

HM Treasury

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Dear Accounting Officer,

INTRODUCTION OF THE EURO, 1 JANUARY 1999

Purpose of this DAO

On 1 January the euro was introduced in eleven member countries of the European Union. This letter summarises the main implications. It includes a revise of paragraphs 28.7.9 to 28.7.13 of Government Accounting on procurement contracts and foreign exchange cover, and attaches further guidance on managing foreign exchange risk, and other euro related matters.

Euro-zone countries

2. The euro is now the legal currency in the eleven countries participating in European Monetary Union (EMU): Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

3. Conversion rates between the euro and the national currencies were fixed irrevocably from midnight on 31 December 1998. Bank accounts and cheques etc can be denominated in euro but euro bank notes and coins will not be introduced until January 2002. During the transitional period from 1 January 1999 until January 2002 the national notes and coin of EMU countries will still circulate in those countries and will be used for cash transactions, but they will be designated as non-decimal denominations of the euro (ie, as euros and/or the appropriate number of cents - the euro is made up of 100 cents).

4. Many bonds and equities previously in national currencies will be traded in euro. EMU member Governments will issue debt in euro and convert much of their existing debt. Short term interest rates will be set by the European Central Bank (although commercial banks rates to customers will vary in accordance with factors such as credit rating).

United Kingdom (UK) and other non-participants

5. The UK and three other members of the EU are not participating in EMU. Sterling will continue to be the legal currency of the UK unless and until the UK decides to join EMU. (A referendum on this is not expected before the next General Election.) The Bank of England will continue to be responsible for official interest rate policy in the UK.

6. The euro should be regarded as a foreign currency, albeit one which may come to be one of the most widely used foreign currencies because of our proximity to EMU member countries and our membership of the EU. The exchange rate between sterling and the euro will fluctuate, just as the exchange rate has fluctuated against participating countries' national currencies.

Application of Government Accounting to the euro

7. The most relevant sections of Government Accounting are:

- **Chapter 4: European Communities.** References in this chapter to the ecu should now be read as references to the euro (1 ecu = 1 euro);
- **Chapter 28, section 7: foreign currency transactions and overseas banking.** See paragraphs 9-14 below about revised guidance on contracts and foreign exchange cover. The basic principles on minimising exposure to foreign exchange risk, when to channel transactions through the Bank of England, and using forward exchange cover, still apply.

8. Before departments agree to make or receive payments in euro in respect of functions for which they are responsible, they should ensure that this would not be inconsistent with any relevant legislation. Departments should also consult the Treasury, where appropriate, as set out in paragraph 2.4.10 of Government Accounting.

Contracts and foreign exchange cover

9. Government Accounting has, until now, advised departments that in their purchasing they should aim to negotiate contracts denominated in sterling wherever possible. This reflected the view that sterling contracts would offer the best overall value for money and would avoid foreign exchange risk.

10. In the vast majority of cases the introduction of the euro is not expected to have a significant impact on current procurement practice. For higher value contracts, however, the changed business environment may bring new opportunities. Some suppliers and contractors may prefer to tender in euros and may offer more competitive terms for the opportunity. Government Accounting has therefore been revised to allow departments to take advantage of any benefits that may arise from the euro (and, where it may be appropriate, from the other major international currencies the US dollar and the yen). The revised paragraphs 28.7.9 to 28.7.13B are at Annex 1.

11. However, we should stress that departments will still need to secure value for money in sterling terms, the guidelines for minimising foreign exchange risk still need to be followed and any potential costs must be constrained within Departmental Expenditure Limits.

12. Departments should consider in advance whether or not there is likely to be a significant overall advantage in offering the option of quoting in a major foreign currency. Factors to take into account include the size of the contract, and the likely number of potential suppliers either from the UK or overseas. Where they are prepared to receive quotes in foreign currency, they may also want to place a time limit on their acceptance of the foreign exchange risk involved (eg to the delivery date promised in the contract) to make it easier to cover the risk with forward exchange cover.

13. Departments should make their intentions clear in any advance advertisements, etc. (Note: there will be no change in the existing sterling thresholds under EC public procurement legislation before 1 January 2000, when the normal two year review is due.)

14. The European Council's Regulations provide for continuity and freedom of contract, ie the introduction of the euro cannot be used as a reason to break or change an existing contract. Where a contract refers to a particular currency - to an old national currency or to the euro itself - payment will be made in that currency during the transition period, unless the parties agree otherwise. There is no requirement to accept the euro to pay a debt denominated in a non-EMU currency such as sterling. If departments are asked to agree a change in the currency of payment for existing contracts they should consider whether it would represent value for money after taking account of the implications for foreign exchange risks, and the costs of existing or new forward cover.

