ASSEMBLY — 36TH SESSION

ADMINISTRATIVE COMMISSION

Agenda Item 49: Budgets for 2008, 2009 and 2010

PROTECTING THE PURCHASING POWER OF THE ICAO BUDGET

(Presented by the Secretary General)

EXECUTIVE SUMMARY

This paper provides an overview of the most common methods to protect the purchasing power of the budget and recent ICAO papers on the subject.

It offers a brief synopsis of lessons learned by those United Nations (UN) agencies who have implemented one of these methods: the split assessment system.

It concludes with a set of recommendations in respect to the need for a further review of how best to protect the purchasing power of the ICAO Budget.

REFERENCES*

A36-WP/23-AD/1

C-WP/12831, Addendum No. 1, C-DEC 181/16
C-WP/12663, C-DEC 179/3
FI-WP/641

1. INTRODUCTION

1.1 At its 181st Session, the Council recommended *inter alia* to mitigate the risk of possible future erosion of budget appropriations due to adverse exchange rate fluctuation by establishing the budget in the main currency in which the budgeted expenditures are incurred, that is through the development of a Canadian dollar (CAD) budget. The latter was based on the funding envelope of USD213.5 million converted at the exchange rate of 1.15 equivalent to a budget in Canadian dollars of 245.5 million (A36-WP/23, AD/1).

1.2 Several Council Members stated in this respect that – while they supported the consensus recommendations in principle – additional information would still be required to ensure their governments' support. Additional information on protecting the purchasing power of the ICAO Budget was provided to the Council during the twenty-fourth meeting of its 181st Session on 7 September 2007[1], and while the funding of CAD245.5 million was not disputed, one Delegation proposed that the option of split assessment regime be examined further.

1.3 What follows below is a review of the recent history of the issue of protecting the purchasing power of the budget, a summary of what has been learned from other United Nations agencies in respect to the split assessment, and a list of recommendations.

2. REVIEW OF RECENT ICAO PAPERS ON PROTECTING THE PURCHASING POWER OF THE BUDGET

2.1 The issue of protecting the purchasing power of ICAO's budget from adverse exchange rate fluctuations has been under discussion for the last five years.

2.2 The persistent weakening of the U.S. dollar (USD) - the Canadian : U.S. exchange rate has fallen from 1.54:1.00 in spring 2001 to almost par in September 2007 - has now resulted in the Business Plan facing the very real possibility of a setback due to the potential loss in purchasing power of the budget, unless a Zero Real Growth (ZRG) budget is adopted. Since ICAO's work programme should be protected, to the extent possible, from the effects of fluctuating exchange rates, the issue has been considered several times by the Council in recent years.

2.3 FI-WP/641, "Methods for Protecting and Stabilizing the Purchasing Power of Approved Budgets" dated 31 October 2003, presents various methods that may be considered for the protection and stabilization of the Programme Budget against adverse currency fluctuations. These include:

a) providing contingencies within the budget to meet potential shortfalls in funds arising from exchange rate fluctuations;

b) establishing a split currency system of assessment;

c) forward currency cover through purchase of forward currency contracts;

d) special reserve accounts to finance exchange rate fluctuations;

[1] Addendum No.2 to C-WP/12831

e) utilization of the accumulated surplus to provide a buffer against exchange rate fluctuations; and

f) establishing the budget in the main currency in which the budgeted expenditures are incurred.

2.4 In the framework of FI-WP/641 a comparative analysis is performed between “b” and “f”.

2.5 C-WP/12663, “Proposals for Dealing with Foreign Exchange Fluctuations in the ICAO Budget” dated 28 April 2006, recommends that ICAO continue the current practice of purchasing forward contracts, as necessary, to protect and stabilize the Budget against adverse currency fluctuations and utilize the currency reserve method of protecting the Organization from long-term fluctuations in the value of the Canadian dollar (C-DEC 179/3 refers).

2.6 It should be noted that in both papers noted above, the issue of a split assessment system for ICAO was considered but not approved as other methods were deemed to be more effective for an Organization the size of ICAO.

