HM Treasury

Guidance for the Management of Foreign Exchange Exposure

March 2023

HM Treasury

Guidance for the Management of Foreign Exchange Exposure

March 2023

© Crown copyright 2023

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

This publication is available at: www.gov.uk/official-documents.

Any enquiries regarding this publication should be sent to us at public.enquiries@hmtreasury.gov.uk

Contents

Chapter 1	**Introduction and scope**	**6**
Chapter 2	**Key requirements and the FX Approval Framework**	**9**
Chapter 3	**Developing an FX strategy**	**19**
Annex A	**Glossary**	**27**
Annex B	**FX policy document template**	**30**

Chapter 1
Introduction and scope

1.1 Foreign exchange (FX) risk is a complex area that requires specialist expertise not typically embedded across the public sector. Exchange rates are volatile, and Accounting Officers will want to consider how they manage their FX exposure. There are circumstances when a public sector organisation may consider using financial instruments, and Accounting Officers must ensure there is a clear rationale for using them and that they provide value for money while also ensuring the regularity of spending. The government has developed this guidance to support those Accounting Officers and strengthen the management of FX risk across government.

1.2 This document provides support and guidance for departmental bodies exposed to FX risk. It sets out the requirements for how FX risk should be managed and for HM Treasury approvals. It is to be read alongside Managing Public Money [1] (MPM) and Consolidated Budgeting Guidance [2] (CBG) and the Budget Holders Forecasting Handbook[3]. It introduces a new FX Approval Framework and new FX Advisory Board.

1.3 All departmental bodies subject to MPM must comply with this guidance and key requirements including the FX Approval Framework from 1st April 2023. Any departure from these requirements must be agreed in advance in writing with HM Treasury.

1.4 Departmental bodies should read this guidance if they have FX transactions, assets and liabilities impacted by exchange rates or foreign currency balances.

Aim of the guidance

1.5 This guidance has been developed to assist departmental bodies to understand and manage FX risk, determine an appropriate strategy, and in the preparation of their FX policy document.

---

[1] See Managing Public Money at https://www.gov.uk/government/publications/managing-public-money

[2] See Consolidated Budgeting Guidance at https://www.gov.uk/government/collections/consolidated-budgeting-guidance

[3] See the Budget Holders Forecasting Handbook at https://www.gov.uk/government/publications/budget-holder-forecasting-handbook/budget-holder-forecasting-handbook

1.6 This document provides practical guidance on:

- understanding the FX Approval Framework and mandatory requirements
- determining what may be considered a hedge and when it may be appropriate to use financial instruments to manage risk
- designing an appropriate FX strategy

1.7 Queries regarding this guidance, FX Approval Framework or FX Advisory Board should be sent to: FX_AdvisoryBoard@hmtreasury.gov.uk.

Responsibilities

1.8 This section sets out the responsibilities relevant to the management of FX risk.

Accounting Officers

1.9 Accounting Officers are accountable for their organisation's budget and FX risk management. In support of that, they can draw on: MPM, this FX guidance, the FX Advisory Board, HM Treasury, the Bank of England, and Government Banking. Their responsibilities include:

- designing and implementing their department's FX policy document
- identifying and monitoring their transaction exposure and risk tolerance
- managing risk accordingly, with approved instruments and counterparties
- managing the funding and operation of their foreign currency bank accounts
- reporting on all aspects of FX exposure as part of their normal financial reporting

HM Treasury

1.10 HM Treasury's (the Treasury) responsibilities include:

- updating MPM on cash management policy including FX transactions
- issuing guidelines for the management of FX risk within government
- approving departments' FX policy documents

- approving the opening of bank accounts with commercial entities
- issuing instructions regarding the terms and conditions under which bank accounts may operate
- approving FX transactions

Bank of England

1.11 The Bank of England (BoE)'s responsibilities include:

- managing the UK's official gold and foreign currency reserves on behalf of government
- providing FX payment services to the government on request
- executing G10 FX spot transactions above £2 million on behalf of departments
- FX forward contracts, where requested by the department

Government Banking

1.12 Government Banking (GB)'s responsibilities include:

- facilitating departments' FX transactions (spot transactions above £2 million forward transactions of any value) through the Bank of England when requested by departments
- supporting departments' FX spot transactions under £2 million through contracts and services provided by commercial banks

FX Advisory Board

1.13 The FX Advisory Board (FAB)'s responsibilities include:

- supporting departmental bodies on the development and application of their FX risk management strategies, including providing advice on demand and proactively on transactions within scope
- reviewing departmental FX risk across the whole of government and improving the management of FX risk that the government is exposed to at a departmental level, via regular reviews within departmental bodies, and ad-hoc assessments of large transactions
- giving assurance to inform the Treasury's approval of FX transactions and FX risk management strategies of departmental bodies in accordance with MPM and this FX guidance

