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COMPTROLLER AND
AUDITOR GENERAL

HC 759
SESSION 2010–2011

18 FEBRUARY 2011

Departments managing EU Funds

Managing the impact of changes in the value of the euro on EU funds

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National Audit Office

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

15 February 2011

Each year the UK receives the equivalent of £5 billion from the European Union to fund or part-fund payments to farmers under the Common Agricultural Policy and to support regeneration, training and other EU approved projects and programmes.

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This report can be found on the National Audit Office website at www.nao.org.uk/EU-funds-2011

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Summary

Introduction

1 Each year the UK receives the equivalent of around £5 billion from the European Union (EU) to fund or part-fund payments to farmers under the Common Agricultural Policy and to support regeneration, training and other EU approved projects and programmes.

2 The funds provided by the EU are denominated in euros. However, UK departments make commitments and pay recipients in pounds. This gives rise to gains and losses to real funding levels caused by movements in the exchange rate between the pound and the euro. The euro has appreciated by more than 30 per cent since the credit crisis in 2007, but it has tended to depreciate since January 2009. The relative value of the pound and the euro is uncertain, and the exchange rate has fluctuated by up to 14 per cent in a single month.

3 Departments have to try to match spending in pounds as closely as possible to the equivalent value in euros. A 14 per cent change in the euro can entail an increase or decrease of £700 million in the value of the funds provided by the EU if the movement in exchange rates is sustained. At the end of most programmes there is a two-year period to settle prior commitments. Unused exchange rate gains cannot be utilised whilst, exchange rate losses may need to be covered by the UK taxpayer from within existing departmental budgets.

4 UK departments also spend around £3.5 billion a year to meet commitments in euros overseas. While an appreciation in the value of the euro will increase the amount of pounds available to the departments managing EU funds, it will also increase the amount of pounds those departments that spend euros abroad need.

5 This report examines how well the UK maximises the value of the euro funds it receives and reduces the risks of calls on the UK taxpayer from changes in the exchange rate. For value for money to be achieved the following criteria would need to be met:

- Departments have assessed the value of funds at risk from euro exchange rate movements and taken cost effective measures to manage the risk; and
- Government as a whole addresses the risk to the taxpayer in the most cost effective manner, using a clear framework on which to base an exchange rate management policy.

6 Our assessment included surveys and interviews with departments managing EU funds to map how and when transactions take place and to understand how exchange rate risks are managed. We interviewed HM Treasury officials and reviewed guidance available to departments. We undertook quantitative analysis to identify the value of euro transactions.

Key Findings

Departments decide individually whether to bring about greater certainty by hedging using commercial banks

7 HM Treasury is responsible for the *Managing Public Money* guidance which departments must adhere to when managing risks to UK programmes and funds arising from changes in the value of the euro. They can decide to respond to changing exchange rates by adjusting their planned programme expenditure to match as closely as possible the value of EU funds and/or negotiate a financial instrument (hedge) with commercial banks to fix expenditure at a particular exchange rate (**Figure 1**).

Figure 1
Departments can use a 'hedge' to protect against uncertainty

Hedging method	How it works
A forward contract	Two parties agree to fix a rate of exchange between them for a specific transaction in the future. In that way both parties gain certainty.
An option	Party A pays a fee to Party B to have the option, but not the obligation, to invoke an agreed exchange rate in the future. It allows Party A to benefit from a favourable exchange rate movement and protects against an unfavourable movement.
A combination of forward contracts and options	Departments can use multiple forward contracts and options for more complex programmes.
Internal hedge	Departments can offset gains and losses arising on assets and liabilities or income and expenditure denominated in the same foreign currency.

Source: National Audit Office

8 The departments managing most of the funds provided by the EU are the Departments for Work and Pensions, Communities and Local Government, and Environment, Food and Rural Affairs. All three departments have considered the impact of potential losses from exchange rate movements and their ability to absorb them within their existing budgets. This ability varies by department. EU funds are equivalent to 43 per cent of the spending of the Department for Environment, Food and Rural Affairs, but less than 1 per cent at the Department for Work and Pensions and the Department for Communities and Local Government.

9 The Rural Payments Agency, which makes payments to farmers on behalf of the Department for Environment, Food and Rural Affairs, has used hedging arrangements with commercial banks for the £2.7 billion Single Payment Scheme since 2005. The Agency extended its hedging arrangements to include the Rural Development Programme in 2009. The Department does not hedge payments made under the European Fisheries Fund because exchange rate gains and losses are relatively small. We found other departments could have done more to estimate the cost and effectiveness of their mitigating approaches. In particular:

- The Department for Work and Pensions considered several arrangements to treat its exchange rate risk. It rejected the use of a forward contract to fix the exchange rate, without identifying the costs, because the arrangement would involve surrendering exchange rate gains to a third party. Instead it considered using currency options to protect against an unfavourable movement whilst retaining the opportunity to benefit from gains. However, the Department determined that at £120 million the cost of a currency option would be too expensive. Instead the Department chose to tolerate the risk by adjusting spending commitments and absorbing gains and losses within its overall budget.

- The Department for Communities and Local Government considered using a currency option but was put off when it found out the cost quoted to the Department for Work and Pensions. The Department for Communities and Local Government did not cost the use of hedging instruments to meet its specific requirements. It was, however, the only department to model the impact of exchange rate gains and losses on its funding. It concluded that it did not have the expertise or the quality of forecasting needed to hedge, and decided that it could tolerate gains and losses.

10 Departments receive an advance from the EU of up to 7.5 per cent of the total programme cost to help with cash flow and start-up costs. The advance can represent a long-term exchange rate risk if departments do not repay the advance until the end of the programme, nine years later. The Departments for Work and Pensions, and Environment, Food and Rural Affairs have considered whether they can reduce the size of gains and losses arising on the advance, but none of the departments have yet implemented an approach to mitigate the exchange rate risk.

The Departments for Work and Pensions, and Communities and Local Government have not protected against potential calls on the UK exchequer

11 The departments are not able to spend currency gains or react to losses that occur in the final two years of long-term programmes because under EU rules they cannot adjust their spending commitments after the seventh year. The departments must surrender any under-spends to the EU, but must accommodate over-spends out of UK funds. In total the three departments under-spent on the most recent programmes by £698 million. They were not protected from exchange rate movements because:

- The departments' approach to adjust spending in response to exchange rate changes is only suitable while departments have the ability to adjust their commitments.
- The UK recovers only 14 per cent of EU funds it does not spend. Funds unspent by the Departments for Work and Pensions, and Communities and Local Government are returned to the EU and carried forward for the EU budget in the next year. All member states benefit from a proportionate reduction in their EU contributions. The UK therefore forfeited some £514 million out of the £598 million returned to the EU. Under Rural Development Programme rules the Department for Environment, Food and Rural Affairs was able to use unspent funds in the next programme.

12 The Rural Payments Agency introduced forward contracts to protect the Rural Development Programme against exchange rate volatility in 2009. The Department for Work and Pensions also identified the risk in 2009, and has since indicated that it is interested in re-examining the costs of forward contracts to protect against risks in the final two years of the programme.

13 Our analysis indicates that forward contracts would be cost effective in the final two years of long-term EU funds. Without a hedge the Departments for Work and Pensions, and Communities and Local Government are exposed to potential exchange rate losses of £150 million per 10 per cent incremental depreciation in the euro. The UK can only benefit from gains of around £20 million (14 per cent) of the gain from each equivalent appreciation because an under-spend is distributed amongst all member states. We estimate that forward contracts could be put in place for these departments at a cost of less than £6.5 million, and that this would be cost effective if the exchange rate changes by more than 1 per cent in the final two years. Our analysis indicates departments should consider the use of forward contracts as part of an assessment on how to mitigate their risks.

