FOR AGENDA

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To: Members of the Executive Board

From: The Secretary

Subject: **Charges on the Supplemental Reserve Facility**

This paper provides background information to the paper on the supplemental reserve facility (EBS/97/225, 12/5/97), which is tentatively scheduled for discussion on Monday, December 15, 1997. Summary and conclusions appear on pages 11–13.

Mr. David Williams (ext. 38305) or Mr. Wittich (ext. 38307) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Charges on the Supplemental Reserve Facility

Prepared by the Treasurer's Department

(In consultation with the Policy Development Review Department
and the Legal Department)

Approved by David Williams

December 12, 1997

I. Introduction

1. The staff paper on the Supplemental Reserve Facility (SRF) suggested for Executive Board consideration that the rate of charge on the use of credit under the new facility should be between 200-400 basis points higher than the Fund's (adjusted) basic rate of charge, both for prudential reasons and to provide incentives for members to treat access as precautionary and to make early repurchases when conditions permit. The paper indicated that a higher rate of charge under this facility could potentially generate a large amount of income, which would raise a number of issues. These relate to the impact on the Fund's target amount of net income and the determination of the rate of charge, to the adequacy of precautionary balances more generally, and possibly to burden sharing, and could affect both the present and future financial years.[1] These issues, and in particular the adequacy of the Fund's precautionary balances, also arise as a result of the sharp increase in credit extended by the Fund under recent stand-by arrangements.

2. The main question dealt with in this paper is whether income deriving from the recent large expansion of credit and the prospect of further income deriving from the extension of credit under the new facility—i.e., the proceeds of the service charge, basic charges, and the proposed surcharge—should be taken into account for the purpose of determining the target amount of net income and setting the rate of charge on the use of Fund resources, or whether charges on and income from the credit expansion under the SRF should be treated separately when setting net income target and the rate of charge? In this connection, the question arises whether the use of income in excess of the target amount for FY 1998 should be reconsidered. This paper discusses the main alternative approaches.

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[1]See *Supplemental Reserve Facility* (EBS/97/225, 12/5/97), paras. 20-23.

3. The paper is structured as follows. A brief overview of the evolution of the Fund's system of charges is provided in Section II as background information. Section III discusses the impact of higher charges or a surcharge under the SRF on current procedures to determine net income and the rate of charge. Section IV considers possible alternative uses of income resulting from the expansion of Fund credit and from a surcharge on SRF purchases. Section V discusses the potential impact on net income and charges for FY 1998, and Section VI provides a summary and conclusions.

II. PRESENT SYSTEM OF CHARGES

4. A single rate of charge now applies to all use of credit in the General Resources Account (GRA), irrespective of whether such use is made under the credit tranches or under a special facility. Rates of charge must be uniform for all members in accordance with Article V, Section 8(d).[2] However, uniformity does not imply that there must be a single rate of charge on all use of the Fund's resources. The Fund can make distinctions among uses, provided these distinctions are based on relevant criteria and consistent with the purposes of the Articles, and provided they are applied to all members in the same circumstances.

5. Under the original Articles of Agreement, the schedule of charges progressed both by tranche, each equal to 25 percent of quota, and also over the period during which balances subject to charges remained outstanding; later, different charges were applied to special facilities financed by borrowed resources. The progression of charges based on the level of holdings was abolished in 1974, and progression over time, designed to encourage repurchases, was ended after the introduction of fixed repurchase periods under the Second Amendment of the Articles, although provision for an increase in the rate of charge over time remains in the Articles.[3]

6. The progression of charges both with increasing access and over time had resulted in a highly complex set of matrices of different rates of charge on different segments of purchases; moreover, repurchases were attributed to the segments subject to the highest rates, and which normally were not related to purchases that were in fact repurchased. As a consequence, the Fund's charges not only were difficult to understand and lacked transparency, but also did not appear to contribute to avoidance of prolonged use of Fund credit as had been intended.

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[2]See *Uniformity in Relation to Charges* (SM/74/47, 2/21/74).

[3]Article V, Section 8(b).

