

EBS/85/242
Supplement 1
Correction 2

CONFIDENTIAL

December 23, 1985

To: Members of the Executive Board
From: The Secretary
Subject: Special Charges on Overdue Financial Obligations to the
Fund - Further Considerations and Proposed Decision

The following corrections have been made in EBS/85/242,
Supplement 1 (12/16/85):

Page 2, line 19: for "3.52 percent" read "4.02 percent"
line 23: for "3.02 percent" read "3.52 percent"

Page 3, tabulation, columns 2 and 3, line 3: for "3.02 and 3.52"
read "3.52 and 4.02"
line 4: for "3.52 and 3.52"
read "4.02 and 4.02"

Page 4, para. # 7(b), penultimate line: for "the difference between"
read "the sum of"

Page 6, Proposed Decision, para. # III, lines 2 and 3 and line 5:
for "the difference between" read "the sum of"

These changes correct an error in the calculation of the midpoint
between the SDR rate of interest and the rate of interest on Trust Fund
loans, which is proposed as the basis for special charges on overdue
Trust Fund obligations.

A corrected document including the corrected note of transmittal
issued on December 17, 1985 is attached.

Att: (1)

**FOR
AGENDA**

EBS/85/242
Supplement 1
Corrected: 12/17/85

CONFIDENTIAL

December 16, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Special Charges on Overdue Financial Obligations to the
Fund - Further Considerations and Proposed Decision

Attached for consideration by the Executive Directors is a paper containing a draft decision reflecting Executive Directors' agreement in principle at EBM/85/175 and EBM/85/176 (12/6/85) to establish a system of special charges based on Option A in EBS/85/242 (10/29/85) with the modification that special charges for Trust Fund obligations would be based on a level mid-way between the SDR interest rate and the rate of interest on Trust Fund loans. The draft decision appears on pages 6 and 7.

It is proposed to bring this subject to the agenda for discussion on Monday, December 30, 1985.

Mr. Dhruba Gupta (ext. 7627) or Mr. Corr (ext. 7621) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Special Charges on Overdue Financial Obligations to the Fund--
Further Considerations and Proposed Decision

Prepared by the Treasurer's and Legal Departments

Approved by W.O. Habermeier and George P. Nicoletopoulos

December 20, 1985

1. At EBM/85/175 and EBM/85/176 (12/6/85), the Executive Board decided in principle to establish a system of special charges designed to recover direct financial costs and losses arising from members' overdue financial obligations to the Fund. In line with the conclusions of that meeting, the system would be based on Option A presented in the staff paper prepared for the discussion on December 6, 1985, ^{1/} with modifications as discussed below. This paper responds to certain questions that arose in the Board's discussion on December 6, summarizes the principal features of the system as it would be modified in light of the discussion, and proposes a draft decision for adoption by the Executive Board. This decision will enable the Fund to levy special charges in order to recover financial losses incurred by the Fund as a result of the failure by a member to pay financial obligations to the Fund on time.

2. Trust Fund. With respect to special charges on overdue Trust Fund obligations, a number of considerations were mentioned in the Executive Board's discussion on December 6. The staff had suggested in EBS/85/242 that the SDR rate of interest might be used as a proxy for the measurement of costs on these obligations, based on potential investment earnings forgone (which, if collected, would add to the amounts available in the Special Disbursement Account). Some Directors considered that, in view of the highly concessional nature of the Trust Fund, it would be appropriate to dispense with any special charges on overdue Trust Fund obligations or to set such charges at very low levels. Others considered that members in arrears on Trust Fund obligations should no longer benefit from the very concessional rates on those obligations in arrears, and that it would be appropriate for the members in arrears to be charged amounts that would, in effect, compensate other potential beneficiaries for the corresponding losses. It was also suggested that a "cap," possibly well below the SDR rate of interest, might be placed on special charges with respect to overdue Trust Fund obligations.

In commenting on the measure of the losses on overdue Trust Fund obligations, the staff explained that the SDR rate of interest, as had

^{1/} See "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund - Further Consideration" (EBS/85/242, 10/29/85).

been suggested in EBS/85/242, was itself only a proxy measure of loss with respect to Trust Fund obligations. In part, the measure of loss (income forgone) might be related to the rate of interest to be charged on new lending by the Special Disbursement Account (SDA); this rate had not yet been decided by the Executive Board, but a rate close or identical to the rate on Trust Fund loans--0.5 percent per annum--would be proposed in the forthcoming staff paper on use of SDA resources. On the other hand, a part of the reflows from the Trust Fund, and perhaps a substantial part in light of uncertainties about the actual rate of use of these funds, would be temporarily invested at market-related rates of interest which might yield a higher rate of return than the SDR interest rate. On balance, taking into account the views of Executive Directors and the differing considerations in assessing the extent of loss, it was suggested that the level of special charges on overdue Trust Fund obligations designed to recover loss might reasonably be based on a point mid-way between the yield on loans from the Trust Fund (0.5 percent per annum) and the SDR rate of interest (currently 7.53 percent per annum). (On the basis of current rates, therefore, the mid-point would be 4.02 percent per annum.) The special charge to be levied on overdue Trust Fund interest would be the rate yielded by this formula; that to be levied on overdue Trust Fund repayments would be the rate resulting from this formula less the normal rate of charge of 0.5 percent on overdue repayments, or 3.52 percent at current rates.