Forward contracts can be costly without accurate information and should be handled with commercial sensitivity

14 Whilst the Rural Payments Agency has protected the UK exchequer from volatility in the value of EU funds available to reimburse UK payments, the arrangements have cost some £69 million more than they might. Administrative errors costing £29 million were avoidable. The remaining losses of £40 million arose because forecasts of the total hedging requirement were out by around 3 per cent and the impact of the error was exacerbated by high euro exchange rate volatility. The additional costs were incurred because:

- The Agency was unable to identify the exact rate needed for its forward contract arrangements because the Bank of England did not publish the rate it used to convert euros. The Bank of England uses the prevailing rate at the time of the transaction to convert euros received from the EU, whilst commercial markets may fix the rate for a specific time of day. The difference in rates meant the Agency was not protected if rates moved markedly on the day of each trade and resulted in losses of £6.2 million in 2007. In 2008 the Agency held discussions with HM Treasury and the Bank of England to resolve the issue. However, the Agency and the Bank of England continued to use different rates, resulting in losses of £21.6 million. The Agency has since reached agreement with the Bank of England to use a specific rate and has reported no losses since.
- In 2009 the Agency lost £1.6 million on the Rural Development Programme hedge because its monitoring did not identify a reimbursement from the EU. As a result there was a two day delay in closing the forward contract.
- The Agency is reliant on information from other parties which makes accurately forecasting its total hedging requirement more difficult. In 2006 and 2007 the Agency over-estimated its hedge requirements by £103 million (3 per cent of the total budget) and £114 million (3.5 per cent). It incurred unnecessary losses of £20.1 million and £11.8 million respectively on the unused portions of the hedges as a result.
- In June 2010 the Agency concluded it had under-estimated its hedging requirement for the Single Payment Scheme by £91 million (3.2 per cent of total budget). It took out a supplementary hedge, nine months after the scheme rate was set, to fix its exchange rate loss for some of the unprotected funds. The rate of 82.65 pence to the euro was eight pence below the scheme rate and fixed the loss to the Agency at £5.2 million. In total the Agency lost £9.4 million as a result of its under-estimate.

15 The Rural Payments Agency is taking action to address the issues identified above by contracting additional expertise to improve the management of its hedging arrangements and by working more closely with the Bank of England to resolve technical issues. It has improved its forecasting accuracy on the Single Payment Scheme; and has adopted an options strategy at a cost of £2.9 million to protect it against an over or under hedge of around £71 million. Depending on movements in exchange rates and the extent of any inaccuracies in forecasting, the option could reduce exchange rate losses by around

£9 million. However, the Agency did not obtain written HM Treasury approval. HM Treasury has subsequently granted retrospective approval on the grounds the arrangement represents value for money. Options are more expensive than forward contracts and there is scope for the Department for Environment, Food and Rural Affairs and the Agency to reduce costs and improve value for money if it improves its forecasting to a point where options are not needed.

16 The size and date of the Single Payment Scheme hedge has become widely known, and the transaction anticipated by the City. The Rural Payments Agency has been provided with evidence, by its commercial provider, of private hedge funds exchanging several billion pounds prior to the transaction. In 2010 on the day of the hedge, the value of the pound depreciated by 0.5 per cent against the euro.

Hedging when undertaken correctly, can help to reduce the funds at risk from exchange rate volatility

17 The use of forward contracts has helped to reduce the gross value of government funds which are exposed to exchange rate movements between the pound and the euro from £8.5 billion to £2.4 billion in 2009-10. Wider use of hedging could further reduce the value of taxpayers' funds at risk.

18 Cost effective risk management depends on departments accurately forecasting their transactions to identify their foreign exchange exposure with the minimum of error. If forecasts are inaccurate then it may expose the taxpayer to more losses. Departments opting to hedge typically hedge a proportion of spend when there is uncertainty over the timing and the volume of transactions. All choose to hedge at least 80 per cent, leaving the remainder of transactions exposed. The more departments are able to improve their forecasting, the better they can protect taxpayers' funds from exchange rate movements.

The departments managing EU funds are not equally supported in carrying out hedging and all departments would benefit from clearer guidance

19 HM Treasury has outlined a high level principle-based approach to foreign exchange management to allow departments to apply the guidance to its own circumstances, on the basis that each department is best placed to understand the specific risks it faces. HM Treasury must approve any foreign exchange management policy that contains novel or contentious transactions.

20 Departments told us they would welcome a more detailed set of principles to guide their risk management in this area. Foreign exchange policy guidance on the use of some financial instruments, such as options, may conflict with wider HM Treasury guidance that departments should not normally buy commercial insurance to protect against risk.

21 HM Treasury provides advice on whether departments bear the impact of foreign exchange gains and losses on a case-by-case basis. Exchange rate gains and losses are deducted from Departmental Expenditure Limits or from Annually Managed Expenditure according to the specific programme. In 2010-11 the Department for Environment, Food and Rural Affairs has been advised to recognise gains and losses on its EU funds under its departmental budget, while the Departments for Work and Pensions, and Communities and Local Government have not. Where gains and losses are recorded in Annually Managed Expenditure the department will have no incentive to hedge, and since the costs of hedging fall under departmental budgets there is a perverse incentive not to hedge. In January 2011 HM Treasury circulated draft guidance to departments for consultation. The guidance proposes that gains and losses are charged to Departmental Expenditure Limits by default but allows departments to consult with HM Treasury if this is not appropriate or if hedging creates perverse incentives.

22 The Exchange Equalisation Account is a HM Treasury Exchequer Funds account with responsibility for managing the UK's foreign currency reserves. Departments can agree forward contracts with the Exchange Equalisation Account for foreign currency transactions, but under existing legislation the Exchange Equalisation Account can not give advice on payments from the EU. While amounts due are denominated in euros the actual payments are made in pounds.

23 The departments managing the EU funds are exposed to commercial risks that they would not face if they were able to use the Exchange Equalisation Account. The departments managing the EU funds have little or no experience in negotiating hedging arrangements, are less familiar with the market, and do not have access to the same range of data on prices. Under current public sector arrangements the departments would need to follow a competitive tender process to gain assurance over prices which risks alerting commercial markets to their intentions before a deal is struck. Whilst the Exchange Equalisation Account charges departments on the same basis as a commercial provider, the benefit accrues to the Exchequer rather than to the private sector.

Conclusion on value for money

24 The current arrangements for reducing potential calls on the UK taxpayer from exchange rate movements between the euro and the pound are not value for money because the Government is exposed to large potential losses from a euro depreciation, and it cannot benefit in equal measure from a euro appreciation. Without using a hedge the Departments for Work and Pensions, and Communities and Local Government are exposed to potential exchange rate losses of £150 million per 10 per cent incremental depreciation in the euro, but the UK can only benefit from gains of around £20 million from each equivalent appreciation.

25 Forward contracts have significantly reduced the value of taxpayers' risk to exchange rate movements from £8.5 billion to £2.4 billion in 2009-10. However, current arrangements whereby each department managing EU funds works in isolation on developing its policy is not cost effective. Without the advice available to other departments from the Exchange Equalisation Account the departments managing EU funds do not necessarily have the expertise to negotiate their hedging arrangements with commercial markets. More detailed guidelines and a more coordinated approach could improve foreign exchange management and reduce costs and risk to taxpayers.

Recommendations

26 Departments could benefit from more detailed guidance. HM Treasury should develop more helpful guidance on exchange rate management in consultation with the relevant departments.

27 Under current arrangements, the Departments for Work and Pensions, and Communities and Local Government are exposed to large potential losses from a euro depreciation, especially in the later stages of EU funded programmes. The departments should:

- **a** review their foreign exchange management policies and in particular their decision to tolerate the risk of such losses;
- **b** undertake a cost-benefit analysis of the different hedging arrangements available to them; and
- **c** engage with the Department for Environment, Food and Rural Affairs, and the Rural Payments Agency to learn from their experience and expertise.

28 The departments do not mitigate the exchange rate risk arising from the advance of funds received for all long-term EU programmes. These departments should also explore the opportunities to reduce the risk of losses arising from exchange rate movements on advances from the EU as part of reviews of their foreign exchange management policies.

29 The departments managing the EU funds are not able to use the Exchange Equalisation Account. Departments managing EU funds should consider establishing a shared service for commissioning, operating and monitoring their hedging arrangements to enable the pooling of expertise and reduce potential duplication of effort. This shared service might be supported with technical expertise from the Exchange Equalisation Account or the Government Banking Service.

Part One

Introduction

Each year the UK receives payments from the EU denominated in euros

1.1 UK membership of the EU involves flows of funds both from the UK to the EU and from the EU to the UK (**Figure 2**). These include the payment by the EU of the equivalent of around £5 billion each year to fund or part-fund EU approved programmes in the UK[1]. Most EU funded programmes run for a nine year period. The exception is the Single Payment Scheme, under which Common Agricultural Policy support payments are made to farmers on an annual basis.

