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Departments managing EU Funds

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

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.