7. By early 1993, the Fund completed the process of simplifying the structure of charges, making all use of credit subject to the same rate of charge.[4] At present, the structure of charges consists of (i) a uniform rate of charge on the use of the Fund's resources, independent of the policy and facilities under which the drawings are made, which is adjusted for burden sharing; (ii) a commitment fee on stand-by or extended arrangements of one quarter of one percent, refundable when purchases are made; and (iii) a service charge of one half of one percent on each purchase, other than reserve tranche drawings which carry no charges.

III. Impact of Higher Charges on the Determination of Net Income and Setting the Rate of Charge

8. As mentioned, there are two issues that arise in the context of the current procedures for determining the net income target and for setting the rate of charge. First, whether the sharp increase in income from the use of Fund credit under the proposed new facility should be taken into account in setting the basic rate of charge on the use of Fund resources, or whether some part of this income from use of the SRF should be excluded for this purpose. And second, what should be the use of income from credit extended under the facility; in this context, the use of income in excess of the target amount in FY 1998 may usefully be reconsidered.

A. Amount of Additional Income from Use of the SRF

9. Although it is not possible to estimate with any degree of accuracy the use of the proposed facility for the next few years, its use could result in substantial but likely to be highly variable income from service and periodic charges and, in particular, from the surcharge.[5] To give an impression of possible orders of magnitude, income on use of credit outstanding under the proposed facility of SDR 5, 10, 15, and 20 billion, assuming a surcharge of 200, 300, and 400 basis points, is shown in Table 1. If, for illustrative purposes, it were assumed that SDR 10 billion were to be outstanding, additional income would be in the order of SDR 84 million from the service charge and the margin of basic charges over

[4]See *Simplification of the Fund's Charges* (EBS/92/184, 11/20/92) and Executive Board Meeting No. 92/147 (12/9/92).

[5]High variability of potential income reflects the nature of the facility which essentially addresses crisis situations; credit under it would most likely be extended only intermittently and also would be expected to be reversed in relatively short periods.

remuneration,[6] and SDR 200-400 million per year from the surcharge.[7] To the extent that credit under the SRF is repurchased quickly, additional income would accrue only for a short period of time.

Table 1. Income From Service and Periodic Charges and Surcharge on the Use of Resources Under SRF

	Outstanding Credit Under SRF (In millions of SDRs)			
	5,000	10,000	15,000	20,000
Proceeds from service charge	25	50	75	100
Proceeds from the margin between the basic rate of charge and the remuneration rate 1/	17	34	50	68
Proceeds from surcharge of:				
200 basis points	100	200	300	400
300 basis points	150	300	450	600
400 basis points	200	400	600	800

1/ Assuming purchases at the beginning of a year and net income from the SRF is to be separated from the net income derived from other Fund credit and a charges coefficient of 107.8 percent (item (iii) in Table 2).

[6]Assuming income from the facility to be treated separately, as discussed further below.

[7]The service charge would accrue once while periodic charges and surcharge accrue each year.

B. Impact on Setting the Net Income Target and the Rate of Charge

10. Inclusion of all income from the use of credit under the SRF—including income from the surcharge—could significantly affect the determination of the **basic** rate of charge on the use of Fund credit. The income-producing balances are linked to the main component of the financing cost of Fund credit—remuneration expense—by setting the rate of charge as a proportion of the SDR interest rate which determines the rate of remuneration. The coefficient for the basic rate of charge is set at the beginning of the financial year, on the basis of projected use of Fund credit, so as to generate income sufficient to cover all projected operational expense (remuneration of reserve tranche positions and borrowing costs, if any), the Fund's projected administrative expenditures, and to yield a net "surplus" (i.e., the target amount of net income).[8] It is this basic rate of charge, adjusted for burden sharing, to which the surcharge on the use of credit under the SRF (proposed to be between 200 and 400 basis points) would be added.

