United Nations Nations Unies

REF: AUD-8-10: 6 (00018/05) 22 July 2005

TO: Mr. Christopher Bancroft Burnham
A: Under-Secretary-General for Management and
Representative of Secretary-General
for the Investments of the UNJSPF

FROM: Patricia Azarias, Director
DE: Internal Audit Division I
Office of Internal Oversight Services

P. Azarias

SUBJECT: **OIOS Audit No. AS2005/801/1: Review of the UNJSPF Real Estate Investments**

1. I am pleased to present herewith our final report on the subject audit which was carried out at the United Nations Headquarters from February to April 2005. The audit was conducted in accordance with the standards for the professional practice of the internal auditing in the United Nations Organizations.

2. We noted from your response of 13 July 2005 that you have generally accepted our recommendations. Based on your comments, we are pleased to inform you that we have closed recommendations 6, 9 and 11 in the OIOS recommendation database. In order for us to close the remaining recommendations (nos. 1 to 5, 7, 8 and 10), we would appreciate your providing us with the information requested in the text of the report when implementation action is taken for each of the recommendations.

3. I would like to take this opportunity to thank the management and staff of the Investment Management Service for their assistance and cooperation provided to the auditors in connection with this assignment.

Copy to:
Ms. Chieko Okuda
Mr. Bernard Cochemé
UN Board of Auditors
Programme Officer, OIOS

United Nations

OFFICE OF INTERNAL OVERSIGHT SERVICES

Internal Audit Division I

Audit Report

Audit subject:	Review of the UNJSPF Real Estate Investments
Audit No.:	AS2005/801/1
Report date:	22 July 2005
Audit team:	William Petersen Irene Gichinga Mariel Arcilla-Aguilar

Review of the UNJSPF Real Estate Investments (AS2005/801/1)
Executive Summary

The Investment Management Service (IMS) of the United Nations Joint Staff Pension Fund (UNJSPF or the Fund) is responsible for managing the real estate investment portfolio which had a market value of US$1.6 billion as of 31 December 2004. In view of the significance of these investments, from February to April 2005 the Office of Internal Oversight Services (OIOS) conducted an audit of the UNJSPF real estate investment operations covering the period 2003 and 2004.

Significant findings

The audit found that the Fund had generally complied with applicable guidelines and policies, but noted a few cases where the procedures were not well documented or where the level of detail was insufficient. For example:

- The responsibility for monitoring and evaluating investment management performance and specific evaluation benchmarks are not documented in the IMS Manual; and
- The IMS Manual does not contain the requirements and procedures for performance evaluation of the Fund's service providers.

As recommended by its real estate advisor, the UNJSPF maintains a broadly diversified portfolio by property types, geographical locations, and investment vehicles. Additional diversification is provided through funds which invest in a hybrid of real estate-related investment vehicles.

- These funds appear to carry higher risks than conventional real estate funds and require a more versatile risk to reward tolerance;
- Also, they appear to require more specialized investment skills than would be required by traditional real estate investment vehicles; and
- Although the returns on these investments have continuously been above the applicable benchmarks, in OIOS' opinion, UNJSPF needs to ensure that the funds are properly categorized as real estate investments, and that the higher risks of these funds are fully understood and monitored.

The UNJSPF's Operations Section had promptly performed all monthly reconciliations of the consolidated reports provided by the master record keeper (MRK) and the regional custodian banks, thus ensuring that the General Ledger was promptly updated. However, several cases were noted where the integrity of the information had not been confirmed by the Operations Section:

- A comparison of the quarterly performance measurement reports with those provided by the various investment fund managers revealed that the balances did not agree;
- No reconciliation between reports provided by the MRK and those from the various investment fund managers had been prepared since December 2003;
- The audit determined that the $126,290 dividend declared by one REIT had been paid in November 2002, but the check had been lost or otherwise misplaced; and
- Dividends totalling over $1.1 million paid by a REIT were received from 5 to 20

months after they were declared.

OIOS is of the view that the IMS should put in place automated procedures to assist in monitoring the dividends declared with an aim of ensuring their timely receipt and recording in the accounting records.

Recommendations

OIOS made a total of 11 recommendations to the Investment Management Service aimed at, *inter-alia*:

- Strengthening its policies and procedures for monitoring and evaluating the performance of its service providers;
- Improving the reliability and completeness of the real estate valuation reports and the level of compliance with IMS accounting and financial reporting requirements; and
- Reviewing the classification of its hybrid investment vehicles and ensuring that the risks of these investments are fully understood and that they are properly monitored.

OIOS also followed-up on prior audit recommendations related to the UNJSPF's direct investment in an office building in New York City and found that most of the recommendations have been fully implemented by IMS. Although the building was sold in 2004, a question still remains as to whether an economic benefit will have to be paid to the minority investor upon dissolution of the holding company formed to purchase the building.

Table of Contents

I. INTRODUCTION

1. The United Nations Joint Staff Pension Fund's (UNJSPF or the Fund) real estate portfolio is comprised of investments in publicly traded real estate investment trusts (REITs) and private commingled real estate funds. The Investment Management Service (IMS) of the UNJSPF is responsible for managing the real estate investment portfolio whose market value as of 31 December 2004 was US$1.598 billion. In addition, as at the same date, the Fund had $340.6 million in unfunded commitments (capital allocated to real estate funds, but not yet called). The majority of the unfunded commitments in the portfolio is expected to be called over the next three years.

2. IMS invests in real estate in accordance with applicable investment guidelines and with an overall objective of achieving a balanced portfolio through diversification in investments which meet the Fund's safety, profitability, liquidity and convertibility criteria.

3. Real estate transactions are initiated by the Investments Section using a Real Estate Purchase Recommendation form for purchases or capital contributions, and a Real Estate Sale Recommendation form for sales or capital withdrawals. All real estate purchases transactions have to be made in firms on the Approved List which is comprised of those companies which have been considered and approved as possible sources of investments for the Fund. In addition, the purchase and sale transactions have to be supported with appropriate comments from appropriate investment officers supporting the transaction. In all cases, these transactions have to be approved by two senior officers in the Investment Section.

4. Record keeping services are currently provided by State Street Bank (UNJSPF's master record keeper or MRK) while the real estate assets are held in the custody of the regional custodian banks namely, Boston Safe Deposit and Trust (Mellon) and Northern Trust Bank. The IMS is in the final stages of a procurement exercise to merge the two functions of record keeping and custody of the Fund's assets to be provided by one firm. In addition, the Fund has a nondiscretionary advisor, the Townsend Group (Townsend), whose responsibilities include provision of diverse real estate management approaches including recommendations on the acquisition and disposition of real estate investments. The fees paid to these third parties were $3.9 million in 2004 and $4.4 million in 2003. The decrease in cost was primarily attributable to a change in the real estate advisor.