Managing foreign exchange risk within budgets

15. It is for departments to minimise risk arising from their policies, and to assess the potential costs, and how they will contain that cost within their Departmental Expenditure Limits. For further guidance, supplementing that in Government Accounting Chapter 28, see Annex 2.

Other euro issues

16. A summary of the position on banking services for handling euro payments and receipts, conversion procedure between euros and other currencies, and on accounting for euro transactions, is given in Annex 3.

Action

17. Departments should draw this letter to the attention of relevant staff, and ensure that it is sent to any executive agencies, NDPBs, or other subsidiary bodies for which they are responsible.

Enquiries

18. A list of contacts in the Treasury, the Office of HM Paymaster General, and the Bank of England to whom enquiries can be put is given in Annex 4.

JAMIE MORTIMER

ANNEX 1

**GOVERNMENT ACCOUNTING - REPLACEMENT FOR EXISTING PARAGRAPHS
28.7.9 - 28.7.13**

Contracts and foreign exchange cover

28.7.9. Departments **are advised to negotiate contracts denominated in sterling or, where it represents value for money, in a major international currency (ie euro, US dollar, Japanese yen)** with suppliers or contractors (hereafter referred to as 'suppliers'). **If departments operating in the UK wish to negotiate in other foreign currencies they should consult the Treasury (DRM) or Bank of England.** This applies whether departments negotiate direct or through UK intermediaries.

28.7.10. Departments may elect to invite quotes from potential suppliers or contractors in sterling only, in sterling and one or more foreign currencies, or, exceptionally (for example when operating overseas) in currencies other than sterling. But **the negotiated contract should specify in which currency payment would be made so that, if appropriate, forward foreign exchange cover is used.** As departments will bear any risk of contracts denominated in foreign currencies it is important they make use of forward foreign exchange cover. In doing so, they should also follow the guidance on channelling transactions greater than £ ½ million through the Bank of England, and on informing the Bank in advance, in Government Accounting paragraphs 28.7.3 and 28.7.7.

28.7.11. **In assessing the value for money of quotes in sterling and other currencies, departments should convert all prospective payments in foreign currency to sterling (to compare like with like).** They should also take into account other price differences including the commission charge for forward exchange cover and, for example, any differences in advertising, transport or other associated costs of contracting (assuming delivery dates, quality, etc are satisfactory in each case).

28.7.12. Quotes in sterling only may be preferred, for example, for small value contracts where there are a range of suppliers quoting in sterling, and there is unlikely to be any significant overall advantage in a purchase in foreign currency. Conversely quotes in sterling and/or foreign currencies may be considered where there is a prospect that suppliers (in the UK or from overseas) would welcome the opportunity to quote in a foreign currency and that in so doing they may offer the best overall value for money.

28.7.13. Where quotations are invited in sterling, some suppliers or contractors who are resident in the UK may find difficulty because they would be exposed to an exchange risk. In order that they should be able to quote alongside other prospective suppliers in sterling, it is advisable to encourage the suppliers concerned to take forward cover. That will generally produce a cost in sterling terms. If such a cost is added to the price, it is advisable to ask the supplier to identify this cost separately. If a department doubts whether this properly reflects the cost of forward cover, or if a supplier claims that forward cover is unobtainable, the department may need to seek advice from its regular provider of foreign exchange.

28.7.13A. For some contracts, where the supplier is exposed to exchange risk but cannot obtain forward cover (and the department is satisfied that is so), it may be appropriate for a department to accept an exchange variation clause. This provides that prices may be revised to take account of uncovered movements in exchange rates.

28.7.13B. **Exchange variation clauses need careful consideration. They should provide for currency movements in both directions** (so that, for example, the department receives the

same

benefit if sterling appreciates as the supplier or intermediary receives in the event of an equivalent depreciation of sterling). They should apply only to those goods or services for which a sterling contract price is derived from a price expressed in foreign currency. They should not cover any down-payment or progress payment made before the exchange rate movement which triggers the application of the clause.

MANAGING FOREIGN EXCHANGE RISK

The general policy on foreign exchange risk is set out in paragraph 28.7.1 of Government Accounting. **Departments should aim to minimise the cost of their overseas transactions while protecting government funds against loss and uncertainty due to foreign exchange movements. They should therefore minimise their exposure to foreign exchange risk, and must not speculate in foreign exchange movements.**

2. Where a department has agreed to make or receive payment in foreign currency within the UK, the same principles apply to foreign exchange risk.

3. **It is for departments to seek to minimise risk arising from their policies, and to assess the potential costs, and how they will contain that cost within their Departmental Expenditure Limits** (and resource budgets and departmental financing limits when resource budgeting is introduced).

