

Aide-Mémoire

Impact of Currency Exchange Fluctuations on UNHCR's Operations

1. Following a request at the thirty-second meeting of the Standing Committee in March 2005, under the agenda item "Update on programme budgets and funding", this document is submitted for the information of the Committee and is aimed at facilitating understanding of the subject of the impact of foreign currency exchange rate fluctuations on UNHCR's operations.

A. Issues

2. The central issue to be explained is why the organization faces difficulties both during periods when the US dollar strengthens or weakens against other major currencies. The empirical evidence would suggest that exchange rate fluctuations are, in general and in the long run, "neutral" on UNHCR operations. During periods when the US dollar is strengthening against other major currencies, income received in currencies other than the US dollar would be reduced when converted to US dollars. At the same time, it would cost the organization less to implement the same level of activities as budgeted. Reduction in income would be offset by the reduction in expenditures and as such exchange rate fluctuations would have a less than perceptible influence on the financial situation of the organization. In a period of a weakening US dollar, the opposite should be the case, i.e. income will be increased and expenditures would also be increased leaving the organization in a similarly compensating financial position.

3. However, in practice and in the short term, there are several factors that are brought to bear on the situation explained in paragraph 2 above, causing a non-synchronous impact on income and expenditure, thus creating financial management difficulties. The main drivers are: a) the time lag between when pledges are received and paid; b) the monthly revaluation of monetary assets; c) currency conversions; d) differences between the exchange rates used in the preparation of the budget and the United Nations monthly operational rate of exchange;¹ and e) in general, the time lag between recording of income and expenditure. Further below there follows a brief explanation of how each of these variables influences this situation, identifying impacts on income and expenditure separately.

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The operational rates of exchange of the United Nations between the US dollar and other currencies are established by United Nations Headquarters. Field area rates are determined by the Treasurer on the basis of information received from UNDP, the regional commissions, peace-keeping operations, and other market sources. Each of the specialized agencies has the authority to establish its own rates. However, common rates are agreed among the organizations in practice and in the interest of uniformity. While the UN operational rate of exchange is fixed for a month at a time unless there is a substantial change during the month, the market rates of exchange fluctuate on a daily basis; as such, it is impossible to avoid exchange gains and losses.

4. The table below provides an overview of the composition of the currencies in which UNHCR prepares its budget, contributions received and expenditures incurred. It indicates the magnitude of the foreign currency exposure generated from the fiscal planning cycle and from actual cash flow movements during the year.

Currencies	2004 – Budget (US\$)	2004 – Actual Income (US\$)	2004 –Actual Disbursements (US\$)
US\$	58% (580M)	50% (500M)	63% (630M)
Nordic currencies (SEK, NOK, DKK)	-	18% (180M)	
CHF	11% (110M)	3% (30M)	13% (130M)
GBP	-	6% (60M)	
Euro	2% (20M)	18% (180M)	3% (30M)
CAD	-	3% (30M)	-
AUD		2% (20M)	
CAF	3% (30M)		5% (50M)
Others	26% (260M)		16% (160M)

B. Impact on income

Time lag between the receipt of pledges and their payment

5. The effect of currency exchange fluctuations on pledges depends on the timing of the pledge, the currency the pledge is denominated in, the date of payment of the pledge and the operational UN exchange rate in force on those dates.

6. From the time a written pledge is received from a Member State and recorded, exchange gains and losses are recorded in the accounts till the pledge is paid in full. This is best illustrated with an example. Let's assume that on 1 January 2005, UNHCR received a written pledge from a member State to the amount of 1 million euros and the pledge was paid in full on 15 June 2005. The UN operational rates of exchange on 1 January and 15 June 2005 were 0.7370 euros to US\$1 and 0.8290 euros to US\$1 respectively (i.e. there was an appreciation of the US dollar during these 6 months). As a result, on 1 January 2005, UNHCR would record income and a corresponding receivable for an amount of US\$ 1,356,852 [€1,000,000 at 0.737€to 1US\$]. On 15 June when the pledge is paid in full, the following actions would be taken:

- the receivable account is relieved;
- the US dollar cash equivalent of 1 million euros is recorded, this yields US\$ 1,206,272 [€1,000,000 at 0.829€to 1US\$] by applying the UN operational rate of exchange in effect on the date of the transaction;
- a loss on exchange of US\$ 150,580 [\$1,356,852 – \$1,206,272] is recorded (some 11 per cent of the original value).