11. The first issue to be considered therefore is whether or to what extent credit and income from purchases under the SRF should be taken into account when determining the coefficient for the basic rate of charge, given an agreed target amount of net income. There are three possibilities: (i) to take into account income from the **total** amount of projected Fund credit, including credit under the SRF; (ii) to take into account income on SRF purchases produced by the basic rate of charge and service charge but disregard the proceeds from the surcharge proposed to be added to the rate of charge; or (iii) to exclude from the calculation all income (derived from the service charge, the basic charge, and the surcharge) on projected use of Fund resources under the SRF.

12. As purchases under the SRF may well be large compared to the total of outstanding Fund credit, the inclusion or exclusion of purchases under the facility may be expected to have a significant impact on projections of the Fund's net income and on the calculation of the charges coefficient necessary to achieve an agreed target amount of net income. It is difficult to quantify that impact without a projection of demand for Fund credit under the proposed facility, but orders of magnitude can be indicated for illustrative purposes. Some simulations for the next financial year (FY 1999) are summarized in Table 2 and discussed in the following paragraphs.

13. Assume purchases under the SRF were projected to average SDR 10 billion during the next financial year (FY 1999, beginning May 1, 1998). As can be seen in Table 1, **total** income from SDR 10 billion use of the SRF would amount to between SDR 284 million and

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[8]Prior to FY 1993, credit outstanding under the *Supplementary Financing Facility* and under *Enlarged Access* financed by borrowed resources was not taken into account when determining the (coefficient of) the basic rate of charge; charges on the use of borrowed resources were set in a manner so as to cover the Fund's costs of borrowing the resources used for *SFF* and *EAR* (plus a small margin).

Table 2. Illustrative Rate of Charge Coefficient and Net Income: FY 1999[1]

(In millions of SDRs and in percent)

	Surcharge (basis points)		
	200	300	400
Coefficient and net income if:			
(i) Calculation of Coefficient includes **all** income from SRF			
Rate of charge coefficient (percent)	95.1	90.7	86.2
Net income (SDR million)	103	103	103
Net income in excess of target amount	0	0	0
Total net income	103	103	103
(ii) Calculation of Coefficient includes all income from SRF **except** proceeds of surcharge			
Rate of charge coefficient (percent)	104.1	104.1	104.1
Target amount of net income (in SDR million)	103	103	103
Proceeds of surcharge (SDR million)	200	300	400
Total net income	303	403	503
(iii) Calculation of Coefficient includes **no** income from SRF			
Rate of charge coefficient (percent)	107.8	107.8	107.8
Target amount of net income (in SDR million)	103	103	103
Proceeds of Service +Basic Charge on SRF credit[2]	84	84	84
Proceeds of surcharge	200	300	400
Total net income	387	487	587

[1]Assuming average use of credit under SRF of SDR 10 billion.
[2]Net of remuneration expense.

SDR 484 million, of which the proceeds of a surcharge of between 200-400 basis points would be between SDR 200-400 million, and income from the service charge SDR 50 million. Under this assumption, net income from credit extended under the proposed facility would substantially exceed the target amount of net income of recent years of 5 percent of reserves (or about SDR 100 million in FY 1999). Given this net income target,[9] and on the assumption that the total amount of credit and net income derived from purchases under the SRF would be taken into account when determining the charges coefficient, the coefficient would be projected at between 86.2-95.1 percent (or a basic rate of charge of between 3.72 percent and 4.10 percent on current projections compared to 4.65 percent in the absence of SRF credit), depending on the magnitude of the surcharge (item (i) in Table 2). Net income would equal the target amount, with the basic rate of charge much lower than in the absence of such credit.

14. If proceeds from the surcharge were excluded in the determination of the charges coefficient (but those from the service charge and from the margin between basic charges and remuneration expenses taken into account), the coefficient for FY 1999 would be calculated at 104.1 percent, and projected net income would be in the order of SDR 303-503 million, i.e., the target amount plus the proceeds of the surcharge of SDR 200-400 million (item (ii) in Table 2).

15. It would, of course, also be possible to exclude all income from purchases under the facility when setting the charges coefficient. In this example, the coefficient for FY 1999 would be set at 107.8 percent, and total net income—including proceeds of the service charge, the margin between basic charges and remuneration, and the surcharge—would be SDR 387-587 million (item (iii)).

