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To: Members of the Executive Board
From: The Acting Secretary
Subject: Simplification of Operations in SDRs

There is attached for consideration by the Executive Directors a memorandum on the simplification of operations in SDRs. A proposed decision appears on page 17.

This subject has been tentatively scheduled for discussion on Wednesday, September 7, 1983.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Simplification of Operations in SDRs

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August 12, 1983

I. Introduction

The Second Amendment to the Fund's Articles substantially increased the scope for participants to enter into voluntary transactions in SDRs. In addition, it authorized the Fund to permit participants, by agreement with other participants, to engage in dealings in SDRs classified under the general heading of "operations". The Articles do not include a definition of operations, leaving it to the Fund to prescribe, i.e., permit additional uses of SDRs in the light of developments in the SDR system.

Since the Second Amendment became effective, the Fund has prescribed seven types of operations in which participants may use SDRs, namely, (i) to settle financial obligations; (ii) to make loans; (iii) in pledges; (iv) as security for the settlement of financial obligations; (v) in swaps; (vi) in forward operations; and (vii) in donations. ^{1/} The Fund has also authorized prescribed holders of SDRs to engage in these operations, by agreement with other prescribed holders and with participants. ^{2/}

In the paper "Possible Further Improvements in the Existing SDR" (SM/82/92 dated March 7, 1982), it was suggested that a further broadening and simplification of the authority to use SDRs in operations could help to make the SDR a more attractive reserve asset. The paper proposed that the existing decisions be replaced by a single decision authorizing all participants and prescribed holders to engage in any transaction or operation by mutual agreement, subject only to the limitations imposed by the Articles. It also proposed that the application of the "equal value" requirement to operations be eliminated,

^{1/} Decision No. 6000-(79/1)S, (12/28/78), as amended; 6001-(79/1)S (12/28/78); 6053-(79/34)S, (2/26/79), as amended; 6054-(79/34)S, (2/26/79), as amended; 6336-(79/178)S, (11/28/79); 6337-(79/178)S and 6437-(80/37)S, (3/5/80). See Selected Decisions, Ninth Issue, pp. 249-259.

^{2/} Decision No. 6467-(80/71)S (4/14/80). The Decision also authorizes prescribed holders to engage in voluntary transactions with participants and other prescribed holders.

and that the existing reporting requirements imposed on both parties to an operation be reduced and simplified. 1/

This memorandum examines these ideas in greater detail, and makes recommendations for changes in the relevant Rules and decisions of the Fund to achieve the desired simplification. The principal consequence of adopting these changes would be to permit participants and prescribed holders to transfer their SDRs among themselves, in any voluntary dealing other than a transaction, by a simple, authenticated instruction to the Fund from the user which states the SDR amount to be transferred, the recipient and the date the transfer is to take effect, accompanied by a declaration that the use is pursuant to an operation authorized by the relevant rules. The proposed changes would also allow the use of any exchange rate mutually acceptable to the parties in those cases where an exchange rate is relevant, and would enable prospective users to readily determine the Fund's requirements for operations in SDRs by examining a few brief provisions in the rules.

II. Existing Prescription Payments

The Fund's existing requirements for operations in SDRs are complex. Each prescribed operation is subject to a number of individual conditions and restrictions relating to the character of the operation, the terms on which it may be carried out, and the specific information that must be supplied before the Fund will give effect to it. A potential user of SDRs must currently examine seven Executive Board Decisions, the Fund's Rules and the Articles in order to establish the Fund's classification of and requirements for the contemplated use. Even then the potential user cannot have complete confidence that it is aware of all the Fund's requirements, or that the Fund will be satisfied that the proposed use meets these requirements.

The prescription arrangements are also very rigid, since they require holders to confine their operations in SDRs to a limited number of specified classes of contractual dealings, which holders may not always find convenient or fully appropriate to their needs. Each class of dealings, in turn, must contain certain specified features or meet certain conditions. Further, there is no flexibility to engage in contractual dealings falling outside the specified classes.

To date, the use of SDRs in operations has been minor, being limited to 23 cases amounting to SDR 553 million where SDRs have been used to settle financial obligations, or to make loans. In 13 of these operations, SDRs in a total amount of SDR 408.4 million have been used by nine participants and three prescribed holders to settle financial obligations. Four were settlements among participants of obligations

1/ Dealings between the Fund and other holders (i.e., participants and prescribed holders) fall outside the scope of this paper.

arising in connection of the workings of the European Monetary System and the remaining nine involved interest and principal payments on loans and capital subscriptions. In addition there have been 10 loans of SDRs. Most of these were loans made by prescribed holders to participants at concessional interest rates (ranging from 3.75 to 7 per cent). Three were loans by participants to two other participants and one prescribed holder and were made at (or in one instance 0.375 per cent above) the SDR interest rate. These operations have generally been preceded by several exchanges of cables between the Fund and the users in order to clarify and fulfill the detailed requirements of the existing prescriptions.