II. AUDIT OBJECTIVES

5. The principal objectives of the audit were to: (i) assess the adequacy of the Fund's internal controls over investments in real estate and the level of compliance with prescribed UNJSPF policies and procedures and UN Financial Regulations and Rules, and (ii) determine whether the Fund's investment monitoring procedures were appropriate and performed in an efficient and effective manner.

III. AUDIT SCOPE AND METHODOLOGY

6. The audit covered the Fund's real estate investment operations in 2003-2004 and included reviewing and assessing the soundness, adequacy, and application of internal management controls over investments in real estate funds. This included assessing the risk factors associated with real estate investments and ascertaining the extent of compliance by IMS and other participants with established regulations and rules, policies, procedures, and guidelines.

7. OIOS reviewed a sample of 16 private real estate investments and 2 public real estate investments. The sample was selected based on a variety of criteria such as funds acquired and liquidated in the period under review, high value funds, funds that had shown significant gains or losses, and funds that charged high management fees. Annex 1 lists the real estate investment funds sampled.

8. The audit involved the examination of financial reports and records, interviews with key personnel and advisers, and the evaluation of the appropriateness of the investment policies and guidelines followed. OIOS also followed up on prior audit recommendations related to the Fund's direct investment in real estate, and reviewed the governance process and management control framework in executing the direct real estate sale transaction that was consummated in September 2004. The audit was conducted in accordance with the standards for the professional practice of internal auditing in United Nations organizations at the United Nations Headquarters, and was carried out from February to April 2005.

IV. OVERALL ASSESSMENT

9. The Fund has generally complied with the applicable real estate investment policies, procedures and guidelines. Also, for the period under review, the returns on the Fund's real estate investments remained well above the NCREIF Index ("NPI"), which is the Fund's overall performance benchmark.

10. To ensure the reliability of information reported, the Fund performs timely reconciliations between the reports provided by the MRK and those from the regional custodians. However, the audit identified a need to extend these reconciliations to reports received from the various investment fund managers, and to improve the integrity and reliability of the financial information used in the investment decision making process.

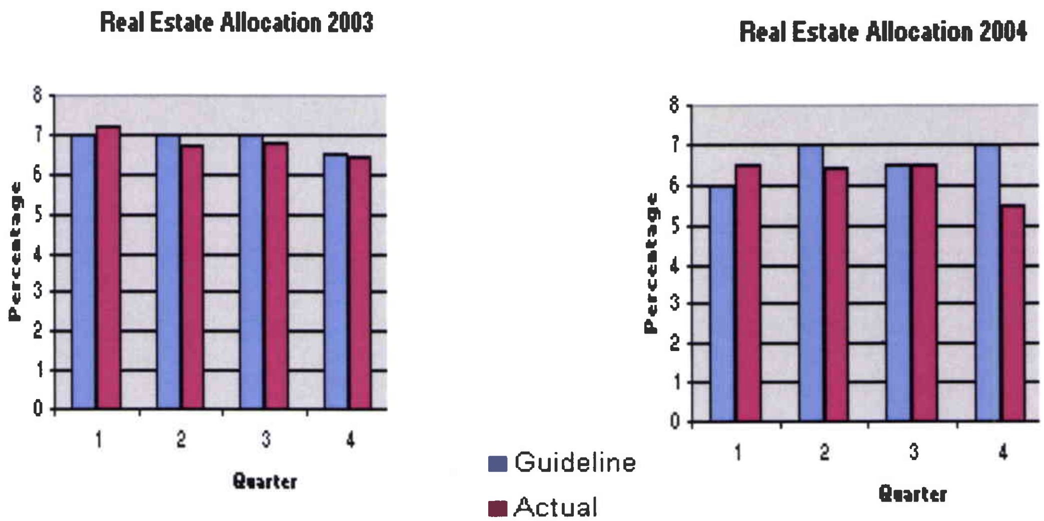
11. The Fund has not established specific performance indicators for its real estate service providers and there is need for strengthening the Fund's policies and procedures for monitoring and evaluating these service providers. The audit also disclosed that there is need for reviewing the classification of hybrid investment vehicles, and for ensuring that this class of investments is fully understood and adequately monitored. Dividends declared should also be monitored to ensure timely receipt.

V. FINDINGS AND RECOMMENDATIONS

A. Fund compliance with performance and allocation guidelines

12. The Representative of the Secretary-General for the Investments of the UNJSPF (RSG) approves asset allocations for each type of investments, which are reviewed by the United Nations Investments Committee. The long-term guidelines for real estate as a percentage of total Fund assets include lower and upper ranges along with a target desired level set for each quarter. The long-term range percentage goal set for the period ended December 31, 2004 was 5 to 8 per cent while the short-term guidelines together with the actual real estate allocation is as shown below.

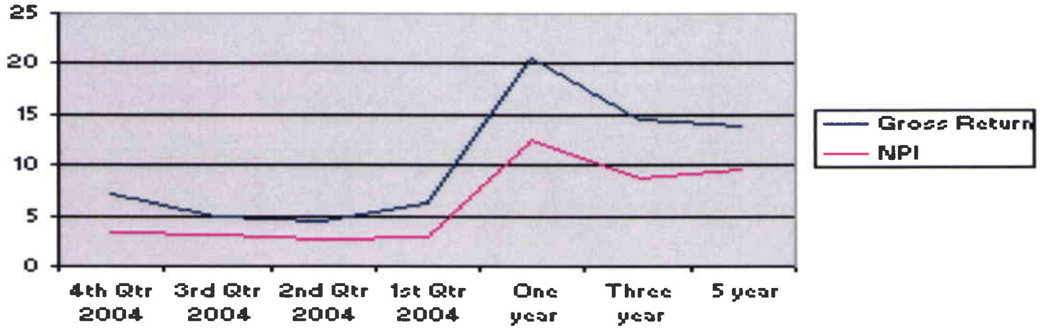
Graph 1: Real Estate Allocation – Guideline vs. Actual



13. For most of 2003 and 2004, the Fund remained close to the short-term guidelines except for the 4th quarter 2004 where the real asset portfolio was under allocated by nearly 2 percentage points mainly due to the sale of the 222 East 41st Street building.

