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FINANCIAL, BUDGETARY AND ADMINISTRATIVE MATTERS

OPERATIONAL RESERVE

Report of the Administrator

Summary

In accordance with Governing Council decision 79/31, paragraph 8, the Administrator sets out here the criteria for establishing the level of the Operational Reserve in the third cycle, 1982-1986. The Administrator considers that the appropriate level should be 25 per cent of the anticipated annual pledges during the cycle.

The Administrator further recommends that the Operational Reserve should be for the purpose of guaranteeing the financial viability and integrity of the Programme, and that the elements to be compensated for or covered by it be limited to:

- (a) Downward fluctuation or shortfalls in resources;
- (b) Uneven cash flows;
- (c) Increases in actual costs as compared to planning estimates or fluctuations in delivery;
- (d) Other contingencies which result in a loss of resources for which UNDP has made commitments for programming; and
- (e) Such other requirements as may be decided by the Governing Council.

The Administrator further recommends that the Operational Reserve be fully funded at all times and held in liquid assets which are irrevocably and promptly available for UNDP disbursements and that the decision to make a drawdown from the Operational Reserve rest solely with the Administrator, who would be required to report all drawdowns to the Governing Council at each next regular session. The Administrator will present to the Governing Council each year for its approval, his recommendation as to the amount by which the Operational Reserve should be increased in that year.

UNDP RESERVE REQUIREMENTS

A. Introduction

1. At its twenty-sixth session, the Governing Council requested the Administrator to provide a report on criteria that would assist the Council in determining the appropriate level of the Operational Reserve for the third IPF cycle, 1982-1986 (decision 79/31, paragraph 8). In reviewing the subject, all previous discussions and decisions of the Council were taken into account including suggestions made during the discussions leading to the Consensus decision and the General Assembly resolution on the capacity of the United Nations development system (resolution 2688 (XXV)).
2. The Operational Reserve was initially established in accordance with paragraphs 28 and 29 of the Annex to General Assembly resolution 2688 (XXV) in the amount of \$150 million. The original composition of the Operational Reserve was \$90 million in the form of cash, bank deposits, loans and short term investments and the balance, \$60 million in the form of instruments of credit. In accordance with the Council's decision in 1972, 1/ the size and composition of the Operational Reserve were to be reviewed annually by the Governing Council. At its twenty-first session in January 1976 the Governing Council decided to maintain the level of the Operational Reserve as constituted and recommended that the portfolio of assets be changed by conversion to make its resources fully available to the Programme. 2/ At the same session, the Council recommended that the Operational Reserve be replenished to a \$150 million level on a funded, fully liquid basis as soon as possible. At the twenty-third session, the Council approved a schedule for replenishment 3/ which was altered at the twenty-fifth session. 4/ At the twenty-sixth session, the Council approved, 5/ subject to the availability of resources and without affecting programme delivery, the increase of the Operational Reserve by \$25 million in both 1980 and 1981 to attain a level of \$200 million.
3. The review of the various decisions referred to, as well as the related discussions and documentation, suggested a number of contingencies which could influence UNDP's financial viability and, although the Governing Council did not explicitly authorize them to be covered by the Operational Reserve, it was so understood. The contingencies were:

- (a) Downward fluctuations or shortfalls in resources;
- (b) Uneven cash flows;

1/ See Official Records of the Economic and Social Council, Fifty-third Session, Supplement No. 2A (E/5185/Rev.1), paragraph 227.

2/ Ibid, Sixty-first Session, Supplement No. 2 (E/5779), paragraph 193.

3/ Ibid, Sixty-third Session, Supplement No. 3 (E/5940) paragraph 58 (j).

4/ Ibid, 1978, Supplement No. 13 (E/1978/53/Rev.1), Chapter XX, decision 25/16, para. 16.

5/ Ibid, 1979, Supplement No. 10 (E/1979/40), Chapter XXI, decision 79/31, para. 7.