While several factors may account for the relatively limited extent to which SDRs have been used in operations, it seems reasonable to suggest that the complexity and the restrictiveness of the requirements governing these operations tend to deter rather than encourage such use. It seems appropriate, therefore, to review the present requirements to see whether a simplified scheme can be developed that permits holders a degree of freedom and ease in using their SDRs more comparable to the freedom and ease with which they can use other reserve assets. Such an approach would be consistent with the objective of making the SDR the principal reserve asset of the monetary system.

Maximum simplicity would be achieved if holders were able to transfer SDRs among themselves in the same way as they can transfer currency through the banking system. These transfers involve an authenticated instruction by the customer of a bank to credit a particular account with a specified amount on a particular date by debiting the account of the customer issuing the instruction. This degree of simplicity is achievable in banking transactions mainly because the paying bank is not concerned with the arrangements leading up to the transaction and needs no information relating to those arrangements in order to make the payment.

By contrast, before transferring SDRs, the Fund needs sufficient information to establish that the use is in conformity with the Fund's other requirements. Two types of requirements that are responsible for most of the Fund's informational needs and, hence, for the complexity of the arrangements surrounding the use of SDRs, are the application of the Fund's official exchange rates, and the need that the user of the SDRs fashion the desired use so as to fit into one of the specific dealings authorized by the Fund. Maximum simplification would be possible if the Fund were able to authorize any transfer of SDRs agreed by SDR holders at any exchange rate agreed by them (if a rate is involved), whether from the viewpoint of the Articles the transfer was under a transaction or an operation. It would then become completely immaterial whether a transfer by agreement involved a transaction or an operation, which is in any event a distinction that occurs only in the Fund's terminology.

This degree of simplification is, however, precluded by the requirement of the Articles that all transactions be carried out at official exchange rates (except in certain circumstances). ^{1/} Nevertheless these provisions allow considerable scope for the Fund to extend a greater freedom to SDR users than it has in the past. The following two sections examine the steps that the Fund can take, consistently with the Articles, to relax and simplify its requirements, and make specific proposals in that regard. The first section deals with exchange rate requirements, the second with the scope of prescribed operations and the Fund's information and recording requirements.

III. Exchange Rate Requirements

In general, when one holder agrees to transfer SDRs to another for a financial consideration, the Fund requires that the amount be determined on the basis of the exchange rate established by the Fund under its O-Rules for a given day before the value date of the transfer. This requirement applies to all voluntary transactions. In the case of operations, under present decisions, the SDR rates determined by the Fund for the relevant currencies (referred in this paper as "official rates" of the Fund) must be used in transfers arising from loans, the settlement of financial obligation, pledges and the use of SDRs as security, and in the initial exchange under a swap. Official rates need not be used where an exchange is arranged on a forward basis, including the reversal of a swap, and they are not applicable to donations of SDRs.

The Fund's practice derives from Article XIX, Section 7(a) and the Rules relating to the valuation of the SDR. Article XIX, Section 7(a) specifies that exchange rates for transactions between participants under Sections 2(a) and (b) of that Article

"shall be such that participants using special drawing rights shall receive the same value whatever currencies might be provided and whichever participants use those currencies, ..."

The Rules of the Fund give effect to this general principle by requiring that the amount of currency provided under the transaction be determined on the basis of the exchange rate in terms of the SDR determined by the Fund under Rule 0-2 on a specified date which is normally three days before the settlement date.

^{1/} The Fund is empowered by Article XIX, Section 7(b) to adopt policies under which, in exceptional circumstances, it may authorize participants in transactions by agreement to use other rates if they wish. The decision to adopt such a policy requires an 85 per cent majority of the total voting power, and the authorization to participants to agree on other rates requires 70 per cent majority of the total voting power.

The Fund uses its official rates as the standard for applying the equal value principle. However, a complete equality of value between different currencies provided and different providers of those currencies is obtained only when the rates used in all dealings occurring at a given time are those prevailing at that time in fully arbitrated currency markets. Complete equality is not achieved by the Fund's daily official rates, even at the point in time when they are set, since they mix rates prevailing in different markets at different points in time. This condition is even less fully satisfied at other times of the day. More complete equality of value could be achieved, for example, by the use of market rates current at the time the transfer was agreed, and there would seem to be room for further refinement in the process by which the Fund's official rates are established, so as to achieve more precisely the principle of equal value set out in the Articles. 1/

Under the Articles the equal value principle applies to transactions by agreement as well as transactions with designation, although the Fund is empowered to waive this principle in the case of voluntary transactions, in exceptional circumstances. It has not yet granted such a waiver. There is no provision in the Articles requiring the Fund to apply equal value to uses of SDRs in operations. However, under Article XIX, Section 2(c), the Fund is authorized to prescribe operations in which participants may engage "on such terms and conditions as the Fund deems appropriate", and it is open to the Fund to determine whether or not to apply the equal value principle, as one of the terms and conditions of prescribed operations. The only specific requirement of the Articles is that the terms and conditions should be consistent with the effective functioning of the SDR Department and the proper use of SDRs in accordance with the Articles.