14. The current real estate objectives are aimed at providing diversification to the Fund's overall investment program while at the same time preserving investment capital. The Fund also aims at generating attractive risk adjusted returns. OIOS was pleased to note that for 2004 and indeed for the past five years, the Fund remained consistently above the NCREIF Index ("NPI") which is the Fund's overall real estate portfolio performance benchmark:

Graph 2: Real Estate Portfolio Gross vs. Benchmark Returns



15. In addition to the long-term and short-term allocation targets and performance benchmarks, the Fund establishes desired exposures in the various real estate categories, and by property type as well as geographical location. For the quarter ended 31 December 2004, there was general compliance with the set guidelines with a few exceptions as shown below:

Table 1: Compliance by category

Category	Compliance	Property Type	Compliance	Geographical Location	Compliance
Core	√	Apartment	√	Developing Markets	√
Private	√	Industrial	√	Emerging Markets	√
Public	√	Office	√	Non US	√
		Retail	Underweight	Aggregate US	√
		Other	√	West	√
				Midwest	√
				East	Overweight
				South	√

B. Real Estate Investment Policies, Procedures, and Guidelines

Guidelines for real estate transactions need to be updated

16. The UNJSPF's investment policies provide a broad framework for investing and safeguarding the Fund's assets so as to mitigate risks against losses, misappropriation, or fraud. The IMS Organization, Policies and Procedures Manual (IMS Manual) contains an overview of the policies and procedures to be followed by the IMS management when investing the Fund's assets. The Real Estate Investment and Management Guidelines (the Guidelines), developed by the real estate adviser and approved by the IMS management, form the control infrastructure for, and outline the responsibilities of, the staff of IMS and the advisor in the real estate investment process. The guidelines also define the constraints placed on the assets held in the real estate program and outline the actions to be taken in meeting the Fund's goals.

17. The audit found that the Fund had generally complied with applicable guidelines and policies as documented in the IMS Manual. However, OIOS noted a few cases where the procedures were not well documented or where the level of detail was insufficient.

(a) The responsibility for monitoring and evaluating investment management performance and specific benchmarks to be used for evaluation purposes are not documented. The IMS Manual also does not contain the requirements and procedures for performance evaluation of service providers including the MRK, securities custodians and the real estate adviser. In the absence of policies or guidelines for periodic performance evaluation, there an objective basis for assessing the overall effectiveness of these service providers appears to be lacking.

(b) While the IMS Manual describes in general terms the procedures to be followed for real estate investments, it does not provide sufficiently detailed procedures for specific investments such as hybrid funds. OIOS is of the opinion that due to the specialized nature of the hybrid funds, appropriate policies and procedures including investment limits and monitoring requirements for hybrid funds investments should be documented.

Accounting procedures as detailed in the IMS Operations Manual are not being followed

18. The controls over accounting systems are fundamental to good management and enhance the reliability of information produced for the financial statements. Section 7 of the IMS Operations Section Manual (Operations Manual) indicates the monthly accounting procedures to be followed by the MRK in reporting on the valuation of the Fund's assets including real estate investments.

19. The audit identified a few cases where the accounting procedures as specified in the Operations Manual were not being followed. For instance, the Manual calls for recognizing cash distributions as redemptions for the Prudential Financial fund. OIOS' re-computation of the realized gain or loss on a $ 1,887,329 cash distribution for the third quarter of 2004 resulted to a gain of $48,669 using the algorithm provided in the Manual. The MRK had recorded a gain of $71,412 for the same transaction.

20. Also, the Manual states that, for the Prudential Financial fund, the management fees should be netted from the fund balance in their entirety and no gain or loss should be realized thereon. Notably, the MRK periodically recognized gains and losses on management fees and for the same third quarter of 2004, a gain of $9,392 had been realized on the management fees of $238,834. The MRK acknowledged that they did not always follow the procedures outlined in the Operations Manual.

21. Such inconsistencies in the accounting treatment may compromise the integrity of the financial information. Therefore, in OIOS' opinion, the UNJSPF needs to review the effects of such non compliance and advise the MRK concerning the need to account for gains and losses in compliance with the procedures contained in the Operations Manual.

Compliance with limitations of ownership interests

22. According to the current guidelines, the Fund may not hold more than 20 per cent of a particular real estate fund at the time of initial purchase, but the size of holding could

subsequently rise above this percentage due to withdrawals by other partners or increase in the Fund's position to take advantage of investment opportunities. Under these circumstances, the limit is determined by the RSG on a case-by-case basis.

23. As of 31 December 2004, the Fund held shares in Hendersen U.S. Properties (formerly Phoenix Mutual Life) valued at $69.5 million. This fund had been performing poorly and in 1989, UNJSPF's real estate adviser had recommended that the investment in Phoenix be reduced, both to be in compliance with the applicable guideline and also to reduce the Fund's exposure, since Phoenix had continuously underperformed the required benchmarks. The IMS subsequently sold a portion of its holdings in Phoenix. However, the Fund's stake in this investment continued to grow to 47 per cent of the total amount invested as of 31 December 2004, which was well above the recommended 20 per cent limit.

24. OIOS notes that the UNJSPF initiated the redemption of its ownership interest in Hendersen in February 2005, but the sale has not been completed as of the date of this report. OIOS considers the lack of structured guidelines concerning the level of ownership in this case to be a serious concern, particularly in view of the real estate advisor's prior recommendation to reduce the Fund's position in this underperforming investment. Since withdrawals from the fund by the other partners may have been prompted by envisaged poor investment performance, in the view of OIOS, there should be constant monitoring of the Fund's real estate investments for such withdrawals to ensure that the Fund does not become overexposed.

25. Contingencies such as this case may be realized when the other partners withdraw their capital, and have been provided for in the guidelines. However, OIOS is of the opinion that: (a) the 20 per cent ownership limitation should be considered as the objective for the life of the investment, and not just the value at inception, and (b) whenever this level is exceeded, the fund's holdings should be reduced and brought into compliance as soon as possible.

26. In addition, OIOS believes that closer monitoring of the UNJSPF's percentage level of its real estate investments would allow for the timely disposition of poorly performing funds to reduce the Fund's exposure to potential losses. In this regard, reports to the Investment Committee could be revised to include the ownership percentages in the various funds so as to highlight, in a timely manner, any significant exposures the Fund may be facing. The Committee might also wish to include in its quarterly meetings a review of the Fund's exposures that result from exceeding the applicable guidelines.

Recommendations 1 to 3

OIOS recommends that IMS:

(i) Revise the Organization, Policies and Procedures Manual (IMS Manual) to ensure that all relevant policies and procedures governing the Fund's real estate activities are adequately covered. In particular, the performance monitoring and evaluation procedures should be documented, as well as policies regarding investments in hybrid funds and limitations on the level of ownership during the life of the investment. (AS2005/801/1/01)

(ii) Review the accounting procedures being followed by the master record keeper vis-a-vis those required by the Manual with an aim of :

(a.) Establishing the effect of noncompliance with the established procedures on the integrity of the financial reporting of the Fund's performance; and

(b.) Advising the master record keeper on the accounting procedures that should be followed (AS2005/801/1/02); and

(iii) Regularly review the Fund's compliance with applicable guidelines as regards ownership interests in the various funds so as to identify and rectify in a timely manner any unwarranted exposures. (AS2005/801/1/03)

27. *IMS agreed to implement recommendations 1 through 3. Concerning recommendation 1, IMS stated that it has requested resources for the services of a consulting group to assist in revising the IMS Manual. In regard to recommendation 2, IMS stated that the consultants would also be requested to determine the depth and volume of accounting, verification and reconciliation procedures. IMS also stated that it would confer with the new Global Custodian/MRK to implement these accounting procedures in a computerized environment to minimize manual tasks. Regarding recommendation 3, IMS stated that it has discussed the recommendation with Townsend so that ownership interests will be reported quarterly to the Investments Committee and monitored regularly for immediate implementation, if so required. Townsend and IMS also agreed to institute an upper ownership limit for the life of the real estate investment in the Fund in addition to the existing limit at the time of purchase.* Recommendations 1 to 3 will remain open in OIOS' database pending their full implementation.