7. From the illustration, it can be concluded that in periods when the US dollar is appreciating against other major currencies, UNHCR would be better off if contributions denominated in currencies other than the US dollar were paid in cash, or pledges were paid off shortly thereafter. In that case, UNHCR could minimize the risk of foreign exchange loss exposure as donors would assume currency risk. In this illustration, if we assume that the US dollar has been depreciating against other major currencies, the converse would hold true, and exchange gains would have been recorded by UNHCR.

Monthly revaluation of monetary assets

8. At the end of each month, UNHCR revalues all monetary assets² denominated in currencies other than the US dollar. This generates exchange gains and/or losses based on the difference between the UN operational rate of exchange in effect when transactions are recorded and the rate of exchange at the end-of-month closing.

Currency conversions

9. As indicated earlier, the currencies in which contributions to UNHCR are presently received and held differ from the currencies in which a large proportion of expenditures are incurred. Because of this multi-currency operational environment, UNHCR must convert one currency to another to fund expenditures, which exposes the Office to gains and losses which arise from fluctuations in the applicable UN operational rate of exchange following the actual fluctuations in international monetary markets. It is not possible to eliminate all gains and losses that arise from foreign exchange rate changes between the functional currency and the currency of assets / liabilities.

C. Impact on expenditures

10. For an organization that incurs a large proportion of its expenditures (60 per cent) in US dollars and 40 per cent in other major currencies, and which relies almost exclusively on voluntary contributions in a range of currencies, exchange rate management is an important consideration. The inevitable discrepancies between the exchange rate used in budget preparation and the actual monthly UN exchange rates have a more than perceptible influence on the total projected expenditures for the year.

11. For purposes of illustration, if the US dollar strengthens against other major currencies during the year, and everything else remains the same, less expenditure would be incurred in US dollar terms for the same level of activity as budgeted. On the other hand, if the US dollar weakens against other major currencies during the year, more expenditure would be recorded in US dollar terms for the same level of activity. In theory, these decreases / increases in expenditure would be offset by an inverse movement on the income side. However, impacts on income and expenditure are, in reality, non-synchronous due to the factors listed in paragraph 3 above.

12. While impact of exchange rate fluctuations on income is relatively easy to assess (due to the limited number of donor currencies other than US dollars) and is felt immediately, identifying the impact of exchange rate fluctuations on the expenditure side is very difficult. There are a large number of currencies used in funding UNHCR's operations in the Field, and the movement of some of these currencies against the US dollar is unpredictable. Expenditures are incurred over several months, during which applicable UN operational rates of exchange will vary, making it difficult to trace the impact of currency fluctuations. Furthermore, changes in the volume of UNHCR's operations (e.g. emergency activities funded from the Operational Reserve Category I) make it difficult to distinguish between the impact of volume changes (i.e. increase or decrease in the level of activities) and between the impact of price change (i.e. changes in exchange rates). With the implementation of its new information system (MSRP), UNHCR is enhancing its analytical and projection capacities as regards the

² Monetary assets are cash, claims to receive a fixed amount of cash, and obligations to pay a fixed amount of cash or, stated differently, assets and liabilities with contractual payoffs.