In practice, in nearly all of its existing prescription decisions the Fund has elected to apply equal value by requiring the mandatory use of its official exchange rates. This has been done even though, in some cases, the requirement seems to be one of form rather than substance. In the case of a loan of SDRs, for example, the fact that under the existing prescription the interest rate (and hence the effective yield) is freely negotiable means that the requirement that official rates be applied to the capital amount has little practical effect, other than to restrict the manner in which the parties must arrange their dealings to achieve the financial results they desire. A somewhat comparable restraint exists in the case of swaps involving SDRs, where the parties must apply official rates to the initial exchange, though they are free to use rates of their choice for the later reversal of this exchange. The rate at which the swap is reversed in comparison with the rate at which it was undertaken implicitly determines the overall return.

1/ The paper "Possible Further Improvements in the Existing SDR" (SM/82/92) suggested several possible improvements in this area, e.g., more frequent fixing of the SDR/U.S. dollar rate, or use of the SDR basket rates as the representative rates of the basket currencies. These and other possibilities are still under examination by the staff.

The mandatory use of the Fund's official exchange rates in some dealings but not in others also leads to anomalies and inconsistencies as between different permissible uses of SDRs. For example, a holder may donate SDRs in any amount to another holder, but is required to receive full value when accepting SDRs in payment of an obligation owed to it by the other holder. As another example, the parties to a forward sale of SDRs are free to use any rate they choose when determining the purchase price of the SDRs, yet, when two holders agree to use SDRs to settle a financial obligation falling due at a future date, they are obliged to determine the amount of SDRs on the basis of the official rates prevailing at the time of payment. It is difficult to find any clear or uniform rationale for these distinctions.

These comments raise a more fundamental question concerning the mandatory use of official exchange rates. In principle, undue control of the terms on which holders may deal with the SDRs tends to conflict with the objective of making the SDR the principal reserve asset of the monetary system. Taking into account the experience gained in operating the SDR system since the Second Amendment, it is appropriate to consider whether the retention of the requirement is necessary for the effective functioning of the SDR system.

The official price established by the Fund is, and for the foreseeable future will remain, the benchmark for all valuations of the SDR. The primary reason for requiring all dealings to occur at official rates has been a concern that an authorization to holders to use SDRs freely at agreed exchange rates might result in significant and widespread discounts or premiums from this official price. In particular, if SDRs were freely available at a discount this could create difficulties for the designation process, since designated purchasers would be obliged to pay full value for an asset that was currently being "traded" in voluntary dealings at a discount. If, on the other hand, SDRs could only be acquired in the market at a premium, this could impose an undue burden on holders needing SDRs to meet obligations which, under the Articles, must be discharged in SDRs at their official value. Either situation could also lead to problems when the Fund disburses SDRs to purchasers from its holdings in the General Resources Account, at their official value.

Since central banks and the other official entities that may hold SDRs would not lightly dispose of reserve assets at a loss, or acquire them at a greater cost than is necessary, the development of a situation in which SDRs customarily change hands in voluntary dealings at a pronounced discount from or premium on the value of the SDR as determined by the Fund would reflect a general perception on the part of holders that the official price represents a material overvaluation or undervaluation of the asset, relative to comparable reserve assets. Unless holders exercised a high degree of restraint, such a perception would result in a general desire to "dump" or hoard SDRs, which could place severe strains on the SDR system. This risk already exists, but because the rules of the system prohibit nearly all dealings at any price other than the

official one, a general desire to dispose of SDRs would currently be expressed by participants using them to the fullest possible extent in designation and in the discharge of obligations to the Fund. In other words, this risk is independent of whether holders are allowed to use their SDRs at discounted rates. If anything, the ability to deal at agreed rates might tend to diminish somewhat the extent of any perceived inferiority and therefore reduce the desire that holders may have to dispose of SDRs.

The likelihood that the SDR will be traded at a discount or a premium will depend on a number of considerations. A primary consideration influencing the relative attractiveness of the SDR is the interest rate on SDR holdings. As long as this rate is competitive with the yield on comparable assets, the SDR would tend to be priced at par in a market environment. In recent years, the rate of interest on the SDR has been progressively improved, and is now closely linked on a current basis to certain related market rates. At present this rate is probably in the neighborhood of the rates of alternative reserve assets. This in itself provides a strong assurance that a more extensive freedom for SDR holders to determine the value of their SDRs in voluntary dealings would not result in significant departures from official values. This assurance is strengthened by the fact that there is no evidence of any general propensity of holders to make use of all existing opportunities to dispose of their SDRs through designation or in repurchases. Moreover, even though under the current operational prescriptions holders have some limited scope for avoiding the use of official rates if they have a wish or incentive to do so, they have not in practice shown any such inclination.

