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Study on recosting and options for the Organization in dealing with fluctuations in exchange rates and inflation

Report of the Advisory Committee on Administrative and Budgetary Questions

Introduction

1. The Advisory Committee on Administrative and Budgetary Questions has considered an advance version of the note by the Secretary-General transmitting the report of the High-level Panel of Experts on the study on recosting and options for the Organization in dealing with fluctuations in exchange rates and inflation (A/69/381). During its consideration of the report, the Advisory Committee met with representatives of the Secretary-General, who provided additional information and clarification along with explanations provided by the Panel itself, concluding with written responses received on 29 October 2014.

2. In its resolution on questions relating to the proposed programme budget for the biennium 2014-2015, the General Assembly requested the Secretary-General to commission an independent study on recosting and options for the Organization in dealing with fluctuations in exchange rates and inflation, drawing, inter alia, on the experience of other international organizations, and to report thereon to the Assembly through the Advisory Committee at the main part of its sixty-ninth session (resolution 68/246, para. 10).

3. In response to this request, in April 2014, the Secretary-General established a Panel of Experts, composed of six members, to undertake the study. The names, nationalities and a short biography of the members of the Panel are contained in annex II to the Panel's report. The Secretary-General indicates that a technical team of consultants was also commissioned to support and work under the direct guidance of the Panel. Where requested, the Secretariat provided technical assistance and information.

4. The report of the Panel, completed in September 2014, sets out the scope of the exercise, in section II; the methodology followed by the Panel, in section III; a

description and assessment of the current state of recosting practices, in sections IV and V; recommendations, in section VI; additional options and analyses, in in section VII; other previously discussed options, in section VIII; and the results of the benchmark analysis undertaken by the Panel, in section IX. Details of recosting practices and experience in a number of United Nations system and international organizations are set out in annex IX to the Panel's report.

Background

5. The practice of recosting and its impact on the biennial budgets of the United Nations is explained in paragraphs 1 and 2 of the report of the Panel. The Panel states that given the biennial nature of the budget of the United Nations, budget estimates are revised or "recosted" from period to period within a biennium to adjust for variation in currency exchange rates; actual inflation experience; changes in standard staff costs, including payroll and common staff costs; and vacancy rates previously approved by the General Assembly.

6. In terms of its impact on the Organization's budget, the Panel notes that recosting has consistently resulted in upward adjustments of proposed programme budgets during the course of successive bienniums, with the exception of 2000-2001. The effect of recosting during the bienniums from 2004-2005 to 2012-2013, that is to say, the difference between initial and final budget appropriations attributed to recosting, is set out in table 1 of the report of the Panel. According to the Panel, the average recosting effect of the past five bienniums amounted to 6 per cent of the final biennial budget appropriation. Annex I to the report indicates that the recosting effect has been driven largely by currency exchange rates and inflation, rather than by other factors (standard staff cost adjustments and vacancy rates) which, according to the Panel, have had a relatively small impact on final budget appropriations, by comparison.

7. In its report, the Panel notes that the impact of currency fluctuations and inflation on the biennial programme budget of the United Nations has been of interest since the 1970s, with a first working group of Member States set up in December 1973 to address the issue. The Panel indicates that the first group did not yield general alternatives beyond the current policies. The Panel also indicates that, since that time, much work has been carried out by the Secretariat, legislative bodies, auditors and Member States, resulting in the current methodology (see A/69/381, para. 3). The recosting process currently used by the Organization is set out in table 2 of the report of the Panel, which summarizes the four sequential recosting phases in the existing system, their components and bases for calculation, using the biennium 2010-2011 as an illustration.

Findings of the Panel

8. Overall, the Panel concludes that the Organization could improve the forecast of budget estimates to reduce variances between initially agreed budget levels and final costs and to manage remaining uncertainties (ibid., summary). In its assessment of the current practices and methodology, the Panel states that current methodologies for capturing the effects of currency and inflation have hampered the Secretariat's ability to effectively forecast initial budget estimates. In addition, the

Panel maintains that the Organization has limited internal visibility of the currency composition of spending and lags in reporting and is, therefore, unable to measure major risks (ibid., para. 38).

9. The report indicates that the recosting effect over recent bienniums has been driven by changes in currency exchange rates and inflation. Specifically, with respect to currency and inflation assumptions used in the current recosting methodology, the Panel states that such assumptions simplify and do not necessarily match actual inflows and outflows experienced in local accounts, noting that the actual currency exposure of the United Nations is largely concentrated in United States dollars, Swiss francs and euros (ibid., para. 40). In addition, in the view of the Panel, the current practice of using operational currency exchange rates in budget proposals, based on the lower of the spot and average monthly rates in a year, exposes budget projections to volatility and unpredictability. An additional limitation, according to the Panel, is a constrained ability to enter into effective hedges, as the rates are neither reflective of current forward market rates nor does the currency mix of the budget reflect the actual risk exposure of the United Nations (ibid., para. 41).