IV. Uses of Additional Income Deriving from Charges on the Use of Credit Under the SRF

16. There are essentially four possible uses of net income deriving from the use of credit under the SRF: (i) additional placements to the Fund's precautionary balances (reserves or a contingent account); (ii) a retroactive reduction of the basic rate of charge absorbing part or all of excess income; (iii) suspension of burden-sharing, which presently offsets the impact of overdue obligations on the Fund's financial position; and (iv) to meet part of the Fund's administrative and operational expenses.

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[9] The question of the adequacy of precautionary balances will be touched upon later. See paragraph 18 below.

A. Addition to Precautionary Balances

17. To the extent that purchases under the SRF increase the Fund's exposure to risk, income derived from credit extended under the facility, including the surcharge, could be placed to the Fund's precautionary balances, either in the form of a further addition to the Fund's General or Special Reserves, or by placement to a special contingent account. Addition to the Fund's reserves would increase precautionary balances permanently,[10] which *ceteris paribus* may reduce the need for further reserve accumulation (and consequently the net income target and the rate of charge) in the future when credit outstanding under the SRF has been repaid.

18. Alternatively, additional precautionary balances could be held either in a special contingent account established for this purpose (SCA-3) or in the existing SCA-1. If a new SCA were to be established, the contingency upon which the Account would be dissolved and the distribution of the assets in it would need to be established. For example, when the Fund is no longer subject to the risk for which the contingency reserve was established,[11] balances in the Account could either be taken into the Fund's income or could be returned to the members who made payments into the Account, or a combination of the two. If the additions were paid into the SCA-1, balances would be returned to the members who paid them when there are no outstanding overdue charges and repurchases or at such earlier time as the Fund may decide; distributions would be made to all members who made contributions to the Account in proportion to these contributions.[12]

B. Lower Charges

19. Income on credit extended under the SRF or from the surcharge that was collected after the level of precautionary balances of the Fund is judged adequate, and which would result in net income in excess of the target amount, could be used retroactively to reduce the (basic) rate of charge on the use of the Fund's general resources.[13] The reduction of the rate of charge that would be possible if all or part of the income on credit extended under the

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[10]Unless the Fund decided to distribute reserves under Article XII, Section 6(d). Such a distribution would have to be made to all members in proportion to their quotas, and only the General Reserve may be distributed. The issue of a distribution of the Fund's General Reserve (or of net income) is not discussed as an option in this paper.

[11]For instance, when purchases under the facility have been repaid, or when the Board decided the Account was no longer needed.

[12]See Executive Board Decision No. 8780-(88/12), paragraph 3, *Selected Decisions*, Twenty-Second Issue (1997), pp. 289-90.

[13]The same applies to balances in a contingent account that are no longer needed for precautionary purposes and are taken into income.

facility, including the proceeds of the surcharge, were used for this purpose would, as mentioned, depend on the amount of credit outstanding under the facility and on the size of the surcharge. A surcharge of 200-400 basis points on average balances of SDR 10 billion of credit outstanding under the facility would allow the coefficient for the rate of charge in FY 1999 to be about 12.7-21.6 percentage points lower than it would otherwise have to be (i.e., 86.2-95.1 percent instead of 107.8 percent[14] or a basic rate of charge of 3.72-4.10 percent instead of 4.65 percent on present projections). For each additional SDR 1 billion of average credit outstanding, the reduction would be 1.0-1.7 percentage points higher with a surcharge of 200-400 basis points. To the extent that credit under the facility would be outstanding only a short time period, fluctuations in the charges coefficient would, of course, become much larger than they have been in the recent past.

