Consultants fear mis-selling as forex brokers discover new options

Range accrual and Tarf variants too complex for UK SMEs, critics say

Sam Bett, JCRA

Fiona Maxwell

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The film *Boiler Room*, released in 2000, tells the story of pump-and-dump stock-broking practices at fictional firm JT Marlin, in New York. Its brokers lie to gullible investors, sell them shares in fictional or failed companies, and leave them to suffer the consequences.

It is a horrible depiction of the industry. Surprisingly, in the UK's foreign exchange broking sector, it is also used as an induction video for new recruits, according to James Ducker, a director at Benchmark Treasury Pricing in Cambridge, who spent two years working in forex brokerage.

"When I was interviewed for a job as a forex broker, they told me to watch the film *Boiler Room*, because that was a good indication of what I was going to walk into. Boy, were they right. It was a nightmare at those places – it's hard sell by telephone, and the end-users don't know what they're being sold," he says.

While the criminal antics depicted in *Boiler Room* are these days largely confined to the shadiest corners of the penny-stock market and the world of make-believe, mis-selling remains a problem throughout the financial services industry – and there are growing concerns that the spotlight may, in years to come, be trained on forex brokerage, where some of the roughly 150 brokers in the UK have recently stepped outside their traditional world of vanilla spot and forward trading, to start offering more complex forex products.

Risk spoke with four risk management consultants, who all claim to have seen currency brokers selling relatively complex derivatives – including variants of range accrual products and target redemption forwards (Tarfs) – to unsophisticated counterparties in the course of this year. They claim brokers are picking up customers that big banks have been turning away, and are offering options-based strategies that appear to have little downside, but which can result in heavy losses if currency movements go the wrong way.

"We have seen trades that include a leveraged element, which means when a certain event happens, like the forex rate trades at a certain level, clients have been obliged to deliver twice the amount of euros they were prepared to deliver. Also, some of our clients have been sold products as ‘packages'. There have been occasions where the brokers have not broken down the component parts of the structure and been completely transparent with the client. If they were transparent, the layers of derivatives products contained in these structures would become very clear, and it would certainly highlight the complexity – and potentially the inappropriateness – of the product," says Samantha Bett, a director at risk management consultants JC Rathbone Associates (JCRA) in Edinburgh.

Currency brokers that spoke to Risk for this article deny the claims. Spokespeople for two currency brokers, World First and Money Corp, say they offer derivatives-based products in which a customer can outperform the current rate, but insist the downside is floored. They also say they don't allow customers to enter into derivatives purely for speculation.

"We have face-to-face meetings with customers, we go through these products in quite a lot of detail with them. We'll put them into real-world scenarios – this is what will

happen monthly, daily, this is what it will mean to you. We explain what the outcomes could be so the customer is completely and utterly clear before they enter into a transaction. Most importantly, we don't take on purely speculative positions," says Alex Sullivan, a managing director at World First.

Forex currency brokers are a common feature on the UK high street, allowing holiday-goers to exchange cash, but they also have many small and medium-sized corporate customers that need foreign currency or want to hedge forex exposure.

JCRA's Bett says shrinking credit lines at banks since the 2008 financial crisis have left some of these small companies without dealer counterparties. "It means the client – import and export businesses – could not hedge their positions, so the non-banks filled a gap there and were able to grow quite substantially," she says.

How substantially is not completely clear. Last year, Money Corp transacted around £10 billion, and has worked with more than 140,000 clients over the past 10 years. World First transacted more than £6.1 billion last year and says it has over 100,000 registered clients - of which just over 13,000 are corporate clients. Money Corp works with approximately 3,000 small and medium-sized enterprises (SMEs). Neither firm would disclose volumes of derivatives transacted, or the size of positions.

In their traditional spot business, brokers claim to offer much cheaper prices than banks. On its website, World First says a £100,000 transfer into euros could save £1,470.25 versus a bank. The brokers do this by bulk-buying currency and offering cheaper transactions as a result. Consultants say companies are confident using the brokers for spot and forward trades, and will therefore trust them when they suggest products that are more complicated.

"To win a new relationship, they may quote an attractive headline rate which looks better than other counterparties, but then as the ongoing hedging is being executed, the chances are those spreads will start to widen out from where they started," **says Jackie Bowie, chief executive of JCRA**.

The majority of brokers offer spot and forward contracts, but consultants say they know of two that have branched into bespoke structured products that were previously the sole preserve of banks. The trend began in 2012, after the UK's Financial Conduct Authority (FCA) found 19,060 sales of structured interest rate collars, swaps and caps to "unsophisticated" counterparties. This has so far led to a total of £1.23 billion in fines at the eight banks involved, and consultants say banks have stepped back from SME customers as a result.

For brokers, the opportunity is obvious – structured currency hedges can deliver fatter margins than plain-vanilla spot or forwards. The opacity of the pricing also means it's harder for counterparties to work out if the rate they're being offered is a good one.

