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SM/83/188

August 16, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Establishment of Special Procedures for Operations to
Set Aside SDRs to Secure the Performance of Obligations

There is attached for consideration by the Executive Directors a memorandum establishing special procedures for security operations in SDRs. A proposed decision appears on pages 6 and 7.

This subject, together with the memorandum on the simplification of operations in SDRs (SM/83/187, 8/15/83) has been tentatively scheduled for discussion on Wednesday, September 7, 1983.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Establishment of Special Procedures for Operations
to Set Aside SDRs to Secure the Performance of Obligations

Prepared by the Legal Department and Treasurer's Department

Approved by G. Nicoletopoulos and W. O. Habermeier

August 15, 1983

Introduction

The staff memorandum on "Simplification of Operations in SDRs" (SM/83/187, dated August 15, 1983) proposes a comprehensive definition of operations in SDRs authorized under Article XIX, Section 2(c), together with standard procedural requirements to govern the recording of transfers pursuant to these operations. The definition and procedures would be incorporated in revised P Rules, which would replace the existing prescription decisions and Rules on the subject.

These simplified procedures may not fully answer the needs of the parties wishing to use SDRs as security for the performance of a debt or similar obligation. Uses of SDRs for this purpose include, but are not necessarily limited to, those prescribed by the existing decisions on "Use of SDRs in Pledges" and "Use of SDRs in Transfers as Security for the Performance of Financial Obligations." ^{1/} This memorandum reviews the special features of such uses. It recommends that, after the adoption of the simplified prescription scheme, the Fund continue to assist holders engaging in these operations by authorizing a special procedure under which the SDRs used as security may be set aside in the books of the SDR Department, and their use for other purposes restricted during the period of the commitment. This action would be taken pursuant to Rule P-11 of the revised Rules attached to SM/83/187, which is in the following terms:

"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."

^{1/} Executive Board Decision No. 6053-(79/34)S as amended, and Executive Board Decision No. 6054-(79/34)S, as amended, Selected Decisions, Ninth Issue, pp. 252-256.

Purpose and Scope of the Proposed Procedure

Under the existing decision on "pledges" of SDRs, a holder may pledge an amount of its SDRs to secure performance of a financial obligation that it owes to another holder. The SDRs so pledged will be retained in the debtor's holdings, but the Fund as registrar will record the existence of the pledge in the books of the SDR Department, and the SDRs will be set aside in a special subaccount in the name of the debtor. During the period covered by the pledge, the Fund will not give effect to any instructions to transfer these SDRs, except instructions to transfer them to the creditor as needed to discharge the financial obligation when it falls due. Similar arrangements apply under the decision on transfers of SDRs by way of security. In this latter case, the SDRs used to secure an obligation will be transferred to the creditor at the outset, and set aside to a special subaccount on the basis of a commitment by the creditor to transfer the SDRs back to the debtor when the obligation has been discharged, except to the extent needed to satisfy the obligation.

Under the revised prescription scheme proposed in SM/83/187, as under the existing decisions, holders of SDRs will be permitted to pledge their SDRs, or to transfer them to a creditor as security for the performance of obligations. The freedom of holders to make security arrangements of this kind will, in fact, be greater than at present, since a number of restrictions contained in the existing prescription decisions--in particular, the requirement that the amount of SDRs actually used to discharge the obligation must be determined on the basis of the Fund's official rates in SDR terms--will no longer apply. Holders will also be free to introduce variations in the arrangements, for example, by transferring the SDRs to a third holder to hold in escrow, a technique that is not explicitly authorized by the existing prescriptions.

Operations of this kind can be carried out without any special assistance from the Fund. Under the revised scheme, a holder wishing to transfer SDRs pursuant to an operation need only furnish the Fund with a transfer instruction and declaration, in an appropriate form. In the case of the use of SDRs as security, as with other types of operations, the Fund's involvement can therefore be limited to giving effect to an instruction from the holder to transfer SDRs to the party entitled to receive them under the contractual arrangement, if and when the instruction is actually given. The prospective transferee will then rely on the holder of the SDRs to take the action necessary to transfer them when required to do so by the terms of its contract. If the holder fails to take this action, the prospective transferee may invoke such remedies or enforcement procedures as are available to it under the contract, without reference to the Fund.

At the same time, the Fund has already permitted the adoption of a special registration procedure to set aside SDRs that involve a

greater degree of intervention by the Fund than in the case of other operations. The essential feature of the procedure is that, pending the occurrence of the events which will give rise to a transfer of the SDRs to the party contingently entitled to receive them under the operation, the amount of SDRs used as security is "set aside" in a special subaccount opened in the holder's name in the books of the SDR Department, and the holder's freedom to use this amount for other purposes is restricted. ^{1/} This protects the interests of the party contingently entitled to receive the SDRs, by assuring it that these SDRs will remain available for their agreed purpose and will not be diverted to other uses. This is a very valuable assurance, and one that can only be provided by the Fund, in its capacity as registrar of the SDR system.