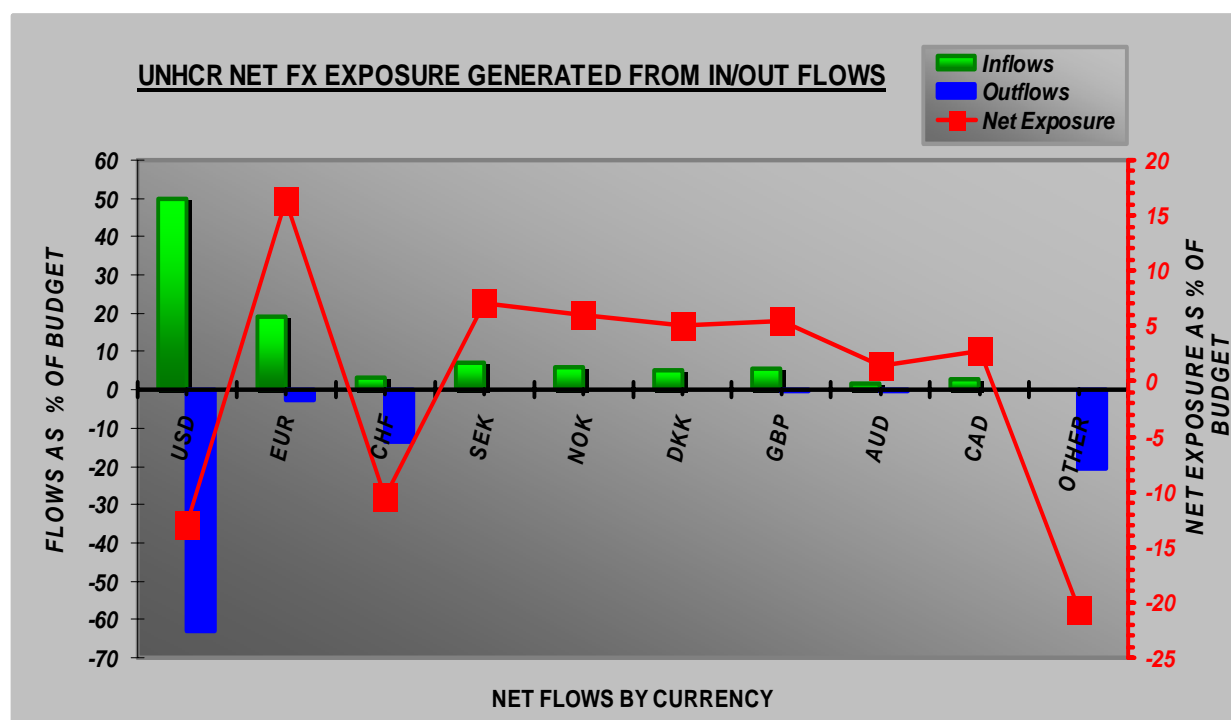
impact of exchange rates on expenditure. However it will take some time before UNHCR is equipped with sufficient capacity to analyze, project and proactively manage exchange issues to its satisfaction.

D. Actual experience

13. As stated earlier, exchange rate fluctuations are, in the long run, “neutral” on UNHCR operations. From 1990 to 2001, the combined net exchange gains and losses were zero due to a “natural hedge”. However, in the short run, UNHCR could experience significant net exchange gains or losses. The total combined net exchange gains and losses from 2003 to 2004 have amounted to a gain of US\$ 81 million due to the fact that the US dollar has depreciated by some 58 per cent against major UNHCR donor currencies from January 2001 to December 2004. More recently, at the beginning of 2005, UNHCR projected a gain on currency exchange of US\$ 30 million based on prevailing market assumptions that the US dollar would continue its decline against all other major currencies throughout the year. However, this assumption has not yet held up. In terms of the UN operational rate of exchange at December 2004, the US dollar appreciated by approximately 12 percent against other major currencies in the 6 months up to 15 June 2005. Accordingly, UNHCR has had to change its projection of currency exchange effects for 2005 from a net gain of \$30 million to a net loss of \$10 million as at 30 June 2005. A change in estimates of this magnitude in just a six-month period indicates the challenge constantly facing UNHCR.

E. UNHCR’s approach to mitigate adverse impact of exchange rate fluctuations

14. The table below demonstrates the actual cash inflows and outflows exposure that UNHCR currently has during the course of the year in addressing the foreign exchange dimension. UNHCR has performed a Value at Risk (VaR) analysis and concluded that risk attributed to foreign exchange movements is in the magnitude of 3 per cent with regard to the yearly budget as denominated in US dollars, after correlation to the various currency volatilities in their portfolio. As a result, natural hedging and a policy of partial hedging could be taken into consideration in order to limit the downside of foreign currency risk.



