NATIONAL AUDIT OFFICE BRIEFING FOR THE FOREIGN AFFAIRS COMMITTEE

MANAGEMENT OF EXCHANGE RATE RISK BY THE FOREIGN AND COMMONWEALTH OFFICE

Background

1. This briefing has been prepared for the Foreign Affairs Committee to provide an overview of the management of exchange rate risk by the Foreign and Commonwealth Office (FCO), in support of the Committee's enquiry into the FCO Departmental Report and Resource Accounts 2008-09.[1]
2. This briefing has been shared with the FCO and Treasury to ensure that the evidence presented is factually accurate, but the commentary and views expressed are the sole responsibility of the NAO.
3. In its Report on the FCO Annual Report 2007-08 the Committee concluded that:

   '*We are deeply concerned that as a result of the Treasury's decision to withdraw its support for the Overseas Price Mechanism, the FCO may not be able to meet the higher international subscriptions over the next two financial years unless it cuts its activities. We conclude that it is deplorable that the FCO should have to shoulder the financial burden from within its already tight budget to pay for subscriptions which also benefit other Government departments, and we recommend that additional non-discretionary costs should properly be met by the Treasury*'.[2]

4. The FCO responded that:

   '*We note the Committee's concern over HMT's decision to withdraw its support for the Overseas Price Movements mechanism and the recommendation that additional non-discretionary costs of international subscriptions which benefit wider HMG should be met by the Treasury. This will need to be considered in the next Comprehensive Spending Review (CSR). In the meantime we have put in place, with HMT agreement, a number of mitigating measures. These include forward purchase of our foreign currency requirements and agreement that the costs of*

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[1] *HC 460, Session 2008-09*

[2] *Para 214, Second Report of the Foreign Affairs Committee Session 2008-09, HC 195*

international subscriptions in excess of £102 million would be shared by the Treasury and FCO in the ratio 60:40.'[3]

5. Accordingly, this paper provides further background on:

   - the Overseas Price Mechanism;
   - the reasons why Treasury removed its support for this mechanism as part of the CSR 2007 settlement;
   - actions taken by FCO to mitigate the exchange rate risk;
   - related governance matters and skills within FCO;
   - the impact of foreign exchange rates on the financial results for 2008-09; and
   - FCO forecasts of the impact on FCO budgets and its business going forward.

   This paper draws upon interviews with Treasury and FCO staff, together with an examination of relevant FCO documentation.

The Overseas Price Mechanism (OPM)

6. FCO has a global network of 268 overseas Posts which help it to deliver its key objectives. Posts' budgets are set in sterling at the beginning of each financial year. Significant elements of the budgets are spent in the local currency and are affected by both local inflation rates and currency fluctuations, affecting in turn a Post's spending power during any financial year. The Overseas Pricing Mechanism (OPM) was designed to identify the effect of inflation and currency movements on local budgets.

7. Until 2007, FCO and Treasury used the OPM to maintain the local purchasing power of the Department's settlement through technical adjustments to the sterling settlement, to take account of changes to local purchasing power resulting from exchange and differential inflation rate movements. Every six months, the Department would calculate the impact of exchange rate movements and differential inflation rates on its purchasing power in over 160 countries in which FCO operates, and advise Treasury of the net outcome across

[3] *Response of the Secretary of State for Foreign and Commonwealth Affairs, April 2009, Cm 7585*

the Department's overseas operations. If the settlement would have resulted in greater local purchasing power than intended (because sterling's value had strengthened since the spending settlement), sterling was returned to Treasury. If additional sterling was needed to maintain local purchasing power (because sterling's value had fallen since the spending settlement), it was provided by Treasury. The annual adjustment was made from the Treasury Reserve in the Spring Supplementary Estimates each year. Figure 1 gives details of the annual OPM adjustments for the four years up until 2007-08, as made in the Spring Supplementary Estimates. This shows that in three out of the four years FCO transferred resources back to the Reserve.

Figure 1: OPM adjustments as reflected in the Spring Supplementary Estimates

Financial Year	Amounts of adjustment (£ million)	Claim from the Reserve or transfer to the Reserve
2004-05	-14.1	Transfer
2005-06	-4.9	Transfer
2006-07	-9.6	Transfer
2007-08	+1.4	Claim

Source: FCO Spring Supplementary Estimates

8. Treasury support to FCO under the OPM extended over a number of years, going back at least as far as the 1980s. This arrangement was unique to FCO as a tool to protect the Department from exchange rate movements.

Why was OPM removed by the Treasury as part of the CSR 2007?