It would therefore be appropriate for the Fund, when adopting the simplified arrangements for operations in SDRs recommended in SM/83/187, to continue to offer to participants and prescribed holders a facility to set aside SDRs, although it would be left to the parties to an operation to decide whether they wished to make use of the facility in any particular case. There seems no reason why the facility should not also be available in operations where the SDRs are transferred by the obligor to a third party to hold during the period the obligation is outstanding, on the basis that the third party will transfer them to the obligee if and to the extent that the obligor does not meet its obligation, with any balance still held when the obligation is fully discharged being returned to the original holder.

It would be possible to extend the procedure to operations other than those where SDRs are used as security, and Rule P-11 is formulated in terms broad enough to permit this. There can be many types of contractual arrangements in which a holder of SDRs commits itself to transfer SDRs to another participant or prescribed holder on some future date or on the occurrence of some future event. If this commitment is accompanied by an undertaking on the holder's part to retain in its holdings sufficient SDRs to discharge the commitment when it falls due, the parties could request the Fund to help enforce this undertaking by applying the set-aside procedure. On the other hand, except in cases where SDRs are being used as security, an undertaking to retain sufficient SDRs to enable a future transfer to be effected is not a usual feature of future or contingent operations: normally, the holder is free to deal with its holdings as it wishes in the interim period, and holders will generally wish to preserve this freedom. Moreover, it may not be in the interests of the SDR system for the Fund to appear to encourage the imposition of restrictions on the use of SDR holdings by adopting a general decision sanctioning the use of the set-aside procedure in all such operations. It therefore seems prudent at the present time to limit any general decision authorizing this procedure to that class

^{1/} The SDRs set aside as security in a special subaccount of a holder would be reflected in the amount of that holder's holdings of SDRs.

of operations where SDRs are used as security, leaving any broader application of the procedure for further consideration at a later date.

Procedural Requirements for Setting Aside SDRs

The proposed procedural requirements to be followed to set aside SDRs would be substantially the same as those provided in the existing decisions on the use of SDRs in pledges and in transfers as security. In each case, the request to the Fund to open a subaccount would be made by or with the concurrence of all parties to the operation, including any third party holder, and would be accompanied by agreed instructions regarding the manner in which the subaccount would be operated. These instructions would, as a minimum, specify the amount of SDRs to be set aside, the period the subaccount is to remain open, the party or parties eligible to receive transfers from the subaccount, and the nature of the special transfer instructions needed to effect such transfers. They could also provide for other matters, such as the possibility of terminating the subaccount prior to expiration of the period by special notice to the Fund, the disposition of any SDRs remaining in the subaccount when it is closed, and the disposition of interest accruing on the SDRs that have been set aside, to the extent the parties wish to make special provision for such matters. Any subsequent change in the initial instructions would also require the concurrence of all parties to the operation.

Before opening the subaccount, the Fund would need to satisfy itself that the instructions are consistent with the provisions of the authorizing decision and are expressed in clear and precise terms. This would apply also to any subsequent change in the instructions. In particular, there should be no ambiguities regarding the form of the special transfer instructions and the entity entitled to give them, since once the SDRs have been set aside the Fund will act on the basis of these transfer instructions, and only on that basis. The responsibilities of the Fund as registrar of the SDR system do not require it to act as judge or mediator in disputes between the parties to an operation as to the nature and extent of their respective obligations, nor to determine whether or not one party is contractually entitled to call for a transfer from the other, and as far as practicable the Fund should avoid becoming involved in disputes of this kind.

Under the present prescriptions no time limit is imposed on the period during which SDRs can be set aside. However, it would seem advisable for the Fund to specify a period of, say, two years as the maximum period for which a subaccount could be opened. This would help to reduce any concern that the SDR system might be adversely effected if a substantial quantity of SDRs were to be removed from circulation for an unduly long period, by being frozen in these subaccounts. It also means that, if in future the Fund were to find it desirable to modify the set-aside procedure as now envisaged, or to eliminate it altogether, it could do so with the assurance that

arrangements already in existence at the time this decision was reached would expire of their own accord within a relatively short time. If on the basis of experience it appears that the maximum period of two years now proposed is too short to accommodate the reasonable wishes of holders, it could be extended by the Executive Board, either generally or in particular cases when so requested by the parties.