10. In terms of the inflation effect, calculated as the remainder between movements in post adjustment multipliers or cost-of-living adjustments and currency exchange rates, the Panel concludes that this calculation is not representative of actual fluctuations in local prices. It attributes this to the fact that post adjustment multipliers and cost-of-living adjustments have not been designed to track core inflation but are used rather to track various external and internal parameters as they seek to maintain purchasing parity with New York and to reflect movements in local wages (ibid., para. 42). The Panel acknowledges that the post adjustment multipliers and cost-of-living adjustments reflect eventual institutional requirements for the United Nations, however, in its view, their application has meant that the Secretariat has been unable to isolate and study the effects of various parameters, including inflation (ibid., para. 45).

11. Another main observation of the Panel is that the Secretariat lacks internal visibility and timely information concerning expenditure patterns and exchange rate exposures. The Programme Planning and Budget Division cannot, for example, currently compile detailed expenditure data on the basis of actual currencies in which expenditures are occurred. In the view of the Panel this limitation, inter alia, has an impact on the Secretariat's ability to accurately monitor cash requirements and limits any potential hedging programme. The Panel expresses some uncertainty over whether the introduction of Umoja will address such limitations (ibid., paras. 46-50).

Recommendations of the Panel

12. In its report, the Panel recommends that in order to increase the accuracy of budget forecasts, the United Nations use forward exchange rates, so as to reduce the recosting effect (ibid., para. 54). In this connection, the Panel foresees that further analytical work would be needed, with the cooperation of the International Civil Service Commission, concerning the methodologies for determining post adjustment multipliers and cost-of-living adjustments (ibid., paras. 55-56).

13. A second set of recommendations relate to the Panel's assessment that there is a need to improve visibility and the flow of information regarding risk exposures, including the possibility of accelerating the deployment of the relevant components of Umoja to address this deficiency (ibid., para. 58). The Panel recommends that the Programme Planning and Budget Division review the data requirements and make an assessment as to whether Umoja can reduce current gaps with respect to internal visibility and the flow of information. It also believes that coordination between different regional offices needs to be strengthened in order to analyse payroll and expenditure data across local offices.

14. In its report, the Panel also recommends a reduction in the frequency of recosting, by combining the first two recosting phases in the current system (ibid., paras. 62-63 and table 3).

15. In addition, the Panel proposes that the Organization institute a hedging programme for its regular budget, thereby reducing the variances between its forecasts and actual expenditures (ibid., paras. 64-66).

16. A proposed road map for the implementation of this package of actions is set out in paragraph 68 and table 4 of the Panel's report.

Additional options and analyses

17. In section VII of the report, the Panel discusses additional options and analyses that could be conducted to further manage additional risks that cannot be addressed by the measures set out above, including the possibility of introducing recosting caps and/or establishing reserve funds to manage the costs arising from recosting. At the same time, the Panel states that a failure to fully analyse the appropriate mechanics and implementation risks of those solutions could place duress on the Secretariat's ability to implement all planned programmatic activities (ibid., paras. 69-74)

Other previously discussed options

18. Other options, which the Panel states have been considered previously in the context of different discussions on the question of recosting, are set out in section VIII of the report. Those options, which, according to the Panel, would be designed to manage additional, non-hedgeable recosting risk, include built-in budget contingencies (absorption), split assessments, local currency budgets and active vacancy rate management. The Panel concludes, however, that none of these options would effectively manage additional recosting risk and would pose several administrative challenges for the United Nations (ibid., para. 75).

Benchmark analysis

19. The results of a benchmark analysis of United Nations system organizations and other international organizations are contained in section IX of the Panel's report. While concluding that most of those organizations adjust budgeted estimates across the same operational parameters as the United Nations, the Panel states that most of the institutions believe that frequent recosting is an inefficient method of

managing the budget and prefer to use accurate estimates to avoid revisionary procedures and increases in assessments (ibid., para. 85). The Panel also concludes that a direct comparison between the budget processes of the United Nations and those of other organizations has finite value owing to the differences between the requirements of those organizations and the budget requirements of the United Nations (ibid., para. 84) and that applying budget management techniques used at other international organizations would not necessarily eliminate recosting within the United Nations (ibid., para. 90).

