Annex II

A. Review of the UNOPS operational reserve requirements

Introduction

1. In its decision 2020/08 the Executive Board requested that UNOPS conduct a detailed study of its operational reserve and the formula for calculating the mandatory minimum reserve level. The Executive Board further requested that UNOPS, pursuant to review by the Advisory Committee on Administrative and Budgetary Questions, provide an oral update at the annual session 2021 and submit the outcome for consideration by the Executive Board at the earliest opportunity and no later than the first regular session 2022, with the ambition to present it at the second regular session 2021.

2. The present annex to UNOPS budget estimates 2022-2023 first elaborates on the background for the review, then summarizes the findings and recommendations of the report that was commissioned in December 2020, and finally presents the UNOPS proposal for an appropriate minimum requirement for consideration by the Executive Board.

Background

3. According to rule 9.01 of the UNOPS financial regulations and rules, as a self-financing entity UNOPS shall operate on the basis of full cost recovery and shall set its management fees accordingly. Resulting from its ordinary activities during each financial period, UNOPS shall generate sufficient net surplus to maintain operational reserves at the level established by the Executive Board.

4. According to regulation 22.02, (a) the purpose of the operational reserve is to guarantee the financial viability and integrity of UNOPS as a going concern. The operational reserve shall be fully funded and held in irrevocable and promptly available liquid assets. The elements to be compensated for and covered by it shall be limited to:

    4.1. Downward fluctuations or shortfalls in revenue;
    4.2. Uneven cash flows;
    4.3. Increases in actual costs above planning estimates or fluctuations in project costs; and
    4.4. Other contingencies which result in a loss of resources for which UNOPS has made commitments.

5. The same regulation states that the decision to draw from the reserves rests solely with the Executive Director who shall report all drawdowns to the Executive Board.

6. At its second regular session 2013, the Executive Board approved the current basis of the minimum requirement for the UNOPS operational reserve at 4 months of the average of the previous three years' expense under its management budget (DP/OPS/2013/6, DP/OPS/2013/CRP.1, 2013/33). The change was approved after UNOPS, in line with the other United Nations organizations and as mandated by General Assembly resolution

60/283, had adopted International Public Sector Accounting Standards as of 1 January 2012. The UNOPS operational reserve is presently well above the minimum requirement.

7. Since the previous review of UNOPS minimum operational reserve requirements, UNOPS revenue has increased from $ 717.1 million in 2013 (A/69/5/Add.11) to $ 1 211.8 million in 2019 (A/75/5/Add.11). At the same time total expenses have increased from $ 703.6 million in 2013 (A/69/5/Add.11) to $ 1 190.3 million in 2019 (A/75/5/Add.11). UNOPS shares the view of the Executive Board that in light of the growth of the organization, the current detailed study of its operational reserve and the review of the formula for calculating the mandatory minimum reserve level is well timed to ensure that it is fit for purpose.

Summary of the report commissioned

8. In December 2020, UNOPS engaged Deloitte, a consulting firm, to review its minimum operational reserve requirements. The review was concluded in March 2021.

9. Deloitte conducted 18 interviews with UNOPS key personnel, analysed a wide range of internal performance data and other relevant records provided by UNOPS to identify risks related to UNOPS operations in line with items to be covered from the operational reserve, performed external benchmarking analysis with other UN organizations and relevant private sector companies, referred to off-the-shelf studies and analysed UNOPS certified financial statements for the period 2012 to 2019. Additionally, Deloitte used one of their proprietary tools to simulate the risk of default (negative net asset), with the Monte Carlo simulation chosen to test and validate the recommendation provided to UNOPS.

10. Through the review, Deloitte concluded that (i) the current level of minimum operational reserve is too low and is not adequate for UNOPS risk exposure profile, and (ii) the minimum operational reserve should be correlated to UNOPS level of activities and engagement portfolio composition, in particular in relation to the risks resulting from its infrastructure projects.

11. To determine an appropriate formula for the minimum operational reserve requirement, Deloitte analysed UNOPS past losses by service line and tested the likelihood of default in a worst-case scenario through Monte Carlo method. As a self-financing organization, UNOPS was considered to be very safe with a likelihood of default of less than 1 per cent with a minimum operational reserve of $ 122 million, with a worst-case ranging from $32 million to $135 million.