C. Integrity and reconciliation of fund balances

28. A key role of State Street Bank, the UNJSPF's MRK, is the audit and detailed verification of each real estate transaction in cooperation with the Fund's custodians. In addition, the UNJSPF receives reports from the Townsend Group, the Fund's non discretionary adviser and from the various investment fund managers. However, according to Section 6 of the Operations Manual, UNJSPF Operations Section is ultimately responsible for the accuracy and integrity of the books of account of the Fund. To ensure the reliability of information reported, the Operations Section staff is required to perform timely reconciliations between the reports provided by the MRK and those from the investment fund managers.

29. OIOS reviewed the financial reports prepared by the various service providers and noted that UNJSPF's Operations Section had promptly performed all monthly reconciliations of the

consolidated reports as provided by the MRK with those from the regional custodians with the aim of verifying investment transactions, income earned, taxes withheld and subsequently ensuring that the General Ledger was promptly updated. However, the following cases were noted where the integrity of the information had not been confirmed by Operations Section:

(a) Reconciliation between reports provided by the MRK and those from the various investment fund managers had not been prepared since December 2003. While the Operations Section was cognizant of the need for these reconciliations, they were unable to do so because of the limited staffing resources. Lack of prompt reconciliations leads to considerable and costly manual efforts being expended when the reconciliations are eventually done. While OIOS appreciates the fact that these third parties are paid for services they should be providing, ultimate responsibility of the Fund's performance is vested with IMS and appropriate mechanisms, including the possible need to review the adequacy of staffing resources, should be put into place to monitor the performance and results of these third party service providers.

(b) Comparison of the quarterly performance measurement reports with reports provided by the various investment fund managers revealed that the balances for the private real estate investments did not agree. This was explained as a timing difference since the balances reported by the MRK normally relate to the actual balances for the previous quarter. OIOS was informed that this was due to the reporting deadlines which often made it impossible for the MRK to update the records with the relevant transactions. OIOS accepted the explanation as long as the practice was consistently applied.

(c) For the 16 private real estate investments sampled, the quarterly market value balances agreed to the prior quarter reports from the various fund managers for all the quarters, with the exception of the first quarter of 2004. The audit determined that the 2004 first quarter balances as reported in the performance measurement reports did not agree with the investment funds' balances as of the last quarters balances of 2003 or the balances for the first quarter of 2004 as shown in the following examples:

Table 2: Unreconciled Fund Balances (Market value in US$)

Fund	Performance measurement report:	Investment fund balances	
	First Quarter 2004 results	31/12/03	31/03/04
JER Global Fund II	28,821,253	28,836,402	29,616,112
Greenfield Acquisition	60,953,616	57,959,061	61,654,695
Doughty Hanson & Co	24,250,077	38,898,018	39,690,871

(d) Further, the quarterly performance measurement reports reviewed during the audit appeared unreliable as the balances brought forward from previous quarters did not agree with opening balances in the following quarter as shown below.

Table 3: Real Estate Fund Balances (Market value in US$)

Period	Beginning Market Value	Ending Market Value
1st Quarter	1,595,972,511	1,688,095,376
2nd Quarter	1,634,399,203	1,710,081,515
3rd Quarter	1,676,878,767	1,722,359,652
4th Quarter	1,708,298,805	1,595,358,079

(e) Moreover, the Operations Section does not have a mechanism in place to monitor the commitments and the unfunded commitments. Indeed, it was not clear as to whether this should be done by Operations Section or by the Investments Section.

30. Notably, the performance measurement reports are used as the basis for reporting to the quarterly Investment Committee meetings. Although the variances are not always material, they could affect the quality of the information used for decision making purposes. Further, if the variances are unresolved at the time of preparation of the financial statements, the reliability of financial reporting may be affected. In this regard, if there are material changes to the information contained in the performance measurement reports, the Investment Management Service should provide the Committee with updated information as soon as it becomes available.

31. In the view of OIOS, the Fund should endeavor to ensure that the reports presented to the Investment Committee fairly represent the correct market value of the real estate investments by regularly marking the assets to market which entails adjusting the value of the real estate assets on the books of the pension plan to the then-current market value of these assets. The IMS staff should spot check the quarterly reports on a sample basis for accuracy, and any reports so produced should reflect the revised market values of the individual investments.

Recommendations 4 and 5

OIOS recommends that the Investment Management Service put mechanisms in place to ensure:

(i) The reliability and completeness of the real estate valuation reports, including those provided to the Investment Committee to enable them to make informed decisions; (AS2005/801/1/04) ; and

(ii) The timely reconciliation of quarterly performance measurement reports from the master record keeper with those from the individual investment fund managers. (AS2005/801/1/05)

32. *IMS accepted recommendations 4 and 5. IMS stated that recommendation 4 was discussed with Townsend, which has a dedicated department that closely reviews and monitors the reports from the investment managers and those provided to the Investment Committee. Townsend agreed to document their procedures on monitoring the investment manager reports and how these are translated into the Investments Committee reports in the near future.*

33. *Concerning recommendation 5, IMS stated that it would work with the new Global Custodian and the Real Estate Advisor to obtain more timely reconciliations of reports received from individual investment managers. The Operations Section will work with the new MRK/Custodian to deliver these reports accurately, on time and as part of the contract. Townsend has agreed to speak with the new Global Custodian/Master Trustee to aid in the initial setup of the real estate report characteristics. IMS indicated that advice of a consulting group will be sought to determine the industry practice and regard to the timing of such reconciliation procedures.* Recommendations 4 and 5 will remain open pending notification of their full implementation.

D. Hybrid Funds

34. Management of risk is usually achieved through diversification and the strict application of investment policies. In their Investment Strategy report of August 2004, the Townsend Group recommended that the UNJSPF maintain broadly diversified portfolio by property types, geographical locations, and investment vehicles.

35. Some of the diversification is provided through funds which invest in a hybrid of real estate-related investment vehicles. One such fund is Lone Star Fund IV which mainly invests in non-US investments including distressed markets. UNJSPF committed $75 million to Lone Star IV which made investments in various vehicles such as secured and non-secured loan acquisitions, distressed debt and acquisition of companies' outstanding stock and indebtedness.