Comments and observations of the Advisory Committee

20. The Advisory Committee notes that the High-level Panel of Experts undertook its review between April and September 2014. The Secretary-General transmitted the report to the General Assembly for its consideration, pursuant to its resolution 68/246.

21. **The Advisory Committee is of the view that the analysis conducted by the Panel in the course of its review contained several limitations, which have a detrimental effect on the overall quality of the report and the utility of its findings and recommendations.**

22. First, the Advisory Committee notes that the Panel's review did not encompass a full examination of the entire regular budget and its constituent sections. In paragraph 10 of its report, the Panel states that sample data was used from components within 3 of the 36 budget sections, using the 2010-2011 budget as a sample. In addition, responding to a specific query as to the reasons why special political missions were excluded from the recosting study, the Committee was informed by the Panel that it understood that budgets for special political missions were not recosted after approval of the resource requirements for those activities. The Committee was also informed that the Panel understood that budgets for the special political missions take into account actual expenditures from the previous year, actual exchange rates, actual and projected vacancy rates and are based on expenditure experience for common staff costs.

23. In its periodic review of the resource requirements for special political missions, the Advisory Committee notes that budgets for such missions are typically prepared on an annual basis. Adjustments are consistently made to reflect changes in budgetary assumptions and actual expenditures, including differences between actual and budgeted vacancy rates, changes in standard staff costs and variations in currency exchange rates. **In this sense, the Committee points out that although the special political mission budgets typically cover a 12-month period, in cases where missions continue into the second year of the biennium for the United Nations programme budget, elements of recosting are included in those budgets.**

24. **The Advisory Committee does not believe that the exclusion of special political missions from the Panel's review was justified. A more in-depth review of the annual estimates submitted for the special political missions would have yielded a more complete analysis of the different recosting dimensions contained within the programme budget of the United Nations. The Committee is also of the view that a broader analysis of the different budget sections within the regular budget and the variable effects of inflation and currency**

movements between different budget sections would have been essential given the globally dispersed nature of Secretariat activities.

25. Second, with respect to the recosting practices of other entities in the United Nations system, the Advisory Committee believes that the analysis performed by the Panel is not comprehensive enough, lacking contextual specificity. For example, the report does not comment on the utility of comparing organizations that have annual budget cycles with those that have biennial budgets, in the context of recosting practices. Similarly, the study does not comprehensively set out the differences in functions, funding sources or the degree of decentralization within different organizations and their comparability with the United Nations, with its decentralized global presence and reliance on assessed contributions. In addition, the study fails to include information on how each organization ensures that their initial budget estimates incorporate the resources required to ensure full implementation of their respective programmes of work, including issues such as the application of vacancy rates and the use of contingency provisions. However, at the same time, in its report, the Panel mentions that the United Nations is exposed to idiosyncratic risks arising from its own programmes and that directly applying budget management techniques used at other international organizations would not necessarily eliminate recosting within the United Nations (ibid., para. 90).

26. **The Advisory Committee is of the view that a comprehensive analysis of the experiences and practices of other organizations in budgeting different cost factors and their potential applicability to the United Nations would have been useful, along with more detail on the unique nature of the United Nations, including the particularity of its budget processes and sources of funding.**

27. Third, the Panel states that the Secretariat's systems do not provide it with the required visibility and information to improve cost management, citing the Organization's current reliance upon its Integrated Management Information System (IMIS) and Budget Information System, which it characterizes as fragmented legacy systems running on dated architecture. The Panel further states that it is unclear whether the new enterprise resource planning system (Umoja), can provide the Secretariat with all of the required capabilities to improve the accuracy of forecasts and flow of information in order to measure its real-time currency exposures (ibid., paras. 49-50).

28. Upon enquiry, however, the Advisory Committee was informed by the Secretariat that Umoja will be able to provide the required capabilities to improve the accuracy of forecasts and flow of information. The Committee was also informed that real-time transactions in the budget ledger under Umoja are booked in both the currency of the transaction and United States dollars, hence standard reports can be created to provide the necessary information. **The Advisory Committee expects therefore that Umoja, once fully implemented, will properly satisfy the Secretariat's need for timely, detailed information concerning currency exposures.**

Use of forward exchange rates

29. In its report, the Panel states that improving the accuracy of initial budget forecasts could reduce the likelihood of recosting and therefore recommends that the Organization use parameters that are more representative of current market

conditions (ibid., para. 53). In this connection, the Panel indicates that budgets will be more accurate if the approved currency exchange rates are based on forward rates, rather than the current practice of using the lower of the latest spot rate or the average rate over the past 12 months. **While the Advisory Committee has no objection to this proposal in principle, the report of the Panel does not contain an analysis on the impact of such a change, including whether the use of forward exchange rates may lead to higher initial assessments for Member States in respect of the United Nations programme budget.**