- (c) Increases in actual costs as compared to planning estimates or fluctuations in delivery;
- (d) Increased levels of non-usable resources resulting from either non-payment of pledges or the non-convertibility of the currency contributed to UNDP;
- (e) Other events which reduce UNDP's resource base; or
- (f) Liquidation of the programme.

B. Purpose and elements of the Operational Reserve

4. The Administrator proposes that the Operational Reserve be for the purpose of guaranteeing the financial viability and integrity of the Programme and that the elements to be compensated for or covered by it be limited to:

- (a) Downward fluctuations or shortfalls in resources;
- (b) Uneven cash flows;
- (c) Increases in actual costs as compared to planning estimates, or fluctuations in delivery;
- (d) Other contingencies which result in a loss of resources for which UNDP has made commitments for programming; and
- (e) Such other requirements as may be decided by the Governing Council.

5. It will be noted that elements 4(d) and 4(e) have been changed from those in 3(d) and 3(e). The non-convertibility of currency is taken into account by the Administrator in UNDP's continuous planning process and should therefore not be covered by the Operational Reserve. The proposed definition excludes the Operational Reserve as a source of funding for liquidation of the Programme. A decision of such importance could only be taken by the Governing Council after considering, inter alia, information provided by the Administrator. It would be necessary for the Administrator to provide an analysis of all existing assets (liquid and non-liquid), including assets held in all reserves at the time and outstanding receivables and liabilities; UNDP's liability under contracts and commitments entered into by the Executing Agencies; and a plan for the orderly liquidation of the Programme including funding requirements, if any. A reserve of sufficient magnitude to provide for this contingency would in the opinion of the Administrator have to be so large that it would significantly reduce the level of resources available for programme purposes. However, it is understood that any balances in reserves, including the Operational Reserve, held by UNDP at such a time will be used to offset the above-mentioned liabilities.

6. The Administrator further recommends that the Operational Reserve be fully funded and held in liquid assets, which are irrevocably and promptly available for UNDP disbursements, and that the decision to make a drawdown from the Operational Reserve would rest solely with the Administrator, who would be required to report all draw-downs to the Governing Council at each next regular session.

C. Level of the Operational Reserve

7. The level of the Operational Reserve should be determined on the basis of an aggregation of the amounts estimated to be required to cover the contingencies it is intended to meet. As the various contingencies are mutually exclusive and may, as in 1975, occur in combination, it is essential that the total reserve be sufficient to cover the several contingencies. The level of the reserves established must be adequate to carry UNDP until measures can be taken to bring expenditures in line with resources and to re-establish the Operational Reserve at the approved level on a fully funded basis. In the following paragraphs, an amount and the basis for its computation is suggested for each of the purposes of the reserve.

(a) Downward fluctuation or shortfalls in resources

8. One of the major problems faced by UNDP is the synchronization of annual funding with multi-year project approvals. UNDP is vulnerable to resource shortfalls should the level of pledges in a given year not attain the anticipated level on which programme planning and approvals are based. To achieve the expenditure targets which are established, consistent with the level approved by the Governing Council for planning purposes, certain assumptions can be made regarding pledges on a year-to-year basis so that timely project approvals can be made. If the assumptions of the levels of pledges are not met, shortfalls in resources will result. While the Council establishes an annual rate of growth for pledges to UNDP over each IPF cycle, there can be significant fluctuations in the level from year to year even if the target established for the cycle is met. Such fluctuations have ranged from an increase of 20.3 per cent in 1975 to an increase of 3.8 per cent in 1980. The average increase in pledges over the first four years of the cycle has been 11.5 per cent against the 14 per cent annual increase approved by the Council for planning purposes.

9. An additional vulnerability is that, at present, approximately 91 per cent of UNDP's resources are received from 15 countries. A major change in the pledge of any one of these countries or a failure to meet the percentage annual increase established by the Council for planning purposes can result in problems of a substantial magnitude.