36. A review of the 2004 Lone Star Fund IV financial statements showed that $262.6 million, or about one-third of the fund's total assets of $1.27 billion were actually invested in real estate properties, and that in addition to the other investments described above, the Fund had significant investments in derivative instruments on behalf of its affiliates. As of 31 December 2004, the fund controlled foreign currency forwards and futures having an underlying notional value of $3.1 billion, and in 2004, it had incurred realized losses of $14.4 million and unrealized losses of $135 million from derivative investments.

37. UNJSPF committed $50 million to another real estate-related investment vehicle, DB Realty Mezzanine Investment Fund II, LLC, which invested in high yield "mezzanine" securities issued by real estate companies and trusts. According to the Fund's 2004 audited financial statements, the securities held in the portfolio as of 31 December 2004 yielded from 375 to 1,000 basis points above the London interbank offered rate (LIBOR) and fixed interest rates of from 10.5 to 16.6 per cent. Although the securities were secured by pledges of the borrowers' ownership interests in the underlying properties, the very high interest rate yields indicate that the loans bear significantly more risk than traditional mortgage-backed securities.

38. While investing in the hybrid funds provides additional diversification to the overall investment program, including opportunities to capitalize on global inefficiencies, these funds appear to carry higher risks than conventional real estate funds and require a more versatile risk to reward tolerance. Also, they appear to require more specialized investment skills than would be required by traditional real estate investment vehicles.

39. OIOS notes that the returns on these investments have continuously been above the applicable benchmarks. OIOS also notes that nature of the investment activities of these funds was properly disclosed in the Approved List and Equity Purchase recommendations. However, in the opinion of OIOS, UNJSPF needs to ensure that the funds are properly categorized as real estate investments, and that the higher risks of these funds are fully appreciated by the Representative of the Secretary General and the Investment Committee. Moreover, OIOS questions whether adequate procedures have been established for monitoring risks and performance of such hybrid funds. Other players in the market usually accomplish this through a specialized investment consultant or a strategic partner, and the UNJSPF should ensure that its current real estate adviser, the Townsend Group, is actively involved in monitoring these hybrid investments.

Recommendations 6 and 7

> OIOS recommends that the Investment Management Service:
>
> (i) Consult with the real estate advisor concerning the classification of its hybrid investment vehicles and ensure that the risk to reward profile of these investments is understood by the Representative of the Secretary General for the Investments of the Fund and the Investment Committee; (AS2005/801/1/06); and
>
> (ii) Strengthen the monitoring mechanism for hybrid funds by either obliging the current real estate adviser to more actively monitor the performance of such hybrid funds or by engaging the services of a firm specializing in hybrid funds. (AS2005/801/1/07)

40. *IMS accepted recommendation 6 and discussed with The Townsend Group these particular investments. Townsend stated that industry practice classifies as real estate those investment vehicles whose underlying assets are mainly real estate. The real estate market has evolved and there are now very sophisticated vehicles that still qualify as real estate, and each purchase recommendation is reviewed by the Investments Committee and approved by the RSG. However, IMS will pay particular attention to the categorization of Real Estate investments and redefine real estate investments as necessary, in light of the risk level appropriately attributed to the Real Estate investments. Furthermore, the Executive Summary of Townsend's Investment Analysis and Recommendation will be attached to the IMS recommendation to the Investments Committee in order to provide more detail into each real estate investment manager's strategy and risk level.* OIOS considers recommendation 6 as implemented.

41. *IMS also accepted recommendation 7 to monitor more closely the opportunistic sector (higher risk vehicles) of the Real Estate portfolio by conferring more closely with the Townsend Group. As its real estate advisor, Townsend has the fiduciary responsibility to monitor all investment managers, must be fully cognizant of the characteristics of hybrid investments and competent to evaluate and recommend its purchase. Furthermore, they are fully engaged in processing hybrid investments as well as core investments. Additionally,*

Townsend sits on advisory boards of several of the Fund's real estate vehicles to monitor strategy and protect the interest of the Fund. Townsend will send a list of these boards and their activities to IMS. Also, IMS will evaluate the documentation on the procedures provided by Townsend (see paragraph 32) to assure proper monitoring for hybrid funds. Recommendation 7 will remain open until OIOS receives and reviews the above-mentioned procedures on hybrid funds.

E. Performance monitoring and evaluation

42. The Fund employs the services of three custodian banks, a master record keeper and a real estate adviser. Total fees paid to these service providers amounted to $3.9 million in 2004 and $4.4 million in 2003. These service providers, as well as the fund investment managers, are involved in the management and monitoring of the Fund's real estate portfolio. However, the ultimate responsibility of the portfolio's performance is vested with the Investment Management Service.

43. OIOS found that the fees charged by these service providers were as stipulated in the contracts with the service providers in all cases. OIOS noted that the decrease of $ 0.5 million in these fees in 2004 was primarily attributable to the change of the real estate adviser. While cost considerations should not be the sole reason to change a service provider, OIOS notes that the services provided by the new real estate adviser were of a very high standard and appeared to provide good value for money. OIOS was also informed that the Fund is in the final stages of a procurement exercise to replace the existing fund custodian and MRK contracts and notes that such a move may result in more competitively priced services to the Fund.

44. Monitoring, which includes the systematic collection of information to provide indications of performance, is crucial for optimizing the value and return of each individual fund's performance. However, OIOS found no evidence to show that the IMS staff is systematically monitoring and evaluating the performance of individual fund managers and the other service providers. Further, there are no set benchmarks against which these service providers can be evaluated. Given that a total of $3.9 million was paid to these service providers in 2004, in the view of OIOS, appropriate monitoring and evaluation mechanisms should be established to ensure that the Fund obtains value for money. These should include specification of the range of monitoring information, scheduling of periodic evaluations and a process for dealing with underperformance.

45. The performance of the real estate investments should be reviewed regularly, particularly since many of the real estate funds require advance notification for redemption. Although past performance does not predict future results, it may provide an ability to determine cases where there is underperformance on the part of the service providers. OIOS is of the opinion that the Fund should establish appropriate monitoring mechanisms which may include the following:

- Review at least annually the service providers' compliance with applicable investment and accounting guidelines as well as the overall performance of each one of them
- Review each fund manager's quarterly report vis-a-vis those provided by the Fund's custodians

- Compare quarterly investment results from each fund manager with appropriate indices or benchmarks
- Verify each real estate investment fund's quarterly fee computations
- Meet at least annually with each service provider to review the service levels provided as well as any significant changes that may have occurred in the providers' operations

Recommendation 8

The Investment Management Service should set clear expectations and establish monitoring procedures for the master record keeper, custodian banks and the real estate adviser. The results of the monitoring and evaluation procedures applied should be documented.
(AS2005/801/1/08)