There are, in addition, a number of institutional arrangements in the SDR system which serve to support the official price of the SDR, and to reduce the likelihood of significant departures from this price. In particular, the existence of the designation mechanism means that no participant with a need to use its reserves can be forced to dispose of SDRs at a discount. The availability of this mechanism and the fact that SDRs can, and in some cases must, be used in settlement of Fund-related obligations at their full official value must necessarily have a major effect in stabilizing the "market value" of the asset at, or very close to, its official value. Moreover, the Fund itself has substantial holdings of SDRs in the General Resources Account which it is empowered to sell only at par to participants, so that even in a "free market" environment no participant would be forced to pay a premium in order to acquire SDRs needed for this purpose. More generally, in any such environment the Fund could, if it wished, help to maintain the official value of the SDR by a more general exercise of its power to buy and sell SDRs through the General Resources Account.

For these reasons, it is concluded that a more extensive freedom for participants and prescribed holders to agree on exchange rates of their choice is unlikely to have a material adverse effect on the

functioning of the SDR system, or to result in widespread or significant discounts or premiums. There are a number of measures open to the Fund by which it can control the situation, including measures to modify the relative attractiveness of and return on the SDR or to increase or reduce the number of SDRs in circulation at any given time. If in fact a situation were to arise in which SDRs were persistently changing hands in voluntary dealings at rates significantly different from the official ones, this would indicate an imbalance requiring corrective measures by the Fund. In principle, the most appropriate method of maintaining the valuation of SDRs at or very close to par is to ensure that the characteristics of the SDR, as well as the volume of SDRs outstanding, justify this valuation in the eyes of holders. This is also the method that seems most compatible with the long-term development of the SDR as a reserve asset.

These considerations would seem equally valid for all voluntary dealings in SDRs among participants and prescribed holders, whether these are to be characterized as "transactions" or "operations". The distinction between the two types of dealings is itself a somewhat artificial and arbitrary one, found only in the Articles of the Fund. In the case of transactions, the existing practice of the Fund requiring the use of its official rates derives from the equal value principle laid down in the Articles. As already noted, however, the Articles authorize the Fund to permit operations on any terms and conditions that it deems appropriate, as long as these are consistent with the effective functioning of the SDR Department and the proper use of SDRs. It is proposed that the Fund now decide to eliminate the mandatory use of official exchange rates in all operations in SDRs. This would be a major step towards simplifying the Fund's requirements for such operations. It would also constitute a move in the direction which, it is believed, the Fund should follow in the longer-term development of the SDR system. It would, of course, remain open to the parties to an operation to effect the transfer on the basis of the Fund's official rates at the time the transfer occurs, and it is expected that in most cases this would be the agreed basis of settlement. However, the parties would be free to deal on a different basis if they considered this preferable, given the nature of the arrangement and other relevant circumstances. It would be the staff's intention to keep under review the use that holders choose to make of this freedom, since, among other things, this could help determine the need for measures to improve the attractiveness of the SDR.

It is not the purpose of this paper to make substantive proposals concerning the future application of the equal value principle in transactions by agreement. As indicated in SM/82/92, however, one minor change is recommended in the existing Rules, to allow the parties greater freedom in selecting the settlement date, rather than requiring them to settle on the second or third business day following that on which the exchange rate was established. Two-day settlement is the norm in foreign exchange markets for spot transactions, but one-day and same-day

settlements are not uncommon. It is proposed to allow such settlements also in the case of transactions in SDRs. There have been occasions when this additional flexibility would have enabled members to meet on time obligations that were in fact met late, as a result of having to wait two days for the delivery of SDRs.

IV. Permissible Uses and Recording Requirements

Elimination of the mandatory use of official exchange rates would allow holders engaging in SDR operations greater freedom than they have at present, and reduce the amount of information needed by the Fund before recording an operational transfer of SDRs. However, operations would still be subject to a number of other restrictions and procedural requirements. The following paragraphs contain additional proposals for revising the existing prescription scheme by expanding the scope of permissible operations, and simplifying the requirements of the Fund relating to information to be supplied by holders and the recording of transfers.

1. Scope of Prescribed Operations

The Articles provide for two categories of dealings in SDRs, i.e. transactions and operations. "Transactions" in SDRs are defined in the Articles as exchanges of SDRs for other monetary assets, and "operations" in SDRs as other uses of SDRs. ^{1/} Article XIX, Section 2(c) gives the Fund a general authority to prescribe operations in which participants may engage in agreement with other participants, and this prescription can be extended to prescribed holders pursuant to Article XVII, Section 3. It follows that prescribed operations can, in principle, include any use of SDRs, other than a use in a transaction, that may be agreed between a prescribed holder and any other holder, or between the Fund (through the General Resources Account) and a prescribed holder.

