



INTERNAL AUDIT DIVISION

AUDIT REPORT 2013/068

Audit of the management of United Nations Joint Staff Pension Fund Investment Management Division's back office operations

Overall results relating to the efficient and effective management of back office operations were initially assessed as partially satisfactory. One recommendation has been implemented satisfactorily; the implementation of two important recommendations remains in progress.

FINAL OVERALL RATING: PARTIALLY SATISFACTORY

**21 August 2013
Assignment No. AS2012/801/02**

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AUDIT REPORT

Audit of the management of United Nations Joint Staff Pension Fund Investment Management Division's back office operations

I. BACKGROUND

1. The Office of Internal Oversight Services (OIOS) conducted an audit of the management of United Nations Joint Staff Pension Fund (UNJSPF or the Fund) Investment Management Division's (IMD's) back office operations.

2. In accordance with its mandate, OIOS provides assurance and advice on the adequacy and effectiveness of the United Nations internal control system, the primary objectives of which are to ensure (a) efficient and effective operations; (b) accurate financial and operational reporting; (c) safeguarding of assets; and (d) compliance with mandates, regulations and rules.

3. UNJSPF comprises the Secretariat, which is responsible for pension administration matters, and IMD, which is responsible for investment of the Fund's assets. The management and administration of the investments of the Fund is the fiduciary responsibility of the Secretary-General of the United Nations. At the time of the audit, the Secretary-General had delegated this responsibility to the Assistant Secretary-General of the Office of Central Support Services in his role as the Representative of the Secretary-General (RSG) on matters related to the investments of the UNJSPF¹. The Representative was assisted by IMD, which managed the Fund's portfolio on a day-to-day basis.

4. The Fund invests in a global portfolio of equities, fixed income, real estate, short-term instruments, and alternative investments. As at 31 December 2012, the preliminary market value of the Fund's assets was \$44,643 million, and the asset allocation was: 61.7 per cent in equities, 28.0 per cent in fixed income, 4.9 per cent in real estate, 2.4 per cent in short-term instruments, 1.1 per cent in alternative investments and 1.9 per cent in the Minimum Volatility Index Fund.

5. The Operations Section of IMD is responsible for investment back office operations including: processing investment trades and transactions for settlement; collecting investment income, maturities and refund taxes; keeping records of investment activities; reconciling internal records with those maintained by the custodians and Master Record Keeper (MRK); accounting; and, financial reporting. The Section also prepares daily cash projections to support the Fixed Income Section in the front office in managing cash in all the currencies utilized by IMD for investment purposes. The Section, under the general guidance and direction of the Fund's Chief Finance Officer, implemented the use of International Public Sector Accounting Standards (IPSAS) for use, with effect from 1 January 2012, in Fund-wide financial statements.

6. The Section's 2012-2013 budget of \$11,041,800 provided for the continuation of nine posts, the redeployment of one General Service post to the Office of the Director and another one to the Risk and Compliance Section, and the establishment of one new post. The budget included an increase of \$9,012,200 in non-post resources attributable primarily to contractual services (\$7,812,500) and resources that were previously requested under executive direction and management, comprising other staff costs (\$897,100), travel of staff (\$52,600) and consultants (\$250,000).

¹ As and from 19 February 2013, the Secretary-General delegated to the Assistant Secretary-General for Programme Planning, Budget and Accounts, and Controller the authority to act on his behalf in all matters involving the fiduciary duties of the Secretary-General relating to the investments of the assets of the UNJSPF.

7. Comments provided by IMD are incorporated in *italics*.

II. OBJECTIVE AND SCOPE

8. The audit was conducted to assess the adequacy and effectiveness of the Fund governance, risk management and control processes in providing reasonable assurance regarding **the efficient and effective management of the Fund's back office operations**.

9. This audit was included in the 2012 OIOS risk-based audit plan due to the operational and financial risks related to safeguarding investment assets and processing trades for settlement.

10. The key controls tested for the audit were: (a) risk management and strategic planning; and (b) regulatory framework. For the purpose of this audit, OIOS defined these key controls as follows:

(a) **Risk management and strategic planning** – controls that provide reasonable assurance that a valid business case, including risks, controls and costs, is established for initiating major changes that have significant operational/financial impact and such changes are aligned with a clear long-term strategy of the Fund..