46. *IMS agreed with recommendation 8, particularly on improving the documentation of the evaluation of service providers. IMS' Operations Section conducted evaluations of two custodians and the MRK in May 2005 for performance of services for the years 2003 and 2004. These were undertaken as part of the RFP process for the Global Custodian/MRK. The Section has now assigned two people to monitor each fund manager's quarterly reports versus those of the custodians and MRK. IMS' Operations Section will establish these monitoring procedures with the new global custodian/MRK and perform annual evaluations based on the Service Level Agreement.*

47. *Expectations of IMS service providers are included in their contracts, or in the case of investment fund managers, in their offering documents/prospectus. Monitoring of the performance of all service providers and also of all investments is undertaken seriously and consistently. IMS discussed with the real estate advisor the same for the individual real estate investment fund managers. However, Townsend stated that it is not industry practice to have formal evaluations of each investment manager. Townsend has no other clients that require formal investment manager evaluations but will research other sources for guidance on this issue. Furthermore, there would be significant additional costs to be paid by the Fund to Townsend for these services outside the contract. The evaluation is generally implied when an agreement is made in either to continue to hold and to purchase or sell an investment.* In view of the above information, OIOS has modified its recommendation and has deleted its reference to the evaluation of investment fund managers. Recommendation 8 will remain open pending IMS' implementation of monitoring procedures for its service providers.

F. Need to monitor the receipt of dividend income

48. Publicly traded REITS help to provide diversification as they show a low correlation with other real estate classes. In addition, they are required to distribute most of their income through dividends that can be reinvested or taken out in cash and invested elsewhere.

49. The audit disclosed that no mechanisms have been established by IMS to monitor the timely receipt of dividends declared. Delays were noted in receipt of the declared dividend as shown in Table 4 below which has resulted in lost investment income to the Fund.

Table 4: Delayed Dividends

Fund	Currency	Amount Outstanding - 4th Quarter	Dividend Payable Date	Dividend Date Paid
Investa property group	US$	58,315.51	21 Feb 05	outstanding
Investa property group	US$	402,102.54	20 Feb 04	31 Jul 04
Investa property group	US$	382,487.79	21 Feb 03	31 Jul 04
Investa property group	US$	372,680.41	21 Nov 02	31 Jul 04
PanEuropean Property Units	GBP	78,292.16	06 Jan05	2 Mar 05
Equity Residential	US$	126,290.00	Nov 02	outstanding

Note: Investa property group was not in the OIOS sample, but was added based on a review of the IMS cash book entries for dividends received

50. The audit determined that the $126,290 dividend declared by Equity Residential had been paid in November 2002, but the check had been lost or otherwise misplaced. Notably, IMS Operations staff were not aware of the missing check or of the fact that this particular fund always remits the dividends in two instalments. More significantly, dividends totalling over $1.1 million paid by the Investa property group were reported by the MRK as being received from 5 to 20 months after they were declared.

51. The above examples of delayed dividend payments relate only to REITS, but they indicate that this problem could extend wider to dividend payments in other securities classes. OIOS is of the view that the Fund should put in place procedures to assist in monitoring the dividends declared with an aim of ensuring their timely receipt and recording in the accounting records. OIOS notes that the IMS has requested funding in its 2006-2007 budget request to automate its monitoring of investment performance. OIOS supports this objective and believes that such a system could also help IMS to better monitor the accuracy of accounting transactions and the receipt of dividend payments.

Recommendation 9

OIOS recommends that the Investment Management Service develop procedures to monitor the receipt of dividends declared to ensure their timely receipt and recording in the accounts. (AS2005/801/1/09)

52. *IMS accepted and implemented recommendation 9. IMS Operations Section was aware of the above-mentioned missing dividend payment, as evidenced by the email communications between IMS, the custodian and the registrar in February 2003, but acknowledged that the missing payment should have been more diligently followed up to assure collection. The Operations Section is now working closely with the custodian and the registrar to recover this amount expeditiously. Also, they have now instituted a procedure whereby all dividends/interest*

not received will be monitored on a monthly basis through the issuance of a discrepancy letter which will not be cleared until the cash payment is received. In view of the above, OIOS has closed recommendation 9 as implemented.

G. Status of prior recommendations regarding the Fund's direct investment in real estate

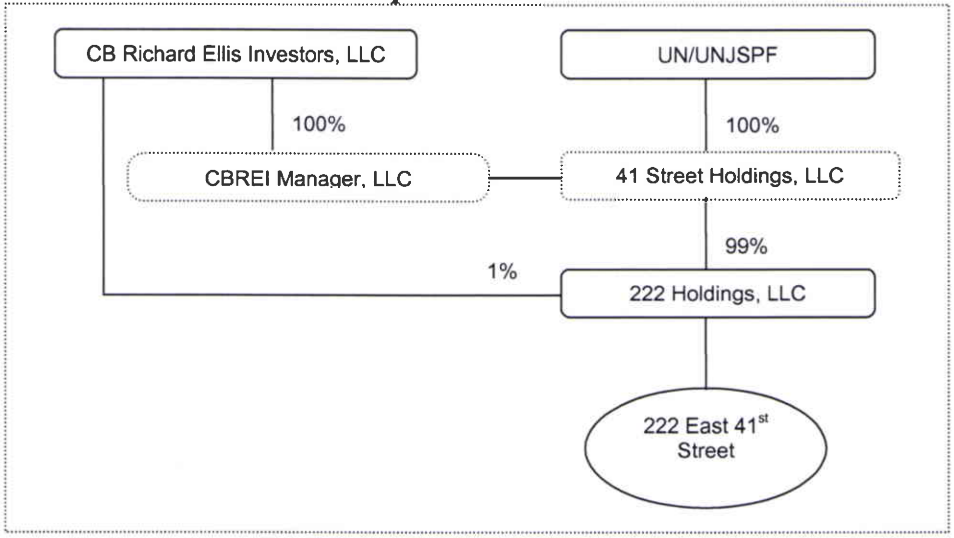
53. In an audit report dated 18 August 2004 (AS2003/95/1), OIOS identified a number of issues surrounding the UNJSPF's direct investment in an office building in New York City which was purchased in January 2003 at a total cost of $180.45 million. OIOS concluded that overall, IMS did not take adequate steps when acquiring the property, such as consulting with the UN Office of Legal Affairs (OLA), to fully protect the interests of the Fund. The report made 16 recommendations to the Investment Management Service to improve controls over the Fund's direct investments in real estate. After completion of the audit, IMS advised that a decision was taken to sell the building. The OLA has been involved and consulted systematically in the resolution of the outstanding issues, and the sale was concluded in September 2004.

54. As part of the current audit, OIOS followed up the status of the prior audit recommendations, and examined the sale transaction for the 222 East 41st Street building. OIOS is pleased to note that most of the recommendations have been fully implemented by IMS, and that the sale of the building resulted in an estimated profit to the Pension Fund of $17.56 million. However, a question still remains as to whether an economic benefit will have to be paid to the minority investor, CB Richard Ellis Investors, LLC. The status of the prior audit recommendations is shown in Annex 2.