1.2 These programmes are administered by the Departments for Work and Pensions, Communities and Local Government, and Environment, Food and Rural Affairs. **Figure 3** shows the flow of funds between the EU down through departments and their agencies to the final recipients in the UK.

Figure 2
UK membership of the EU involves a number of flows of funds

- The UK contributed about £14.8 billion to the EU budget in 2010. The level of the UK contribution to the EU is based on UK economic performance.
- The UK receives payments from the EU to fund or help fund EU approved projects or programmes in the UK. In 2010 these payments were worth £5.5 billion.
- The UK receives an abatement of its contribution based on its status as a net contributor to the EU; the returned amount was around £3 billion in 2010.
- The UK made a net contribution of around £6.3 billion to the EU in 2010.

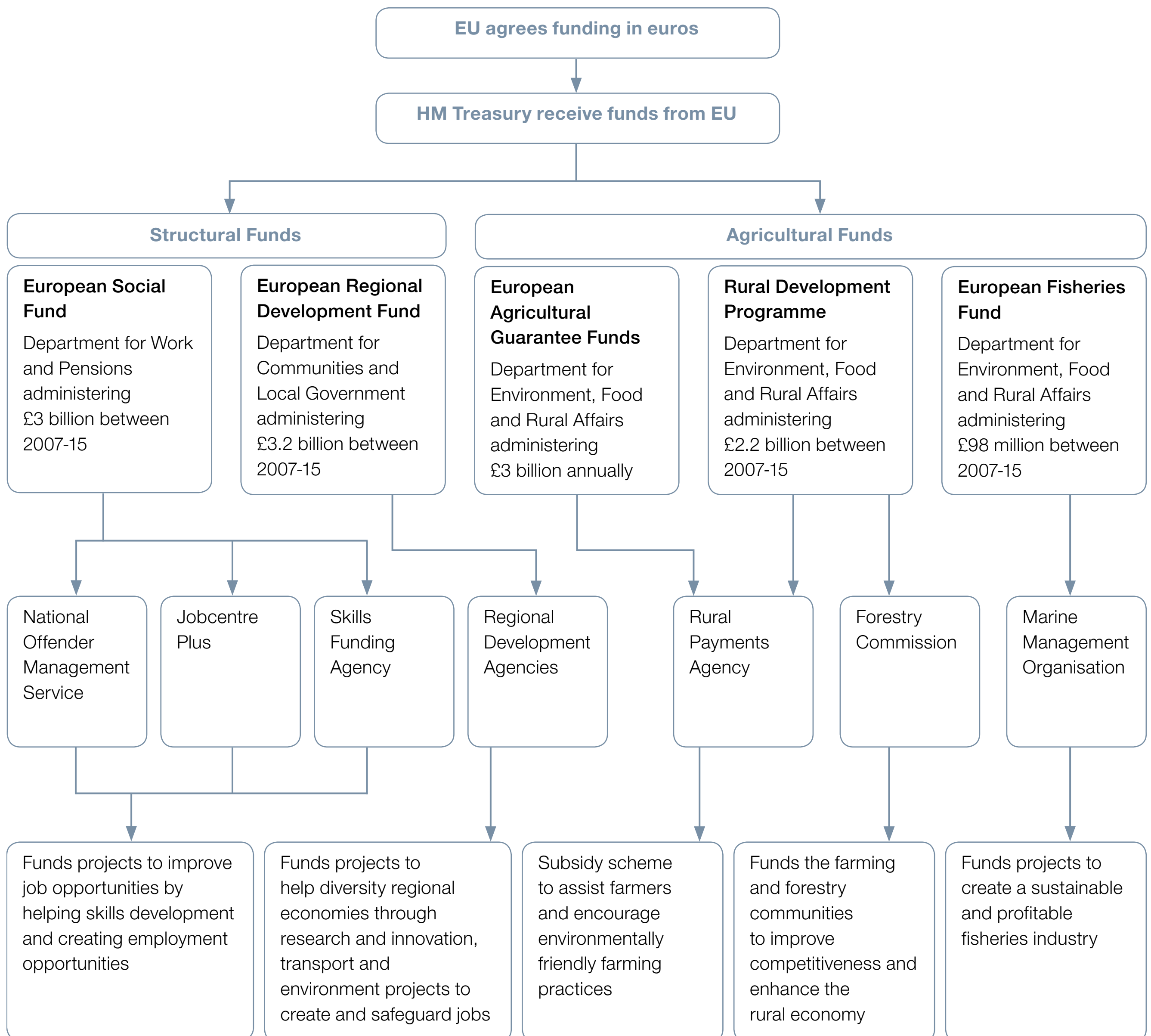
NOTE
1 EU figures presented are for calendar years.

Source: National Audit Office analysis of HM Treasury data

1 HM Treasury, *European Union Finances, 2010: Statement on the 2010 EU Budget and measures to counter fraud and financial mismanagement.* Average taken across outturns between 2004-05 to 2009-10.

Figure 3

The flow of funds from the EU to recipients in the UK



NOTES

1 The UK is also a recipient of around £40 million of funds a year for a number of smaller EU programmes. These programmes support a range of policy objectives including developing transport infrastructure, science initiatives and crime reduction.

2 The Marine Management Organisation administers only the European Fisheries Fund.

3 The Department for Communities and Local Government is responsible for the European Regional Development Fund in England only.

4 The Department for Work and Pensions is responsible for the European Social Fund in England and Gibraltar only.

5 The Department for Environment, Food and Rural Affairs is responsible for EU agricultural funds in England, Scotland, Wales and Northern Ireland.

Source: National Audit Office analysis

The value of payments from the EU depends on the exchange rate between the euro and the pound

1.3 Departments must manage exchange rate risks that crystallise in the short and longer term including:

- Budgets are determined in euros at stages of the programme, but funding allocations are made in pounds under arrangements with the EU. Fluctuations in the exchange rate between the euro and the pound can increase or decrease the value in pounds of these budgeted allocations over time. This can make departmental planning of how much to award to recipients in pounds difficult. If departments do not plan accurately they have to give back unspent funds to the EU or find funding for an over-spend from existing departmental budgets.
- It can take up to six months between the department administering an EU programme making a payment to a UK recipient in pounds, and reimbursement from the EU in euros. Exchange rate fluctuations during this window can lead to departmental gains or losses.
- In addition, departments receive an advance of up to 7.5 per cent of the total budget to help with cash flow and start-up costs on long-term programmes. The advance can represent a long-term exchange rate risk because gains and losses on the advance are not realised until it is repaid to the EU; which can be at anytime during the programme, and up to nine years later.
- In the case of the Single Payment Scheme, the rate between the euro and the pound is fixed each year in September for all transactions over a 12 month period, regardless of fluctuations in the actual rate of exchange during this time. Around 80 per cent of transactions are reimbursed from the EU by February.

1.4 Whilst funds paid by the EU to the UK are affected by the exchange rate between the pound and the euro, this is not the case with the UK contribution to the EU budget. The UK makes payments in pounds into an EU controlled account. The same exchange rate is applied in the calculation of the UK's contribution and to the payments the UK makes throughout the year to honour its contribution. We understand previous requests made by departments for payments from the EU to be treated in the same way and be paid in pounds have been refused on the grounds that the euro is the adopted currency for EU transactions.

1.5 Other UK departments spend around £3.5 billion a year to meet commitments in euros overseas. A favourable movement in the exchange rate for the EU funds is unfavourable for other departments. While an appreciation in the value of the euro will increase the amount of pounds available to the EU funds, it will also increase the amount of pounds which departments must use to meet euro commitments overseas.

Exchange rates have been and are likely to continue to be volatile

1.6 The long-term trend in exchange rates has seen a decline in the value of the pound against the euro, with the exchange rate dropping from €1.51 per pound in January 2007, to €1.03 in December 2008, before strengthening again to €1.17 in January 2011 (**Figure 4**).

1.7 Exchange rate movements have become more volatile since 2007, with the pound depreciating by 30 per cent in 2008. At the peak of the recent financial crisis, exchange rates fluctuated by up to 14 per cent between November and December 2008. As a result of these movements the value of EU programmes to the UK could have increased or decreased by up to £700 million. The value of the pound against the euro is likely to remain volatile in the near future in light of the continuing international financial uncertainty.