9. As part of the 2007 CSR settlement, Treasury withdrew the OPM mechanism, as one of a package of elements within the settlement. In Treasury's view, whilst some of these elements were highly challenging (such as the required efficiency savings and withdrawal of OPM), other elements were to FCO's benefit, including substantial growth in the Department's capital expenditure limit and a cost sharing agreement with the Treasury for subscriptions to international organisations. In the Department's view, the increase in capital was provided to fund the increased costs of security across the network including those resulting from a personnel shift from Europe to the conflict zones, notably South Asia as well as the Middle and Near East and North Africa, to help fund a new Embassy in Kabul and to assist with the UK's share of UN and NATO Headquarters costs.

10. Treasury’s purpose in withdrawing OPM was to introduce what it saw as more modern methods of risk management. The Treasury faces many competing demands on the expenditure reserve it retains, so it has long been the Government’s policy to ask departments to bear the risk of predictable variations in expenditure in their Departmental Expenditure Limits (DEL). At the time of the 2007 CSR settlement, the Treasury considered it appropriate to extend this to include currency movements, particularly as there were risk management instruments commonly available in the financial markets, and historically the FCO’ s annual adjustment for currency variations had averaged out at around £10 million.
11. In general terms, Treasury has long recognised that some expenditure is subject to variation that is unpredictable and results in cost variations of a scale that cannot be managed within departments’ DELs, and these are scored against Annually Managed Expenditure (AME). FCO considers that the fluctuations in sterling since 2007 and the high proportion of its annual expenditure spent in foreign currencies should lead to foreign currency spend being classified as AME, rather than DEL. However, Treasury does not consider this spending is appropriate for AME, not least because it looks to FCO to factor in exchange rate changes as a part of resource allocation decisions.
12. FCO contends that in several areas of foreign policy priorities, such as the need to negotiate a climate change agreement or to respond to the terrorism threat, the risks and opportunities to the United Kingdom of doing business abroad, or choosing not to, do not change alongside rises or falls in foreign exchange rates.

Actions taken by FCO to mitigate the exchange rate risk

13. At the time of the CSR settlement, sterling was at a historically high point against the US dollar and euro. The Department’s budgets for the CSR 2007 period were agreed at assumed rates of £1 to 2.0143 US dollars and £1 to 1.4578 euros. An appreciation of sterling against the CSR rates would increase the spending power at Posts and also reduce the sterling costs of the Department’s contributions to international organisations. Depreciation against the CSR rates would reduce spending power at Posts and increase the sterling cost of the Department’s contributions to international organisations.

14. The Department began considering how to manage its exposure to foreign exchange risk immediately after receiving notification of the November 2007 CSR settlement, in which Treasury confirmed its intention to withdraw funding for OPM. At the FCO's request, the Treasury agreed in principle that the Department could adopt a forward purchase regime for the main currencies it needs. Between November and January 2008, staff attended workshops with banks to understand the various options available. The Department then began to assess its total annual exposure to foreign exchange risk.

15. The Department's objective in developing its proposals was to achieve as much budget certainty as possible, through buying foreign currency forward. Spending power would, though, still be reduced if foreign currency were to be purchased at any rate below the CSR assumed rates, and since then all forward and spot purchases have been significantly lower. For example, the average forward purchase rates secured for US dollars were $1.95 for 2008-09, $1.62 for 2009-10 and (to date) $1.52 for 2010-11. With the CSR rate at $2.0143, this has put considerable pressure on US dollar-based budgets. What neither the FCO nor the Treasury foresaw was the extreme volatility in foreign currency markets in the early part of the CSR period following the global financial crisis.

16. The FCO considered three main options for managing its net foreign exchange exposure:

    (a) continue to purchase at spot rates for all currencies as and when the currency is needed;

    (b) forward purchase 100% of its currency needs for the whole of the CSR period; or

    (c) forward purchase a significant portion of its major currency exposure (initially US dollars and euros), and purchase the remainder at spot rates as and when needed.

17. In February 2008, proposals were submitted to the FCO's Finance Committee, which finally approved option (c) and recommended the forward purchase of 80 per cent of the FCO's net US dollar and euro exposure for 2008-09. This percentage would allow for any incorrect profiling by budget holders and avoid any build up of unnecessary pools of foreign currency.

18. The FCO operates in over 120 local currencies around the world, with significant expenditure incurred in US dollars and euros. 27 currencies are

purchased by the FCO's Treasury Team in the UK, with the exposure in only 6 worth more than £4 million each per year (US dollar/euro/Japanese yen/Swiss franc/Canadian dollar/Hong Kong dollar) and 14 costing less than £2 million each per year. The FCO now includes Japanese yen in the currencies it forward purchases, but does not consider it cost effective to place forward contracts for the others, which it purchases at spot rates in the UK and sends to Posts. It should be noted that the majority of currencies the FCO uses cannot be purchased in the UK and continue to be purchased locally.