Investment strategy and structure

55. The acquisition of the building was made through the creation of two limited liability companies as illustrated in Figure 1. 222 Holdings, LLC was formed in October 2002, and on 23 December 2002 it entered into a purchase and sale agreement with the Seller. In order to purchase the building in the form of debt/equity leverage, 41st Street Holdings, LLC financed a mortgage loan of $86.85 million to 222 Holdings, LLC, with the balance of the investment of $93.6 million made as an equity contribution. CBRE Investors, LLC held a one percent interest in 222 Holdings, LLC through a capital contribution of a note payable in the amount of $860,000. This ownership structure is described in the chart below.

222 East 41st Street Ownership Structure



56. The UNJSPF paid $180.45 million in cash to purchase the building, which was recorded as a capital contribution to 41st Street Holdings, LLC, of which UNJSPF is the sole member. Upon completion of the financing of the investment, 222 Holdings, LLC had planned to repay the loan from 41st Street Holdings, LLC. CBRE Investors, LLC's one percent interest in 222 Holdings, LLC was then to be redeemed without economic benefit and removed as minority member of 222 Holdings, LLC. However, since the Fund decided to sell the building, no refinancing took place and CBRE Investors, LLC's one percent minority interest was not extinguished in accordance with Section 7.2 (a) of the 222 Holdings Limited Liability Agreement.

57. OIOS' review of Section 7.2 of the 222 Holdings Limited Liability Agreement disclosed that CBRE Investors LLC's one percent interest could result in an economic benefit: "Upon the closing of a first mortgage loan on the Property, which mortgage loan is generally expected to be in the amount of approximately $133 million, the Company shall be obligated to purchase and CBREI shall be obligated to sell, CBREI's Interest in the Company for a purchase price equal to (a) CBREI's Capital Account balance if the closing of such purchase occurs within 180 days of the acquisition of the Property or <u>(b) the fair market value of CBREI's Interest in the Company if the closing of such purchase occurs more than 180 days after the acquisition of the Property.</u> The purchase price for the Interest in the Company shall be paid in immediately available funds, and CBREI shall convey good and marketable title to its Interest in the Company to the Company free and clear of all liens and encumbrances." Underscoring provided.

58. The conditions under Section 7.2 (a) of the Limited Liability Agreement were not satisfied (i.e., no first mortgage loan was obtained on the property). Further, there are no legal documents to indicate that CBRE Investors, LLC has relinquished its minority ownership interest in 222 Holdings, LLC. A question therefore remains about whether CBRE Investors, LLC may continue to have a right to a share of the profits from the sale of the 222 East 41st Street building.

59. OIOS originally recommended that IMS management should request the law firm representing the purchaser in the transaction to provide an opinion letter to the effect no economic benefit will be derived by CBRE Investors, LLC from the elimination of its one percent interest (See Annex 2, Recommendation 1). IMS agreed with this recommendation. However, that the attorneys contracted to represent the Fund in the building's sale, Greenberg, Traurig, LLP, did not address this issue when the building's sale took place.

60. Moreover, according to the opinion letter to the 31 December 2004 audited financial statements of 41st Street Holdings, LLC, "The Company sold its real estate investment in 2004 and it is expected that all operations will be completed by June 30, 2005, at which point the Company will be dissolved." As of 28 February 2005, the net assets of 41st Street Holdings totaled $290,174. OIOS believes that this amount would be sufficient to cover the one per cent minority interest, if CBRE Investors decides to pursue a share of the profits from the sale under Section 7.2 (b) of the 222 Holdings Limited Liability Agreement.

Recommendation 10

The Investment Management Service should consult with the Office of Legal Affairs concerning the dissolution of 222 Holdings, LLC and 41st Street Holdings, LLC and determine its liability, if any, to the minority member under Section 7.2 of the 222 Holdings Limited Liability Agreement. (AS2005/801/1/10)

61. *IMS accepted recommendation 10 apprising that they have been in regular contact with OLA regarding this issue. OLA's preliminary recommendation is to seek the final accounting of the transactions involving 222 Holdings LLC and 41st Street Holdings LLC and to consult OLA further as necessary.* This recommendation will be closed when information on the final accounting is provided to OIOS.

Reasonableness of legal fees on the sale

62. OIOS reviewed the closing documents for this transaction and noted that the Fund paid legal fees totaling $140,000 to Greenberg Traurig, LLP as part of the settlement of funds. However, there was no detailed statement of the legal fees and expenses. Normally there should be an advance agreement for a flat rate legal fee for the sale or a detailed breakdown of the billing for the time charges of the attorneys who worked on the case as well as the incidental expenses incurred.

Recommendation 11

The Investment Management Service should request a detailed bill from Greenberg Traurig, LLP to support the $140,000 fee charged for sale of 222 East 41st Street building and provide same to OIOS to review the reasonableness of the legal fees charged. (AS2005/801/1/11)

63. *IMS accepted and implemented recommendation 11. IMS requested and received detailed invoices from Greenberg Traurig, which were forwarded to OIOS for evaluation.* OIOS has closed recommendation 11 as implemented.

VI. ACKNOWLEDGEMENT

64. We wish to express our appreciation for the assistance and cooperation extended to the auditors by the staff of the Investment Management Service during the course this audit.

P. Azarias

Patricia Azarias
Director, Internal Audit Division I
Office of Internal Oversight Services

ANNEX 1

OIOS Sample of Real Estate Funds

Portfolio Category		Region	Fund
Stable portfolio			
	1	Europe	Immobilien Sweiz
	2	Canada	Great West Life Real Estate
	3	Australia	Aust. Prime Property Fund Commercial
	4	USA	Prudential Property Invest.
	5	USA	Hendersen US Properties
Enhanced Portfolio			
	6	Europe	Trans European Property Limited Partnership III
	7	Europe	Hanover Prop UT Property Fund
	8	USA	CBRE Strategic Partners II
	9	USA	DB Realty Mezzanine Inv. Fund II
High Portfolio			
	10	Asia	Aetos Capital Asia GP LP
	11	USA	Morgan Stanley Prime Props
	12	USA	Guggebhein Structured Re LP
	13	USA	Greenfield Acquisition Partner II LP
	14	Global	Lone Start Fund IV
	15	Europe	Doughty Hanson & Co European Real Estate
	16	Global	JER Global Fund II
Public Investments			
	17	USA	United Dominion Rlty Inc. Com
	18	USA	Simon Property Group

Status of OIOS Recommendations
Review of UNJSPF Direct Investment in Real Estate (AS2003/95/1)