In authorizing uses of SDRs in operations, the Fund has proceeded on a step-by-step basis, by identifying individual categories of contractual dealings. Each new type of dealing has been defined in specific terms and incorporated in a separate prescription decision, together with the terms and conditions applicable to the dealing. This approach has enabled the Fund and its members to examine and accept each new type of operation as it has been proposed, and has provided an increasingly broad base for further development. The cumulative effect is that, at present, SDR holders are authorized to engage in most usual modes by which one entity might wish to transfer SDRs to another.

As long as the Fund requires the use of official exchange rates in most or many cases there is a substantive reason for defining each permissible type of operation, since this makes it possible to distinguish

^{1/} See Article XXX(i).

those cases where the requirement is to be applied from those where it is not. If the recommendation that this requirement be eliminated is accepted, however, this rationale no longer applies. The question then arises whether any material interest of the SDR system is served by limiting the types of contractual dealings in which holders may engage within the general class of operations.

The fact that, apart from the Fund itself, the holding and use of SDRs is restricted by the Articles to participants in the SDR Department and certain other official entities prescribed by the Fund, in itself, tends to limit the nature and scope of voluntary dealings in which holders may engage. As public entities, the use which they may make of their assets is controlled by their laws and constituent instruments, and by standard commercial practice. Any arrangement which one holder may make with another for the transfer of SDRs will, necessarily, be one that conforms to these requirements and is seen by each party to be in its interests. In this context, it is difficult to conceive of any mode of using SDRs likely to be engaged in by holders that, in itself, could be regarded as detrimental to the SDR system.

Accordingly, it is recommended that the Fund remove the existing restrictions on the scope of prescribed operations, and permit holders a general freedom to make any operational arrangement they wish for the transfer of their SDRs. Given the number and type of arrangements already permitted, this may not, in practice, greatly enlarge the existing scope of prescribed operations. However, by eliminating the existing restrictions limiting operations to certain particular contractual forms, it would remove the burden on users and the Fund to ensure that one or other of the specified forms has been adhered to, and thereby help to enhance the attractiveness of the SDR. There is, however, one feature of existing restrictions which the Fund may wish to retain under its control, for the time being: this is a restriction on SDR operations involving gold. It is suggested that, in the revised and expanded prescription now proposed, the Fund should reserve the right of prior approval of any operation in which SDRs are, directly or indirectly, exchanged for gold.

The possibility cannot be excluded that, as holders exercise the new freedom, the Fund may find them undertaking dealings in SDRs which give it grounds for concern. If so, it is always open to the Fund to alter the rules, if this seems necessary to prevent any further such dealings. 1/

1/ Article XIX, Section 2(d) empowers the Fund to make representations to participants entering into operations or transactions that the Fund considers prejudicial to the process of designation or otherwise inconsistent with Article XXII, and to impose sanctions on participants that persist in entering into such operations or transactions. It will be noted that these provisions assume a situation in which the Fund has given effect to the operations or transactions, even though it considers them objectionable in principle.

Article XXX(i) gives a general description of transactions as "exchanges of special drawing rights for other monetary assets", but the practice of the Fund is to limit the concept to exchanges on a spot basis. 1/ As a corollary of the broadened definition of prescribed operations, it is proposed to incorporate in the Rules a definition of transactions by agreement which reflects this existing practice of the Fund.

In the foreign exchange markets, a "spot" transaction is for settlement two days after the date on which the exchange rate is fixed. Largely as a result of the difficulties for the Fund to communicate with members in other time zones sufficiently early in the day, Fund transactions are normally for settlement three days after that date, and that timing provides the basis for the definition being proposed for transactions by agreement. However, the staff regards it as desirable for Fund transactions to be brought into line with market practice to the maximum extent feasible and will be considering techniques that might make this possible. In that event, it would be consistent with the present proposal to amend the definition of transactions by agreement, and thus enlarge the scope for operations.

2. Information and Recording Requirements

As registrar of the SDR system, the Fund is responsible for giving effect to transfers of SDRs by making appropriate entries in the books of the SDR Department. 2/ The Fund is not obliged to record a transfer if the underlying transaction or operation does not conform to its requirements. However, a system under which transfers result from agreements between holders can function effectively only if holders are made fully aware of all the Fund's requirements, and can enter into contractual arrangements with the confidence that they conform to these requirements, and that instructions to transfer SDRs in fulfillment of these arrangements will be duly implemented by the Fund. The Fund should also aim to make the registration process itself as simple and convenient as possible, so as to facilitate the prompt implementation of transfer instructions.

The adoption of a single general prescription of permissible operations and the elimination of provisions for the mandatory use of official exchange rates, as recommended in this memorandum, would substantially facilitate the conduct of operations by holders. Their understanding of the Fund's requirements would be further improved if these were, as far

1/ The Fund prescription on "future operations" recognizes that exchanges for settlement after a longer period constitute operations, not transactions.