19. For the longer term, the Department considered a more sophisticated risk management strategy. In April 2008, the Department placed a contract with HiFX Intelligent financial services, a specialist Forex trade company, to provide, in exchange for a monthly fee, professional advice on the range of options available to the Department in managing its risk. HiFX recommended two hedging strategies; one for euro and one for US dollar. Both of these derivative based options were approved by the FCO Finance Committee on 14 April 2008.

20. However, HM Treasury has set out the main principles for dealing with resources used by public sector organisations in the UK in a document known *as Managing Public Money*. Paragraph 5.9.3 of Managing Public Money states that the Treasury 'will always refuse proposals to speculate'. The rationale is that providers of complex financial instruments intend to profit from their business and provide a cost of finance that is inferior to the UK government's cost of borrowing. Adhering to these guidelines, the Treasury would not sanction the more complex hedging proposals that had been put forward by the Department.

21. The Department then submitted proposals to the Treasury to purchase forward for up to 80 per cent of FCO's requirements for US dollars and euros for 2008-09. This was to include all foreign currency spend within FCO's DEL, including all international subscriptions and the Peacekeeping budget. Following a further period of negotiation and discussion, in May 2008, Treasury agreed this proposal and the Department placed its first contract on 28 May 2008.

22. In August 2008, Treasury agreed that FCO could proceed to enter into forward purchases to cover requirements for 2009-10. Mindful of the principles of Managing Public Money, the Department continued the practice that contracts for forward purchases of US dollars and euros would be placed on the 15th day of each month, with contracts entered into for a maximum of 12 months ahead. Monthly data on exposure to foreign currency risk would be derived from

detailed forward profiling spreadsheets that were maintained by FCO's Strategic Treasury Team. Figure 2 illustrates how FCO calculated the number of US dollars that they would forward purchase during 2008-09 for delivery in 2009-10.

Figure 2: Illustration of how the Department calculates the amount it purchases in a forward contract

The Department assessed the amount of total US Dollars required to meets its obligations under its three main expenditure sub-heads of (i) Peacekeeping and Conflict prevention, (ii) Contributions and Subscriptions to International organisations and (iii) Post funding as $932.1 million for 2009-10. This figure was used as the basis for determining the amount of US Dollars that would be secured in forward purchase contracts during 2008-09, maturing in 2009-10. A percentage of either 80% or 90% was then applied to each of the subhead requirements based on the degree of certainty over the amounts and timing. The total amount of US dollars required for 2009-10 is $819.1 million. In the event, the Department secured $811.6 million in forward contracts to be purchased during 2009-10.

Expenditure Subheading	**Estimated US Dollar requirement**	**Percentage applied**	**US Dollars required for 2009-10**
Conflict Prevention & Peacekeeping	537.2	90%	483.5
International Subscription	197.0	90%	177.3
Post funding	197.9	80%	158.3
Total requirement	**932.1**		819.1

Source: FCO management information

23. In December 2008, as expertise within the FCO and the Treasury's confidence in them grew, the Department developed proposals to modify its initial strategy to one based on a 'horizontal layered' approach, in order to counter the increased volatility of the foreign exchange markets. The strategy involved purchasing, each month, one year ahead 1/12th of each of the following 12 months' exposure. The two benefits of this proposal were presented as (i) greater budget certainty, sooner and therefore improved forward planning and

(ii) improved risk management, by spreading the risk of sudden changes in exchange rates.

24. Both Treasury and the FCO Finance Committee approved this 'horizontal layered' strategy and the first purchase, including a "catch-up" forward purchase, was made in December 2008. HiFX continues to provide the Department with weekly advice on available trading options.

25. In terms of management information, the Director of Finance receives monthly updates on the currency forward purchases. Within the Monthly Key Performance reports presented to the Board, there is a one page high level summary on forward purchases. For each currency purchased, this includes the period covered by the last contract placed and the foreign currency value and the sterling equivalent of that contract, together with the total value of contracts entered in the CSR period to date and the total realised and unrealised gains and losses in the financial year.

26. In June 2009, the Department sought and Treasury gave it permission to forward purchase into the next CSR i.e. from 1 April 2011 onwards. Until this point all of the Department contracts had been up to 31 March 2011. The rationale behind this continues to be a non-speculative strategy with the objective of achieving budget certainty.