(b) **Regulatory framework** – controls that provide reasonable assurance that policies and procedures: (i) exist to guide the operations of the Back Office, such as processing investment trades for settlement and safeguarding investment assets; (ii) are implemented consistently; and (iii) ensure reliability and integrity of financial and operational information.

11. The key controls were assessed for the control objectives shown in Table 1. Certain control objectives (shown in Table 1 as “Not assessed”) were not relevant to the scope defined for this audit.

12. OIOS conducted this audit from 24 July to 19 October 2012. The audit covered the period from 1 January 2011 to 30 September 2012. The audit reviewed the following processes and functions of the Back Office:

- Processing of trades for settlement
- Cash forecasting
- Reconciliation of back office records of cash, income, trades, transactions, positions/holdings, corporate actions and tax withheld with custodian/MRK, and resolution of discrepancies identified internally and by the MRK

13. OIOS conducted an activity-level risk assessment to identify and assess specific risk exposures, and to confirm the relevance of the selected key controls in mitigating associated risks. Through interviews, analytical reviews and tests of controls, OIOS assessed the existence and adequacy of internal controls and conducted necessary tests to determine their effectiveness.

III. AUDIT RESULTS

14. The UNJSPF governance, risk management and control processes examined were assessed as **partially satisfactory** in providing reasonable assurance regarding **the efficient and effective management of the Fund's back office operations**. Although the Fund's risk management and strategic planning controls over the processing of trades for settlement and cash forecasting were adequate, OIOS made three recommendations to address issues identified in the audit. IMD needed to demonstrate the

benefits of the dual custodial model and to clarify its strategy regarding the Master Record Keeper function, and address the potential duplication of functions by IMD and the independent MRK. The regulatory framework controls over the core functions of the Back Office needed improvement in the area of the monitoring and recovery of taxes withheld on the Fund’s income by various countries.

15. The initial overall rating was based on the assessment of key controls presented in Table 1 below. The final overall rating is **partially satisfactory**. One recommendation has been implemented satisfactorily; the implementation of two important recommendations remains in progress.

Table 1: Assessment of key controls

Business objective(s)	Key controls	Control objectives			
		Efficient and effective operations	Accurate financial and operational reporting	Safeguarding of assets	Compliance with mandates, regulations and rules
Efficient and effective management of back office operations	(a) Risk management and strategic planning	Partially satisfactory	Not assessed	Satisfactory	Partially satisfactory
	(b) Regulatory framework	Partially satisfactory	Partially satisfactory	Partially satisfactory	Partially satisfactory
FINAL OVERALL RATING: PARTIALLY SATISFACTORY					

A. Risk management and strategic planning

Need to conduct a cost benefit analysis of the custodial model

16. Two custodians and one MRK were providing services to the Fund. The custodians were responsible for trade settlements, safekeeping of securities, financial instruments and cash, consolidated reporting of securities under custody, collection of income and tax recovery. The MRK was responsible for keeping records of investment transactions and positions, monitoring and auditing custodians through daily reconciliation, preparation of general ledger, and performance measurement/reporting.

17. In the wake of the 2008-2009 financial crises, IMD management decided to change its custodial model to two custodians and one independent MRK. After delays in the procurement process, IMD signed a contract in June 2012 with a second service provider for custodial services for the Fund’s emerging/frontier markets and markets in Hong Kong and Singapore. The contract took effect on 2 July 2012, but IMD had yet to complete the transfer of assets to the service provider when the audit was conducted.

18. IMD amended the original custodian/MRK contract with the first service provider so that it would only serve as the custodian for the Fund’s developed market portfolio, American Depositary Receipts and Global Depositary Receipts. IMD also separately contracted this service provider as the independent MRK. The contract has a five-year term and can be extended for another full term. The United Nations can terminate the contract with one-month notice. It took effect on 1 June 2012.

19. In a submission to the Pension Board, IMD stated “the dual custodian approach was intended to mitigate the risk of keeping all the assets of the Fund with a single custodian bank amidst the economic crisis, similar to the one experienced in 2008-2009.” However, a written business case was not completed

to support the need for two custodians. There was no documentation that identified and assessed the risks and benefits related to the custodial model and the associated costs.

20. The dual custodians/independent MRK arrangement will incur transition costs and higher recurring costs. In addition, subsequent to the audit the Back Office began to identify operational challenges associated with working with two custodians. For example, each custodian reports in a different format and requires unique processes.