In light of these considerations, the staff proposes that the special charges to be imposed with respect to Trust Fund obligations be calculated on the basis described immediately above; the actual rates to be charged would vary over time with movements in the SDR rate of interest. ^{1/} This proposal is incorporated into the proposed decision presented below.

3. Illustrative calculations. The rates of regular, special, and "effective" (special plus regular) charges, that would have prevailed as of December 16, 1985 are illustrated in the table below.

A special charge would be applied to overdue repurchases of ordinary resources only if, and to the extent that, the SDR rate of interest exceeds the regular rate of charge on use of ordinary resources. On the basis of the rates prevailing as of December 16, 1985 (rate of charge of 7.87 percent and SDR rate of interest of 7.53 percent), therefore, no special charge would be levied on overdue repurchases of ordinary resources. Nevertheless, as indicated in paragraph I(3) of the proposed draft decision, when the SDR rate of interest exceeds the rate of charge, a special charge would be applied to overdue repurchases of ordinary resources.

^{1/} The basis for calculation could be reconsidered if the rate of interest decided for loans from the Special Disbursement Account differs significantly from the rate of interest on Trust Fund loans.

Type of obligation	Normal rate of charge (1)	Rate of special charge (2)	"Effective" rate of charge (3) (1 + 2)
	(Percent per annum; rates as of December 16, 1985)		
Repurchase (OR)	7.87	0.00	7.87
Charges in the General Dept.	--	7.53	7.53
Trust Fund repayment	0.5	3.52	4.02
Trust Fund interest	--	4.02	4.02

4. Date of implementation. It was also considered at EBM/85/176 that a delay of about one month between the adoption of a decision on a system of special charges and the entry into the effect of the system would provide reasonable notice to members. The beginning of February 1986 was generally regarded as reasonable if the decision was taken by or before January 1, 1986. On the assumption that the decision would be adopted by January 1, 1986, the date of February 1, 1986 is therefore proposed in Paragraph VI of the draft decision for the system of special charges to become effective. Members would be notified of the prospective introduction of special charges upon adoption of the decision.

5. Reviews. At the Board discussion on December 6, 1985, questions were raised as to the effectiveness of special charges, both as a means of recovering costs and as an instrument in the Fund's policies for dealing with the problem of overdue obligations to the Fund. Various considerations bearing on this issue have been discussed in earlier staff papers 1/ and Board meetings, and it is generally acknowledged that the question of effectiveness is most difficult to judge or to predict in advance. This question would be a principal focus of periodic reviews of the operations of the system, which are discussed briefly below and provided for in Paragraph VI of the draft decision.

Executive Directors agreed that it would be important to review the workings of the system of special charges on a regular basis. The staff had suggested that a first review might take place in the spring

1/ See EBS/85/121, especially pp. 3-7, and EBS/85/242, especially pp. 2-3.

of 1986, in conjunction with the review of the Fund's income position for FY 1987. In light of the proposed timing of the introduction of the system, however, this now appears to be too short a period for a general review (although available results would be taken into account in the spring 1986 income review). The staff would consider that a first general review of the system of special charges could appropriately be held in conjunction with the FY 1987 mid-year income review (i.e., in November-December 1986, approximately nine months after entry of the system into effect) and, thereafter, in conjunction with the annual income reviews. The staff would also intend to report developments related to special charges in the regular six-monthly reports on overdue financial obligations to the Fund.

6. Media of payment. It was proposed in EBS/85/242 that special charges be payable in SDRs. However, as Trust Fund obligations (including interest) are payable in dollars to the Special Disbursement Account, it is proposed that special charges in respect of Trust Fund obligations be made payable in dollars as well. Special charges on overdue obligations in the General Resources Account would be payable in SDRs.

7. Summary of system. Executive Directors generally agreed with the other main features of a system of special charges on overdue financial obligations to the Fund as presented in EBS/85/242 (see in particular, pp. 5-9 and 15-16). In light of the Board discussion on December 6 and the considerations discussed above, the main features of the system that would come into effect following adoption of the proposed decision may be summarized as follows:

(a) The system of special charges would apply uniformly to all members.

(b) Calculations of special charges to recover direct financial costs to the Fund would be based on the SDR rate of interest as regards overdue obligations in the General Resources Account and, as regards overdue Trust Fund obligations, on one half of the sum of the SDR rate of interest and the rate of interest on Trust Fund loans.

(c) The system would become effective on February 1, 1986. Special charges would not be applied retroactively, but would apply to all overdue obligations outstanding on February 1, 1986, with effect from that date, and arising after that date, subject to paragraphs (d) and (e) below. The rates of special charge, which would change with the SDR interest rate and the rate of charge on ordinary resources, would be applied to outstanding obligations on a daily basis.