Figure 4

The value of the pound has declined steadily against the euro between 2000 and 2007, but has partially recovered in 2010

Source: National Audit Office analysis of Bank of England data

Scope and methodology

1.8 This report considers whether the Government is maximising the value of the EU funds to the UK through effective management of the risks arising from exchange rate changes and whether there are opportunities to better manage the impact across government[2]. In particular our report considers:

- Departmental decisions to hedge funding from the EU (Part Two).
- Euro exchange rate risk management within government (Part Three).

1.9 To collect evidence for this report we surveyed and interviewed staff at the three key departments responsible for managing EU funds, on the processes involved in administering the funds and managing risks from exchange rate fluctuations. We asked an expert in exchange rate economics to review the risk management guidance to departments issued by HM Treasury. We interviewed HM Treasury experts to better understand the rationale behind the current arrangements and guidance. We undertook quantitative analysis to assess the value and timing of euro transactions by departments managing EU funds and those spending euros abroad.

2 The report does not examine issues around the disallowance of EU funds or how EU funds are applied to achieve particular policy objectives.

Part Two

Departmental decisions to hedge funding from the EU

HM Treasury requires departments to decide individually how to manage risks to their programmes

2.1 HM Treasury is responsible for the *Managing Public Money* guidance which departments must adhere to when managing the risks to UK programmes and funds arising from changes in the value of the euro. It requires departments to consider and manage their risks and has developed a set of principles which it expects departments to consider when assessing how to manage them. The guidance is not prescriptive and is intended to allow departments to determine the most effective approach.

2.2 Departments cannot use all the options that are available in the private sector. Departments cannot use financial instruments to speculate in order to make profits. However, they can:

- monitor exchange rate movements and react by adjusting their planned programme expenditure to match as closely the value of EU funds; and/or
- use a financial instrument, such as a forward contract to fix expenditure at a particular exchange rate and therefore gain certainty over expenditure.

2.3 HM Treasury recommends departments consider whether they can: find opportunities to benefit when exchange rate movements are favourable; to tolerate the risk if the impact of exchange rate movements is considered mild; to treat the risk to reduce its severity using a financial instrument; or transfer the risk to someone else, such as paying recipients in euros. The key financial instruments available from commercial providers are explained in **Figure 5** overleaf. The guidance does not specify which financial instruments departments should use. Instead departments are required to seek HM Treasury approval for any arrangements which are novel or contentious[3].

3 HM Treasury, *Managing Public Money* guidance.

Figure 5

Explanation of financial instruments

Financial instrument	How it works and how costs are calculated	Example
Non-deliverable forward contract	Gains in the value of one currency will lead to an equivalent loss in value with the other currency. Therefore the gains made by one party are given to the counter-party to cover its equal loss. Relatively low costs based on the difference between the interest rates of the two currencies. There is little risk provided parties have correctly estimated their requirements.	Party A wants to insure the value of £1 million, whilst Party B wants to maintain the value of €1 million. On the trade date, the euro has depreciated against the pound by 20 per cent, so Party A has gained 20 per cent, whilst Party B has lost 20 per cent. Party A will give its gain to Party B to cover the loss.
Layered forward contract	A forward contract that provides cover for forecasted expenditure. The arrangement is renewed every six months and the amount to be covered reduces as the end of the programme gets closer. Costs are calculated on the same basis as for a non-deliverable forward contract.	Party A wants to gain certainty over its expenditure over a seven-year period. It enters a layered forward contract with Party B that allows it to hedge for shorter periods where it can more accurately forecast its expenditure. The arrangement is renewed every six months to ensure it does not over or under hedge.
Options	A party purchases a specific exchange rate to gain certainty over the minimum value of a transaction in the future. If on the trade date, however, the actual rate is more favourable than the option rate, the party is not obliged to use the option rate and can benefit from the actual market based rate instead. Prices take into account the prevailing exchange rate, recent rate movements, volatility levels, interest rates and the time period to be covered. Options are more expensive than forward contracts because one party takes on all the risk of an unfavourable exchange rate movement.	Party A wants to guarantee a minimum value on the pound for a trade it plans to do in the future so purchases an option securing £1: €1.20. On the trade date the actual rate is £1: €1.22, so Party A does not exercise its option as it would have lost two cents for every pound transacted.

NOTE

1 The example of a non-deliverable forward contract assumes £1 equals €1 at the inception of the contract.

Source: National Audit Office

2.4 The Department for Environment, Food and Rural Affairs and the Department for Work and Pensions both consulted extensively with HM Treasury about their foreign exchange management policy. HM Treasury was not aware of contact with the Department for Communities and Local Government. The Department for Communities and Local Government was unable to provide us with any evidence of advice from HM Treasury, but officials told us that they had spoken over the telephone.

The departments are taking different approaches to address the specific risks each faces

2.5 All the departments administering the main EU funded programmes have assessed the risks posed by exchange rate movements. The Department for Environment, Food and Rural Affairs first formally assessed the risks in 2005, while the Department for Work and Pensions and the Department for Communities and Local Government did not undertake a formal assessment until 2009.

2.6 The scale of risk for each department depends in part on the relative contribution of EU funding to their overall budgets. In 2009-10 EU funding represented 43 per cent of the funding available to the Department for Environment, Food and Rural Affairs. This compares with less than 1 per cent at the Department for Work and Pensions and the Department for Communities and Local Government. The Department for Environment, Food and Rural Affairs manages three large EU funds and it has a smaller departmental budget in comparison to the Department for Work and Pensions and the Department for Communities and Local Government. **Figure 6** overleaf identifies examples of the options that departments have considered.

2.7 The Department for Work and Pensions considered several arrangements to treat its foreign exchange risk. It considered using:

- a layered forward contract which would protect a percentage of funds if they reduced in value towards the end of the programme; or
- a combination of forward contracts and options that would allow it to secure a specific exchange rate if the market rate was less favourable.

2.8 The EU funds managed by the Department for Work and Pensions also contribute and help fund the policy objectives of the Departments for Education, and for Business, Innovation and Skills. The departments appointed a group of senior officials led by the Department for Work and Pensions to oversee performance and risk.

2.9 The Department for Work and Pensions’ preferred instrument was a forward contract with options, but it found the costs quoted of between £120 million and £185 million to be too high. It considered the use of a cheaper forward contract without options, but did not obtain information on the cost of such an arrangement. It rejected forward contracts because these involve surrendering exchange rate gains to a third party. The Department for Work and Pensions therefore decided to manage gains and losses within existing budgets.

Figure 6

The departments have considered different options to manage risks

Risk Management Guidance and example identified	Department for Communities & Local Government	Department for Environment, Food & Rural Affairs	Department for Work & Pensions
Tolerate: Monitor and react to exchange rate movements. Any losses will be met from existing departmental budget allocations	✔	✔	✔
Tolerate: Develop a tool to forecast the impact of exchange rate movements on transactions	✔		
Treat: Consider adopting non-deliverable forward contracts		✔	✔
Treat: Consider using options	✔	✔	✔
Transfer: Identify opportunities to share the risk with others who benefit from EU funding			✔
Transfer: Consider arrangements to fund recipients in euros		✔	✔
Consulted HM Treasury		✔	✔

NOTE

1 Guidance also includes an option to terminate an activity for intolerable risks and to take opportunities. This is not an option for EU funds.

Source: HM Treasury, Managing Public Money and National Audit Office analysis of departmental data

2.10 The Department for Communities and Local Government also considered different options. It reviewed the quotes received by the Department for Work and Pensions but it did not quantify how much its specific requirements would cost. Neither did it look in detail at a forward contract without options.

2.11 The Department for Communities and Local Government examined the impact of exchange rate movements using a forecasting model and concluded that it should not adopt a financial instrument, it concluded that:

- it did not have the appropriate expertise;
- it had concerns about its ability to forecast accurately the amounts that would need to be hedged; and
- its gains and losses could be covered through its existing budget allocation.