(1) IMD should prepare a cost benefit analysis that supports its decision to implement a dual-custodian and independent MRK model.

IMD accepted recommendation 1 and stated that it will prepare an executive summary to provide an awareness of the issues surrounding custody services and the resulting decision to move to a dual-custodian and independent MRK model. Recommendation 1 remains open pending receipt of a written analysis supporting management's decision to implement a dual-custodian and independent MRK model.

Need to clarify MRK strategy and address the potential duplication of functions by IMD and the independent MRK

21. IMD started implementing a new Back Office system in 2010, MUREX, which will have three critical functions: a) Operations: record, control and track settlement instructions, multi-currency, multi-asset and real-time market-to-market holdings, etc.; b) Reconciliation: reconcile with the custodians to ensure daily matching of investment data including investment holdings, transactions and income; and c) Accounting: support IPSAS-compliant accounting and financial reporting. Full implementation was planned for 2014.

22. IMD also planned to implement a data hub to provide consistent and coherent market data in real time to all critical business applications in IMD. The data hub would be linked to major market data providers such as Thomson Reuter and Bloomberg, and to the Fund's dual custodians and the independent MRK.

23. The implementation of the new systems and tools served to increase capacity in IMD to perform the functions of the independent MRK. However, there was no evidence of a clear strategy, including a needs and feasibility assessment and timeline, to eventually have internal functions and systems that can perform all MRK responsibilities. It was also unclear whether it would still be necessary to retain the services of the independent MRK once such internal capacity was in place. The potential duplication, if not addressed on a timely basis, exposes the Fund to the risk of inefficient use of financial and human resources.

(2) IMD should prepare a strategy relating to its establishment of internal MRK functions, which addresses the potential duplication with the independent MRK.

IMD accepted recommendation 2 and stated that it will prepare the strategy that establishes the need, feasibility and timeline for internal MRK functions and addresses the interaction with the independent MRK for the consideration of the Representative of the Secretary-General for the Investments. Recommendation 2 remains open pending receipt of the written strategy.

B. Regulatory framework

Need to improve monitoring of recoverable taxes withheld on Fund income by various countries

24. The Fund, a UN organ, is exempt from direct taxes on assets, income and other properties pursuant to article II, section 7 (a) of the Convention on the Privileges and Immunities of the United Nations of 13 February 1946. However, some countries withhold taxes on income received at source. The custodians file for reclamation of these taxes withheld from the taxing authorities by submitting proper documentation. Reimbursement of taxes is subject to the individual countries' rules and regulations. Some countries have no formal tax reclamation mechanism.

25. The Back Office maintained an electronic spreadsheet by country/tax authority to keep track of the withheld taxes, which amounted to US\$21 million as at 30 June 2012. The amounts on this spreadsheet did not reconcile with the custodian's consolidated recoverable tax report as at 30 June 2012. The custodian included in its report the small caps and had written off taxes receivable from countries that did not have supporting documentation or the tax reclaim mechanism in place. On the other hand, the IMD spreadsheet still included the taxes written off and excluded the small caps. There were also two errors on the in-house spreadsheet, which were immediately corrected by IMD.

(3) The IMD Back Office should restructure the content of its spreadsheet on taxes withheld on Fund income and receivable from various countries to correspond with the related custodian report to improve the efficiency of the reconciliation process, and to strengthen the monitoring of recoverable taxes.

IMD accepted recommendation 3 and stated that the recommendation has been implemented. As of 31 December 2012, in-house spreadsheets incorporated both small caps and large caps and any taxes withheld or written off by jurisdiction. The corresponding tax records also have been reconciled with MRK accounting records. Based on the action taken by IMD, recommendation 3 has been closed.

IV. ACKNOWLEDGEMENT

26. OIOS wishes to express its appreciation to the Management and staff of IMD for the assistance and cooperation extended to the auditors during this assignment.