2.7 Addendum No. 1 to C-WP/12831, “Implications of Moving the ICAO Regular Programme to a Full Canadian Dollar Financial Regime” dated 6 June 2007 (C-DEC 181/16 refers), outlines the implications of the move of ICAO’s Budget to a full Canadian dollar financial regime in respect to assessed contributions, international staff salary and post adjustment, and other entitlements. It concludes that this change in policy would not completely protect ICAO from foreign exchange impacts but would mitigate their effect.

3. OVERVIEW OF OTHER METHODS TO PROTECT THE BUDGET FROM EXCHANGE RATE FLUCTUATIONS

3.1 As establishing the budget in the main currency in which the budgeted expenditures are incurred was already touched upon in the previous section of this paper, this section focuses on three other methods: the forward purchase of currency; the establishment of exchange rate reserves or currency stabilization funds; and the establishment of a split assessment system.

3.2 The forward purchase of currency

3.2.1 The forward purchase of currency is an agreement to buy (or sell) currency at a predetermined price on a specified future date. This is already ICAO’s practice at this time. However, it does not provide full protection if the forward rate is different from the budget rate and the market rates move against it.

3.2.2 Patterns of expenditures must be determined with accuracy so forward purchase requires specialised expertise and dedicated staff.

3.2.3 Furthermore, there is a limit on how far forward the market is prepared to contract. Beyond that limit, the budget’s purchasing power is at risk.

3.3 Exchange rate reserves or currency stabilization funds

3.3.1 Exchange rate reserves or currency stabilization funds are another tool that contribute to mitigate the exchange risk. They do so by collecting the losses and gains on specified transactions thus enabling them to be collected in a separate account instead of impinging on the Business Plan during the budget period.

3.3.2 States would have to agree to use year end cash surpluses to fund such a reserve. However, the reserve could be established with a zero balance.

3.4 **Split assessment system: definition and issues**

3.4.1 The split assessment is a dual currency methodology of assessment whereby assessed contributions to be paid to the Organization are stated as two amounts – one each of the two currencies of their regular budget expenditure. Accordingly, States would be requested to pay specific amounts in both currencies.

3.4.2 ICAO's present practice is that the budget is developed and approved in U.S. dollars, and States contributions are assessed and paid in the same currency. Under a split assessment system, the budget would still be developed in one currency[2] but the approved amount would be split between U.S. dollars and Canadian dollars. Two separate assessment amounts would be calculated for each currency by applying the assessment rate of each individual country to the total approved appropriations amounts of each year in each one of the two currencies.

3.4.3 With respect to currencies of expenditure, ICAO currently receives all of its assessed contributions in U.S. dollars and has to buy Canadian dollars to meet expenditures in this currency. Within a budget, any such purchase presents the risk of an exchange variance (i.e. a loss) between the budgeted rate and the market rate at the time Canadian dollars are purchased. Between budgets, if a ZRG regime is not endorsed and assessed contributions are not increased because of a fluctuation in the exchange rate, the loss caused by exchange rate variances represents a potentially material risk in respect to the Organization's ability to deliver.

3.4.4 Under a ZRG option, all States would share the burden of the loss or the benefit of the gain by virtue of the fact that the budget appropriation would take into account the negotiated exchange rate or the spot exchange rate of the day the Assembly approves the budget. Under a split assessment - even if ZRG is not applied - the risk of exchange losses and the benefit of gains arising from the fluctuation of exchange rates between subsequent budget periods would still be deflected to States.

3.4.5 The actual cost to each State will depend upon the rate of exchange between the State's own currency and the assessed currency or currencies. It could be argued that, being assessed in two currencies, the exchange risk for States does not double but rather establishes scope for diversification, creating the conditions for offsetting the risk of each individual currency. Under a split assessment, it will be the responsibility of each State to ensure the convertibility of its currency of payment into U.S. dollars and Canadian dollars. States whose currency is the U.S. dollar or is linked to the U.S. dollar should take into account the possibility of facing exchange rate variations for the first time if a split assessment is implemented.