10. As presently envisaged, it is expected that expenditures, as from the second year of the third cycle, will basically match the liquid resources of UNDP so that the only cushion available would be the Operational Reserve. It is therefore imperative that steps be taken to ensure that the momentum of the programme is not adversely affected by a shortfall in any given year or a decrease in the level of resources over the cycle. Adequate time is required to adjust the level of the programme to the realities of available resources in the following year. Accordingly, the Administrator would recommend that for "downward fluctuations or shortfalls in resources" the Council establish as a base for the Operational Reserve a level in accordance with the same percentage increase in annual pledges as is approved by the Council for planning purposes.

(b) Uneven cash flows

11. Over the past two years there has been a significant change in the pattern of payments by Governments to UNDP. Many Governments who had in the past paid their pledges to UNDP by a single payment early in the year have adopted a practice of paying their pledges in installments throughout the year. Furthermore, the level of outstanding receivables can vary from year to year for a variety of reasons beyond the control of UNDP. In these instances, the payment will usually be received although not when initially anticipated. These factors increase the probability of a cash shortfall, particularly in the third cycle when UNDP asset holdings will be reduced to minimum levels.

12. UNDP presents to the Governing Council an annual forecast of its cash flow and financial position. For operational purposes, however, a three-month rolling cash flow forecast is prepared based on the best available estimates of both the timing of the payment of pledges and Agency and UNDP projections of disbursements. A variance analysis of the preceding months cash flow is made and any difference is noted monthly prior to preparation of the next three-month rolling cash forecast. The three-month rolling forecast has been found to be accurate within a margin of five per cent. The forecast is used to identify possible cash shortfalls within the period, based on current information on income and disbursement patterns as well as the total availability of cash over the period. A reserve equivalent to approximately 1 1/2 months cash requirements would be sufficient to cover any shortfall within the period and also sufficient to allow time to initiate other courses of action. The experience in 1975 and 1976 showed that UNDP was able, at that time, to generate earlier payment of pledges and to make other arrangements to cover the shortfall within that length of time. Accordingly, the Administrator recommends that the reserve requirement for "uneven cash flows" be established at 12.0 per cent of total anticipated annual pledges for the year, which represents roughly 1 1/2 months cash outflows.

(d) Increases in costs or fluctuations in delivery

13. Increases in actual costs as compared to planning estimates can arise as a result of several factors, one of which is the inflationary trend. When preparing project budgets, Agencies are asked to incorporate an annual inflation factor into the cost of inputs. Instability in international economies can result in inflationary levels which can surpass reasonable assumptions used for planning purposes. In that such inflationary costs must, for the most part, be paid in the year in which they are incurred, provision for this contingency should be included in deciding the level of the Operational Reserve. Another factor which could result in an excess level of expenditures is the flexibility provided to Agencies, which also must be met in the year in which the additional expenditures are incurred.

14. The pace of delivery can affect the level of expenditure in a given year, too. It is important to note that in order to achieve the projected level of expenditure, it is necessary to adopt a policy of adequate programming. Moreover, UNDP cannot entirely control the rate of expenditure in any given period due to the need to give Agencies a margin of manoeuvrability to ensure full delivery of the expenditure level for the year. Expenditures in any given period may, therefore, exceed planned levels. In either case, time will be required to bring expenditures back into line

with resources. Accordingly, although this contingency relates to the level of expenditures, for simplicity, the Administrator recommends that resources of the Operational Reserve to meet "increases in costs or fluctuations in delivery", be based on 2.5 per cent of anticipated annual pledges.

(d) Other contingencies

15. Other contingencies which could have an impact on the level of resources available to UNDP could include a reduction in or withdrawal of an announced pledge, a write-off of receivables, losses on exchange due to fluctuations in world money markets or similar occurrences. As the availability of such resources would have been planned for and programmed, losses could result in a difficult cash position within the Programme. While it is difficult to evaluate the impact of these contingencies, they would be a function of the level of assets including receivables held by UNDP at the time. Since the various aspects of these other contingencies are mutually exclusive, they could occur at the same time. In total, when related to historical occurrences, the potential loss could be as high as \$25 million, based on the level of resources managed by UNDP. Accordingly, the Administrator recommends for "other contingencies" that a level of 1.5 per cent of anticipated annual pledges be established. (Note: for the sake of simplicity, the Administrator would suggest that the reserve factor for the contingency described in this paragraph be combined with the factor described in paragraph 14 above for a total of 4 per cent of anticipated annual pledges.)

