatives business has grown by 30% during the past three years, says Tony Crivelli, head of Western Union Business Solutions (WUBS) for the UK and EMEA.

Crivelli estimates that up to a fifth of its customers buy complex derivatives, which includes leveraged products. Who are its main customers? SMEs.

Complex structured options might seem alluring, but are intrinsically more risky than simply swapping one currency for another or buying a forward contract to lock in today's exchange rate. A buyer can quickly find themselves owing far more money to their counterparty than they ever hoped to make, which can financially destroy their business.

Western Union promises that, "in just two minutes", business owners can "learn how to identify the ways fluctuating currencies impact your business, set yourself a budget level and understand the amount of risk you are willing to take", simply by watching a video on its website:

'No free lunch'

However, the small print, which is virtually indecipherable on the video, reminds customers that WUBS is ultimately a counterparty to their transactions, and has a 'financial incentive' to enter into such transactions.

Crivelli insists its customers are carefully vetted using a suitability check to gauge their business' currency risk, measure their understanding of derivatives and ensure they can afford to enter into a derivatives contract.

However, he admits some SMEs can find themselves in trouble when exchange rates move substantially. UK sterling has rapidly strengthened against the euro – GBP/EUR has moved from 1.20 in April 2014 to 1.43 today.

"Many SMEs have come to us being over-committed to buying euros at around 1.20, which has a material impact on their business, a negative impact. There is definitely no such thing as a free lunch, once [a customer] has got an obligation in a derivative then we need to manage that."

A customer might find themselves obliged to shell out a substantial sum of money over a short timeframe, say three months, under the terms of their derivative contract.

"That obligation may be cash-flow negative for them," says Crivelli. "They may not have enough cash to meet it."

Western Union can then restructure the derivative, at a cost, into a simpler product that has a longer tenor of perhaps six or even nine months, but hedging experts warn against restructuring without first seeking independent advice – the end result can be even worse.

Customers cry foul

Vedanta Hedging is increasingly pursuing currency mis-selling claims against brokers as opposed to banks. Sachdev believes that clients should take responsibility when speculating, where culpable, but ultimately brokers need to ensure they have sound compliance procedures.

Sachdev says: "I'm concerned that if we continue to see a shift in FX derivatives being sold by brokers, there is a risk that compliance functions may not be as robust as current bank compliance functions."

He is working on a number of FX derivatives claims from retail clients totalling millions of pounds, including one which is against two different brokers.

In some cases, the brokers sold complex options with digital barriers that were tricky to understand. In one instance, the client, an SME, was sold a ratio derivative that meant it had to purchase far more of a currency than was necessary for its business.

"The level of risk information provided was far below what I would expect a competent, authorized firm or individual to provide," says Sachdev. "There has also not been enough information ascertained from the client about the suitability and appropriateness of the derivatives being provided."

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