Pound Sterling

Brexit boom in currency hedges sparks fears of mis-selling

Analysts fear small businesses could be entering deals they may later regret

Eva Szalay in London 4 HOURS AGO

The tumbling pound is encouraging nervous UK importers to enter into complex currency transactions as they scramble to avoid higher costs. But some consultants warn those deals could expose them to significant losses.

One popular strategy being touted by brokers: a contract known as a “target redemption forward”. This is designed to help businesses to buy and sell currencies at better rates they would otherwise be able to obtain, in return for a greater risk of exchange rates moving against them.

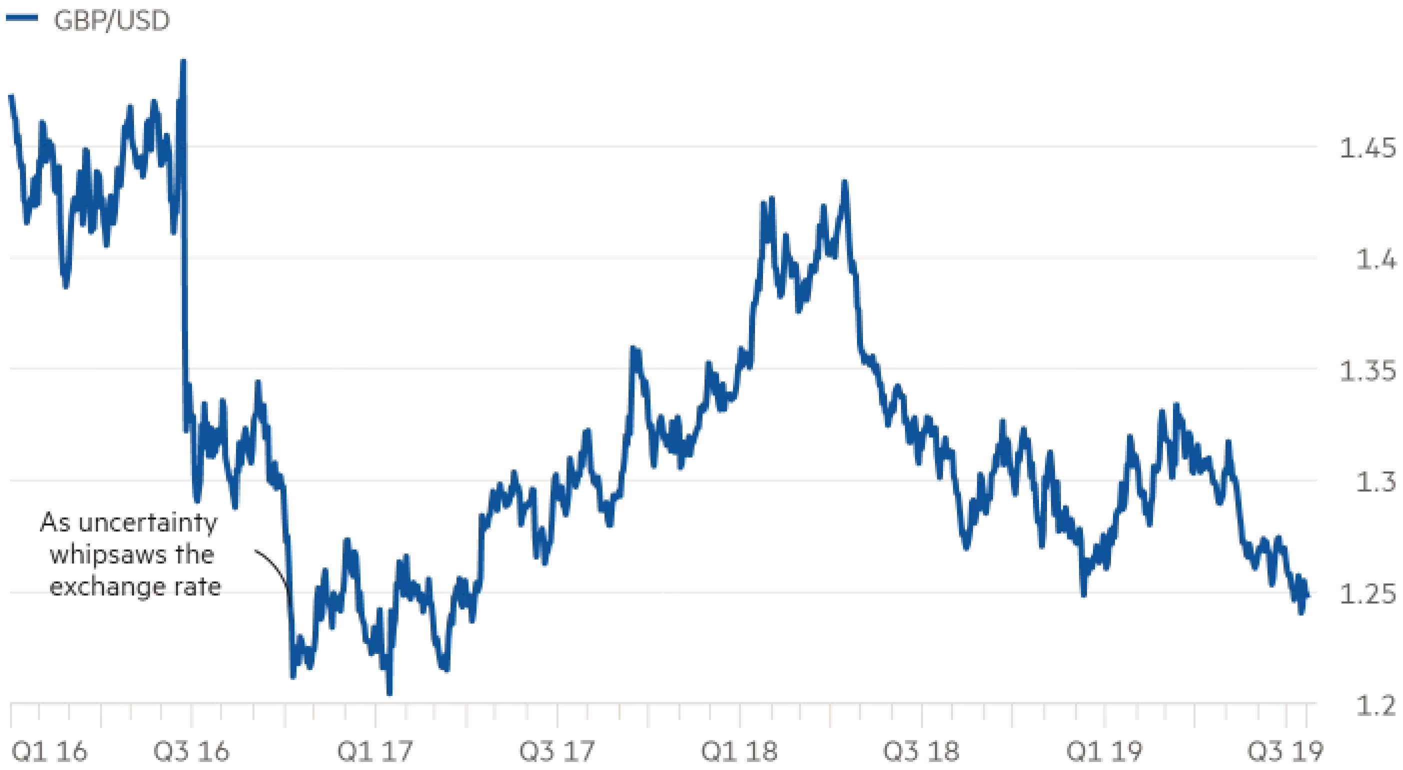
Such contracts, known as TARFs, can be profitable for the customer. But unfavourable movements can mean that TARF holders are forced to trade at costly rates — and in bigger amounts than they originally wanted to buy or sell.

High street banks such as Barclays and Royal Bank of Scotland offer TARFs only to a small number of sophisticated clients, conscious of the potential risks of being seen to mis-sell them — especially to small businesses. Meanwhile, for currency brokers such as London-based Moneycorp and Western Union of Denver, Colorado, the TARF business has become a lucrative income stream.