D. Summary and recommendations

16. The level of the Operational Reserve has been given very careful consideration by the Administrator and is based primarily on the fact that during the third cycle, it is expected that liquid resources as from the second year of the cycle will match expenditures. The liquid assets held by UNDP will be significantly reduced from current levels with the build-up of the programme in 1980 and 1981 and should approximate, at the end of each year during the cycle, the level of established reserves.

17. The Administrator considers that the various components of the Operational Reserve should be established (rounded to the nearest \$10 million) on the following basis:

- (a) Downward fluctuation or shortfalls in resources: 14 per cent of anticipated annual pledges (assuming that this percentage is the annual growth rate target);
- (b) Uneven cash flows: 12 per cent of anticipated annual pledges;
- (c) Increases in costs or fluctuations in delivery:) 4 per cent of anticipated annual pledges;
- (d) Other contingencies:)
- (e) Other requirements decided by the Governing Council.

/...

18. If it were considered that all of the conditions listed above could occur in the same year, an Operational Reserve of 30 per cent of anticipated annual pledges would be necessary to provide sufficient time to resolve the problems. However, with the improved UNDP management tools, which should identify problems sooner, and with tighter controls which have been established, it is unlikely that all these conditions would occur simultaneously. Therefore, the Administrator is recommending that the Operational Reserve be established at a minimum level of 25 per cent of anticipated annual pledges.

19. The Administrator will present to the Council an annualized plan for the third cycle which will clearly set out the suggested growth in the Operational Reserve over the cycle. The Administrator shall present to the Council each year, his recommendation of the amount which should be added to the Operational Reserve for that year, taking into account the availability of resources and anticipated expenditure level. In the event of a drawdown on the Operational Reserve, the presentation would, of course, incorporate the plan for replenishment of the Operational Reserve.

20. The above criteria when applied to the second cycle, 1977-1981, and for the third cycle, 1982-1986, are illustrated in Table 1. As can be seen from this table, the level of the reserves called for under these criteria closely approximates the existing level of reserves approved by the Council. The Council's agreement to the proposed criteria would provide UNDP with a firm base for planning purposes. Adoption of the criteria will not reduce the reporting frequency to the Governing Council of the status of the Operational Reserve or its use.

21. In summary, the Administrator recommends that the Governing Council approve the purpose and elements of the Operational Reserve as set out in this paper; the criteria for determining the level of the Operational Reserve in the third cycle (amounts would be rounded to the nearest \$10 million); that the decision to make a drawdown from the Operational Reserve would rest solely with the Administrator; and the Administrator would be required to report all drawdowns to the Governing Council at each next session. The Administrator will present to the Governing Council each year, his recommendation as to the amount by which the Operational Reserve should be increased in that year.

Table 1

ILLUSTRATIVE COMPUTATION FOR OPERATIONAL RESERVE UNDER RECOMMENDATIONS
 SUBMITTED BY THE ADMINISTRATOR
 (\$ millions)

	<u>Second Cycle</u>				
	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Pledges (DP/390)	524	596	681 ^{a/}	758 ^{b/}	842
Recommended level at 25 per cent	130	150	170	190	210
Increase	-	-	20	20	20

	<u>Third Cycle</u>				
	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Pledges (DP/425) ^{c/}	991	1,130	1,288	1,468	1,674
Recommended level at 25 per cent	250	280	320	370	420
Increase	40	30	40	50	50

a/ Actual \$691.6 million.

b/ Estimated to date, \$719.1 million.

Note: The level of pledges for the years 1979 and 1980 would result in a net shortfall in resources of \$28.9 million, to date, in the second cycle.

c/ Assumed growth rate of 14 per cent.