2.12 Both the Department for Work and Pensions and the Department for Communities and Local Government have chosen to monitor and absorb changes in the value of EU funds. Each department reviews the value of EU funds available in pounds and adjusts its spending commitments. However departments forecast the value of euro funds in different ways. The Department for Communities and Local Government use a forward market rate published by HM Treasury[4]. The Department for Work and Pensions used to use the HM Treasury rate, but found it to be inaccurate and now uses its own conversion rate.

2.13 The Department for Environment, Food and Rural Affairs assessed that exchange rate gains and losses would be difficult for it to absorb within its overall budget. Its aim has been to gain certainty over expenditure primarily through forward contracts. The Rural Payments Agency, which makes payments to farmers on behalf of the Department for Environment, Food and Rural Affairs, has used hedging arrangements with commercial banks to manage its exchange rate exposure on the Single Payment Scheme since 2005. It extended its hedging arrangements to include the Rural Development Programme in 2009. The Department for Environment, Food and Rural Affairs does not hedge payments made under the European Fisheries Fund. The fund is relatively small; with a maximum EU funded annual spend of under £30 million. The Department for Environment, Food and Rural Affairs concluded that it could tolerate gains and losses on this particular scheme.

2.14 Long-term programmes receive an advance, of up to 7.5 per cent of funding, representing an exchange rate risk for departments who do not repay the advance until the end of the programme, up to nine years later. Departments differ in how the advance is used, the Departments for Work and Pensions, and Communities and Local Government has used it to offset claims throughout the programme, whilst the Rural Payments Agency has historically held its advance until it has to be repaid to the EU. The Department for Work and Pensions has considered whether it can reduce the size of gains and losses arising on the advance, and the Department for Environment, Food and Rural Affairs is considering using the advance earlier in the programme, but none of the departments have yet implemented options to mitigate the exchange rate risk for the advance.

The departments have not been able to spend all the EU funds available to them

2.15 Until 2009, all three departments chose to manage the impact of exchange rate movements on long-term programmes by adjusting spending commitments when the exchange rate changed significantly. This approach is only suitable whilst departments have the ability to adjust their commitments. Under EU rules, departments can make commitments to projects up to the programme end date (2013), with payment to fulfil the commitment able to take place up to two years later. Any unspent funding after 2015 is lost to the programme and returned to the EU.

4 The Office for Budget Responsibility has published the rate since summer 2010.

2.16 Departments are exposed to large gains or losses at the end of long-term programmes because payments can be made up to two years after final commitments have been agreed. There is a risk that exchange rate movements during this period will result in the reimbursement of significantly more or fewer pounds than were actually paid to recipients. Between October 2007 and December 2008 the euro appreciated by some 30 per cent, increasing uncertainty for departments. In 2009 the UK returned around £598 million out of £698 million of unspent funds to the EU as a result of exchange rate movements (**Figure 7**).

2.17 The UK recovers only one pound from every seven pounds of EU funds it does not spend. Unspent funds are returned to the EU and carried forward as a contribution to the EU budget in the next year. The effect is a proportionate reduction in the EU contributions for all member states. In 2010, the UK contribution to the EU would have been reduced by around 14 per cent of all unspent funds, equivalent to around £84 million of the £598 million of funding it returned to the EU.

Figure 7

The departments under-spent their EU funding by £698 million largely because of exchange rate movements

Department	Under-spend incurred/date	Reason for under-spend
Department for Work and Pensions	£234 million (7 per cent of programme budget) in January 2009	The Department was managing additional budgetary pressures of up to £100 million, but an under-spend was brought about largely as a result of exchange rate movements.
Department for Communities and Local Government	£364 million (9 per cent of programme budget) in November 2010	It suffered this under-spend at the end of the 2000-06 programme, but has not calculated how much of this is due to exchange rate movements.
Department for Environment, Food and Rural Affairs, Rural Development Programme	£100 million in 2008-09[1]	Exchange rate movements and programme under-spends.

NOTE

1 The Department for Environment, Food and Rural Affairs made a voluntary modulation to carry forward its £100 million under-spend to the next Rural Development Programme. This option was not available to the EU funds administered by the Departments for Work and Pensions, and Communities and Local Government.

Source: National Audit Office

The Departments for Work and Pensions, and Communities and Local Government have not protected against potential calls on the UK exchequer

2.18 While departments cannot benefit from exchange rate gains between the closure of programmes and the settlement of payments (2014 to 2015 for current programmes), they must absorb any exchange rate losses. We estimate that the UK could have been required to find an additional £700 million to cover commitments at the end of the previous programmes if it had been the euro, not the pound, which had depreciated by 30 per cent. Under their current arrangements, the Department for Work and Pensions, and the Department for Communities and Local Government, would need to allow contingency in their budgets for such a movement.

2.19 Our analysis indicates that it would be cost effective for long-term programmes to use forward contracts in the final two years of the programme. Forward contracts without options have relatively low direct costs and provide departments with budget certainty. Departments are then able to commit all funds, without the risk of over-spending as a result of exchange rate movements. Without a hedge the departments are exposed to potential exchange rate losses of £150 million[5] per 10 per cent incremental depreciation in the euro. The UK can only benefit from gains of around £20 million (14 per cent of the gain) from each equivalent appreciation because an under-spend is distributed amongst all member states (see paragraph 2.17).

2.20 We estimate the total costs of using a forward contract for the Department for Work and Pensions or Communities and Local Government could range from £400,000 to £6.5 million depending on interest rates[6]. Our upper cost estimate for all unhedged EU funds in the UK is £10 million. We estimate that a forward contract would be cost effective if the exchange rate changes by more than 1 per cent in the final two years[7]. Our analysis indicates departments should consider the use of financial instruments as part of an assessment of how to mitigate their risks.

5 Forecast spending for 2014 and 2015 is €846 million for the Department for Work and Pensions and €939 million for the Department for Communities and Local Government. Total spend of €1,785 million is equivalent to £1,500 million at the 15 February exchange rate of £1 = €1.19. The pound value is subject to a change of £150 million for each 10 per cent change in the euro-pound rate.

6 The lower estimate is based on the historic difference between European Central Bank and Bank of England Base Rates of 0.3 per cent between 2008 and 2010. The upper estimate is based on a worst case scenario difference of 5 per cent. The historic difference between the base rates peaked at 2.77 per cent in March 2005.

7 Break-even rate of 1 per cent is the point at which the expected value from a currency change is approximately equal to the upper estimate of the cost of using a forward contract.

The Department for Environment, Food and Rural Affairs has used a non-deliverable forward contract to protect itself from currency fluctuations

2.21 The jointly agreed hedging arrangements between the Rural Payments Agency and the Department for Environment, Food and Rural Affairs are necessarily complicated because of the scale, nature and timing of the EU funds it manages (**Figure 8**).

2.22 Under current arrangements with the EU, the funding is allocated in euros but it receives payments in pounds, as a deduction from the overall UK contribution to the EU. Therefore in setting up its hedging arrangements, the Rural Payments Agency does not have any euros to trade. The Agency has therefore used a non-deliverable forward contract, which allows two parties to fix an exchange rate between two currencies, and agree to offset any gains or losses on a particular date. The agreement is with a commercial bank and it does not involve any transfer of actual currency.