3.4.6 A split assessment regime would allow ICAO to match income to expenditure, by major unit of currency of expenditure, thus largely avoiding the need to purchase currency within a budget and eliminating the risk of exchange rate variances. Therefore, the key to effective operation of a split

[2] CAD, as proposed in A36-WP/23 AD/1.

assessment strategy is the accurate analysis and forecasting of expenditure by the currencies in which it is made. Success will depend on the ability to predict expenditures in each currency for the entire budget period.

3.4.7 A key element of the above is also setting the exchange rate between the two currencies of assessment over the three-year budget period and there are different options to address this issue which need to be reviewed and agreed to.

3.4.8 As for possible costs for the transition to a split assessment, there are one-time system development costs[3] that are required to adapt the data warehouse environment and to create revised reports. The recurrent, incremental cost of administering a split assessment system should also be due to the accounting workload involved.

3.5 Other UN Agency experiences

3.5.1 Most UN agencies collect assessments in a single currency, which is usually the functional currency of the Organization[4] and handle the remaining risk by either active or passive hedging. These Agencies face a much lower currency risk if their second most significant currency tends to account for a low proportion of their total budget.

3.5.2 Where this is not the case a split assessment system has been employed. This is currently the case of the following three UN agencies:

a) the Food and Agriculture Organization (FAO) in Rome;

b) the International Atomic Energy Agency (IAEA) in Vienna; and

c) the United Nations Educational, Scientific and Cultural Organization (UNESCO) in Paris.

3.5.3 The United Nations Industrial Development Organization (UNIDO) had also adopted a split assessment system but decided to replace it in the 2002-2003 biennium by a Euro only assessment.

4. ANALYSIS

4.1.1 The UN experience is that the forward purchase of currency or currency stabilization funds do not afford a complete degree of protection from exchange rate fluctuations and that – when implemented - split assessment systems accomplish their primary purpose of protecting finances from the impact of such fluctuations.

4.1.2 However, ICAO’s review also highlights that the following general issues are of critical importance and should be kept in mind whilst assessing the opportunity of migrating to a split assessment regime *inter alia*:

a) it is recommended when the first and second most significant currency accounts for comparable proportions of the total budget;

[3] Estimated by FAO in 2003 between US$ 150,000 and US$ 250,000
[4] E.g. US dollars for the New York-based agencies and Swiss francs for the Geneva-based agencies

b) the development of a methodology and its agreement by the governing bodies requires time to review many factors involved and should not be entered into without significant analysis and planning and, as was the case for the FAO, by availing of the advice of external professional expertise;

c) there are one-time development costs and ongoing costs that need to be weighted against the benefit of budget protection;

d) there are several accounting implications, primarily that delays in the receipt from large contributors will still create shortages in cash flow and exchange rate differences;

e) there are budget monitoring and control issues due to the allotment currency being different from the currency of expenditure.

4.2 With respect to ICAO, it should be noted that the Organization is presently in the final stages of design for a new financial system which is scheduled for implementation on 1 January, 2008. Given the complexity of a split assessment system it may not be able to modify such a system to manage a split assessment. In this case, a manual system would have to be designed with a resulting increase in the number of financial staff needed to monitor and manage such a system.

4.3 Noting that ICAO expends funds in the currencies of the eight duty stations, it may be that Contracting States could be invited to pay their assessments in their own currency – based on expenditure requirements - which would allow ICAO to manage receipts in different currencies in respect of Financial Regulation 6.6.

5. RECOMMENDATIONS

5.1 The proposed Budget for 2008 – 2010 be approved with a funding envelope of CAD245.5 million as presented in A36-WP/23, AD/1.

5.2 ICAO implement a Canadian dollar budgeting and accounting regime as of 1 January 2008.

5.3 The Secretariat study further issues surrounding the split assessment system for ICAO as well as other options, more easy to administer, on how best to protect the Organization in the future from exchange rate risks, such as managing receipts in national currencies to match them to expenditure requirements, as allowed by Financial Regulation 6.6. This subject to be reported on to the Council of ICAO with a view to resolving it to the satisfaction of the Council.

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