Priority of Obligations under the Articles

One feature of the set-aside arrangements prescribed by existing decisions is the provision that, notwithstanding the arrangement, the SDRs set aside may be used in order to discharge obligations of the holder under the Articles. Although this limits the protection afforded to the parties for whose benefit the SDRs are set aside, there are certain obligations under the Articles for which all of a participant's SDRs must be available, ^{1/} and it is also desirable that participants retain the possibility to use the SDRs set aside to meet other obligations to the Fund (i.e., to the General Department) as well. ^{2/} For these reasons it is proposed that this provision of the existing decisions remain unchanged.

It may be added that in certain special situations the Fund has the power under the Articles to require a participant to sell SDRs needed by another participant: see Article XX, Section 5, Article XXIV, Section 3, and Schedule G, paragraph 1(a)(iv). As long as participants can continue to be free to acquire SDRs from other sources it is difficult to justify such forced sales, and there seems no need to take the possibility into account when formulating the set-aside procedure.

Proposed Decision

For the reasons given above, it is recommended that, in conjunction with the adoption of the revised Rules proposed in SM/83/187, the Executive Board adopt the following decision authorizing the establishment of special subaccounts to facilitate the operations by which SDRs are set aside as security for the performance of obligations.

^{1/} These consist of cancellation of SDRs under Article XVII, Section 2, and the payment of net charges and assessment in the SDR Department under Article XX, Sections 2 and 4. The Fund is authorized by the Articles to debit a participant's SDR account for any of these purposes.

^{2/} These include obligations to the Fund that must be met in SDRs and those for which the use of SDRs is optional. However, the settlement of both types of obligations requires an instruction from the participant before the Fund can debit the participant's account. The effect of the relevant provision of the current and the proposed decisions is to allow the Fund to act on such an instruction.

Establishment of Subaccounts for Purposes of Setting Aside
SDRs to Secure the Performance of Obligations

Pursuant to Rule P-11 of the Rules and Regulations, the Fund, at the request of the parties to an operation in which SDRs are used as security for the performance of an obligation, will establish a special subaccount in the books of the SDR Department and set aside to this subaccount the amount of SDRs used as security. The subaccount shall be governed by the following terms and conditions, as supplemented by instructions agreed between the parties in a form acceptable to the Fund prior to the establishment of the subaccount (hereinafter called the standing instructions). Any subsequent change in the standing instructions shall require the agreement of all the parties and the concurrence of the Fund.

1. The subaccount shall be opened in the name of the participant or prescribed holder (hereinafter called the holder) that is to hold the SDRs for purposes of the operation, and shall remain open for such period, not exceeding two years, as shall be specified in the standing instructions, unless closed earlier as provided in this Decision.
2. During the period the subaccount is open, the Fund shall not give effect to any use of the set-aside SDRs, except transfers to a party eligible to receive such transfers pursuant to a special transfer instruction as specified in the standing instructions.
3. Notwithstanding paragraph 2, the set-aside SDRs may be drawn upon by the Fund to meet net charges and assessments due from the holder under Article XX, and shall be subject to cancellation under Article XVIII, and may also be used by the holder to discharge other obligations of the holder under the Articles of Agreement, but only to the extent that the unrestricted SDR holdings of the holder are insufficient for these purposes. Any reduction in the set-aside amount resulting from such drawings or cancellations shall automatically be replenished as SDRs are subsequently received by the holder. If two or more subaccounts have been opened in the holder's name under this Decision, the earlier in time shall be reduced last and replenished first.
4. Interest accruing on set-aside SDRs shall be credited to the unrestricted SDR holdings of the holder, provided that the standing instructions may provide for the transfer of such SDRs to the holdings of another participant or prescribed holder.
5. (a) The subaccount shall be closed on the expiration of the specified period or when any of the following events occurs, whichever is earlier:

(i) the full set-aside amount has been transferred as provided in paragraph 2;

(ii) the Fund receives notice to close the account in a form specified in the standing instructions;

(iii) the holder or the party eligible to receive transfers as provided in paragraph 2 ceases to be a participant or prescribed holder;

(iv) operations in SDRs are suspended, either generally or with reference to the holder, under Article XXIII, or a decision is taken to liquidate the Special Drawing Rights Department under Article XXV.

(b) Unless otherwise provided in the standing instructions, any SDRs remaining in the subaccount when it is closed shall be consolidated with the unrestricted SDR holdings of the holder, and all restrictions on the use of such SDRs imposed pursuant to this Decision shall lapse.

6. The Fund shall promptly notify the parties whenever a transfer is made as provided in paragraph 2, whenever a drawing, cancellation, or replenishment occurs as provided in paragraph 3, and when the subaccount is closed.