"It's a very efficient way for these brokers to make enhanced returns – as the layers of derivatives are embedded into the structured products, spreads are opaque and it is much easier to widen them. But it doesn't mean you're selling the most appropriate product for the client's needs," says JCRA's Bett.

Consultants say the products they have seen include variants on range accruals, in which a company receives a fixed coupon while a currency pair stays within a particular range. Others have reportedly been sold versions of target redemption forwards (Tarfs) – a controversial product containing multiple forex options, **which in some cases can force corporates to sell twice the amount of currency they planned to**, at an unfavourable rate with no downside protection.

Tarfs have been involved in a number of emerging market mis-selling scandals, and this year attracted the attention of Taiwan's regulator. **Banks in Taiwan are now required to include downside protection in the products**.

"The way we've seen these packaged is that the broker won't tell the end-user how the deal is structured – they just present it in terms of what rate you can deal at. For instance, they'll set a rate of 1.65, but if the market improves to a rate of 1.70, you can sell up to 1.70. But then if it trades above 1.70 you'll have to sell at a rate of 1.62," says JCRA's Bett.

"The way they come out with these outcomes is by structuring different layers of options on top of one another, but if the market does something you don't want it to do, you end up with a worse rate. That's not hedging at all, it's really entering the realms of speculation," she adds.

Bett says some of these products have been sold to end-users without being explained properly. She says she has seen some products that contain triggers that can extend the life of the product for a further six months. If the company was hedging a very particular cashflow, that extra six months of duration may be unnecessary, she says. The triggers are often set to maximise the seller's profits if the rate moves to the disadvantage of the corporate, and often don't exist when the rate moves the opposite way.

But are clients really being mis-sold these products, or are they entering the trade with full knowledge of the potential outcomes? According to the UK FCA's conduct of business sourcebook, which sets out standards UK-registered financial firms must

follow, any firms that are communicating or promoting financial products to clients must ensure these communications and financial promotions are "fair, clear and not misleading".

The FCA declined to comment on forex hedging by SMEs. A spokesperson said the regulator does not ignore any complaints it receives, but would not say whether it had received any complaints on this particular subject.

Six currency brokers were asked to comment for this article, and only three responded. World First and Money Corp said they do sell derivatives, but denied selling anything clients do not understand or need. World First's Sullivan says the firm is very careful not to sell any products purely for speculation.

"A customer might come to us and say ‘I actually want to outperform the rate at the moment'. So if the rate is x, ‘I want x-plus-2% or 5%, but at the core of it I need to protect my risk'. The way those trades are built is they will still have an absolute worst-case rate. Our derivatives are not speculative, we don't take speculative trades on as a business at all – not because we can't, we just choose not to. Our products absolutely focus on making sure the customer gets the operational margin it needs, and if it can outperform that, then it does," says Sullivan.

Benchmark Treasury Pricing's Ducker, however, argues adding sold options to plain-vanilla products is an inherently risky activity, which can lead to significant costs if the markets move the wrong way.

Unlicensed advice

It's not just the structures themselves that consultants raise concerns about – it's the way they are sold. Brokers need to be licensed by a financial regulator to provide financial advice, but Abhishek Sachdev, managing director at treasury and risk management advisory firm Vedanta Hedging, says some unlicensed firms have sought to persuade customers to use more complex products.

"I have had two clients that were given advice when the brokers weren't allowed to. One time was quite explicit, where a currency broker was offering the client a simple spot transaction, but out of the blue one day another contact within the broker firm rang up the client and said ‘We can offer you more interesting products that will make you more money'. That constitutes giving advice. There's nothing wrong with forex derivatives, but they should not be advising clients to do them," says Sachdev.

Andrew Woolley, executive director in the corporate forex division at Money Corp, says the company is licensed to provide advice, although tends not to do so, instead giving market commentary about the current price of various currency pairs.

"We will give commentary like ‘the euro is at a six-month high', which is a factual comment, so people can infer that the market has got stronger. What we won't call is the market going forward, for example that the market is going to 1.62 against the dollar. I know one of our competitors has a chief economist who makes those comments, but we don't," says Woolley.

When it comes to derivatives, he adds the company is careful only to sell products that are appropriate for a customer's needs: "We want clients to have an underlying reason to trade, so we wouldn't encourage companies to do it for speculation. A typical scenario is a company will come to us and say it's got a budget rate of 1.60 against the dollar, it wants to lock in profit today on its business, but they want to participate in the upside as well," he says.

JCRA's Bowie is not against brokers *per se* – she says it's good to have competition in the market. However, she warns corporates not to rely on explanations and advice from salespeople, and instead gather independent advice on any non-plain vanilla transaction – or simply avoid structured derivatives altogether.

"Clients will use us for independent advice and we would always actively discourage people from looking at anything structured. We want to be comfortable the clients we advise always have the right product," says Bowie.