C. Impact on Burden Sharing

20. Alternatively, it could be considered whether income on credit extended under the facility, including the proceeds of the surcharge, would allow for a revision of the burden-sharing arrangement after taking into account whether there was a need for higher precautionary balances. As mentioned, burden sharing (which was introduced in 1986 and has been renewed annually since then) aims at a simultaneous and symmetrical sharing between debtor and creditor countries of the financial consequences for the Fund which stem from the existence of overdue obligations. Adjustments under burden sharing to the rate of remuneration and the rate of charge presently amount to about 24 and 21 basis points[15] and yield SDR 50 million a year to offset deferred charges and SDR 100 million for additions to SCA-1. The amounts currently needed to finance burden sharing are equivalent to income from SDR 3.8-7.5 billion of credit outstanding under the SRF with a surcharge of between 200-400 basis points. The use of proceeds from the surcharge in place of the burden-sharing adjustments would result in a different incidence of the contributions to the Fund's financing, and would raise a question as to how the costs of overdue obligations—to the extent they continue to exist—would be borne when the short-term credit under the facility has been repaid.

D. Meeting Administrative and Operational Expenses

21. It will be recalled that it would be possible to make available to the ESAF-HIPC Trust the resources of the ESAF Trust Reserve Account that are presently used to reimburse the

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[14]See Table 2.

[15]In view of the large amount of balances subject to charges involved, the adjustment would fall to 18 and 16 basis points if credit under the SRF, were subject to burden sharing.

GRA annually the costs of conducting the business of the ESAF Trust.[16] The resulting shortfall in the administrative budget resulting from the transfer of the proceeds of the annual reimbursement to the GRA from the ESAF Trust Reserve Account to the ESAF-HIPC Trust could be financed from the income deriving from use of the SRF. As noted in *Status Report and Options for Financing the ESAF and the HIPC Initiatives* (EBS/97/201), such a transfer to the GRA would need to be adopted by the Executive Board by a majority of 85 percent of the total voting power.

V. Net Income and the Rate of Charge in FY 1998

22. For FY 1998, the Executive Board has decided that any income in excess of the target amount would be used at the end of the year retroactively to reduce charges.[17] On the assumption of use under the SRF at a similar rate as illustrated above for FY 1999—say purchases of SDR 5 billion during the last four months of the financial year and a surcharge of 200-400 basis points on the basic rate of charge[18]—additional net income for FY 1998 (service charge, margin, and surcharge) would be between SDR 59-88 million. The establishment of a new facility allowing large-scale but short-term use of Fund credit in specified circumstances was not anticipated at the beginning of the year. In these circumstances, the question arises whether the income resulting from higher charges or a surcharge, and possibly also the service charge, on use of Fund resources under the new facility in FY 1998 should be segregated from the Fund's other net income, and excluded from net income in excess of the target amount that will be used retroactively to reduce the rate of charge at the end of the financial year.[19] The unprecedentedly large amounts of credit recently extended to a few member countries (and credit that could be extended under the SRF) will need to be taken into account in the next review of the adequacy of the Fund's precautionary balances, and could result in a conclusion that a strengthening of the Fund's prudential stance is called for. Pending this review, the Executive Board may wish to reserve

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[16]See *Status Report and Options for Financing the ESAF and the HIPC Initiatives* (EBS/97/201 (11/6/97), paras. 29-32.

[17]See Executive Board Meeting No. 97/42 (4/21/97) and Executive Board Decision No. 11482 (97/42) of April 21, 1997.

[18]Purchases of SDR 2.5 billion each assumed to be made January 2, 1998 and February 2, 1998.

[19]Based on use of SRF credit of SDR 5 billion projected above, net income with a surcharge between 200-400 basis points would be SDR 59-88 million for the remainder of FY 1998, and would allow a reduction in the charges coefficient by 3.3-5.0 percentage points. The resulting average rate of charge for FY 1998, after retroactive reduction, would depend on the amount of net income in excess of the target amount *other than* the proceeds of the surcharge.

judgement on the use of net income that derives from the use of credit under the SRF. An amendment of Decision No.11482-(97/42) on the use of net income in excess of the target amount for FY 1998 to exclude such income from use for any retroactive reduction in the rate of charge for FY 1998 would require 70 percent of the total voting power and would apply only to net income on purchases under the SRF earned after the decision has been taken.