Chapter 2

Key requirements and the FX Approval Framework

2.1 This chapter sets out:

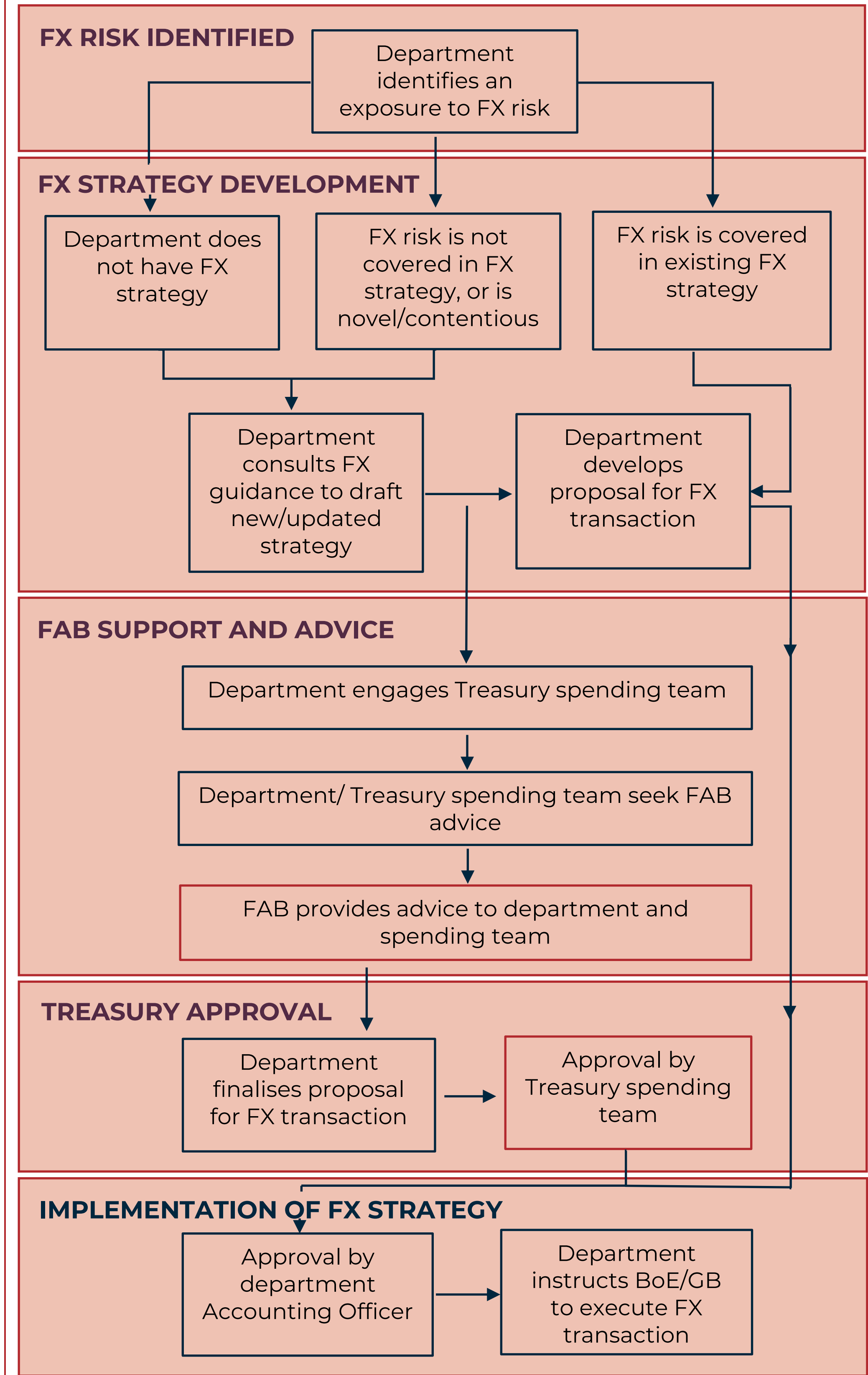
- the FX Approval Framework
- the FX Advisory Board
- the mandatory requirements for departments

2.2 The mandatory requirements apply to all departmental bodies with FX currency needs. The use of complex types of financial instruments to manage FX risk such as hedging instruments and forward contracts requires Treasury consent. Paragraphs 2.5 and 2.6 set out when it will need to seek Treasury approval and paragraphs 2.12 to 2.16 set out when it will need to obtain an opinion from the FX Advisory Board (FAB). The FX Approval Framework clearly sets out how this should be done, as shown in Box 2.A. The FAB is also there to support departmental bodies and strengthen the management of risk in an area of complexity across government.

FX Approval Framework

2.3 The FX Approval Framework sets out when departmental bodies need to engage with Treasury and the FAB on the use of financing techniques in relation to FX transactions and balances that expose the government to risk.

Box 2.A FX Approval Framework



Requirement: Treasury consent

2.4 A departmental body should consider spot transactions for FX transactions by default. The use of more complex types of financial instruments may need the explicit consent of the Treasury. Accounting Officers should be aware that the use of more complex financing instruments to hedge might not be the cheapest option for the exchequer as a whole, compared to departments and ALBs absorbing volatility risk within their budgets. However, such transactions can support the Accounting Officer in ensuring the regularity of spending. This could arise, for example, if a significant portion of their budget is subject to foreign exchange value fluctuations and volatility.

2.5 Treasury consent is required if:

1. The proposed transaction is novel, contentious, or repercussive in accordance with MPM, which includes:
    a) Entering a forward contract where there is no existing FX strategy
    b) Setting up the functionality to be able to do forward contracts
    c) Any spot transactions outside of Government Banking contracts
    d) Any financial instruments (including forward contracts) arranged through commercial providers
    e) Any financial instruments that are not spots or forward contracts such as options
2. The Value at Risk (VaR) is above the departmental delegated authority limit.
3. A FX policy document when developed for the first time must be approved by the relevant spending team in the Treasury following advice of the FAB, and if there are substantial changes to it or a material departure from it.

2.6 Treasury consent is not required for:

1. Spot transactions carried out within Government Banking – but they must be reported in accordance with paragraphs 2.41 onwards.
2. An FX transaction in accordance with an existing FX policy document which is reviewed annually by the departmental body and appropriately covers the FX transaction.
3. FX transactions that are part of the normal course of business and part of a department's business model which has been authorised by parliament as within the department's ambit. "Normal course of business" is defined in Box A5.4A of MPM. For example, entering FX

forward contracts needs to be part of the normal course of business for this exemption to apply.