Rec. No.	Recommendation	Status
01	IMS management should request the law firm representing the purchaser in the transaction to provide a detailed summary of the transaction, including an opinion letter to the effect that notwithstanding anything contained to the contrary in the Amended and Restated Limited Liability Company Agreement of 222 Holdings, LLC, no economic benefit will be derived by CBRE Investors, LLC from the elimination of its one percent interest.	Open, pending dissolution of holding companies and determination of liability, if any, payable to CBRE Investors (minority interest holder).
02	IMS should consult OLA in a timely manner to ensure that the assets of the Fund are sufficiently protected from loss and that the UN's legal interests, including the privilege and immunities to which the UN and the assets of the Fund are entitled, are not adversely affected.	Closed - IMS agreed that the Office of Legal Affairs should have been involved in all aspects of the building transaction, and stated that OLA has been consulted systematically in the resolution of these issues since the recommendation was made.
03	OLA should review the investment structure IMS utilized to acquire the building and provide its opinion in regard to any relevant legal implications, particularly with respect to the Organization's potential legal ability and its privilege and immunities.	Closed - By its memorandum dated 7 June 2004, the Office of Legal Affairs provided OIOS with its opinion stating that the Organization's privileges and immunities were compromised by UNJSPF's decision to acquire the property through the limited liability companies.
04	IMS management should re-examine its strategy concerning its investment in the property to determine if refinancing with a third party is still a viable option, or whether alternative strategies should be pursued to protect the returns on its investment in the property.	Closed – IMS advised that leveraging was never pursued and the building was subsequently sold at a substantial profit.
05	IMS management should take immediate action to lease the property to other qualified parties.	Closed - The sale of the building has superceded this recommendation.
06	IMS management should provide OIOS with documentation supporting the basis and justification for the payment of a brokerage fee to CB Richard Ellis, Inc., and initiate legal action to recover the	Closed – The UN Office of Legal Affairs advised OIOS in a memorandum dated 27 August 2005 that a legal basis existed for the payment of the real estate

	fee amounting to $882,500, if there was no valid legal basis for the payment.	commission to CB Richard Ellis, Inc., and that the amount paid (one-half per cent of the gross sales price) was considered to be reasonable compensation for the brokerage services provided.
07	IMS management should ensure that in future transactions for the purchase of real property, all liabilities for the payment of real estate commissions and other similar charges are properly reflected in the pertinent agreements.	Closed – IMS stated that it would ensure that real estate commissions and charges would be properly reflected in pertinent agreements for any future acquistions.
08	IMS management should request the UN Insurance Service to conduct a comprehensive review of the existing insurance coverage of the real estate acquired by the Fund, and ensure that a new policy is procured as soon as possible.	Closed - The sale of the building has superceded any need for insurance coverage.
09	When determining the insurance requirements on future property acquisitions, IMS management should consult with the UN Insurance Service in order to ensure the adequacy of insurance coverage and to obtain the best value for money expended	Closed - IMS agreed to work closely with the UN Insurance Service in ensuring that insurance coverage is obtained in any future acquisitions.
11	The RSG and the UNJSPF management should establish a policy designating which officials approved by the RSG have signing authority to enter into contracts, agreements, instruments, or documents, relating to the establishment and operation of commercial entities, on behalf of the Fund.	Closed - IMS advised that the Representative of the Secretary General is the appropriate signatory for contracts and agreements, and that the RSG's written authorization will be obtained for such documents going forward. For investment instruments, the signature of the RSG is obtained in accordance with the Delegation of Authority.
12	IMS management should establish adequate controls and procedures over the approval and monitoring of related party relationships, where outside contractors and advisers perform various roles, relating to real estate investments.	Closed - The Deloitte Touch study reviewed IMS' investment practices, controls and procedures which IMS has accepted and is implementing.
13	IMS management should ensure that, in the course of appointing professional advisors and service providers, selection is carried out on a competitive basis and that bid submissions, oral discussions, and management decisions are documented and maintained internally by the Fund.	Closed – IMS is currently following the UN Procurement Service procedures to conduct competitive bidding as has been done for the procurement of the new bank custodian and master record keeper service contract.

14	IMS management should assign the responsibility of monitoring the real estate portfolio to an IMS Investment Officer who reports to the Director, to facilitate segregation of duties between the approval and monitoring functions, as appropriate, and to minimizing the Director's involvement in the day-to-day activities.	Closed – IMS has assigned real estate duties to a senior investment officer having dual responsibilities for equities and real estate. IMS has also requested funds in the 2006-2007 budget to add an investment officer for real estate to the current organizational structure.
15	IMS management should provide training to IMS staff responsible for monitoring the portfolio in order to enhance their knowledge of real estate investment management, and to ensure that the appropriate level of skills, qualifications, and experience are developed in order to fulfill the Fund's fiduciary responsibilities.	Closed - IMS is relying on its real estate advisor until an experienced real estate investment officer can be hired. Staff will attend conferences and seminars to better improve the knowledge level within IMS.
16	IMS management should establish recordkeeping requirements to ensure that reliable management information underlying investment transactions is documented in an accurate, timely, and easily accessible manner.	Closed - IMS agreed to conduct a comprehensive inventory of its real estate files to assess the level of existing documentation and will make those files available in a more readily accessible and orderly condition.

United Nations Nations Unies

OIOS/IAD-1 Client Satisfaction Survey

The Internal Audit Division-1 is assessing the overall quality of its audit process. A key element of this assessment involves determining how our clients rate the quality and value added by the audits. As such, I am requesting that you consult with your managers who dealt directly with the auditors, and complete the survey below. I assure you that the information you provide will remain strictly confidential.

Audit Title & Assignment No.: Review of the UNJSPF Real Estate Investments (AS2005/801/1)

By checking the appropriate circle please rate:

		1 (poor)	2	3	4(excellent)
1.	The extent to which the audit addressed your concerns as a programme manager.	○	○	○	○
2.	The audit staff's understanding of your operations and objectives.	○	○	○	○
3.	The professionalism of the audit staff (communications, integrity, professional knowledge and responsiveness)	○	○	○	○
4.	The quality of the audit report in terms of:				
	-- accuracy and validity of findings and conclusions	○	○	○	○
	-- clarity and conciseness	○	○	○	○
	-- balance and objectivity	○	○	○	○
	-- timeliness	○	○	○	○
5.	The extent to which the audit recommendations were appropriate and helpful.	○	○	○	○
6.	The extent to which your comments were considered by the auditors	○	○	○	○
7.	Your overall satisfaction with the conduct of the audit and its results.	○	○	○	○

Please comment on any areas in which you have rated the audit team's performance as below your expectations. Also, please feel free to provide any further comments you may have on the audit process to let us know what we are doing well and what can be improved.

____
____
____
____
____
____
____
____
____
____
____
____
____
____

Name:______________________________ **Date:**___________

Title:______________________________

Organization:____________________

Thank you for taking the time to fill out this survey. Please send the completed survey form as soon as possible to:

by mail: ***Ms. Patricia Azarias, Director, Internal Audit Division-1, OIOS Room DC2-518, 2 UN Plaza, New York, NY 10017 U.S.A.***

by fax: ***212-963-3388***

by email: ***iad1support@un.org.***