(Signed) David Kanja
Assistant Secretary-General for Internal Oversight Services

STATUS OF AUDIT RECOMMENDATIONS

**Audit of the management of United Nations Joint Staff Pension Fund
Investment Management Division's back office operations**

Recom. no.	Recommendation	Critical ² / Important ³	C/ O ⁴	Actions needed to close recommendation	Implementation date ⁵
1	IMD should prepare a cost benefit analysis that supports its decision to implement a dual-custodian and independent MRK model.	Important	O	Issuance of a written analysis supporting management's decision to implement a dual-custodian and independent MRK model.	30 October 2013
2	IMD should prepare a strategy relating to its establishment of internal MRK functions, which addresses the potential duplication with the independent MRK.	Important	O	Issuance of the written strategy relating to the internal MRK functions and interaction with the independent MRK.	30 June 2014
3	The IMD Back Office should restructure the content of its spreadsheet on taxes withheld on Fund income and receivable from various countries to correspond with the related custodian report to improve the efficiency of the reconciliation process, and to strengthen the monitoring of recoverable taxes.	Important	C	Implemented.	31 December 2012

² Critical recommendations address significant and/or pervasive deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance cannot be provided regarding the achievement of control and/or business objectives under review.

³ Important recommendations address important deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance may be at risk regarding the achievement of control and/or business objectives under review.

⁴ C = closed, O = open

⁵ Date provided by IMD in response to recommendations.

APPENDIX I

Management Response

UNITED NATIONS



NATIONS UNIES

UNITED NATIONS JOINT STAFF PENSION FUND
CAISSE COMMUNE DES PENSIONS DU PERSONNEL DES NATIONS UNIES

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MEMORANDUM

Ref:

New York, 26 July 2013

To / Ms. Carmen Vierula, Chief, New York
A: Audit
Service Internal Audit Division, OIOS

From / De : Maria Eugenia CASAR
Representative of the Secretary General
for the Investments of the Fund

A handwritten signature in black ink, appearing to read "M. Casar".

Subject / IMD response to OIOS Assignment No. AS2011/801/02 - Audit of IMD Back Office
Object: operations

Reference is made to your memorandum dated 24 April 2013 providing the report on the above mention audit.

I am pleased to provide IMD's comments on the findings and recommendations as requested.

Please find attached the Annex to the audit recommendations which details IMD's responses to the findings.

I wish to thank you and OIOS for the recommendations made following the review of the IMD Back Office and for the constructive discussions with IMD Staff regarding this matter.

cc: Ms. Suzanne Bishopric
Mr. Toru Shindo
Mr. Ajit Singh
Mr. Daniel Willey
Ms. Zelda Tongoan-Fourcade
Mr. Kamel Kessaci
Mr. Fernando Salon
Ms. Anna Halasan

AUDIT RECOMMENDATIONS

Audit of the management of United Nations Joint Staff Pension Fund Investment Management Division's back office operations

Rec. no.	Recommendation	Critical/ Important ⁱⁱ	Accepted? (Yes/No)	Title of responsible individual	Implementation date	Client comments
1	IMD should prepare a cost benefit analysis that supports its decision to implement a dual-custodian and independent MRK model.	Important	Yes			<p>IMD will prepare a one-to-two page risk-benefit executive summary to provide an awareness of the issues surrounding custody services i.e., the lag effect of the UN Procurement Department, the global diversity of UN pension fund securities, the variation of services and pricing from various custodians, the importance of not being dependent to one custodian to transfer cash for the monthly benefit payments, the safe keeping of assets.... and the resulting decision to move to a dual-custodian and independent MRK model.</p> <p>Expected completion date – 30 October 2013.</p>
2	IMD should prepare a strategy relating to its establishment of internal MRK functions, which addresses the potential duplication with the independent MRK.	Important	Yes			<p>As IMD assesses its internal MRK functions / interaction with the independent MRK, a formal strategy will be developed and presented to the RSG.</p> <p>Expected completion date – 30 June 2014.</p>

Rec. no.	Recommendation	Critical/ Important ⁱⁱ	Accepted? (Yes/No)	Title of responsible individual	Implementation date	Client comments
3	The IMD Back Office should restructure the content of its spreadsheet on taxes withheld on Fund income and receivable from various countries to correspond with the related custodian report to improve the efficiency of the reconciliation process, and to strengthen the monitoring of recoverable taxes.	Important			Closed	Completed. As of 31 December 2012, in-house spreadsheets incorporated both small and large caps and any taxes withheld or written off were separately tracked by jurisdiction. Corresponding tax records have also been reconciled with the Northern Trust/MRK accounting records.

ⁱ Critical recommendations address significant and/or pervasive deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance cannot be provided regarding the achievement of control and/or business objectives under review.

ⁱⁱ Important recommendations address important deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance may be at risk regarding the achievement of control and/or business objectives under review.