2/ Article XVI, Section 3 provides that all changes in holdings of SDRs shall take effect only when recorded by the Fund in the SDR Department.

as practicable, consolidated in the form of a comprehensive code which, directly or by reference, incorporates all the matters which the Fund will take into account when exercising its powers as registrar of the system. The most appropriate place for this code would be the Fund's P-Rules, which already deal with transactions and contain some provisions applicable to operations.

Under the existing Rules and prescription decisions, both parties to an operation must provide a transfer instruction to the Fund. In addition, both parties are required to provide detailed information about the arrangement under which SDRs are used, as well as declarations that the intended use is in accordance with the applicable prescription, before the Fund will give effect to the transfer. Much of this information seems relevant to the recording function only in the sense that it may enable the Fund to determine whether the proposed operation complies with the terms of the relevant prescription decision, and in particular the requirement to use the Fund's official exchange rates. The proposed simplification of the Fund's substantive requirements will necessarily lead to a substantial reduction in the amount of information needed by the Fund before it can properly record a transfer.

It is recommended that, under the revised Rules, the Fund should be ready to record a transfer arising from an operation in SDRs on the basis of an instruction from the transferor specifying the amount to be transferred, the name of the transferee, and the intended date of the transfer, together with a declaration that the transfer is an operation pursuant to the relevant rules. This declaration would serve to identify the dealing as an operation under Article XIX, Section 2(c) rather than a transaction under the other provisions of Article XIX, thus meeting the requirement of Article XVI, Section 3 that participants notify the Fund of the provisions of the Articles under which SDRs are used. It would also serve to assure the Fund that the dealing is within the class of operations which have been authorized by the Fund, and the Fund would be entitled to rely on the declaration when recording the transfer. It does not seem necessary to require a similar declaration from the transferee.

To the extent that the Fund thinks it desirable to seek more detailed information about the operation, this can normally be obtained after the event. The staff would request the holders concerned to provide information periodically on a consolidated basis. Apart from this routine procedure, it would remain open to the Fund to ask for information about a dealing at the time a transfer instruction is received, if there seemed a special reason for doing so, but this would not be a usual event. The Fund could also at any time seek similar information from the transferee, if it thought this necessary in a particular case. However, the recording of an operation that has been notified to the Fund in accordance with the rules would not be impeded or delayed

because of such requests for additional information. It is proposed that, as in the past, operations in SDRs be reviewed once a year by the Executive Board in connection with the preparation of the Annual Report.

One group of authorized operations requires further examination: these are operations in which SDRs are used as security, as envisaged by two of the existing prescription decisions. ^{1/} It is proposed that the Fund facilitate the carrying out of operations of this type by authorizing a special procedure under which the SDRs can be set aside in the Fund's books, and their use restricted pending completion of the operation. This proposal is explained in a companion memorandum.

V. Text of Proposed Rules

Procedures governing transactions and operations in SDRs between participants are set out in the Fund's P Rules. No change is proposed in the first five of these Rules, which deal with transactions with designation. A revised and expanded version of the Rules dealing with transactions by agreement and with operations in SDRs, designed to give effect to the proposals in this memorandum, is given in the Attachment. The following summary explanation of the intended effect of the revised Rules deals first with those relating to prescribed operations in SDRs, (numbered in the Attachment as Rules P-8 through P-11). It then refers to certain consequential or related changes in the present Rules relating to transactions by agreement and the recording of transfers arising from transactions and operations.

1. Prescribed Operations

The only existing Rule under this heading is Rule P-7, which requires the parties to an operation to declare that the operation is in compliance with the Fund's prescription. It is proposed to replace this Rule and the seven prescription decisions with four new Rules which, taken together, would comprise the code governing all operations in SDRs between participants.

The draft Rule P-8 defines "operations" between participants as any dealing, other than a transaction with designation or by agreement, in which one participant in agreement with another arranges to transfer SDRs to the other. The transfer may be intended to occur immediately, or at some future date, or it may be contingent on the occurrence of some future event. The definition includes, but is not limited to, all the types of operations prescribed by existing decisions. The Rule authorizes

^{1/} See the Decision on "Use of SDRs in Pledges" EBD No. 6053-(79/34)S as amended, and "Use of SDRs in Transfers as Security for the Performance of Financial Obligations" EBD No. 6054-(79/34)S as amended.

participants to engage in operations as so defined, thereby according these dealings the status of prescribed operations as envisaged by Article XIX, Section 2(c). However, prior approval of the Fund would be required for any operation involving gold.

Rule P-9 describes the standard transfer instruction and declaration to be furnished by the transferor under an operation, in order to have the transfer recorded by the Fund. Although all this information is required on or before the date the transfer is to be effected, the intention is to allow reasonable flexibility to the holder to supply it either in a single communication to the Fund, or at different times as it becomes available. ^{1/} The holder may wish to be sure that the other party has carried out its obligations under the arrangement, before the transfer actually occurs. Accordingly, the Rule permits the holder to make its transfer instruction subject to subsequent confirmation, and in this case the Fund would not execute the transfer until the confirmation had been received.