VI. Summary and Conclusions

23. This paper has outlined the impact on the Fund's income of the potentially large amounts of credit that may be extended intermittently under the proposed Supplemental Reserve Facility (SRF) and has discussed various alternative uses of this income for the consideration of and guidance by the Executive Board.

24. The increase in the Fund's income from credit extended under the proposed facility—i.e., the proceeds of the service charge, the basic rate of charge, and the proposed surcharge—is likely to be substantial in FY 1998 and beyond, but also likely to be highly variable in the future. While it is not possible at this stage to project the potential amount, additional net income could range up to SDR 300-600 million a year, depending on the total use of the SRF and, in particular, on the size of the surcharge that may be agreed under that proposed facility.

25. This paper has outlined four uses for all or part of the additional net income:

- first, given an agreed addition to precautionary balances, i.e., the target amount of net income, some portion of income generated by use of the large extension of credit could be used to set the coefficient of the rate of charge at a lower level than otherwise would be necessary to meet that target;

- second, the income could be used to increase the rate of accumulation of the Fund's precautionary balances, taking into account the large increase in credit outstanding, and the large amounts of credit extended to a very few member countries experiencing particularly sharp balance-of-payments difficulties. The increase in the Fund's precautionary balances could take the form of additions to the Fund's General or Special Reserves, to the existing special contingent account (SCA-1) or to a new contingent account (SCA-3);

- third, the additional income could also be used to help finance the cost arising to the Fund from the persistence of overdue financial obligations which presently is shared amongst debtor and creditor member countries under the burden-sharing arrangements;

- fourth, the additional income could also be used to replace those resources that are now transferred to the GRA in the form of reimbursements from the ESAF Trust

Reserve Account for the costs of conducting the business of the ESAF Trust, but would instead be made available to the ESAF-HIPC Trust.

26. In their discussion of these issues, Executive Directors may wish to take into account the following considerations, which do not all point in the same direction but which are not mutually exclusive and could be considered separately or in combination:

- in view of the recent and prospective large amounts of credit to be extended over the next few years, it would seem desirable to strengthen the prudential stance of the Fund by increasing the rate of accumulation of precautionary balances. The present ratio of "free reserves" to credit outstanding is of the order of 3.7 percent; consideration may be given to raising this ratio considerably above the current range of 3-5 percent;

- the negotiation of programs and the extension of credits under SRF-like circumstances adds to administrative expenses. In these circumstances, it would seem reasonable that at least part of the additional income—say, an amount equivalent to the proceeds of the service charge and of the margin between the rate of remuneration (the Fund's cost of financing an extension of credit) and the basic rate of charge (its income on credit extended)—would accrue to the Fund and would enter in the calculation of the basic rate of charge to achieve the Fund's net income target;

- in this connection, and taking into account the possible need to increase the level of the Fund's precautionary balances, it is for consideration whether a portion of the proceeds accruing from the use of the SRF should be used to finance a substantial addition to the Fund's reserves;

- the impact on the Fund's financial position of overdue financial obligations (charges and repurchases) has so far been offset by simultaneous and symmetrical adjustments to the rate of remuneration and the rate of charge. It is for consideration whether part of the income derived from credit extended under the SRF should be used to alleviate the burden on creditors and debtors alike under the burden-sharing arrangements. Burden sharing is not a permanent feature of the Fund's financial structure, but it has been renewed each year since its introduction in 1986. If alleviation of the "burden" were considered reasonable in present circumstances, it would seem necessary for an understanding by the Executive Board that the current arrangements would be reinstated in the event that the large amounts of credit under the proposed facility currently in prospect would be repaid prior to the resolution of the arrears problem;

- the establishment of an additional contingent account (SCA-3) would give the Fund additional flexibility for the use of balances accumulated in the account when they are no longer needed;

- the need to augment the financing of the ESAF-HIPC Trust.

27. Directors may wish to indicate their views regarding a reconsideration of the desirable addition to the Fund's precautionary balances in FY 1998 and the use of net income in excess of the target amount for that financial year, and to what extent further additions to the precautionary balances should be linked to prospective credit under the proposed facility.