12. Deloitte analysed UNOPS portfolio related risks, legal risks, corporate liability insurances, uneven cash-flow, personnel related liabilities, reputational risks and possible downturn in new business, and treasury related risks (investment and forex related). These risks, when materialized, are covered from the operational reserve in terms of downward fluctuation or shortfall in revenue, uneven cash flow, increases in actual costs beyond planning estimated or fluctuation in project costs and other losses. Risks with the highest likelihood to materialise were found in UNOPS infrastructure projects, where not all losses can be covered through

insurances, and therefore the minimum operational reserve should be sufficient to cover possible worst case scenario to avoid negative net assets. The minimum operational reserve was also evaluated to ensure ability to exceed the advance financing provided to projects by UNOPS. A number of evaluated project and non-project related risks are evaluated to be sufficiently addressed through insurances, budget or engagement agreements (foreign exchange risk, personnel related liabilities, design risk of third party designed infrastructure etc), while some risks were evaluated to be addressed through the worst case (such as reputational risk, client dispute, catastrophic failure).

13. Following the Monte Carlo test and risk review, to determine an appropriate formula for the minimum operational reserve requirement Deloitte tested the following possible alternatives:

13.1. Alternative A: Portfolio-oriented formula (including variations);
13.2. Alternative B: Simplified formula (including variations)

14. With respect to alternative A, Deloitte proposed to build a percentage basis and weighted average formula based on type of UNOPS expenses. The formula considers a weight of 50 per cent for current year, 30 per cent weight for the previous year, and 20 per cent for the year prior, to be able to adapt to the changes in the level of UNOPS activities and to smoothen the development in reserves in case of large fluctuations in expenses. The formula next applies the risk characteristics of UNOPS portfolio of activities, by applying a higher rate of 25 per cent reserve provision to infrastructure projects (3 months), and 5 per cent reserve provision to the remaining services lines, with maintaining the current reserve provision of 33 per cent (4 months) on the administrative costs.

15. The alternative A, and specifically the 25 per cent reservation on infrastructure service line was supported by a 2015 study published in in the Journal of Public Budgeting[1], with considering the lower risk related to the service lines. The formula was tested with actual data backwards and with simulated data forward, and was found sufficient to protect UNOPS against a worst case scenario, through reaching a level of $ 122 million in 2019.

16. To test variations of alternative A, Deloitte simulated the same calculation with 20 per cent and 15 per cent and reserve reservations of the infrastructure expenses, but that would have increased the likelihood of default in the worst case scenario. Although the 25 per cent reserve reservation for infrastructure projects was recommended, the report found that the rates associated to the type of projects can be amended over time if UNOPS judges that the risks linked to infrastructure have significantly decreased with internal measures or increased due to new activities

17. With respect to alternative B, Deloitte tested a simplified formula applying an overall reserve reservation percentage across average expenses of the past three years. The percentages applied included 13 per cent (based on analysis performed for alternative A), 10 per cent and 4 per cent (UNOPS formula pre-2013). Although the

[1] Financial factors that influence the size of non-profit operating reserves Article in Journal of Public budgeting – March 2015)- C.Grizzle, M.Sloan, M.Kim

simplified formula in Alternative B was found easier to operate, and at 13 per cent sufficient to cover for the worst case, it was found less effective in flattening the variations in the level of expenses year on year and was found arbitrary in the long term.

Proposed minimum requirement

18. UNOPS has carefully considered the outcome of the review, including the benchmarking. Recalling that the purpose of the operational reserve is to ensure the continuity of UNOPS operating business on a 'going concern' basis, three findings were seen as particularly important:

18.1. Risk associated with the execution of projects is dependent on the service line, and to reflect changes in the portfolio, the minimum operational reserve should reflect the actual development by service line.

18.2. The highest risk is associated with the infrastructure service line, while other service lines carry a lower risk, and the reserve reservation on the administrative expenses should cover for a possible shut-down scenario, as previously.

18.3. As a self-financing organization, UNOPS has zero tolerance for risk of default in the worst case scenario.

19. On that basis, UNOPS proposes that the appropriate minimum requirement for the UNOPS operational reserve should be calculated as 25 per cent of the infrastructure service line expenses, 5 per cent of expenses for other service lines, and 33 per cent of administrative cost, with a weight of 50 per cent for current year, 30 per cent for previous year, and 20 per cent for year prior.

B. Review of UNOPS growth and innovation reserve

Introduction

20. The present annex to UNOPS budget estimates 2022-2023 first elaborates on the background of the growth and innovation reserve and the Sustainable Investments in Infrastructure and Innovation (S3I) initiative, then

summarizes the findings of the consultancy that was commissioned in 2020, and finally presents the UNOPS proposal to a change to UNOPS financial regulations and rules, regulation 22.02.

Background

21. According to regulation 22.02 (b) of the UNOPS financial regulations and rules, within the UNOPS accounts, it may establish a growth and innovation reserve to invest in the future revenue generating ability of UNOPS. Transfers to this reserve will be limited to 50 per cent of the excess operational reserves, over and above the level set by the Executive Board. The specific approval of the Executive Board shall be required if the amount to be transferred exceeds 50 per cent of the excess operational reserves. According to regulation 22.02 (c), the decision to draw from these reserves shall rest solely with the Executive Director who shall report all drawdowns to the Executive Board.