15. One typical way to mitigate the adverse impact of exchange rate fluctuations is hedging. UNHCR does not currently hedge against future disbursements. One reason is that the Office is to a large degree “naturally hedged” versus currencies in its portfolio, e.g. by purchasing Swiss francs through selling Euros where the volatility is much less than the volatility between the US dollar and the Swiss franc. Moreover, since the organization relies almost entirely on voluntary contributions, it is hard to estimate the timing of the receipt of pledges and the subsequent cash payment of the pledges, which must coincide with the time that fixed amounts are required in various currencies to execute a hedging contract. The lack of exact confirmation of these timings, i.e. receipt of pledges and subsequent receipt of cash from donors, currently precludes UNHCR from hedging against foreign exchange exposure at a reasonable cost and risk to the organization. Without this precise information, UNHCR would incur unnecessary costs by engaging in complex financial instruments (e.g. currency swap contracts) for financial institutions to bear the risk of non-delivery of cash contributions.

F. The practice in some UN organizations

16. Some UN organizations purchase their foreign currency requirements forward to protect their budgets against the unforeseen effect of fluctuations in exchange rates. Forward purchase is a form of “hedging” which allows the purchaser to meet future needs of a given currency at a guaranteed fixed exchange rate. In theory, forward purchase can provide some protection for the budget; however this protection is not risk-free when the forward rate is different from the budget rate and when the market rate moves against the forward rate. In 2000-2001, one UN organization sustained some US\$20 million in exchange losses when the market rate moved against the forward rate. Moreover, there are costs associated with buying forward purchasing contracts. The cost is the risk premium due to the interest differential between the two currencies. In the case of UNHCR, the ACABQ has cautioned against hedging to protect against foreign currency exchange exposure.

17. Some organizations operating under an assessed contribution regime have adopted a split assessment system. Under this system, member States’ liability to the organization (assessment to be paid) is stated in one of the main currencies in which the bulk of expenditures are incurred. Although the budget is developed in one of the two selected currencies, the approved assessed amount is split between the two currencies. This precludes or reduces the risk of currency exposure as most of the organizations’ disbursements are incurred in the assessed currencies. Furthermore, the benefit of gains and risk of exchange losses arising from the fluctuation of exchange rates are passed on to member States. This funding facility is more applicable for organizations operating under an assessed contribution regime, but is not applicable to UNHCR.

18. Some organizations have established a Special Reserve Account (SRA). The function of an SRA is to collect gains and losses on specified transactions, thus enabling them to be kept in a separate account instead of impinging on the budget. The actual impact of currency exchange gains and losses on the budget is not eliminated, but spread over a longer timeframe (e.g. several years). However, in times of significant losses on currency exchange the resulting deficit in the SRA must be funded, and in the case of UNHCR, an organization funded with voluntary contributions, this could be a daunting prospect.

G. Conclusion

19. The long term impact of exchange rate fluctuation could be said to be “neutral” on UNHCR’s operations. However, in the short term, depending on the timing and magnitude of foreign currency movements, UNHCR may face serious difficulties in neutralizing its impact. In simple terms, foreign exchange impact on the income side is immediate (as per examples above) but, due to the nature of UNHCR’s financial and programme management, the impact on expenditures is felt much later and in a diffused manner. This delay combined with constant currency fluctuations adds to the overall difficulty in managing foreign exchange fluctuations.

20. However, a more fundamental cause of the difficulty in managing currency fluctuations lies outside the field of currency fluctuations, namely the fact that UNHCR’s budgets are chronically underfunded, and that these budgets are often “capped”. Due to inadequate funding of UNHCR’s operations, there is strong and constant pressure to utilize any available funds. Thus, when net exchange gains are realized on the income side due to a declining US dollar, not only are all gains allocated to programmes, but there is continuous pressure to allocate further funds to these chronically underfunded programmes. When net exchange losses are realized on the income side, efforts are made to reduce expenditures by reducing budgetary allocations, however it is extremely difficult to reduce budgetary allocations once they have been made to various programmes. As a result, whether the US dollar appreciates or depreciates, UNHCR constantly faces difficulties in managing exchange rate fluctuations in such a way as to not overspend the available funds.

21. Provided UNHCR has more precise information from donors on when pledges are received and paid, a policy of partial hedging might be considered to limit downside currency risk. For the moment, the evidence gathered appears to be in favour of the current practice of taking advantage of the natural hedge positions. UNHCR will continue to monitor and analyze this situation carefully, to make reasonable projections and to take appropriate actions to minimize the disruptive impact of exchange rate fluctuations.

UNHCR
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