Pound Sterling

Zig-zagging pound sharpens concerns over mis-sold forex hedges

Currency deals have left some small businesses nursing big losses

Target redemption forwards are supposed to help businesses buy and sell foreign currency at a better rate they would otherwise be able to obtain © FT Montage/Dreamstime

Eva Szalay in London AN HOUR AGO

Five years ago Rita and Rahul Sharma were facing financial ruin. The husband and wife team, founders of Best At Travel, had entered into foreign exchange contracts that promised to shield the company's £80m annual turnover from swings in currencies. But the deals had gone badly wrong for the London-based tour operator, leaving it liable at one point to buy hundreds of millions of US dollars.

The couple's struggle is just one case in what analysts describe as a deepening mis-selling scandal, where small businesses trying to hedge forex exposures find that those arrangements leave them nursing big losses. Many are urging the regulator, the Financial Conduct Authority, to take a stronger stance, noting a sharp rise in companies seeking similar protection since the 2016 EU referendum made sterling more volatile.

The squeeze on Best At Travel came after Mr Sharma, as finance director, entered into a series of contracts with banks known as target redemption forwards. Such deals are supposed to help businesses buy and sell foreign currency at a better rate they would otherwise be able to obtain. In exchange, they run a greater risk if the exchange rate moves against them.

The contracts 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.

In Mr Sharma's case, the contracts cost him millions of pounds, wiping out his retirement fund. The couple lodged and later settled a mis-selling claim that named five defendants: National

Westminster Bank, Royal Bank of Scotland, Investec, Abbey National and Santander.

All declined to comment.

"I trusted our banks," said Mr Sharma. "I viewed them as part of my business [and] I just didn't think that they would put me in a situation that exposed my business to collapsing."

Similar cases are now piling up across the UK, pursued by small companies that have had to contend with a weaker and less predictable pound. Owners of such firms can easily fall prey to zealous salespeople who make as many as 80 calls a day, according to a former employee at a broker. Big banks, hurt by lawsuits over the sale of interest rate swaps, have largely retreated from the business of direct selling, but still arrange deals for intermediaries such as London-based Moneycorp and Colorado-based Western Union.

A recent survey of more than 1,000 UK companies carried out by Western Union found that more than a quarter of those with revenues of up to £10m were using complex options such as TARFs in the first half of this year.

Abhishek Sachdev, chief executive of derivatives consultancy Vedanta Hedging, said it was hard to get a handle on how much damage such contracts were causing. He noted that clients often felt embarrassed by losing money so they either stayed silent or settled out of court.

But complaints are mounting. Matthew Wescott, a partner at law firm Carter-Ruck, said he has received "around a dozen" inquiries over forex-related cases over the past year, and expects more in the year ahead — especially if sterling remains volatile.

Another company stung by forex contracts was Savage & Whitten, a Northern Irish groceries and tobacco distributor which lost more than £3.5m in 2016 on "substantial foreign currency options" to hedge against a falling euro, according to public filings. Bluezone Global, a Lancashire-based clothing wholesaler, went into liquidation last year after nearly £6m of forex-related claims.

Following a Financial Times story on TARFs in July, several brokers and at least one bank have conducted internal reviews of the sale of complex derivatives to less sophisticated customers, according to people close to the investigations. A couple of companies have hired a specialist derivatives expert to deal with mis-selling cases that may arise.

The FCA has carried out a preliminary exploration into the sale of such products, but concluded the problem was not big enough to justify a full-scale review, according to a person familiar with the regulator's deliberations.

An FCA spokesperson said: "We are aware of these risks and while we can't comment further, we continue to be focused on instances where complex products may be sold to less sophisticated clients."

Mr Sharma last received a call about TARFs this summer but declined to take up the offer. He is still involved in a separate lawsuit against a bank, which he declined to identify. “The salespeople we worked with were friends, or I certainly viewed them as friends,” he said. “But not once did any of them say, ‘look, this is enough, you are buying too much foreign exchange’.”

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 rest of the payments at the prevailing market rate.

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