(d) Giving effect to the consultation requirements of Article V, Section 8(c), the Fund would consult by rapid means of communication with a member not later than three business days after a repurchase became overdue and would inform the member that a special charge would be applied, from the due date, if the repurchase were not settled within 10 business days after the due date.

(e) Special charges would apply as well, from the due date, to all other obligations (i.e., charges in the General Resources Account and Trust Fund obligations) that were overdue for more than 10 business days.

(f) Special charges on overdue obligations in the General Resources Account would be payable quarterly, in SDRs, at the same time as regular quarterly charges to the General Resources Account; special charges on overdue Trust Fund obligations would be payable on the same quarterly basis to the Special Disbursement Account in U.S. dollars. No special rule would be introduced for the order of discharge of special charges and other obligations nor would further special charges be applied to special charges that may become overdue.

(g) Special charges would be treated in the same way as other charges as regards accrual and nonaccrual in the income and expense statements prepared and published by the Fund. Projections of receipts of special charges would not be included at the outset in projections of income for the purpose of the annual review of income and determination of the rate of charge; to the extent special charges were not paid, this would therefore not affect the Fund's income position by comparison with the projections. This matter would be re-examined in the light of experience.

(h) As has been noted in earlier papers on special charges, the adoption of a general system of special charges would not preclude a decision by the Executive Board to apply further charges to overdue repurchases, outside and in addition to the general system of special charges, in particular circumstances. As mentioned at EBM/85/180 (12/13/85), this possibility could become relevant, for example, if the Executive Board were to consider that a retroactive reduction in the rate of charge was warranted in light of developments in the Fund's income position but that it would not be appropriate for a member in arrears to the Fund to benefit from such reduction.

(i) The system and the basis for rates of special charges levied under it would remain in effect unless modified by the Executive Board by a 70 percent majority of the voting power. ^{1/} A review of the workings of the system would take place periodically. The first review would take place in conjunction with the mid-year review of the Fund's income position for FY 1987, and thereafter annually in conjunction with the annual income reviews. Interim reports on the operation of the system would be included in the periodic reports on overdue obligations to the Fund.

^{1/} Provided that a modification not involving special charges on overdue repurchases could be made by a majority of the votes cast. See EBS/85/242, Section II(2).

Proposed Decision

In light of the above, the following draft decision, which requires a 70 percent majority of the total voting power, is proposed for adoption by the Executive Board:

I. Overdue Repurchases

1. Pursuant to Rule I-6(8) the Fund has reviewed the rates of charge to be levied under Article V, Section 8(c) on its holdings of a member's currency that have not been repurchased in accordance with the requirements of the Articles or decisions of the Fund.

2. Within three business days after (i) the due date for the repurchase by a member of the Fund's holdings of its currency resulting from purchases of the Fund's ordinary resources or (ii) the effective date of this decision, whichever is the later, the Fund shall consult with the member on the reduction of the Fund's holdings of the member's currency that should have been repurchased. The consultation shall take place by rapid means of communication.

3. Unless the Fund's holdings of the member's currency are reduced within the period referred to in Section IV below by the amount that should have been repurchased, the rate of charge on the holdings that should have been repurchased shall be increased by a percentage equal to the excess, if any, of the rate of interest on the SDR over the rate of charge levied on the holdings under Rule I-6(4) or (11).

II. Overdue Charges in the General Resources Account

A special charge equal to the rate of interest on the SDR shall be paid by a member on the unpaid amount of charges owed by it under Article V, Section 8(a) and (b).

III. Overdue Interest and Repayments on Trust Fund Loans

The Fund shall levy a special charge on (i) the amount of overdue interest on Trust Fund loans, at a rate equal to one-half of the sum of the rate of interest on Trust Fund loans and the rate of interest on the SDR, and (ii) the overdue amounts of repayments of Trust Fund loans, at a rate equal to one-half of the sum of the rate of interest on Trust Fund loans and the rate of interest on the SDR, less one-half percent.

IV. Waiver of Special Charges

Special charges under Sections I, II, and III above shall be levied in respect of an overdue financial obligation as of the due date or the effective date of this decision, whichever is the later, unless the obligation is discharged within ten business days after the applicable date.

V. Notification and Payment of Special Charges

1. Special charges levied under this Decision shall be payable following the end of each of the Fund's financial quarters and the member shall be notified promptly of any special charges due. The charges shall be payable on the third business day following the dispatch of the notification.

2. Special charges in respect of overdue repurchases and charges in the General Resources Account shall be paid in SDRs to that Account. Special charges in respect of overdue repayments and interest on Trust Fund loans shall be paid in U. S. dollars to the Special Disbursement Account.

VI. Entry into Effect and Review

This Decision will enter into effect on February 1, 1986. It will be reviewed shortly after October 31, 1986 at the time of the mid-year review of the Fund's income position for the financial year ending April 30, 1987, and thereafter annually in connection with the annual reviews of the Fund's income position.