Governance and skills

27. Both FCO's Director General Finance and Director of Finance are finance professionals who understand the mechanics of making forward purchases of currency. FCO already had plans to enhance its treasury management function before the withdrawal of the OPM and, in February 2008, appointed a new Head of the Treasury Management Team. The Department did not plan to recruit any additional staff specifically to arrange the forward purchases, but did plan to provide focussed training when required to those personnel involved in administering the contracts. The majority of the training has therefore been on the job. This has not been problematic given the relatively straightforward forward purchase arrangements which the Department is dealing with.

28. Although there were some significant senior staff costs incurred in the early stages of setting up the arrangements for placing forward purchase contracts, FCO considers that the on-going in-house staff cost to maintain the spreadsheets and place a call to the Bank of England once a month to be

relatively small. FCO continues to pay HiFX a monthly fee for professional advice in this area. However, the Department considers the indirect costs of managing the broader consequences of the withdrawal of the OPM have been far greater with a considerable amount of senior management time, including that of the FCO Board, Heads of Mission and Management Officers, taken up in managing the impact of currency fluctuations.

29. In September 2009, a firm of external consultants, commissioned by the Director of Finance, completed a review of FCO's foreign currency management arrangements. The review team were also asked to propose a potential foreign exchange management framework. The report concluded that progress had been made in a number of areas but that there was a need to produce a formal document of policies and procedures. The review team noted that a formal Treasury policy was being drafted, to include objectives, policies, instruments, limits, timelines, roles and responsibilities, as well as specifying controls and segregation of duties. In addition to the Policy document, the review team recommended that a Treasury Procedures Manual should be prepared which contained detailed step by step descriptions of the forward purchase process.

Impact of foreign exchange rates on financial results

30. In September 2008, the Chief Secretary to the Treasury agreed to FCO drawing down End of Year Flexibility (EYF) of some £15 million to compensate for adverse currency movements. However, the full year pressure of the decline in sterling was around £100 million (some five per cent of the total budget of some £2 billion). FCO therefore had to look for efficiency savings beyond those planned in the CSR to live within its DEL. In the event, FCO did not need to draw the full EYF because of foreign exchange gains made against early currency purchases and being able to utilise identified under-spends, as part of improved financial management under the Five Star Finance Programme. It ultimately drew down some £6.5 million and stayed within its DEL budget for 2008-09 [4].

[4] *Note 2 of Resource Accounts, Volume Two, Page 122*

31. The 2008-09 Resource Accounts[5] detail the forward purchases entered into by FCO during 2008-09. The Department purchased 559 million US dollars and 102 million euros, which were delivered at a cost of £367 million. Due to the weakening of sterling over the course of the year, these purchases resulted in a realised net exchange rate gain of some £43.6 million. The Operating Cost Statement[6] was credited with an overall net gain of some £40.8 million, after taking account of gains and losses on other currencies.

32. The 2008-09 Resource Accounts [7] also show forecast unrealised gains of some £89.4 million on forward purchases maturing after the balance sheet date, based on the actual exchange rates at 31 March 2009. Since that date, forward purchases have been extended as far as November 2011, while others have matured. As at 18 November 2009, FCO forecasts a net gain of some £30.2 million on forward purchases maturing during 2009-10, as illustrated in Figure 3 below.

Figure 3: Forecast position on forward purchases maturing during 2009-10

FCO forecast position on forward purchases	Gain/(loss) £ million
Realised gains/(losses) on forward purchases maturing between 1 April 2009 and 18 November 2009	43.4
Unrealised gains/(losses) on forward purchases maturing between 19 November 2009 and 31 March 2010	(13.2)
Total forecast gains/(losses) on forward purchases maturing between 1 April 2009 and 31 March 2010	**30.2**

Source: FCO management information (unaudited)

33. As at 20 November 2009 and since the start of forward purchases, the Department has purchased a total of 1,177 million US dollars and 236 million euros, delivered at a price of some £844 million, resulting in an overall estimated net gain to date of some £88 million (unaudited). Forward purchase contracts for 1,238 US dollars and 320 million euros, costing some £1,107 million, will mature between December 2009 and November 2011, with a forecast loss of £48 million.