2.7 If there is uncertainty about whether these exemptions apply, it should be confirmed by the Treasury spending team.

2.8 Note that spending teams and the FAB reserve the right to scrutinise significant or new FX risks. They will be subject to the usual spending controls and MPM, so may be scrutinised by the spending team as with other spend. New transactions may be reviewed by the FAB in the context of reviewing a department's FX policy document.

2.9 The mandatory requirements for FX risk management are set out in Box 2.B below. The reporting requirements set out in paragraph 2.41 onwards need to be complied with, whether Treasury consent is required or not.

2.10 Departmental officials should engage with their spending team in the first instance to obtain Treasury consent.

2.11 The Treasury spending team will be guided by the recommendations of the FAB in its decision whether to give Treasury consent. This decision is likely to reached within 5 working days after receipt of the Board's recommendation.

Requirement: FX Advisory Board (FAB) opinion

2.12 Where a departmental body has material FX risk and is required to get Treasury consent, it must also obtain an opinion from the FX Advisory Board which provides advice and assurance on the management of FX risks from a market and operational perspective and that the proposed FX transactions and strategies are in accordance with this FX guidance.

2.13 A departmental body can seek initial advice from the FAB to help it develop an FX policy document or proposal for an FX transaction. The FAB is there to provide FX expertise and strengthen risk management.

2.14 Departmental bodies should engage with the FAB as well as their Treasury spending team in the design of any new FX exposure to ensure risks are properly understood and managed. Engagement with the FAB should come as early as possible in the design phase, ahead of seeking Treasury approval.

2.15 Departments should get advice from the FAB before seeking external consultants. Consultancy expenses for FX advice should not be incurred until advice has been sought from the Board on the application of this FX guidance.

2.16 By providing an opinion, the FAB gives advice and assurance regarding the effective and efficient management of FX risk. It is not binding but will inform the decision by the Treasury spending team on whether to give Treasury consent and should inform the approval given by the department's Accounting Officer.

2.17 You can contact the FAB on FX_AdvisoryBoard@hmtreasury.gov.uk .

FX Advisory Board

2.18 Given the complex nature of FX risk and the need for appropriate skills and expertise to manage this risk effectively, the government has set up a new advisory board, the FX Advisory Board.

2.19 The FAB has been established to provide support and assurance to UK government departmental bodies on the management of risk arising from FX transactions and/or foreign currency balances, and to inform the Treasury's understanding of the resulting fiscal risk that the UK government is exposed to.

2.20 It comprises FX experts from the Bank of England and Government Banking as well as the Treasury to provide advice and assurance on the management of FX risks from a market and operational perspective. The FAB will consider matters brought to its attention and proactively review FX strategies of departmental bodies to inform and improve management of the government's total FX risk exposure. Treasury officials may also consult with the FAB, drawing on its expertise to inform the Treasury's approval of FX transactions in accordance with MPM. The FAB may write to an Accounting Officer outlining its advice but any final decisions remain the responsibility of a departmental body's Accounting Officer.

Specific Responsibilities of the FAB

2.21 The FAB has 4 key responsibilities:

1. Advising departmental bodies and the Treasury on the development and application of their FX risk management strategies, and giving assurance to inform the Treasury's approval and oversight over FX transactions and strategies of departmental bodies in accordance with MPM and the FX guidance.

2. Reviewing the stock of pre-existing FX strategies – conducting regular reviews and ad hoc assessments of large transactions.

3. Reporting on the management of departmental FX risk across government.

4. Promoting best practice across government – supporting training and outreach events, giving views on the Treasury's work to improve FX risk management across government, including this FX guidance. It may also issue further guidance on best practice, for example on setting FX budget rates.

Scope of the FAB

2.22 The FAB provides advice and assurance, but final decisions on transactions remain with the Accounting Officers of departmental bodies.

2.23 Its advice is given within the constraints of MPM and this FX guidance.

2.24 The group is focused solely on activity related to foreign currencies. Any other hedging activity (commodities, interest rate etc) is not within scope. However, it may include other risks such as credit and counterparty risk.

2.25 The FAB will not take or provide views on the outlook for exchange rates on which current market rates provide the best guide.

2.26 The FAB will meet on a monthly basis to provide, in particular, advice and assurance to departmental bodies and Treasury officials in response to queries as they arise. It may also deal with urgent matters by correspondence. The FAB will conduct a strategic review regularly when it will also consider the management of departmental FX risk for the government.

Mandatory requirements

2.27 There are mandatory requirements that departmental bodies need to follow in managing FX risk, set out in the box below.

Box 2.B Mandatory requirements for departmental bodies

1. Departments should always consider spot transactions and do not need Treasury consent if they are carried out within Government Banking.
2. Consent for FX transactions other than spots must be obtained from Treasury in accordance with paragraph 2.5.
3. Where Treasury consent is required, an opinion must also be obtained from the FAB in accordance with paragraphs 2.12 onwards. Consultancy expenses for FX advice should not be incurred until advice has been sought from the FAB.
4. Departmental bodies exposed to material FX risk must have a FX policy document setting out their FX risk management strategy. It must be reviewed annually by the department and at least once by the FAB. See Chapter 3.

