EUROMONEY

Brexit volatility fuels FX mis-selling claims

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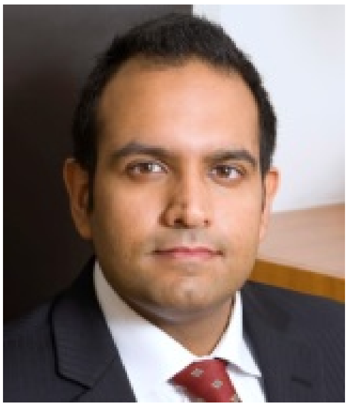
Brexit-related currency volatility is fuelling a rise in foreign-exchange product mis-selling enquiries from businesses that have been burnt on 'fiendishly complicated' currency trades.

Independent derivatives consultant Vedanta Hedging is working on eight new enquiries since the referendum, including one from a clothes importer that is facing million-dollar margin calls from its brokers.



Abhishek Sachdev, Vedanta Hedging

Abhishek Sachdev, founder of Vedanta Hedging, says: "We are definitely seeing more enquiries for mis-sold currency options since Brexit, and as ever, this is just as focused towards the brokers as it is the banks.

"The intense volatility caused by Brexit will cause more to come out of the woodwork."

Britain's unprecedented decision to leave the European Union injected a huge dose of volatility into currency markets. The pound slumped against the euro to as low as 1.16 and is now trailing at around 1.17; it also fell against the US dollar from a high of 1.50 to 1.30 on Thursday.

These currency swings have hit businesses that bought complex FX products – typically from counterparties such as banks and brokers – which are fast becoming a headache. The businesses are now consulting lawyers, advisers and claims management firms to scrutinize the suitability of the products they were sold.

Sachdev says some claims are dismissed out of hand because the complainants knew full well what they were entering into, but others have a genuine grievance.

Brexit pain

Complex FX derivatives can offer protection against currency risk and even potential gains, but the downside can be catastrophic. In times of extreme volatility such as Brexit, a buyer can find themselves overnight owing vast amounts of money to their counterparty, which can annihilate their business.

A customer might have to cough up huge sums over a short timeframe, until the contract expires, with little to no respite. Such contracts should, therefore, only be sold to buyers that truly understand currency risk, and how a derivative can unfold.

"[Some businesses] have been sold hundreds of these," says Sachdev. "They are fiendishly complicated to price. We are having to use bespoke financial engineering."

A safer alternative is a simple forward, which allow buyers to buy a currency at a future date at a pre-agreed exchange rate.

Margin calls

Problems arise from the fact businesses that buy these derivatives are not necessarily au fait with how they work when markets move a lot, warns James Stretton, director at consultancy firm JC Rathbone Associates (JCRA).

James Stretton, JCRA

A business might well find itself faced with multiple demands to stump up cash or securities to cover possible losses, which can easily run into hundreds of thousands.

"I worked on a case where the finance director did not realise what the implications were for margin calls when sterling fell," says Stretton. "Most SMEs don't have the specialist software to work out the mark-to-market on their derivatives, to get a feel for future margin calls."

Brokers operate on a strict margin-call basis, because they back out of their trades with their banks which in turn demand margin.

Stretton says: "The biggest problems I see in terms of FX hedging have actually been caused by margin calls rather than being unhedged in the first place."

Law firm Collyer Bristow is also seeing a "steady trickle" of FX mis-selling cases since the referendum vote, says Robin Henry, partner in the firm's financial services team.

The firm states: "In our experience, one effect of high FX volatility will be a rise in the number of businesses suffering major losses triggered by larger-than-expected FX movements. These losses are often caused by companies having been mis-sold complex FX derivatives by banks or brokers."

FCA silence

Seneca Banking Consultants is advising around a dozen businesses on FX hedging product claims, says founding director Dan Fallows. These include a textiles manufacturer and a furniture retail business.

A recurring theme is that businesses have been aggressively sold expensive, complex products where a simpler alternative would have sufficed, says Fallows.

Dan Fallows, Seneca

He wrote to the Financial Conduct Authority (FCA), urging the watchdog to investigate forex mis-selling, but to no avail. The FCA declined to comment as to whether it is investigating the matter.

Banks have pulled back from selling complex currency hedging products to SMEs, in the wake of the interest-rate hedging product mis-selling scandal.

In 2012, the FCA investigated allegations that nine banks mis-sold interest-rate hedging products, including structured collars, swaps and simple collars to unsophisticated customers, such as small businesses. The banks came under heavy fire over their selling tactics and treatment of customers, and had to pay out £2.2 billion in redress.

However, the vacuum is being filled by brokers, and Brexit volatility is proving to be a boon for business. There are a number of brokers in this space, such as Western Union, World First, Afex and Moneycorp.

A Western Union spokesperson says it has seen an increase in hedging requirements from its customers since the referendum vote, while others are "working more closely with their suppliers and customers to help work through what has been a measureable shift in both the pound and the future of the UK economy".

Currency brokers have boomed in recent years, says James Ducker, ex-banker and founder of Benchmark Standard, which advises on currency and interest-rate hedging.

"Fifteen years ago, there were only about half a dozen FX brokers," he says. "Now there are [more than 150] out there and they are not stunningly regulated. It is not a particularly difficult industry to get into."

JCRA's Stretton says: "I think for a lot of brokers it is too good an opportunity to miss. The rewards system in these places for employees drives behaviour. I've come across language that has been used in the sale of derivatives that is just not appropriate. They are not regulated to give advice."

Brokers can adopt an aggressive stance, such as telephone calls multiple times a day to push trading ideas on to customers.

Vedanta's Sachdev says: "They might say: 'Hey, have you thought about this idea? Your competitors in your industry are doing this. Come along to one of our breakfast seminars.'

"It becomes a vicious cycle that can last years. The company doesn't even understand what contracts are in place because they are so confusing. They are wholly reliant on their broker to tell them their exposure."

Val Jagar, head of corporate services at currency broker HiFX, says compressed margins in the broker industry are compelling some brokers to push structured products on to their clients to enhance revenues.

"This is definitely an issue," he says. "Clients enter these types of derivatives thinking there is a benefit, but not fully understanding the risks. They [can] end up being over-hedged or enter into products they can't afford should the worst-case scenario happen."

Val Jagar, HiFX

A Western Union spokesperson says the Western Union Business Solutions has "a stringent on-boarding process which certifies a customer's experience, objectives and risk appetite".

World First, Afex and Moneycorp declined to comment.