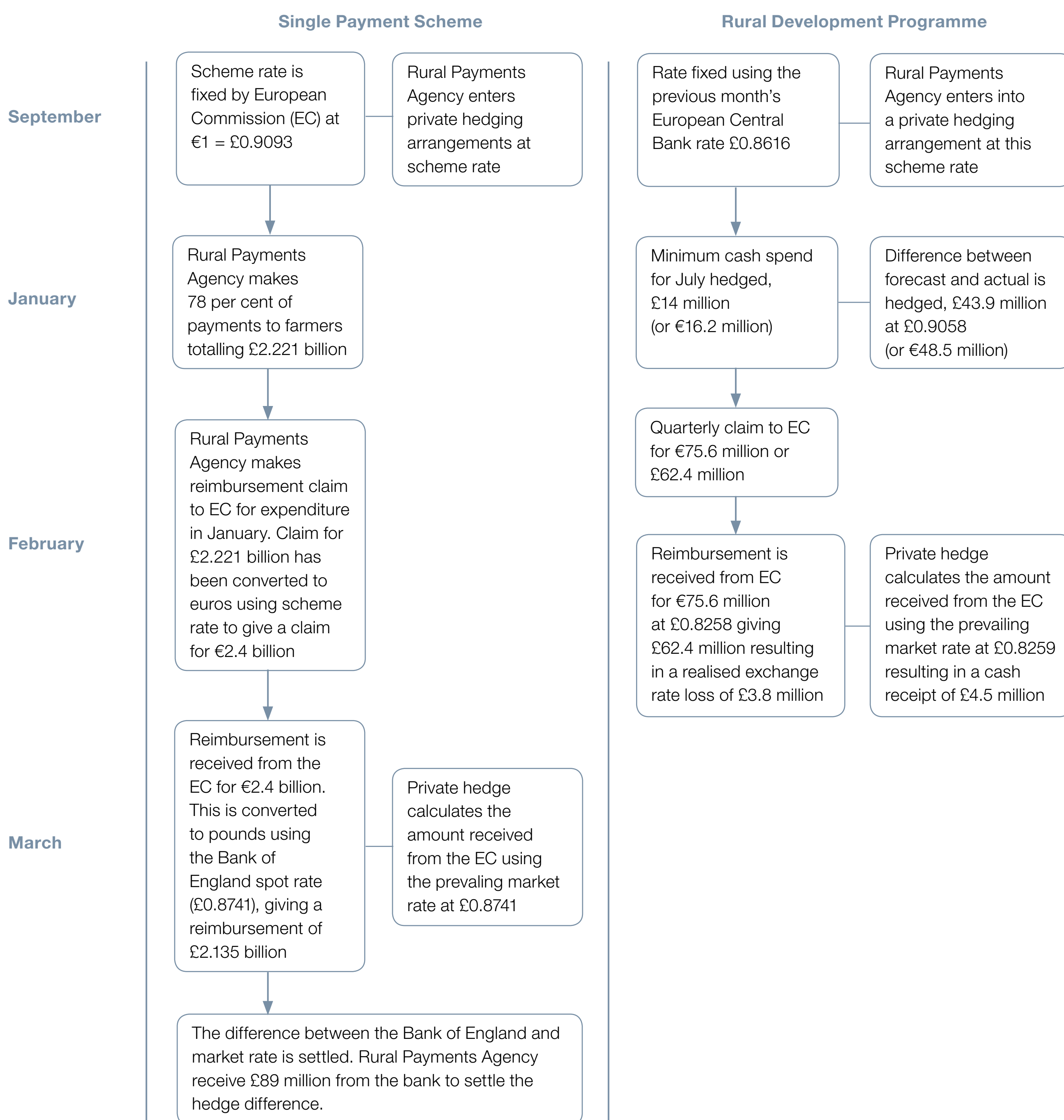
2.23 Under the agreement the Rural Payments Agency fixes its total euro funding in pounds using the prevailing exchange rate on the date of the arrangement. If the exchange rate moves favourably, it will receive a gain when it converts euros to pounds. Conversely if the rate moves unfavourably it will receive less pounds than it expects, and this would normally be recognised as an exchange rate loss. Under the agreement the Agency agrees to pay over to the bank any currency gains it makes above its expected value of pound funds. In return, the bank agrees to pay over its currency gains to offset the Agency's losses. In this way both parties have certainty over the value of funds.

2.24 Without hedging arrangements, foreign exchange movements would have given rise to large gains or losses which would have been difficult for the Rural Payments Agency to manage. The Agency made foreign currency gains of around £213 million and £330 million on its Single Payment Scheme transactions in 2007 and 2008 respectively. These gains were paid to the Agency's commercial provider to offset the equivalent loss on the forward contract used to hedge the foreign currency volatility. In 2009 the Agency incurred a foreign currency loss of approximately £109 million, which was exactly offset by a payment from its commercial provider for the foreign currency gain made on the forward contract.

Forward contracts can be costly without accurate information

2.25 The Bank of England converts euros received from the EU into pounds and pays them to the Rural Payments Agency. The Bank of England uses the prevailing rate at the time of the transaction to convert euros to pounds, whilst commercial markets may fix the rate for a specific time of day. The difference in rates meant the Agency was not protected if the rates moved markedly on the day of each trade and resulted in losses of £6.2 million in 2007. In 2008 the Agency held discussions with HM Treasury and the Bank of England to resolve the issue. However, the Bank of England and the Agency continued to use different rates, resulting in further losses of £21.6 million. In 2009 the Agency reached an agreement with the Bank of England to use a specific rate and has reported no losses since.

Figure 8
Explanation of the Department for Environment, Food and Rural Affairs' hedging arrangement



Source: National Audit Office analysis of departmental data

2.26 The Rural Payments Agency had a similar issue in 2009 when it took out hedging arrangements for the Rural Development Programme, because its monitoring did not identify a reimbursement from the EU, and there was a two day delay in closing the forward contract, resulting in a loss of £1.6 million.

2.27 In order to enter into a hedge for an appropriate amount, the Rural Payments Agency needs to forecast the total amount of payments it will make to farmers and the amounts to be reclaimed from the EU. The Agency estimates the total amount of euros it will receive from the EU for the Single Payment Scheme for the upcoming year. The Agency has hedged 98.5 per cent of payments in 2010. Without accurate forecasts, departments engaging in hedging may have too much or too little cover in place. In 2007 and 2008 the Agency over-estimated its hedge requirements by £103 million (3 per cent of total budget) and £114 million (3.5 per cent) respectively. As a result it incurred unnecessary losses of £20.1 million in 2007 and £11.8 million in 2008.

2.28 In June 2010 the Rural Payments Agency identified its forecast had under-estimated its hedging requirement for the 2009 Single Payment Scheme by £91 million (3.2 per cent of total budget). It was not prepared to risk a depreciation of the euro on the full amount and it therefore chose to take out a supplementary hedge to cover £56 million, nine months after the scheme rate was set, to protect itself against further foreign exchange volatility. The rate of 82.65 pence to the euro was 8 pence below the scheme rate and fixed the loss to the Agency at £5.2 million. The Agency incurred a total loss of £9.4 million as a result of its under-estimate.

2.29 The Rural Payments Agency has told us that it always expects a degree of forecasting inaccuracy because it is dependant on submissions from farmers and forecasts from other bodies, such as the devolved administrations. The Agency considers that its forecasts are now more accurate and has taken out a currency option at a cost of £2.9 million to protect it against an over or under hedge of around £71 million. Depending on exchange rate movements and the accuracy of forecasts the Agency could reduce volatility by up to £9 million. Contrary to guidance however, the Department for Environment, Food and Rural Affairs did not obtain HM Treasury written approval before purchasing the option. HM Treasury has provided retrospective approval on the grounds that the arrangements represent value for money. Options are more expensive than forward contracts and there is scope for the Department for Environment, Food and Rural Affairs to reduce costs and improve value for money if it improves its forecasting to a point where options are not needed.

2.30 The Rural Payments Agency in England, and the paying agencies in Scotland, Wales and Northern Ireland, all make some disbursements to farmers who choose to receive their payments in euros. These payments are worth around £408 million in 2010. Up until 2009 the Agency was not taking account of the euro payments in its hedging arrangements. It has now instituted a new hedging arrangement for payments to farmers who elect to receive funds in euros, and has removed euro denominated payments from its main hedge.

The Rural Payments Agency has brought in new expertise to improve its hedging arrangements

2.31 The Rural Payments Agency is taking action to learn from its previous experiences. It appointed Deloitte in October 2009, at a cost of £250,000 to help improve its accounting and management of its hedging arrangements. The consultants have provided advice on the hedging arrangements for 2010.

2.32 The Rural Payments Agency lacked clarity over the value of the payments it had made to and received from commercial banks that we reviewed, under the agreements it made between 2007 and 2009. A forward contract will incur a premium or discount over the current exchange rate which is in proportion to the interest differential between the home currency (the pound) and foreign currency (euro). Payments made to and from commercial banks are calculated based on interest rate differences between commercial rates. The Agency could not check whether the premiums had been correctly calculated between 2007 and 2009 because the agreement was not specific, and the bank did not provide supporting evidence for its calculations. It is difficult to verify the reasonableness of market prices retrospectively because they change each day, but we checked the rate obtained on two dates with the Bank of England and found the rates were roughly equivalent to historic data on market rates.