4. For any function where there are statutory or other agreed limits set on the size of sterling payments which can be made departments should also ensure that the sterling limit is not exceeded. That should be measured by converting the euro commitment to sterling at the exchange rate ruling on the date on which the commitment to pay in euro is formalised.

5. In seeking to reduce exposure to exchange rate risk, an obvious consideration is whether the risk can be avoided by agreeing to use sterling; or by arrangements which, although involving euro (or other foreign currency), place the exchange risk on the other party rather than the department.

6. **Where foreign currency is to be used as a matter of value for money or policy decision, departments should consider whether they can fix the exchange rate from the start by hedging. Government Accounting advises departments to make appropriate use of the forward foreign exchange market, where available, particularly where they plan to make payments of £100,000 or more on specific dates. However, departments need to have sufficient expertise in foreign exchange and consult their banking advisers before starting to use this or other hedging services. Transactions greater than £½ million (whether forward or spot) should be channelled through the Bank of England, unless otherwise agreed by the Treasury (Debt and Reserves Management team DRM).** (For more detail on spot and forward transactions see Government Accounting paragraphs 28.7.1 to 28.7.8 and the Departmental Banking Manual paragraphs 8.3.1 to 8.4.2.)

7. In aiming to “hedge” foreign exchange risks, departments may find it helpful to consider the following:

i. In assessing amounts for “hedging”, departments need to be reasonably sure what amounts will actually be required;

ii. Where sensible, departments should, at the point of decision to make a commitment to pay, determine on which date or dates they expect to make payment and in what amount(s). Where good sense indicates that payment should be dependent on certain

conditions being met, departments are advised to profile in advance the forecast date(s) and amount(s). This would enable them to include a note to their accounts on future commitments.

- iii. Departments should consider whether aggregation is appropriate and at what level. Factors departments might need to take into account in considering aggregation are that:
 - a. “hedging” may not be worthwhile for small amounts because of the transaction charges but it may be more worthwhile if smaller amounts payable on the same date are aggregated. For EMU countries, as all participating national currencies have become denominations of the euro, departments could aggregate future commitments in these currencies for hedging purposes. The payments could then be transmitted in euro at the appropriate date to be automatically converted by the receiving bank into the currency required by the recipient;
 - b. where commitments are aggregated profiles of future commitments would need to be compiled from the bottom up and to identify separately those which are definite commitments from those which are dependent on certain conditions being met;
 - c. in a larger budget past experience may suggest that it is possible to achieve a greater measure of predictability by balancing slippage on some payments by bringing forward others (provided this would not breach the guidance on timing of payments in Government Accounting chapter 21.) This would imply regular monitoring of progress on disaggregated commitments reported to the manager of the aggregated budget;
 - d. it may be possible to identify a core of commitments within an aggregated budget which is sufficiently predictable to hedge, even though there may be peaks which are so unpredictable that the department may consider that they should be excluded from any “hedging” arrangements;
 - e. for any commitments which have not been hedged, the probable foreign exchange risk should be assessed on the basis of previous experience in currency movements against sterling and should allow enough headroom in the budget for potential losses. For euro, until there is sufficient actual experience to draw on, departments could look at the experience against currencies such as the Deutschemark or the French franc;
 - f. exchange rate gains can be used to finance more expenditure in sterling terms, unless this would result in the agreed budget being exceeded. Losses need to be absorbed within the headroom allowed within the budget, or eg for grants by stopping further offers of grants until the loss in sterling terms has been offset;
 - g. monitoring of foreign exchange risk (and other uncertainties) should normally be undertaken at least quarterly, more frequently if payments are due at more frequent intervals or, where hedging has not been undertaken, in periods of particular uncertainty in the foreign exchange market.

ANNEX 3

OTHER EURO ISSUES

Banking and money transmission services

The Office of HM Paymaster General (OPG) letter to customers of 17 November 1998, advised departments of the euro banking services which OPG would offer from 4 January 1999, when euro payment systems came into operation. Detailed guidance on OPG euro services, which are designed to minimise the need for holding euro balances, is available from the contacts given in Annex 4. OPG can also open accounts for customers who have a need to hold euro balances with facilities for prompt conversion to and from sterling. Departments can also send requests for forward and/or spot transactions to the Bank of England and specify payment from a nominated OPG sterling account using the appropriate OPG form.

2. **Departments should note that sterling payable orders and cheques cannot be used to make payments in euros. Payable orders denominated in euro are available from OPG, and cheques from commercial banks.** The BACs three day clearing service is only available for euro payments and receipts within the UK. Departments should check that their BACS software can originate euroBACS files and that the payee has a euro account otherwise euroBACS payments sent to sterling accounts will be converted to sterling by the receiving bank. CHAPS same day service is available both domestically and, via TARGET, for payments and receipts to and from EU countries.

