Brexit Blows Up Currency Derivatives Sold to U.K. Companies

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For eight years, TTT Moneycorp Ltd. regularly took Dariusz Suchicki to dinner and soccer matches, all while selling him, as the head of finance of a U.K.-based importer of Polish foods, a series of complex currency derivatives.

When the pound started moving sharply against the zloty, those instruments became toxic: They began costing Suchicki's company, Best Foods, tens of thousands of pounds a month, the company said in court filings last year. Now, as Britain prepares for Brexit, blow-ups of this type of complex financial instrument are surging.

About a quarter of all U.K. small and midsize enterprises routinely use hedging tools to manage currency risk, broker Afex Markets Plc found in a survey carried out in 2015. Many of these instruments are highly leveraged, and can result in magnified losses for companies hit by big currency swings.

Since the pound plummeted 12 percent after the U.K. voted to leave the European Union, lawyers say they have been inundated with inquiries from companies that claim they were cajoled into buying similar esoteric products. The concerns come as British firms are already bracing for economic headwinds likely to accompany a future outside the European Union.

Like Best Foods, many of those companies claim they were pressured into buying products they didn't fully understand and whose risks weren't properly explained -- so-called mis-selling. The derivatives sold to Best Foods were so numerous and of such "exceptionally high complexity," the firm said, that Suchicki lacked the expertise and equipment to evaluate them.

Risk Warning

In the court documents, Moneycorp said that by entering the contracts, Best Foods acknowledged and understood that "trading in options, even when used to cover a commercial position, may involve

a high degree of risk and is appropriate only for persons who are able to withstand the risk of loss." The firms settled out of court this year. Both declined to comment for this article.
"It's not until the tide goes out that you discover the hidden risks of some derivatives products," said Alberto Thomas, a founding partner of Fideres Partners, a consultancy that works with law firms to bring mis-selling claims. "We have seen a rise in cases of less sophisticated investors who were sold highly structured products which turn out to be of little or no use as hedging instruments," said Thomas, who wasn't involved in the Best Foods matter.

The story of the unsophisticated investor buying complicated financial products and later facing costs they can't bear is a familiar one. Thousands of public authorities, from Jefferson County, Alabama, to Saint-Etienne, France, have paid millions of dollars to terminate swaps that soured. In the U.K., nine banks, including Royal Bank of Scotland Group Plc and HSBC Holdings Plc, paid 2.2 billion pounds ($2.9 billion) in response to claims they missold interest-rate swaps to 18,000 customers.

The difference this time is that many of these instruments are sold by lightly regulated brokers, because bigger banks have grown fearful of getting embroiled in another potential scandal, said Robin Henry, a partner at London law firm Collyer Bristow LLP, which advised Best Foods on its case. These brokers cold-call prospective customers, offer their services in newspaper advertorials and motivate their salespeople with fat commissions, lawyers said.

Currency Derivatives

The derivatives subject to mis-selling claims have names like "seagull" and "two-times leveraged accelerated knock-out, knock-in forward." Most follow a standard format: The company agrees to buy a certain amount of currency each month based on the foreign exchange rate at the time.

In the short term, it gets a better deal than it would get in the spot market or by using simple forwards. However, if exchange rates fall outside a given range -- after Brexit or the Swiss government's 2015 decision to ditch its currency peg, for example -- covenants are triggered that force the company to purchase much more currency than it needs or buy at unattractive levels.

"We've seen examples of companies who need to swap $50 million worth of currency a year but, because of the leverage, they end up being obliged to buy $500 million," Collyer Bristow's Henry said. "That's where you get these losses of $10 million or $15 million, which are completely unsustainable and take these companies completely by surprise."

Suchicki's problems started in early 2013, when the pound, spurred on by a buoyant U.K. economy and a series of Polish rate cuts, began a two-year ascent versus the zloty. Ordinarily, such moves would have helped the bottom line of Best Foods, which imports Polish meats and vegetables into the British market. Instead, according to the legal filings, the company suffered heavy losses. At one stage, the company said it was paying as much as 16 times more than it would have in the market to transfer pounds into zlotys.

Soured Contracts

It’s unclear just how many companies are struggling with soured contracts like these. Vedanta Hedging Ltd., a firm that provides financial expertise for lawyers who bring mis-selling cases, has helped its clients settle seven currency product cases, and says it has received 18 inquiries since the June 23 Brexit vote. Collyer Bristow is currently working on about half a dozen cases.
Few are likely to make it to court, according to Clive Zietman, a partner at Stewarts Law. “We are seeing more of these types of claims, but we are talking about small businesses, and it’s prohibitively expensive to bring action,” said Zietman. “They are complicated, there’s a lot of evidence work, and banks and other sellers will fight them.”

The total market for foreign exchange derivatives is close to $3 trillion globally, according to the Bank of International Settlements’ most recent review, but most of that is made up of transactions among large financial institutions, funds and sophisticated multinationals.

Big Players

Still, the money to be made from the small and midsize companies market has attracted big players. In August 2014, Bridgepoint, one of the U.K.’s biggest private equity firms, acquired Moneycorp in a deal worth 212 million pounds. The previous year, World First UK Ltd. sold a 40 percent stake to U.S. private equity firm FTV Capital for an undisclosed sum.
A spokesman for Bridgepoint declined to comment. World First and FTV Capital didn’t reply to e-mails seeking comment.

The U.K.’s Financial Conduct Authority has seen little evidence of widespread mis-selling and doesn’t view it as a significant problem, according to a person at the regulator, who asked not to be cited by name. The FCA declined to comment.

So far, at least, many brokers have been willing to work with companies to find a solution behind closed doors -- either through restructuring, delaying payments or increasing credit limits.

The situation could change if the pound continues its Brexit-spurred descent because most buyers of the derivatives haven’t posted enough collateral to cover the losses they would face, according to Collyer Bristow’s Henry. The currency is currently on track for its longest losing streak in three weeks versus the dollar. If enough businesses are affected, it would be the brokers’ profits that ultimately get slammed.