Frequency of recosting

30. The Panel recommends in its report that the frequency of recosting moments in the current budget process be reduced by combining the phases undertaken at the time the budget is initially proposed by the Secretary-General and at the time the General Assembly determines the initial appropriation for the biennium, on the basis of revised estimates. The Panel proposes that the most current market data available in the month of December, prior to the approval of the budget, be used as the base for budgetary projections. **The Advisory Committee is not convinced that a reduction in the frequency of recosting will necessarily have a major impact on the predictability of the budget. The Committee also believes that the impact of such a modification on the existing budget methodology, as prescribed by the General Assembly, and the requisite procedural changes, was not analysed. In particular, the Committee foresees that such a change could affect baselines for making comparisons of budget levels from one biennium to the next.**

Establishment of a hedging programme

31. The Panel also recommends that the United Nations institute a hedging programme for its regular budget. The Advisory Committee recalls that, in part X of its resolution 67/246, the General Assembly authorized the Secretary-General, starting 1 January 2013, to utilize forward purchasing in order to protect the United Nations against exchange rate fluctuations. The Committee was informed, upon enquiry, that currency hedging reduces the variability of a targeted currency exposure identified in the budget forecast by entering into financial transactions with market counterparts. The reduction of currency risk is achieved when forwards or options are purchased and when the budget forecast closely reflects the actual currency used by the Organization.

32. Concerning the implementation of the hedging pilot, the Advisory Committee was informed that the Secretariat had implemented a conservative approach of forward purchases based on the minimum monthly predictable requirement of 20 million Swiss francs for the United Nations Office at Geneva. The Secretariat indicated that in order to reduce its currency exposure in that regard, it had opted for a hedging tool that involved making forward purchases, which requires entering into a binding contract that locks in the exchange rate for the purchase or sale of a currency on a future date, but does not involve any upfront payment.

33. In this connection, the Advisory Committee recalls its recommendation, endorsed by the General Assembly in the context of its review of the second performance report on the programme budget for the biennium 2012-2013, that the

Secretary-General provide a more comprehensive assessment of the experience of forward purchasing in his first performance report on the programme budget for the biennium 2014-2015 (see A/68/656, para. 14 and related General Assembly resolution 68/245 A). However, the Committee notes that the related report of the Secretary-General (A/69/612) contains no such analysis.

34. **The Advisory Committee notes that the General Assembly has not yet had an opportunity to consider a detailed analysis of the Swiss franc pilot hedging programme put in place by the Secretary-General as of 1 January 2013. The Committee will revert to this matter in the context of its forthcoming review of the first performance report of the Secretary-General for the biennium 2014-2015.**

Matters outside the purview of the Panel of Experts

35. In several instances in the report of the Panel, reference is made to the role of the International Civil Service Commission, specifically, to the methodology used by that organization in establishing and revising post adjustment multipliers, which are used to ensure purchasing parity with New York for staff in the Professional and higher categories across the United Nations system, worldwide (see, for example, A/69/381, para. 43). The Panel notes that the methodology, authorized by the General Assembly, is not designed to track inflation as measured by the consumer price index in a particular duty station. Rather, it tracks a variety of costs, some unique to staff serving within the United Nations system, that enable the comparison and measurement of differences in costs of living for staff across different locations. The Panel notes that no United Nations common system organization can modify these methodologies, assumptions and entitlements without the approval of the Assembly.

36. The Advisory Committee notes that while citing the fact that the post adjustment multipliers reflect eventual institutional requirements (ibid., para. 45), the Panel also recommends in its report that the Commission be consulted with a view to separating core elements of inflation driven by economic factors from other factors, specific to the United Nations context, that are currently reported as inflation. The Panel maintains that disaggregating economic inflation from such other factors would enable the Secretariat to develop more realistic forecasts of external factors and potentially reduce the gap between initial estimates and actual expenditures. Further, the Panel recommends that the General Assembly ask the Commission to review its respective methodologies and assumptions (ibid., paras. 55-56).

37. The Advisory Committee recalls that the Commission is an independent expert body established by the General Assembly to regulate and coordinate the conditions of service of staff in the United Nations common system. The Commission's mandate covers all facets of staff employment conditions and the type of action it is empowered to take in a specific area is regulated under its statute and rules of procedure (see ICSC/1/Rev.1). **The Advisory Committee questions the rationale provided by the Panel for assessing the methodologies and assumptions used by the Commission in determining the post adjustment multiplier applicable across all United Nations common system organizations. The Committee believes that every effort should be made to improve the accuracy of budgetary**

estimates for costs relating to international staff based on changes to the post adjustment multipliers.