Payment cards

3. Sterling payment cards can be used to transact in euro in EMU countries where previously they could be used for, eg Deutschemarks or French francs. Euro denominated payment cards are also available, but departments are advised to use them only for payments in euro (to avoid incurring additional currency conversion costs). Departments need to take account of varying transaction costs between card issuers, and to apply similar controls to those for payment cards in the UK (see *Departmental Banking: A Manual for Departments* section 6.13) Before deciding whether to accept a euro denominated card in payment of sterling debts, departments should check with the card issuer that they will receive the required sterling payment (ie with the card holder billed in euros and accepting any foreign exchange costs).

Conversion rates between the euro and other currencies

4. Departments requesting the banking system to pay an amount in euros (or one of the national denominations of the euro) from a sterling account, or credit euro receipts to a sterling account, conveniently avoid having to decide the conversion rate for themselves. But the issue of conversion rates may arise in other circumstances, eg forward budgeting, or submission of contract data or tax returns.

5. Departments should be aware that there are some firm rules on conversion between national denominations of the euro and between them and the euro. Conversion between participating national currencies must be done via the euro in a process known as triangulation. Note, for example, that in any conversion between the euro and the national currencies all six significant figures of the conversion rates must be used. To obtain a more detailed explanation see paragraph 9 below.

6. For conversion between national denominations of the euro and non-participating currencies such as sterling there are two alternative methods: direct or via the euro (see paragraph 9). Departments can obtain a direct spot rate between sterling and the national denominations of the euro by enquiry from the Bank of England, or from the foreign exchange department of

a major UK bank.

7. Departments may wish to specify a preferred method for a particular use, or to indicate that they will accept any legally acceptable method. But to avoid confusion it is important that those concerned are required to make clear which method has been used, and any one organisation should be expected to use a consistent conversion policy for similar purposes or documents.

8. Factors to consider are:

- where the payment or receipt goes through the banking system, the bank should be requested to convert the relevant amount (departments should not attempt to do any part themselves);
- depending on its purpose, the outcome of conversion may need to be very precise, or reasonable accuracy may be adequate. The difference in the two conversion methods between national denominations of the euro and sterling will normally be quite small.

9. The conversion rates between national denominations and the euro were published in the Official Journal of the European Communities OJ L359 of 31 December 1998. A fuller explanation of conversion procedures in connection with the euro is available from the Treasury's Public Enquiry Unit (0171 270 4860) or on the internet at <http://www.euro.gov.uk>.

10. Any departments who may need to use the conversion rates between the euro and national denominations may need to check that their IT is able to handle the necessary number of decimal places, if they have not done so already.

Accounting for euro and other foreign currency transactions

11. **Supply Estimates and Appropriation Accounts will continue to be prepared in £sterling.** Where any transactions are carried out in foreign currency, the transaction costs are entered when cash payment is made. (For example, if forward exchange cover was purchased, there would be an entry when the commission charge was paid, and another when the foreign exchange was used to pay for the goods or services, etc.)

12. **Resource Accounts will be prepared in pounds sterling and in accordance with the Resource Accounting Manual.** (See particularly sections 6.5 (EU income - and expenditure therefrom), 4.3 (about to be revised to reflect FRS 12 on provisions and contingencies), 4.8 (commitments) and 8.1 (foreign currency translation). **Trading Funds, and those executive NDPBs and other public bodies which are beyond the departmental boundary as defined in the RAM, are also expected to prepare accounts in £ sterling.**

13. However, some departments may also have some need to account in euro in respect of certain aspects of the EU budget, which they handle, particularly where this supersedes similar arrangements in ecu.

ANNEX 4

ENQUIRIES: LIST OF CONTACTS

H M Treasury	Name	External Tel	GTN
Treasury Officer of Accounts team (TOA) (For general queries on this letter)	Mary King	0171 270 5315	270 5315
European Preparations Unit (EPU)	Stewart James	0171 270 4734	270 4734
Debt and Reserves Management team (DRM)	John Kidman	0171 270 5556	270 5556
Procurement Policy (PP)	Mike Davis	0171 270 1551	270 1551
Procurement Practice and Development (PPD)	Mike Burt	0171 270 1630	270 1630
Public Enquiry Unit (For leaflet on conversion procedures)	Claire Coast- Smit	0171 270 4860	270 4860
Office of the Paymaster General (OPG)	Peter Harris	01293 60 4410	3021 4410
	Qamila Virani	01293 60 4530	3021 4530
Bank of England			
Customer Settlement Services (CSS)	Brian Porter	0171 601 3581	
Foreign Exchange Division (FED)	Jim Trott	0171 601 3591	