2.33 The Rural Payments Agency re-tendered its hedging arrangements to provide greater transparency. Under its previous arrangements the size and date of the Single Payment Scheme hedge became widely known and the transaction anticipated by the City. The Agency has been presented with evidence by its new commercial provider that private hedge funds have moved several billion pounds prior to the transaction. In 2010, on the day of the hedge, the value of the pound depreciated by 0.5 per cent against the euro. Under its new arrangements the Agency is introducing additional controls to enable it to monitor and independently verify the value of its forward contracts.

Part Three

Euro exchange rate risk management within government

Forward contracts helped to reduce the potential impact on the UK from euro movements

3.1 Exchange rate movements affect all departments with foreign currency transactions. The overall exposure of government funds to exchange rate movements depends on the balance and timing of inflows and outflows of foreign currency transactions. In addition to around £4.8 billion of funding received from the EU, the UK also has long-term spending commitments in euros, through the Ministry of Defence, the Department of Health, the Department for International Development, and the Foreign and Commonwealth Office. In 2009-10 the four departments spent the equivalent of around £3.7 billion in euros (**Figure 9**). In total the gross value of taxpayers' funds at risk is £8.5 billion.

3.2 The drawback of hedging is that it reduces the potential for gains in the same proportion. Planning is easier for government, however, if it has increased certainty over the level of funding available. Departments have less need to allow contingency for unfavourable exchange rate movements, reducing the risk that budgets are not fully used. Similarly, a reduced risk of a favourable exchange rate movement also reduces the likelihood that a department will need to spend a windfall quickly, and without due regard for value for money.

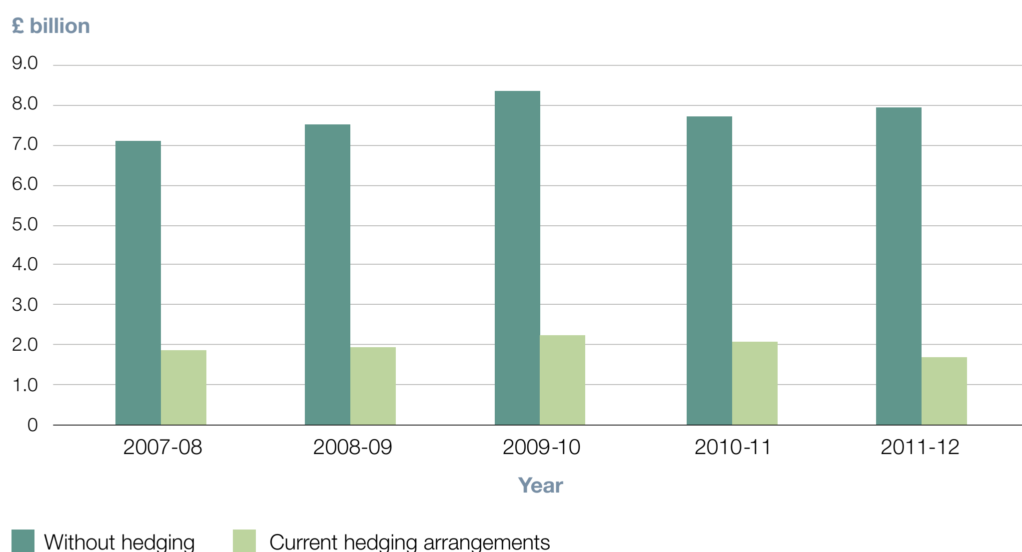
3.3 The use of forward contracts has helped to reduce the gross value of government funds which are exposed to exchange rate movements between the pound and the euro from £8.5 billion to £2.4 billion in 2009-10 (**Figure 10**). The cost of using forward contracts is relatively low, with charges determined by differences in interest rates between the currencies traded. Wider use of hedging, if effectively implemented, could further reduce the value of taxpayers' funds at risk.

Figure 9
Other departments complete euro transactions

Department	Overseas activities	Expenditure in 2009-10 (£m)
Defence	**Defence procurement** such as contributions to purchase of Eurofighter	2,200
Health	**Overseas medical costs** Settlement of healthcare claims for UK citizens in EU member states	815
International Development	**Official Development Assistance** UK contribution towards eliminating poverty in poorer countries, including the European Development Fund for people affected by humanitarian emergencies around the world	505
Foreign and Commonwealth Office	**Humanitarian and peacekeeping programmes**	215
	Total	**3,735**

Source: National Audit Office analysis

Figure 10
The use of financial instruments has reduced the value of taxpayers' funds at risk to exchange rate movements between the pound and the euro



Source: National Audit Office analysis of survey data

Departments are best placed to judge the particular exchange rate risks they face but successful management depends on the quality of forecasts

3.4 HM Treasury policy is that the Accounting Officer in each department decides the process for managing exchange rate risk faced by that department. HM Treasury considers that departments are best placed to judge the certainty of future transactions in relation to their budgets. It is for each department's governing body to make a considered choice about its desired risk profile, taking account of its legal obligations, policy decisions, business objectives, and public expectations.

3.5 Departments are taking different approaches to foreign exchange management. The Ministry of Defence has had hedging arrangements in place since 1986, while the Department of Health had a long standing arrangement for hedging from before 2000, which it revised and extended in 2008. The Department for International Development has sought approval from HM Treasury to use forward contracts from April 2011. Of the departments managing EU funds, only the Department for Environment, Food and Rural Affairs uses hedging instruments.

3.6 HM Treasury asks departments to bear the transaction costs of hedging. The budgeting framework does not provide specific advice on whether departments bear the impact of foreign exchange gains and losses because exchange rate gains and losses are deducted from Departmental Expenditure Limits or from Annually Managed Expenditure[8] according to the specific programme. In 2010-11 the Department for Environment, Food and Rural Affairs has been advised to recognise realised exchange gains and losses under its departmental budget while the Departments for Work and Pensions, and Communities and Local Government both recognise gains and losses as Annually Managed Expenditure. Where gains and losses are recorded in Annually Managed Expenditure the department will have no incentive to hedge, and since the costs of hedging fall under departmental budgets there is a perverse incentive not to hedge. In January 2011, HM Treasury circulated draft guidance to departments for consultation. The guidance proposes that gains and losses are charged to Departmental Expenditure Limits by default but allows departments to consult with HM Treasury if this is not appropriate or if hedging creates perverse incentives.

3.7 Departments also decide what proportion of their spending to hedge (**Figure 11**). Cost effective risk management depends on departments accurately forecasting their transactions to identify their foreign exchange exposure with the minimum of error. Departments opting to hedge typically hedge a proportion of spend to allow for uncertainty over the timing and the volume of transactions. All choose to hedge at least 80 per cent, leaving the remainder of transactions exposed. The more departments are able to improve their forecasting, the better they can protect taxpayers' funds from exchange rate movements. However, if forecasts are inaccurate then it may expose the taxpayer to more losses. The Department for Environment, Food and Rural Affairs hedges a higher proportion of its spending than other departments but it has incurred some £40 million of losses as a result of forecasting inaccuracy (see paragraphs 2.27-2.28).

8 Annually Managed Expenditure is borne by HM Treasury and not departments on the basis that it is beyond departmental control.

Figure 11
Departments choose to hedge different proportions of euro transactions

Department	Percentage of euro transactions hedged
Health	80
International Development	80
Ministry of Defence	86
Foreign and Commonwealth Office	90
Environment, Food and Rural Affairs	
• Single Payment Scheme	98.5
• Rural Development Programme	100

Source: National Audit Office

Government lacks detailed guidance for managing foreign exchange rate risk

3.8 HM Treasury is responsible for the *Managing Public Money* guidance which all departmental policies on foreign exchange management must adhere to. It expects departments to comply with the guidance in developing their foreign exchange management policies.

3.9 HM Treasury has provided limited guidance to departments on how to develop foreign exchange policy. The guidance sets out principle-based, high level responses to risk that should be considered within the context of cost, feasibility, probability and potential impacts. The principle-based approach allows departments to apply the guidance to its own circumstances, as each department is best placed to understand the specific risks it faces. Departments told us they would welcome a more detailed set of principles to guide their risk management in this area. We have suggested examples of guidance we would expect in **Figure 12** overleaf.