5. For all forward contracts of any value and all spot payments in G10 currencies[4] with a value greater than £2 million equivalent, the Bank of England must be used. If using forward contracts, they should be arranged as soon as possible to optimise their benefits.
6. For FX transactions under £2 million equivalent, and non-G10 currencies over £2 million, Government Banking contracts and suppliers must be used for banking services.
7. Incoming foreign currency over £2 million equivalent should be received through the Bank of England.
8. Bank balances (sterling or non-sterling) should only be held in Government Banking, unless prior Treasury approval has been given, in accordance with paragraphs 2.31 and 2.32. Non-Government Banking commercial holdings and transactions require approval from the Treasury and their values must be reported regularly.
9. Foreign currency balances should be minimised, as set out in paragraphs 2.33 to 2.35.
10. Before agreeing foreign currency liabilities, purchases and other contracts in sterling, check if there is an FX risk premium that will be passed on at a greater rate than achievable by the Bank of England.
11. Departmental bodies are not permitted to speculate. They should not attempt to anticipate FX movements and try to "beat the market". It is not the intention of Parliament that voted exchequer funds are used to make profits or savings by trading currencies.
12. Departmental bodies are required to consider budgetary controls and value for money. Accordingly, avoid buying or selling FX options, other than in exceptional circumstances, as options are usually expensive, carrying a risk-based premium.
13. While the Bank of England can help with G10 currencies, where possible, avoid using currencies other than sterling, US dollars or euros as markets in other currencies are less liquid.

---

[44] Refer to the Glossary for a list of the G10 currencies

Requirement: Use of the Bank of England

2.28 Departmental bodies must use the Bank of England (BoE), as agent for the Treasury, for:

- Spot transactions in G10 currencies that are greater than £2 million equivalent
- All forward transactions, and
- Incoming foreign currency over £2 million equivalent.

2.29 To transact with the BoE, please approach Government Banking who manage the BoE's transactions operationally.

2.30 Utilising the BoE provides many benefits to departments. The BoE is cost-effective and able to access competitive margins and prices for government bodies, it reduces credit risk, and it doesn't require collateralisation for forward contracts.

Requirement: Government Banking bank accounts

2.31 All bank balances (sterling or non-sterling) should be held in Government Banking bank accounts unless prior approval from the Treasury has been given. High balances held at commercial banks represent large, unsecured risk to departments and government and reduce exchequer funds available to the Debt Management Office.

2.32 Non-Government Banking commercial holdings and activity (including FX holdings, alternative hedging and derivatives) require approval from the Treasury and their values must be reported to the Treasury regularly as set out in paragraphs 2.41 onwards.

Requirement: foreign currency balances

2.33 Foreign currency balances should be minimised and may be subject to scrutiny by the Treasury and the FAB. Departmental bodies should reduce foreign currency balances as much as possible.

2.34 Holding foreign currency balances is not advisable because: departments may not receive interest on any foreign currencies held; their value is volatile; they give rise to translation risk and increase credit risk through exposure to the counterparty with which they are held; and they reduce the sterling held at the BoE available to the exchequer. Translation risk refers to the effect of fluctuations in exchange rates on financial statements, which crystallises as gains or losses impacting voted budgets and the entity's (and the exchequer's) financial position.

2.35 Sometimes foreign currency balances must be held due to programme or legislative requirements (eg requiring a department to pay or accept payments in euros). The department should get approval from the Treasury and report balances to the Treasury with other cash balances. Euro and US dollar balances held are reported to the FAB.

Setting budget rates

2.36 Budget FX rates are used in the budget process and should be linked to market rates, not departmental forecasts or predictions, at the expected dates of the future exposures. Accounting Officers should set appropriate budget rates commensurate with their best estimates of future foreign currency needs and their ability to manage their FX exposures and live within their budgets.

2.37 Budget FX rates will equal the forward exchange rate where a forward is in place.

2.38 For amounts subject to spot rates, currently departments are setting budget FX rates in a variety of ways, deriving them based on spot rates or forward rates. Further support from the FX Advisory Board and the Treasury will be issued, setting out best practice and practical advice to departments on how to transition to it.

2.39 A budget FX rate should be refreshed when a budget is updated for decision-making purposes, as a departmental body deems appropriate. This may be quarterly. Where transactions occur frequently or the amount is a significant portion of a departmental body's budget, given FX rates are volatile, budget FX rates may need to be refreshed more frequently to check the impact of exchange rate volatility on budget control totals.

2.40 Refer to the Consolidated Budgeting Guidance[5] for scoring and budgeting.

Reporting

2.41 Departments are required to provide quarterly reports of all bank balances within commercial accounts – this includes detailing the US dollar and euro balances, as well as other foreign currency. US dollar and euro balances are specifically required as well as sterling equivalent of all foreign currency. This is provided to the Exchequer and Funds Accounts (EFA) team in the Treasury, in line with MPM.

2.42 Departments should comply with the cash reporting requirements in MPM in Annex 5.6 'Banking and managing cash'. This includes reporting:

- forecast cash flows with detail within agreed timescales – noting that the Treasury can financially penalise poor forecasting and reward good forecasting. Further details on the cashflow management scheme are available from the Treasury EFA team, at cashman@hmtreasury.gov.uk
- major cash flows even if a definite transaction date has not been agreed

---

[5] See Consolidated Budgeting Guidance at https://www.gov.uk/government/collections/consolidated-budgeting-guidance

- if payment or receipt settlement dates are moved even if this is outside normal deadlines

2.43 Additional reporting requirements may be introduced requiring departmental bodies to report identified but uncovered FX risks. Further guidance will be issued before introducing any additional requirements.

2.44 For internal purposes, departmental bodies should produce reports which enable them to understand their transactional exposure consistent with their FX policy document, where relevant, and for periods appropriate to the volume of transactions and/or size of exposure.