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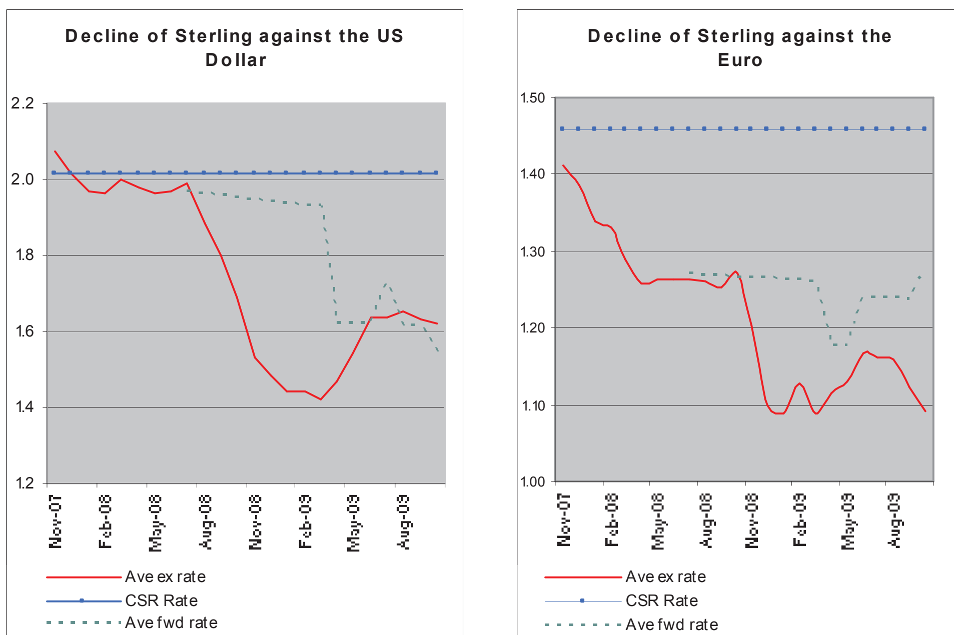
[5] *Note 29 of Resource Accounts, Volume Two, Pages 149 to 151*

[6] *Note 8 of Resource Accounts, Volume Two, Page 127*

[7] *Note 29 of Resource Accounts, Volume Two, Page 150*

34. Figure 4 shows the decline in Sterling against the US dollar and euro since 2007, set against the assumed rates which underpin FCO's CSR settlement and average rate of forward purchases. As sterling has always been below the CSR assumed rates (Paragraph 12) since the beginning of the CSR period, even the forward purchase contracts which appear to deliver gains actually represent a reduction in the Department's purchasing power compared to that agreed in the settlement.

Figure 4: The decline in Sterling against the US Dollar and Euro Nov 2007 - October 2009



Source www.x-rates.com and FCO management information

Impact of exchange rates on FCO for 2009-10 and beyond

35. Several government departments and agencies, including the Ministry of Defence (MoD), Department for International Development, the British Council and the Department of Health do transact some of their business in foreign currency. MoD has been using forward contracts for approximately 20 years, placing quarterly contacts, up to about five years in advance, to cover a schedule of fixed-date payments in US dollars and euros for major capital projects. However, the proportion of its contracts as compared to its overall DEL is considerably less than that of the FCO. FCO has a much smaller DEL, compared to MoD, and about half of FCO's expenditure is in foreign currency,

making it much more challenging to absorb gains and losses. Much of the foreign currency spend is non-discretionary, for example, subscriptions to international organisations, contributions to UN Peacekeeping which are legal obligations set in foreign currency, local staff salaries, rents and other contractual obligations.

36. A number of factors will increase the amount to be spent in foreign currency in 2009-10 and beyond, such as increasing contributions to UN Capital projects and international subscriptions to NATO. The UK government's contribution to Peacekeeping missions has also risen due to increased activity through the UN and the European Union. The forward purchase contracts entered into during 2009-10 are on less favourable rates than those entered into during 2008-09. As a result, during 2009-10 there will be a larger difference between contract rates and the Department's budget rates which were set in December 2007, with a resultant larger gap in budget and reduced purchasing power.

37. The withdrawal of the OPM and the subsequent fall in the value of sterling has had a major impact on the FCO's business worldwide. FCO estimate that from funding of some £830 million for what it considers its core activities[8], the Department has to cope with exchange rate pressures of some £100 million in 2009-10 on budgets where some 80 per cent of Posts' costs are considered to be inflexible in the short term, for example staff salaries, rents and other contractual obligations. Measures taken by Posts to stay within budget include reducing the working week to four days or requiring involuntary unpaid leave for some locally employed staff and embarking on a redundancy programme for others.

38. In addition, FCO told us that it has had to reduce provision for: security abroad; health and safety, including over 50 per cent of essential works in the difficult environments of Africa; and current and future capability. This, in its view, is severely impacting on its ability to deliver frontline diplomacy and has led to wide-ranging cuts to programmes supporting international priorities, including counter-terrorism.

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[8] FCO budget information