3.10 HM Treasury must approve any foreign exchange management policy that contains novel or contentious transactions. Theoretically departments could use any instrument with HM Treasury approval. The two main types of instruments departments can use in practice are currency forwards and currency options. Approval will only be granted if the approach meets the principles set out in *Managing Public Money*. Within HM Treasury, approval must be granted by the spending team for the relevant department, with oversight by the HM Treasury Officer of Accounts team. The Debt and Reserves Management team, which leads on matters concerning exchange rate management, provides advice as necessary. There is no mechanism in place to consider the foreign exchange management policies in place across the whole of government.

Figure 12
HM Treasury guidance for drawing up a foreign exchange management policy and National Audit Office examples of how the guidance could be implemented

HM Treasury outline of possible components of a foreign exchange policy	Examples of guidance the National Audit Office would expect
Outline the volumes and frequencies of foreign exchange transactions required by the organisation's business.	**Identification of foreign exchange risks** Identify the types of exchange rate risks the department is exposed to. These risks should be measured, taking account of the scale, the timing of risks and the potential financial impacts.
Develop a policy on dealing with receipts and payments; normally spot transactions.	**Develop a framework to assess foreign exchange risks** The framework will lead to the development of a foreign exchange management policy and should include the policy's objectives, the approach to appraising potential mitigation strategies, assessment against HM Treasury guidance and the process for securing HM Treasury approval. Key factors to be considered include cost effectiveness and the expertise required to implement.
The case for holding any sums in foreign exchange accounts, identifying any seasonal or other macro factors affecting amounts, preferably through the Government Banking Service where the facilities are available. The case for any hedging transactions designed to limit risk exposure, for example through forward purchases or options, with appropriate exposure limits.	**Implementation of foreign exchange management policy** The policy should outline the: **1** Practical aspects needed to execute the policy including: forecasting accuracy, hedging mechanisms, the costs of hedging, arrangements for recording and making payments between the department and the commercial provider, and accounting procedures related to foreign currency risk. **2** Considerations of the holding of EU fund advances in euro denominated accounts. **3** Development of a control framework to monitor exposure levels, including setting position limits for each hedging instrument. **4** Establishment of benchmarks against which hedging operations are judged.

Source: National Audit Office

There is less support available to the departments overseeing the EU funds than to other departments for implementing financial instruments

3.11 The Exchange Equalisation Account is a HM Treasury Exchequer Funds account which manages the UK's foreign currency reserves. It is managed on a day-to-day basis by the Bank of England (acting as an Agent to HM Treasury). Its remit includes:

- checking undue fluctuations in the exchange value of the pound;
- carrying out functions associated with the International Monetary Fund; and
- securing the means for making payments abroad.

3.12 Most departments can use the Exchange Equalisation Account to undertake foreign exchange transactions but the departments managing the EU funds are not able to use this resource. HM Treasury has not permitted EU fund associated transactions to be carried out through this account because:

- There could be legal difficulties in using the Exchange Equalisation Account in this manner. The Exchange Equalisation Account is a statutory account, and must be used for functions in the Exchange Equalisation Account Act 1979. These transactions do not fit within these statutory functions as they involve pounds only and their purpose is to hedge exchange rate risk.
- The large size and visibility of arrangements to hedge EU transactions could hinder the Bank of England in carrying out other core policy functions of the Exchange Equalisation Account.

3.13 Departments using the Exchange Equalisation Account have access to the expertise of the foreign exchange operations. Departments trade with the Exchange Equalisation Account itself, rather than the external market. Exchange Equalisation Account traders complete corresponding deals with external counterparties. In overall terms the Exchange Equalisation Account is in a neutral position because it seeks to remove foreign exchange risks by matching transactions in the market. The Exchange Equalisation Account selects the best rate available to it in the market at any one time. The Exchange Equalisation Account charges a spread between those rates and that charged to the departments just like a commercial provider, but the benefit accrues to the Exchequer rather than to the private sector. There is no opportunity to achieve a similar return on EU fund transactions.

3.14 The departments managing the EU funds are exposed to commercial risks which they would not face if they were able to use the Exchange Equalisation Account. Government departments, by trading with the Exchange Equalisation Account rather than the external market, have security and certainty over foreign currency trades and have limited exposure to operational and credit risks that would be associated with deals brokered with commercial markets. The departments managing the EU funds have little or no experience in negotiating hedging arrangements, are less familiar with the market, and do not have access to the same range of data on prices. Under current public sector arrangements, the departments would need to follow a competitive tender process to gain assurance over prices, which risks alerting commercial markets to their intentions before a deal is struck.

3.15 The Exchange Equalisation Account can and very occasionally has offsetting trades. The exclusion of EU fund transactions from its remit may restrict opportunities for offsetting government transactions.

Government has not sought to reduce risks and costs and improve expertise by working together

3.16 There is no cross-government group for departments to coordinate the management of their exchange rate risk. The lack of coordination has meant a pool of expertise on the subject has not developed over time within government. This has led to some duplication of effort as each department has individually assessed the options to mitigate exchange rate risk. Some departments undertake informal discussions. The Department of Health seeks advice from the Ministry of Defence, which it cites as the most experienced and expert of the departments. The Departments for Work and Pensions, and Communities and Local Government have liaised in considering their arrangements. The Department of Health told us it would welcome the establishment of a cross-government group, and that it would be keen to play an active role.

Alternative arrangements to manage exchange rate risk may not be practical

3.17 There are two other ways in which the value of taxpayers' funds at risk to euro fluctuations might be managed without recourse by individual departments to financial instruments. The Government could seek to:

a Self-insure by tolerating gains and losses on the basis that they will even out over time.

b Centrally identify and address net risk only, offsetting gains and losses which arise on inflows and outflows of government's euro transactions.

3.18 Self-insurance would rely on central government entirely taking on the exchange rate risk currently faced by departments. This would remove the need for departments to mitigate exchange rate risk either through hedging or through conservative budget planning. However, HM Treasury has concluded that self-insurance could expose the UK to large fiscal risks, while the foreign exchange market could in many cases, provide cost effective protection. It has not carried out a detailed comparison of the costs, risks, and benefits of the two approaches however.

3.19 As an alternative to self-insurance the Government could attempt to identify net foreign exchange risk to reduce the scale of hedging required using the commercial sector. There is no mechanism to offset gains and losses from within government. In 2008-09 for example, the Department for Environment, Food and Rural Affairs incurred a £167 million under-spend for Common Agricultural Policy payments because the euro strengthened. In the same year the Department for International Development incurred £110 million in additional costs to meet commitments made in euros[9].

3.20 The extent to which offsetting can be used depends on how closely exchange gains and losses on EU funds are correlated with gains and losses for departments spending in euros. Differences in the size of euro inflows and outflows, timing through the year, the length of budgetary commitments and the certainty of transactions mean that gains and losses may not be well correlated over time. Currency flows may not be evenly spread throughout the year so that inflows and outflows do not equally offset. In the case of the £2.7 billion Single Payment Scheme for example, some 80 per cent of payments are made in December. In most cases the gains and losses are unlikely to offset because EU fund transactions are settled within six months, while departments spending in euros such as the Ministry of Defence can have long-term commitments in excess of two years. The value of euro outflows does not exactly offset the value of inflows and so there would still be a requirement to approach commercial markets to manage the risk. Given these complexities and the need for hedges to be altered frequently, any savings in commercial fees may be outweighed by the additional administrative costs of accurately determining the net cross-government hedge requirement.

9 International Development Committee, *Aid under Pressure: Support for Development Assistance in a Global Economic Downturn* (May 2009).

Appendix One

Methodology

The methods we used to gather evidence	Purpose
1 Questionnaires to key organisations involved with EU funds: • Survey of the three departments responsible for EU funds. • Questionnaires to four departments completing significant foreign currency transactions. • Survey of HM Treasury.	To gain an overview of the risks affecting each fund and quantify the impact of exchange rate movements on each department.
2 Review of HM Treasury guidance by a leading economic expert, Professor Ronald MacDonald.	To better understand the guidance developed by HM Treasury to assist departments in managing the risk.
3 Walkthrough of processes and mapping of transactions undertaken for EU funds.	To gather quantitative and qualitative data on the value of transactions taking place and the processes involved in managing EU funds.
4 Interviews We conducted semi-structured interviews with departments responsible for EU funds, HM Treasury and the Bank of England.	To further explore survey responses and to better understand wider programme issues which need to be considered alongside exchange rate movements.

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