22. In 2019, a growth and innovation reserve was established. This provides funding to, inter alia, Sustainable Investments in Infrastructure and Innovation (S3I) initiative activities, which contribute to accelerating the achievement of the Sustainable Development Goals through projects with significant potential to deliver social and environmental impact, alongside a financial return. The value of this reserve was set at 50 per cent of the excess operational reserves. At the end of 2019, this stood at $104.9 million. (A/75/5/Add.11)

23. UNOPS launched the Sustainable Investments in Infrastructure and Innovation initiative (S3I, formerly Social Impact Investing Initiative and Sustainable Infrastructure Impact Investments initiative) during 2018 in order to drive progress towards the achievement of the Sustainable Development Goals. The investments under the initiative are funded from the growth and innovation reserve and reported through the UNOPS financial statements under other financial assets. UNOPS invested $30 million in the initiative during 2019 ($8.8 million in 2018). The carrying value of total UNOPS investment in the initiative was $41 million. (A/75/5/Add.11)

24. The Board of Auditors recommended that UNOPS issue specific instructions following up on the issue of the framework, guidelines, procedures and policy to strengthen and formalize the processing and documentation of projects funded through the growth and innovation reserve. (A/75/5/Add.11)

Summary of the findings of the consultancy commissioned

25. Responding to the Board of Auditors recommendation, UNOPS commissioned a consultancy on the Sustainable Investments in Infrastructure and Innovation initiative and projects funded through the growth and innovation reserve from an independent expert consultant. The review resulted in the formulation of Guidelines for S3I operations in October 2020.

26. The consultancy found that in order to act as a reliable partner to the private sector to mobilize funds to drive progress towards the achievement of the Sustainable Development Goals, UNOPS should establish a multi-

year funding framework for S3I. It was found that it is important to avoid a stop/go approach resulting from valuation of the underlying assets so as not to undermine the credibility of the initiative.

Proposed change to UNOPS financial regulations and rules

27. UNOPS has carefully considered the recommendation of the consultancy to create a solid and predictable basis for the funding of the investments taken and to be undertaken under the Sustainable Investments in Infrastructure and Innovation initiative.

28. According to the regulation 22.02 (b) of the UNOPS financial regulations and rules, which governs the growth and innovation reserve, the value of the reserve may not exceed 50 per cent of the excess operational reserves, over and above the level set by the Executive Board. The change proposed in the minimum requirement for the UNOPS operational reserve will reduce the maximum value of the growth and innovation reserve.

29. To earmark the available funding of the S3I investment at the stable level established in 2019, and this way to enable the continuation of the investments under Sustainable Investments in Infrastructure and Innovation initiative also when the minimum requirement for the UNOPS operational reserve is changed, UNOPS is proposing an establishment of the S3I reserve.

30. On that basis, UNOPS proposes the regulation 22.02 of the UNOPS financial regulations and rules to be adapted to include (c) A S3I reserve for funding and recording the valuation of investments under Sustainable Investments in Infrastructure and Innovation initiative, reviewed annually by the Executive Director. The Executive Director may increase the level of funding through the excess operational reserves not allocated to growth and innovation reserve.

31. The updated regulation of the UNOPS financial rules and regulations would as a result state (with new text bolded):

Regulation 22.02

Within the UNOPS accounts, the following reserves may be established:

(a) An operational reserve at a level set by the Executive Board. The purpose of the operational reserve is to guarantee the financial viability and integrity of UNOPS as a going concern. The operational reserve shall be fully funded and held in irrevocable and promptly available liquid assets. The elements to be compensated for and covered by it shall be limited to:

(i) Downward fluctuations or shortfalls in revenue;

(ii) Uneven cash flows;

(iii) Increases in actual costs above planning estimates or fluctuations in project costs; and

(iv) Other contingencies which result in a loss of resources for which UNOPS has made commitments.

(b) A growth and innovation reserve to invest in the future revenue generating ability of UNOPS. Transfers to this reserve will be limited to 50 per cent of the excess operational reserves, over and above the level set by the Executive Board. The specific approval of the Executive Board shall be required if the amount to be transferred exceeds 50 per cent of the excess operational reserves.

(c) A S3I reserve for funding and recording the valuation of investments under Sustainable Investments in Infrastructure and Innovation initiative, reviewed annually by the Executive Director. The Executive Director may increase the level of funding through the excess operational reserves not allocated to growth and innovation reserve.

(d) The decision to draw from these reserves shall rest solely with the Executive Director who shall report all drawdowns to the Executive Board.