Rule P-10 deals with the provision of additional information about the operation. It envisages that the Fund may arrange for this information to be provided on an ex post facto basis in periodic reports from SDR users. In individual cases, the Fund may have particular reason to call for further specific information from either or both parties to an operation, and the Rule reserves the Fund's right to obtain this information at any time.

Rule P-11 is an enabling provision under which, by decision of the Executive Board, the Fund could establish arrangements for "setting aside" SDRs to meet commitments of the holder under certain types of operations. As noted above, a proposal to activate this authority in connection with operations involving the use of SDRs as security for the performance of an obligation is discussed in a companion paper.

2. Transactions by Agreement

As already noted, since "operations" are comprehensively defined in Rule P-8 as comprising all voluntary dealings involving a transfer of SDRs other than transactions by agreement, it is desirable to include in the Rules a precise definition of the transactions. This is the reason for the proposed new Rule P-6, which defines a transaction by agreement as a use of SDRs in which, by agreement, SDRs are exchanged for currency

^{1/} For example, a holder may give the Fund a blanket authority to arrange certain operations on that holder's behalf, as in the case of the proposed loans of SDRs that are intended to facilitate the payment of subscriptions to the forthcoming quota increase. In such a case, it would be pointless to require a specific instruction from the transferor indicating the amount, transferee and transfer date each time a loan is effected.

at rates for that currency in SDR terms determined within the period commencing three business days prior to the intended value date of the exchange. This definition conforms to the current practice of the Fund, but would need to be modified if in future the Fund were to change its practice, e.g., if it were to reduce the period between rate determination and settlement to two business days. The currency used in the exchange may be that of a member or a nonmember, and for purposes of the definition the term "currency" is extended to include monetary assets. This extended definition, which derives from the wording of Article XXX(i), recognizes that spot exchanges of SDRs for currency and for other monetary assets are conceptually the same and should be treated in the same way under the Rules. ^{1/} It does not seem necessary at this time to attempt to formulate a definitive description of the type of assets that will be regarded as "monetary" assets for purposes of the Rule: this can be left for later determination on a case-to-case basis. It may be noted that any arrangement in which SDRs are to be exchanged for value four or more business days after the exchange rate is determined, whether the exchange is for currency or another monetary asset, would be classified as an operation authorized under the Rules.

Rule P-7 in the draft Rules set out in the Attachment corresponds to the existing Rule P-6, which requires equal value to be applied to transactions by agreement and specifies how the applicable exchange rate will be determined. The only substantive change is to accord to the parties greater freedom in selecting the daily rate they wish to apply to the transaction, as proposed in Part V of this memorandum. The combined effect of the two Rules on transactions by agreement is to prevent participants engaging in spot exchanges of SDRs for nonmember currencies or other monetary assets, unless and until the Fund has determined a representative rate for the particular currency or asset in terms of the SDR. ^{2/}

3. Recording of Transfers

The last two P Rules in the Attachment, P-12 and P-13, correspond to the present Rules P-8 and P-9, respectively. The present Rule P-8 requires a participant using SDRs in a transaction to inform the Fund immediately of the receipt of currency under the transaction. The entitlement of the other party to the transaction to receive SDRs arises as soon as it duly provides currency in accordance with the Rules, and the notice required by the Rule serves as confirmation from the holder that the other party

^{1/} For the same reasons, it is considered that the term "currency" in Article XIX, Section 2(b) is to be understood in a functional sense as including monetary assets.

^{2/} In the case of the ECU, for example, the Fund recently determined the basis for establishing a representative rate in terms of the SDR: see EBD/82/6, "Representative Rate for the European Currency Unit (ECU)", January 12, 1982.

has performed its side of the transaction. The only change in the text of the present Rule P-8 proposed in the revised Rule P-12 is in the final part of the sentence, which as phrased at present only calls for notice to the Fund when currency is received "in accordance with the Articles of Agreement and these Rules and Regulations." Notice should be given whenever currency is received, whether or not the prospective transferor considers that the receipt is in accordance with the Articles and Rules, and this is made clear in the revised Rule.

The last Rule, P-13, deals with the manner in which the Fund will exercise its responsibilities as registrar of the SDR system to record transfers arising from both operations and transactions. It is proposed to reformulate the prerequisites for recording a transfer in more specific terms than those found in the present Rule P-9. Accordingly, the first paragraph of the draft Rule P-13 lays down the condition that the transaction or operation should comply with the relevant requirements of the Rules. This formulation reflects the fact that the revised Rules, in themselves, constitute a complete statement of the Fund's requirements, either directly or by reference to applicable provisions of the Articles. The Rule also makes clear that in satisfying itself of compliance the Fund is entitled to rely on the notice and declaration provided by the user.

The second paragraph of Rule P-13 deals with the date as of which a transfer will be given effect. In the case of transactions, the relevant date will be when currency has been provided: this repeats the principle stated in the last sentence of the present Rule P-9. In the case of operations, the relevant date will be that specified in the notice to be given by the user under the new Rule P-9.