38. In paragraphs 68 and 92 of the report, the Panel sets out a potential timetable for implementation of its recommendations, involving decisions on the part of the General Assembly in 2014 and actions by the Secretariat as early as the first half of 2015, thereby allowing time to update budget processes with a number of methodological changes for the 2016-2017 budget. **The Advisory Committee considers that it is for the General Assembly to determine whether any changes to the recosting methodology are required and, if so, to set its own parameters, including target dates for implementation.**

Panel recommendations relating to caps and reserve funds

39. In section VII of its report, the Panel states that if the General Assembly seeks a more complete solution for managing non-hedgeable costs, it could seek further analysis on the feasibility of putting in place recosting caps and reserve funds. With a recosting cap, the Panel states that the Assembly could authorize the Secretariat to set a limit on the maximum allowable recosting increase in a certain biennium. The Panel also states that more analysis would be needed, since various configurations could be possible (ibid., para. 70). In the case of reserves, the Secretariat would maintain contingency funds separately and use surplus reserves in years of low recosting to offset costs in years of high recosting (ibid., para. 72). The Panel points out, however, that a failure to fully analyse the appropriate mechanics and implementation risks of the two modalities could place duress on the Secretariat's ability to implement all planned programmatic activities (ibid., para. 69).

40. **The Advisory Committee is of the view that a decision to impose a recosting cap may lack technical merit and could have programmatic implications.**

41. **In the case of reserve funds, the Advisory Committee believes that the Panel did not fully analyse the impact of reserve funds, including whether their establishment would lead to higher initial assessments for Member States in respect of the United Nations programme budget.**

Previously discussed option of active vacancy rate management

42. The report of the Panel indicates that the Secretariat could actively manage vacancy rates by issuing temporary recruitment freezes, thereby reducing variances between actual rates and estimates (ibid., para. 79). At the same time, however, the Panel points out that it is difficult to isolate expenditures related to vacancies. Moreover, it states that it could have a detrimental impact on programmatic activities and could impose a significant administrative burden on the Secretariat.

43. Regarding the practice of vacancy management, the Advisory Committee recalls its previous concerns in this regard and reiterates the view it has expressed on a number of different occasions that the Secretary-General should fill vacant posts expeditiously and that posts should not be kept vacant in order to achieve budgetary savings (see for example, A/66/7 and Corr.1, para. 93 and A/68/7, para. 109). On the related matter of adjusting or managing the vacancy rates

themselves, the Committee recalls that the General Assembly has reaffirmed that vacancy rates are a tool for budgetary calculations and should not be used to achieve budgetary savings (resolution 66/246, para. 19). **In the light of the reservations outlined above, the Advisory Committee does not consider that active vacancy rate management is a viable means of reducing variances between estimated and actual rates and thereby managing non-hedgeable recosting risk. The Committee stresses that budget projections should be based on realistic vacancy rates, which are usually based on the most recent actual rates recorded at the time of adoption of the budget.**

Observations on the composition of the Panel

44. Details regarding the members of the Panel of Experts commissioned by the Secretary-General to undertake the study on recosting are contained in annex II to the report of the Panel. The Advisory Committee notes that one regional group (Eastern European States) was not represented in the membership of the Panel and that three of the Panel's six members originated from the same regional group (Western European and other States).

45. The biographies annexed to the report of the Panel indicate that three of the members have either worked in the past, or currently work, with the international financial institutions, and that two of the Panel members have direct experience with the financial management and budgetary processes of the United Nations itself. The Advisory Committee was informed, upon enquiry, that the main criteria for selection of the Panel were to ensure broad expertise in the areas of budget and finance, experience at the international and national levels and exposure to United Nations operations. The Committee was further informed that geographical considerations were taken into account to the extent possible and that in its resolution 68/246, the General Assembly had requested the Secretary-General to commission an independent study, without specifying how the study should be carried out. Concerning the background and qualifications of the technical team that supported the Panel, the Committee was informed that the technical team consisted of five senior staff members of an international accounting firm.

46. **While acknowledging that the General Assembly did not specify the requisite composition for the Panel of Experts, the Advisory Committee believes that the Secretary-General should have made every effort to form a Panel with as wide a geographic basis as possible, which could have benefited from the relevant expertise available in all regional groups. The Committee trusts that in future all efforts will be made to ensure that expert panels are constituted with the appropriate breadth of expertise, while aiming to reflect adequate geographic representation.**