Chapter 3
Developing an FX strategy

3.1 This section covers

- developing an FX strategy
- identifying market risk
- setting and monitoring FX risk tolerance
- different strategies to manage FX risk

3.2 Included in Annex B is an FX policy document template.

Developing an FX strategy

3.3 All departmental bodies exposed to material FX risk must have an FX strategy in place. They are required to produce an FX policy document setting out their FX management strategy. This will also support the disclosure requirements regarding risk under accounting standards. Accounting Officers are responsible for its development and implementation in accordance with these guidelines.

3.4 It must be approved by the Accounting Officer of the department, and by the relevant spending team in the Treasury following advice of the FX Advisory Board. Once an organisation's FX policy document has been approved, adherence to it by that organisation will be mandatory.

3.5 Annex B has an FX policy document template which provides an example of best practice. Departments should refer to it when reviewing or developing their FX policy documents. They should ensure that their policy document includes the same considerations as covered in that template.

3.6 In interpreting these requirements, an FX strategy must be commensurate with a department's scale, tolerance for risk, and complexity of financial instruments used to manage FX risk. Where a departmental body does not have material FX risk, it may choose to have a scaled down FX strategy limited to identifying and measuring it.

3.7 This FX guidance should help departments on the development of their FX strategy if they don't have one in place. If further advice is needed, the FAB can provide departments with further support and assurance.

3.8 Departmental bodies must review their FX strategy annually and if their FX risk changes materially to assure themselves that it remains appropriate.

3.9 Departmental bodies exposed to material FX risk should also seek the support of the FAB to review its strategy at least once. The FAB can draw on best practice and its FX expertise to give departments advice to strengthen a policy document and give assurance that it is appropriate.

3.10 The FX policy document must include:

- foreign exchange policy objectives
- accountabilities and responsibilities
- foreign exchange risk faced by the department
- process for identifying FX risk
- management of FX risk – including defining tolerance of FX risk
- management of other associated risks, eg credit risk
- budgeting and accounting

3.11 There are 4 key steps to risk management that departments should employ where foreign currency needs exist. Departmental bodies should strive to:

1. Identify - build a thorough view of forthcoming foreign currency payments/receipts, size and timing.
2. Measure - budget for those payments, the scale of risk to budgets, and monitor risk against risk tolerance.
3. Manage - if risk exceeds the acceptable risk tolerance, manage, or reduce it in a way that is value for money.
4. Report - report to the Treasury including total FX risk exposures.

Identifying market risk

3.12 FX transactions give rise to market risk. Market risk is the principal type of foreign exchange exposure which departments face. It refers to the effect a change in foreign exchange rates would have on the size of the cash flow in one currency necessary to settle a given cash flow in another currency.

3.13 The cash flow exposures may be direct or indirect. Direct exposures are identifiable cash flows which require an FX transaction to be undertaken, eg a purchase of goods from overseas. Indirect exposures reveal no explicit requirement but incorporate a hidden FX

component which may affect pricing and costs, eg transportation costs associated with the purchase of goods from overseas.

3.14 There are other risks which should also be considered, such as translation risk which arise from the volatility of exchange rates affecting the value of assets and liabilities reported in an entity's financial statements.

Setting and monitoring FX risk tolerance

3.15 Departmental bodies should follow a risk-based measure to monitor their FX risks. One approach to setting and monitoring FX risk tolerance is set out below to illustrate how this could be approached.

3.16 Step 1: Identify risk tolerance and objectives

When developing FX policies, identify the tolerance of market risk and risk management objectives. This might be expressed as a percentage of the budget and/or an absolute value. This should be included in the FX policy document.

3.17 Step 2: Value at Risk identification and measurement

Identify the FX exposure and quantify the potential impact of exchange rates on the budget/financial position. Calculate the Value at Risk, how much is likely to be lost if exchange rates moved say 1%. Value at Risk sets out the maximum likely loss based on the amount at risk for a given period at a given level of confidence.

3.18 Step 3: Implement your FX risk management strategy

Consider the different strategies to manage FX risk (see the section below), evaluating them against the risk tolerance and objectives set out earlier. Then implement.

3.19 Step 4: Monitor performance

Continue to assess whether the FX exposure remains below the acceptable risk tolerances.

3.20 The FX Advisory Board and Treasury will continue to review best practice and may issue further support and practical advice to departments as common standards are developed.

Different strategies to manage FX risk

3.21 This section outlines what they are, how to do them, and when each might be appropriate.

3.22 Set out below are different financial instruments that departmental bodies could consider, their pricing and when each might be appropriate:

- spot transactions

- forwards
- options

Spot transactions

What they are:

3.23 An exchange rate is the value of one currency expressed in terms of another currency. The spot value refers to the existing exchange rate on the day of settlement.

When they might be appropriate:

3.24 Spot transactions should be the default transaction that a department considers for meeting its foreign currency needs. They do not need Treasury consent if carried out within Government Banking.

3.25 Future commitments to be settled with spot transactions at the time payments are to be settled do expose departmental budgets to FX volatility up to the point of payment. This may be considered acceptable within the department's risk tolerance.

