

Departments managing EU Funds

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

Methodology

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Study Scope

- 1** The report examines whether the Government is maximising the value of the European Union (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. In particular it focuses on:
 - Departmental decisions to hedge funding from the EU (Part Two); and
 - Euro exchange risk management within government (Part Three).
- 2** The National Audit Office developed criteria which need to be met in order for value for money to be achieved. The criteria are:
 - 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.
- 3** Departments with overall responsibility for the financial management of the main EU funds are the Department of Environment, Food and Rural Affairs, the Department for Communities and Local Government and the Department for Work and Pensions. The report examines the role of these departments in monitoring and managing the exchange rate risk.
- 4** HM Treasury is responsible for producing the *Managing Public Money* guidance which all departments must adhere to when developing an exchange rate management policy. The guidance applies to all departments, whether they are managing EU funds or carrying out transactions in foreign currencies. HM Treasury must also approve any exchange rate management policy which is considered novel or contentious.

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5 We collected evidence between August 2010 and January 2011. The key methodologies used were:

- Surveys completed by eight departments including, those departments responsible for EU funds (the Departments for Work and Pensions; Environment, Food and Rural Affairs; and Communities and Local Government); HM Treasury; and other departments that complete foreign currency transactions (the Departments for International Development, and Health, the Foreign and Commonwealth Office, and the Ministry of Defence).
- A walkthrough of the processes followed by departments in managing EU funds to collect transaction data for analysis.
- Semi-structured interviews with the departments.
- Review of the guidance issued by HM Treasury completed by Professor MacDonald, a leading exchange rate economist. Professor MacDonald is currently Adam Smith Chair of Political Economy at the University of Glasgow.

Survey of a range of departments

6 We surveyed the departments responsible for EU funded programmes. The aim of the survey was to:

- gather information on the value of funds managed;
- collect information on the timing of euro flows;
- understand the risk management procedures in place;
- understand how the performance of exchange rate risk management is monitored; and
- identify any cross-government sharing of expertise on the issue.

7 We asked government departments which make payments in euros to complete a survey to:

- identify the value and timing of euro transactions;
- understand the length of exposure to exchange rate risks; and
- understand the policies in place to reduce exposure to exchange rate risk.

Walkthrough of EU fund processes to collect transaction data for analysis

8 Our findings on the current arrangements for managing exchange rate risk are drawn from information collected during a walkthrough of the departments' processes and financial data. The data collected includes:

- forecasts of future expenditure;
- length of exposure between paying a recipient and receiving reimbursement from the EU;
- monitoring of exchange rate gains and losses;
- the cost of financial instruments; and
- information on the aims and objectives of the EU programme.

9 To supplement the data collected from departments we also drew on a number of existing reports including:

- *European Union Finances, 2010: Statement on the 2010 EU Budget and measures to counter fraud and financial mismanagement*, HM Treasury, 2010. This data provides an overview of the UK's contribution to the EU budget, EU funding receipts and the UK's abatement.
- Exchange rate information from the Bank of England's interactive database to provide evidence on exchange rate trends, volatility and a time series of values.

10 Using these data sources we were able to apply scenario analysis to examine:

- the impact of different exchange rate movements on EU funded programmes;
- the cost effectiveness of forward contracts for the Departments for Communities and Local Government, and Work and Pensions.

The Bank of England data sources can be found at: <http://www.bankofengland.co.uk/mfsd/iadb/Index.asp?first=yes&SectionRequired=I&HideNums=-1&ExtraInfo=true&Travel=Nlx>

Interviews with relevant departments

11 Between October and December 2010 we conducted semi-structured interviews with a range of staff at the departments responsible for EU funded programmes. We explored issues relating to the management of exchange rate risk; how performance of exchange rate risk management is monitored; options for reducing exposure; and whether expert input had been sought externally or from other departments managing exchange rate risks.

12 We discussed the exchange rate risk management of EU funded programmes with HM Treasury and the Exchange Equalisation Account. The Exchange Equalisation Account is responsible for managing the UK's foreign currency reserves. We explored the extent of their involvement with departments using financial derivatives.

Review of guidance issued by HM Treasury, to assist departments in managing their exchange rate risk, by a leading exchange rate economist

13 We reviewed the *Managing Public Money* guidance issued by HM Treasury to identify and understand the principles departments must adhere to when managing the risks arising from changes in the value of the euro.

14 We commissioned Professor Ronald MacDonald, a leading exchange rate economist, to consider the hedging arrangements in place to identify good practice for managing exchange rate risk within government.

15 We consulted PricewaterhouseCoopers about current exchange rate management practices in the private sector.