4. Application to Prescribed Holders

The final change proposed in the Rules is the addition of a new Rule Q-2. The Rule, which is included for purely technical reasons, would have the effect of expanding references to "participants" in the P-Rules to include "prescribed holders," to the extent the Fund has permitted these holders also to enter into voluntary transactions and operations. Under the existing Decision on the subject (No. 6467-(80/71)S, adopted April 14, 1980), prescribed holders are authorized to engage in these dealings to the same extent as participants. Accordingly, the simplified procedures applicable to operations between participants would apply equally to operations with and between prescribed holders.

VII. Proposed Decision

It is recommended that the Executive Board rescind the existing decisions prescribing operations in SDRs, and amend the existing Rules to incorporate the revisions now proposed, by adopting the following Decision. Since they serve to eliminate a number of existing substantive and procedural requirements, without requiring any changes to be made in any operational arrangements that are currently outstanding, the revised

Rules can be brought into effect immediately, and will apply to any operations that may be in process at the time they become effective. The amended Rules contain a prescription pursuant to Article XIX, Section 2(c), and accordingly the Decision adopting them requires a seventy per cent majority of the total voting power.

1. Executive Baord Decisions No. 6000-(79/1)S, 6001-(79/1)S, 6053-(79/34)S, 6054-(79/34)S, 6336-(79/178)S, 6337-(79/178)S and 6436-(80/37)S, as amended to the date of this Decision are hereby rescinded.
2. Rules P-6, P-7, P-8, and P-9 of the Rules and Regulations of the Fund are replaced by the Rules set forth in the Attachment to SM/83/187, which are adopted as Rules P-6 through P-13.
3. The following additional Rule is hereby adopted as Rule Q-2:

Q-2. To the extent that the terms and conditions referred to Rule Q-1 permit prescribed holders to enter into transactions by agreement or operations in the same manner and on the same terms as participants, references to participants in the Rules relating to such transactions and operations shall be deemed to refer also to prescribed holders.

Proposed Revisions to P-Rules

Transactions by Agreement

P-6. For purposes of these Rules, a transaction by agreement under Article XIX, Section 2(b) is a use of SDRs in which, by agreement between two participants, SDRs are exchanged for currency at rates in terms of the SDR determined at any time during the period commencing three business days before the intended value date of the exchange. As used in this definition, the term currency includes other monetary assets.

P-7. (a) Currency shall be provided in a transaction by agreement at the SDR rate for that currency determined under Rule 0-2 for the third business day preceding the value date of the transaction, or for a later day up to and including the value date itself if so agreed between the parties to the transaction.

(b) No participant shall levy any charge or commission in respect of a transaction by agreement.

Prescribed Operations

P-8. (a) For purposes of these Rules, an operation in SDRs under Article XIX, Section 2(c) is a dealing, other than a transaction with designation or a transaction by agreement, in which one participant in agreement with another arranges to transfer SDRs to the other participant.

(b) Participants are authorized to engage in any operation in SDRs as defined in (a) on such terms and conditions as may be agreed between the parties, other than operations in SDRs involving gold.

P-9. A participant that has arranged to transfer SDRs in an operation shall, not later than the date it wishes the transfer to be effected, give the Fund notice of the amount of SDRs to be transferred, the name of the recipient and the intended date of the transfer, and shall declare that the transfer is pursuant to an operation authorized by the Rules on Operations. The notice shall constitute an instruction to the Fund to record the transfer on the date specified in the notice, provided that this instruction may be given subject to later confirmation.

P-10. The Fund may call for periodic reports from participants giving details of their operations in SDRs. Each party to an operation shall provide such additional information relating thereto as the Fund

may at any time request, provided that the recording of an operations shall not be subject to the receipt of such information.

P-11. To facilitate the carrying out of operations in which the transfer of SDRs is to occur at some future date or is contingent on some future event, the Fund may establish procedures under which, at the request of the parties to the operation, the SDRs are set aside in the books of the SDR Department and the holder's freedom to use them for other purposes is restricted pending completion of the operation.

Recording

P-12. A participant using SDRs in a transaction shall inform the Fund immediately of the receipt of currency under the transaction.

P-13. (a) Subject to any special procedures applicable to the SDRs pursuant to Rule P-11, the Fund shall give effect to a transfer of SDRs pursuant to a transaction or operation by recording the transfer in the books of the SDR Department, provided that the Fund is satisfied that the transaction or operation complies with the applicable requirements of these Rules. In satisfying itself of such compliance the Fund shall be entitled to rely on the notices and declarations provided by the user.

(b) A transfer pursuant to a transaction shall be recorded as of the date on which currency is provided in accordance with these Rules. A transfer pursuant to an operation shall be recorded as of the date specified in the notice given pursuant to Rule P-9, upon receipt of any confirmation to which the notice is subject.

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