3.26 Whatever overall FX strategy a departmental body has decided on (for example if it has a policy to use forwards to manage budgetary risk), spot transactions may be particularly appropriate for situations where:

- the value (and therefore FX exposures) is relatively small and/or incidental in relation to overall expenditure, and the volatility can be readily managed within available budget
- a liability has an unknown value or date, including an immediate requirement
- a liability has been agreed in sterling but paid in a foreign currency

How they should be arranged:

3.27 Use the BoE (through Government Banking) for all transactions:

- greater than £2 million sterling equivalent
- G10 currencies - United States dollar (USD), euro (EUR), Japanese yen (JPY), Australian dollar (AUD), New Zealand dollar (NZD), Canadian dollar (CAD), Swiss franc (CHF), Norwegian krone (NOK), Swedish krona (SEK) and Danish Krona (DKK)

3.28 This includes receipts and payments. Regular or known receipts that meet the above criteria should be re-routed through the BoE. Contact Government Banking to get further information on the necessary steps.

3.29 Spot transactions less than £2 million and non-G10 foreign currency payments should be arranged through Government Banking commercial banks.

3.30 Spot transactions outside of Government Banking's contracts with their commercial suppliers must have Treasury approval.

Forwards

What they are:

3.31 A contract that allows the buyer to lock in an exchange rate the day on which the agreement is signed for a transaction that will be completed at a specific date in the future. There can be FX forward purchases or sales, but sales are rarely used by departments. Forwards ensure certainty of cashflow for a future FX transaction and incur minimal transactional cost with the BoE.

3.32 The rate quoted in a forward contract, or the forward price of a currency, is not a forecast of where the value of that currency will be, or is expected to be, at a given future date. On the basis of interest rate parity[6], the price is not speculation about future FX movements. Instead, the price of a forward is a reflection of interest-rate differentials between two countries/currencies. Therefore, FX forwards do not have a built-in predictive risk premium for predicting price like other hedges/insurance might, as they are not a predictor of future price.

3.33 Forwards have the lowest transactional cost when executed through the BoE and are equivalent or slightly more than the cost of a contract using spot rates. FX forward contracts through the BoE do not have upfront premiums (unlike options and insurance) and have negligible cost of credit and funding within the bid-offer spread.

When they might be appropriate:

3.34 The use of financing instruments to hedge might not be the cheapest option for the exchequer as a whole, compared to departments and ALBs absorbing volatility risk within their budgets. However, Accounting Officers may consider them in ensuring the regularity of spending, by ensuring they do not need to absorb significant exchange rate volatility within their control totals. If an organisation considers using forward contracts, its Accounting Officer needs to be satisfied that the benefits of budget certainty outweigh the cost and that the cost and management effort of operating the hedging policy offers value for money.

3.35 Forward contracts reduce FX volatility and can provide budget certainty. If a department or arm's length body is committed to pay an amount in foreign currency in the future that represents a significant portion of their budget subject to foreign exchange volatility, it may enter a simple forward to give certainty that the final cost (in sterling) is known and is within its control totals. In this way, forward contracts can

---

[6] Interest rate parity is defined in the glossary in Annex A

ensure FX volatility does not result in irregular spend and having qualified accounts. In addition, certainty of cashflows can avoid Accounting Officer spending decisions being affected by unexpected gains or losses.

3.36 They may be appropriate where the value (and therefore FX risk exposure to the organisation's budget) is material and the liability has a known value and date.

3.37 A forward may be appropriate for a future receipt of foreign currency, to reduce the impact of foreign currency fluctuations on expected receipts. In this case, departmental bodies should talk to Government Banking about FX sales.

3.38 If the exact value or timing is not known, a partial forward might be appropriate, for example entering a forward contract for 80% of the amount. A departmental body may contemplate a mixture of financial instruments. For example, 20% of a future estimated commitment may be met using spot transactions and 80% met using forward transactions.

3.39 If comparing spot and forward rates, note that a forward rate may result in a higher or lower FX rate than spot as it is not a predictor of price. Comparing spot rates to forward rates of previous transactions over a time period should be viewed cautiously, as historical rates do not determine future performance and may reflect other factors no longer relevant. Departments do not have the expertise to predict future rates, introduce risk trying to beat the market, and should not speculate. The effectiveness of a forward contract is not measured on the rate achieved but rather the certainty it provides of cashflow for a future FX transaction.

3.40 Forward purchases are predominately used when they can be matched to known liabilities. If liability values and dates are not known, an unhedged position or a partial hedge may be appropriate.

3.41 Care should be taken that the budgetary implications of such an approach are considered and appropriately reported as set out in Consolidated Budgeting Guidance.

3.42 Any financial instruments including forward contracts arranged through commercial providers require approval from Treasury and the FAB.

3.43 Where the Accounting Officer is satisfied that the benefits of budget certainty outweigh the cost and that the cost and management effort of operating forward contracts offers value for money, they may consider three different types of forwards: a simple forward, a layered forward and a rolling forward. Departmental bodies should consider which is most appropriate in their circumstance and seek advice from the FAB to give them assurance regarding their analysis.

3.44 Illustrative Example; Department A has a legal requirement to make a payment on 30th September in US dollars totalling USD 100

million which represents 75% of its budget. The exchange rate has been volatile with swings of 20% in the last year. The Department finds that the volatility exceeds its risk tolerance, and it engages with the BoE to enter a forward to buy USD 100 million on 30th September for a cost of £90 million. The amount to £90 million is included in its budget as a known cost.

How they should be arranged:

3.45 Departments should only enter into forward contracts via centralised expertise and frameworks. They must be arranged with the BoE. To transact with the BoE, please approach Government Banking who manage BoE transactions operationally.

3.46 If seeking to enter forward contracts, note that Government Banking will require an indemnity and Treasury approval before departments can enter forward contracts – contact them to discuss this further.

3.47 Collateralisation is not required for forward transactions from the BoE – sterling will be deducted on the value date.

3.48 If a departmental body is considering a forward, it should present its proposal to the FAB to get assurance that it has the most appropriate risk management strategy.