Such contracts saw a wave of interest around the 2016 Brexit referendum, when many small businesses sought protection from a collapse in sterling. But as the UK currency has weakened again, beaten down by renewed expectations of a “no-deal” exit from the EU in the autumn, demand for TARFs has re-emerged among importers whose profit margins fall every time sterling sinks against the dollar or the euro.

A recent survey of more than 1000 UK companies carried out by Western Union showed that 16 per cent of small companies with turnover of less than £2m a year are using TARFs, while more than a quarter of companies with revenues of up to £10m are doing so.

Protecting against a weaker pound can backfire



Source: Bloomberg
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Analysts note that the roughly 6 per cent drop in the pound since the start of May has pushed many import-reliant companies into losses, as many used a rate of $1.25 or even $1.30 to plan for the year ahead. The exchange rate now stands just under $1.25. Having failed to lock in protection against a drop in sterling, some now seem desperate for solutions that offer greater rewards in return for greater risk.

Such contracts are “gambling at best,” said Barry McCarthy, chief executive of Assure Hedge, a corporate FX specialist, who says he recommends that clients steer clear of TARFs completely.

Deals have ended in tears before. One High Wycombe-based jeans distributor, Newstar Garments, filed two lawsuits against its brokers in late 2016 claiming that it had been mis-sold TARFs. Such products caused £3m of losses, the company claimed, halving its operating profit for 2017 and leading to the demise of the subsidiary that had entered in to the agreement.

Robin Henry, head of dispute resolution at law firm Collyer Bristow, says he has handled about a dozen cases focused on allegations of TARF mis-selling since the referendum, all with similar characteristics. Details of cases rarely emerge, as parties tend to reach settlements out of court.

“High street brokers have filled the space left by banks ...and they seem to view these cases as an acceptable cost of business,” said Mr Henry, who acts for companies in the disputes.

Brokers offering TARFs say that clients go through rigorous suitability assessments before contracts are offered to them. Alex Lawson, UK head of hedging at Western Union, said clients are willing to take on more risk in the hope of greater rewards as the prospect of further losses looms.

Lee McDarby, head of corporate foreign exchange and international payments at Moneycorp, said clients can enter into TARFs only if they meet standard industry requirements for "professional" investors.

"More complex products often become more popular in times of uncertainty as simple spot or forward cover may not be quite enough to allow corporates to meet their objectives," said Jonathan Pryor, head of corporate FX at Investec, the South African banking group, which also sells TARFs.

The Financial Conduct Authority, the main UK market regulator, has been alert to cases of mis-selling to small businesses before. In 2013 it published a review of the sale of contracts for hedging interest-rate risks, finding that 90 per cent of the cases it looked at were "non-compliant."

But the regulator has yet to dig into similar practices in currencies markets. Abhishek Sachdev, chief executive of Vedanta Hedging, a corporate treasury consultancy, says he flagged risks around TARFs to the FCA in a letter in October 2016. The regulator responded weeks later, saying a meeting to discuss the matter was not "at this stage ...necessary".

A spokesperson for the FCA declined to comment on the growth of TARFs, referring the FT instead to a section of the regulator's website describing its oversight of interest-rate hedging products.

More vigilance is needed, said Mr Sachdev, who advised the FCA on its 2013 interest rates review. Some small companies find it "very difficult to resist" the TARF products, he said.

What is a TARF?

A Target Redemption Forward transaction allows a company to exchange one currency for another, for a better rate than under a traditional forward contract. But holders of a TARF can lose out if the spot rate moves in the wrong direction, forcing them to trade regularly at unfavourable rates for the full life of the deal.

Case study

A small UK-based business agrees to import $1m worth of materials from the US, to be paid in five equal monthly instalments, assuming an exchange rate of $1.28 to the pound. As the first payment date approaches the company realises that the current spot rate of $1.25 and an available forward rate of $1.26 makes the order uneconomic. The company enters into a TARF in the hope of achieving an exchange rate of $1.28.

Good scenario: pound weakens, but not by much

Exchange rate hovers below the "strike" level of $1.28, allowing the TARF holder to benefit from the stronger rate it has locked in.

Bad scenario 1: pound strengthens; spot rate moves higher than $1.28

The customer is forced to pay for all the instalments at an unfavourably weak rate. Worse, TARFs are often leveraged, so that if the exchange rate moves above the strike rate, the holder has to exchange more than they originally wanted

Bad scenario 2: pound crashes; spot rate falls so much that the contract is cancelled

If the spot rate falls rapidly enough, the contract is voided and the holder is forced to make the

If the spot rate falls rapidly enough, the contract is voided and the holder is forced to make the rest of the payments at the prevailing market rate.