3.49 If using forward contracts, they should be arranged as soon as possible to optimise their benefits.

3.50 Departmental bodies should not attempt to anticipate FX movements. Forward rates should not be compared to spot rates and/or spot transactions delayed due to the prevailing rate.

Options

What they are:

3.51 A contract that gives the buyer the right, but not the obligation, to buy or sell a certain currency at a specified exchange rate on or before a specified date. For this right, a premium is paid to the seller. It removes the risk of further losses while also allowing a department to benefit from gains. They are a more complex instrument and are more expensive than forwards, carrying a risk premium.

When they might be appropriate:

3.52 Options are not recommended as they are usually complex and expensive. They are always considered novel and contentious and require Treasury approval.

3.53 Accounting Officers considering them in exceptional circumstances must be satisfied that they represent value for money, seek advice from the FAB, and get Treasury approval before entering an option. Any organisation using options should ensure that it has the competence to manage, control and track its use and any resulting

financial exposures, which may vary with time. The Treasury will normally be sceptical, as financial hedging generally incurs costs. Private providers can have a higher cost of finance than the government and intend to profit from their business, which may make them poor value for money.

How they should be arranged:

3.54 Departmental bodies considering options must seek advice from the FAB and get Treasury approval before entering an option.

3.55 The BoE does not offer them.

Annex A
Glossary

A.1 This section explains FX terminology.

A.2 Budget certainty

Certainty that an organisation's spend will be within its agreed budget. It can be achieved by hedging FX commitments either at the point of purchase or target price fixing where an organisation can lock-in a certain price.

A.3 Budget stability

Smoothing the volatility of spend impacting on an organisation's budget. It can be achieved by progressively hedging a future payment/s over time up to the point of payment to smooth the FX volatility over time.

A.4 Credit risk

The risk of loss due to the failure of a counterparty to fulfil its financial obligations.

A.5 Forward

A contract that allows the buyer to lock in an exchange rate the day on which the agreement is signed for a transaction that will be completed at a specific date in the future. There can be FX forward purchases or sales, but sales are rarely used by departments. There are three common types:

a) Simple forward

Hedges for the entire year implemented at one single point in time

b) Rolling forward

Hedges implemented throughout the year as new forecasts become available

c) Layered forward

Hedges a future payment or group of payments over time

A.6 FX swap

An agreement to exchange or swap currency between two parties

A.7 G10 currencies

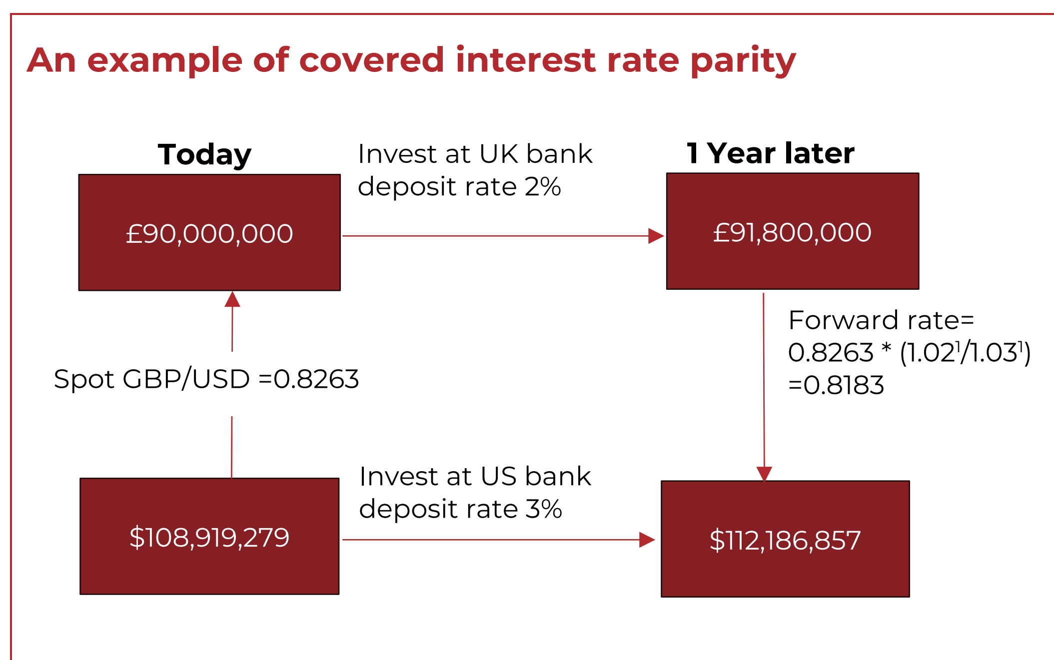
United States dollar (USD), euro (EUR), Japanese yen (JPY), Australian dollar (AUD), New Zealand dollar (NZD), Canadian dollar (CAD), Swiss franc (CHF), Norwegian krone (NOK), Swedish krona (SEK) and Danish Krona (DKK)

A.8 Hedging

A method of protecting an anticipated foreign currency requirement from an unwanted move in exchange rates.

A.9 Interest rate parity

A theory that forward contracts are priced to reflect interest rate parity, i.e. interest rate differentials between the two currencies, rather than as a predictor of future rates. This is illustrated in the example below:



A.10 Margin fee

The charge applied by the bank for purchasing currency. This is usually pre-agreed contractually.

A.11 Natural hedging

Offsetting FX requirements by holding currency received in any foreign currency for expenses in that same currency (eg holding a USD receipt to pay a USD expense)

A.12 Option

A contract that gives the buyer the right, but not the obligation, to buy or sell a certain currency at a specified exchange rate on or before a specified date. For this right, a premium is paid to the seller.

A.13 Spot

The current exchange rate at which a currency can be bought or sold

A.14 Transaction risk

The effect a change in FX rates would have on the size of the cash flow in one currency necessary to settle a given cash flow in another currency. The cash flows may be direct or indirect. Direct exposures are identifiable cash flows which require an FX transaction to be undertaken eg a purchase of goods from overseas. Indirect exposures reveal no explicit requirement but incorporate a hidden FX component which may affect pricing and costs eg transportation costs associated with the purchase of goods from overseas. This is the principal type of FX exposure which organisations face.

A.15 Translation risk

The effect on period-end financial statements or balance sheets of fluctuations in exchange rates which require a revaluation of assets or liabilities. This exposure arises from translating: transactions undertaken in a foreign currency into a base currency (eg GPB) and the financial statements of foreign sub-entity operation into the base currency of its parent.

A.16 Value at Risk

Put simply, it is how much is likely to be lost if exchange rates moved say 1%. It also refers to the method of calculating the maximum likely loss based on the amount at risk for a given period of time at a given level of confidence.

Annex B

FX policy document template

B.1 This is a template to guide departments and ALBs developing and reviewing their foreign exchange policy document. Departments and ALBs do not need to follow this exact format but should ensure that their FX policy documents include these areas.

Foreign exchange policy objectives

B.2 The FX policy document must contain the organisation's policy objectives. These objectives should include that the policies and practices comply with the FX guidance and MPM.

B.3 Organisations may also choose to include other key objectives that the Accounting Officer considers appropriate relating to how they specifically manage their foreign currency transactions and/or banking arrangements. This could include:

- a reference to risk tolerance and budgetary controls
- an objective to minimise counterparty exposure by establishing the criteria for acceptable transaction and bank account counterparties and limiting the amount of exposure to any single counterparty

B.4 Example: The objective is to ensure that the budgetary risk faced by the organisation due to transaction and counterparty exposure is minimised. The organisation will act to minimise this risk by entering into transactions to cover all material FX transaction exposures created in the normal course of their business. This will be achieved by identifying and covering transaction exposures on a timely basis and limiting exposure to any single financial institution.

B.5 This example reflects where a department has followed the above considerations and decided to mitigate budgetary risk by entering hedges. The FAB will look to provide other examples, eg where departments have chosen to use spot transactions, in forthcoming material.

Accountabilities and Responsibilities

B.6 List the delegated authorities and key responsibilities for FX risk management within the organisation

B.7 Detail who and how they will interact with HM Treasury, Bank of England and Government Banking

B.8 Detail how the FX policy document will be reviewed including how frequently

Foreign exchange risk faced by the department or ALB

B.9 Identify income, spend, transactions, funds, balances, assets and liabilities that are affected by exchange rate movements (directly and indirectly)

B.10 The FX policy document must describe the types of FX risk faced by the organisation: transactional risk, translational risk, budget risk and other risks (eg reputational).

B.11 *Transaction risk* is the principal type of FX risk which organisations face. It refers to the effect a change in FX rates would have on the size of the cash flow in one currency necessary to settle a given cash flow in another currency. The scale and type of this risk faced by an organisation will vary depending on the nature of the organisation's operations. The cash flows may be direct or indirect. Direct exposures are identifiable cash flows which require a foreign exchange transaction to be undertaken eg a purchase of goods from overseas. Indirect exposures reveal no explicit requirement but incorporate a hidden foreign exchange component which may affect pricing and costs eg transportation costs associated with the purchase of goods from overseas.

B.12 *Translation risk* is the effect on period-end financial statements or balance sheets of fluctuations in exchange rates which require a revaluation of assets or liabilities. This exposure arises from translating: transactions undertaken in a foreign currency into a base currency (eg GPB) and the financial statements of foreign sub-entity operation into the base currency of its parent

Process for identifying FX risk

B.13 The document should include the points at which FX risk is identified – eg for budgets and estimates, highlighting cashflows (both direct and indirect), timing of contracts for supply or purchase.

B.14 Each organisation should identify its risk at a frequency that reflects the nature of its activities and the budgetary cycle. Each organisation will prepare budgets based on assumed exchange rates. As there is a delay between the preparation of budgets, the approval of appropriations and the conclusion of contracts, organisations could potentially face a material transaction exposure before the contract date.

Management of FX risk

B.15 When determining how to manage FX risk, departmental bodies should always consider spot transactions.

B.16 Define the tolerance of risk – include a risk limit (eg £ amount or % of budget?)

B.17 Approved instruments - identify the instruments which the organisation may use to cover its FX risk: eg spot and forwards

B.18 Approved use of bank accounts – identify any foreign currency funds/deposits

B.19 Describe method for deciding on use of instruments – refer to risks, risk tolerance, review of the appropriate use of approved instruments,

Approval process

B.20 Process for monitoring FX risk – include internal and external reporting

Management of other risks, eg credit risk

B.21 Consider whether there are other material risks such as credit risk, operational, market, reputational and legal risk

B.22 Departments and ALBs must use BoE for undertaking FX transactions and holding FX bank accounts. If they depart from this, they must get Treasury approval and include the rationale in the FX policy document. They may be exposed to credit risk and need to detail how this is managed. Credit risk refers to the risk of loss due to the failure of a counterparty to fulfil its financial obligations.

Budgeting and accounting

B.23 Set out how the budget rate will be determined.

B.24 Set out accounting and budget treatment.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk