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EBS/94/235

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December 6, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Reforming the Financing of the Fund's Operations

Attached for consideration by the Executive Directors is a memorandum from the Managing Director on reforming the financing of the Fund's operations, tentatively scheduled for discussion on Monday, December 12, 1994. A conclusion appears on page 16.

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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To: Members of the Executive Board — December 6, 1994

From: The Managing Director

Subject: Reforming the Financing of the Fund's Operations

1. The exchange of views at the Informal Sessions of October 28 and November 15 on a *Reform of the Financing of the Fund's Operations* was productive, and enabled us all better to understand the concerns of the various constituencies about the present system of sharing the costs of financing the Fund's operations, and the implications of changes in this system. This memorandum is intended to build on our discussion of November 15, 1994. It is in this spirit that I put forward for the consideration and discussion of Executive Directors a set of proposals of how we might achieve, to use the words of the Communiqué of the Interim Committee following the Madrid Meeting, "a more effective and equitable mechanism" for distributing among the membership the expenses of running the Fund.

2. There would seem to be relatively broad agreement that quotas--which determine the rights and obligations of members in the Fund--should be the basis on which the Fund's members should share the costs incurred in carrying out Fund's "systemic" mandate, while the costs arising in connection with functions whose benefits accrue almost entirely to individual members, including operational costs, should be borne to the extent feasible by the individual members themselves, in particular the cost of remuneration should be borne by the members making use of Fund resources. These are important principles that shall guide us in our future work on this matter.

3. As background to our discussion, it is useful to see, in simplified form, the various sources of the Fund's income and its expenditures, using data of FY 1994. Table 1 shows the details of the various sources of the Fund's income and the main categories of its expenses. Other institutions can normally consider the individual income and expenditures items separately, at least to some extent. However, given the financial structure of the Fund, which is based on an exchange of assets, it is not possible to regard the Fund's main sources of income (charges) separately from its main expenditures (remuneration) because a simultaneous change occurs in both revenues and expenditures as a direct result of the Fund's financial operations

Income and Expense: FY 1994

(In millions of SDRs)

Income		Expense and Net Income	
Charges		Remuneration	
• Periodic charges	1,173	• Remuneration 2/	993
Plus: burden sharing by debtors 1/	92	Less: burden sharing by creditors 1/	151
	1,265		842
• Service charges	27		
• Commitment fees	9		
• Settlement of pre-burden sharing charges, special charges, etc.	23		
Interest on the Fund's holdings of SDRs	299	Interest on borrowing	147
		Precautionary balances 1/	
		• SCAs	243
		• Net income	74
Reimbursements for technical assistance, SDR Department, and ESAF/SAF	33	Administrative budget (gross)	337
		Net charge as a result of accounting change	13
	1,656		1,656

1/ Excludes deferred charges for an amount of SDR 94 million, which are burden shared by debtors and creditors in an equal proportion.
2/ This tabulation does not reflect the opportunity cost for creditors of maintaining an unremunerated position in the Fund.

and transactions with its members. 1/ For example, a purchase transaction creates operational income (through the rate of charge on the use of the Fund's resources and the service charge) but also creates operational expense (remuneration expense or reduced SDR income) while a repurchase transaction reduces simultaneously remuneration expense and operational income (or increases SDR income). The offsets are not, however, exact as the Fund needs to earn income to cover, at the margin, administrative expenses and additions to precautionary balances (including the net income target). Consequently, and disregarding the effect of the Fund's interest-free balances, the rate of charge would normally be above the rate of remuneration (or SDR interest rate) to pay for these elements. While the cost of financing overdue obligations has complicated this mechanism, in the sense that the rate of charge is higher than would otherwise be the case and the rate of remuneration is reduced to 80 percent of the SDR interest rate, it has not essentially modified it: operational expense is automatically covered by operational income from charges levied on the use of the Fund's resources, and other costs, after taking into account the Fund's interest-free resources, are met at the margin by adjustments to the rate of charge, which is the residual of the system of financing the Fund.

4. The current system is not transparent, e.g., the role of the unremunerated reserve tranches and interest-free resources and the cost of holding gold are not manifest in the Fund's financial structure, and inequities are perceived regarding the distribution of costs among members, in particular as regards the element of concessionality in the rate of charge. There is a need to simplify--and thereby clarify--the current system of financing the Fund to take into account in an agreed manner all major elements bearing on the Fund's financing of its expenses. The following discussion attempts to show how these aims may be achieved.

5. To facilitate discussion, the operational issues that would arise with the implementation of the uniform but variable "norm" following an amendment of the Articles of Agreement are discussed in Section I; Section II deals with operational issues that would arise in the interim before an amendment took effect, and which, to the

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1/ The discussion in the text is concerned with the financial effects of operations and transactions in the General Resources Account (GRA). Operations regarding the trust accounts--SAF and ESAF--are excluded, but it is worth noting that operational activity with ESAF also generates income for the GRA through the reimbursement of the cost of conducting operations under the ESAF and which is paid from the ESAF Reserve Account; similarly, the proceeds of the assessment for the cost of conducting the business of the SDR Department is related to the level of activity in the SDR Department.

extent feasible, would be resolved on the basis of the same principles that underlie the introduction of the uniform but variable norm--the importance of quotas--as an instrument in the financing of the Fund.

Operational issues relating to the uniform but variable norm

6. The following paragraphs describe first the guidelines regarding the scope of "general" expenses, and how these guidelines could be implemented in the framework of an amendment of the Articles of Agreement.

Operational expenses and rate of charge

7. There is general support for the principle that *operational expenses*--the cost to the Fund of resources used in support of balance of payments adjustment programs, reflected in remuneration payments--would be paid by the members making use of Fund resources. After an amendment of the Articles which stipulated uniform unremunerated positions in relation to quotas (i.e., a uniform but variable norm), this would result in a rate of charge equal to the SDR rate of interest, or perhaps set at a modest premium to the SDR interest rate, as discussed further below.

Financing of administrative expenses through the uniform but variable norm

8. There appears to be broad agreement that *administrative expenses* that arise in the context of fulfilling the general functions of the organization--what could be called systemic expenses--should be shared by all members, say, in proportion to their quotas by way of unremunerated positions that would be uniform in proportion to quotas for all members (the norm). Views differed at the Executive Board's last discussion as to whether some of the expenses that might be identified as arising primarily in the context of negotiating and monitoring stand-by and similar arrangements should be considered to be benefitting individual or groups of members, rather than of a systemic nature, and therefore should be financed by the members using Fund resources. However, there was agreement that at least part of these expenses would continue to be covered under the amended Articles by the service charge (of ½ of one percent of each purchase), and by the commitment fee (of ¼ of one percent) part of which the Fund retains if arrangements expire or are canceled without being fully drawn. Moreover, most Directors would agree that efforts at fine-tuning of cost accounting in order to identify such expenses are likely quickly to run into diminishing returns and the Fund could incur heavy costs of administering a complicated system. Therefore, I propose that we do not spend further effort and resources in an attempt to separate out, and allocate to countries using the Fund's resources, the expenses of negotiating and monitoring financial arrangements, but *consider all administrative expenses not covered by*

the service charge and commitment fee to be general expenses that would be covered by unremunerated positions (the norm) following an amendment of the Articles. If Directors considered it essential that a larger part of the expenses that, on closer analysis, could be considered linked to Fund-supported arrangements ought to be borne by members making use of Fund resources, it would of course be possible to consider a modest increase in the service charge.

Financing of technical assistance

9. Some Directors are of the view that consideration be given to include in the Fund's costs covered by the rate of charge the part of *expenses for technical assistance* that primarily benefit individual member countries rather than the membership as a whole. The issue of charging for technical assistance extended by the Fund has been discussed frequently in the context of the Board's consideration of the medium-term administrative budget. While all would agree that members benefitting directly from technical assistance should bear at least part of the costs of that assistance, perhaps graduated according to ability to pay, Directors have always paid particular attention to the importance of technical assistance for the successful implementation of adjustment programs and have been conscious of the disadvantages and risks in proceeding too far toward full payment for technical assistance services received. This matter will, of course, be reviewed from time to time, and it would be for consideration in the context of such a review whether user fees should be introduced to cover a part of technical assistance extended by the Fund. (Such user fees, moreover, would be borne by the member benefitting from technical assistance projects, rather than by the broader group of members making use of Fund resources and which may or may not also receive substantial amounts of technical assistance.) In these circumstances, and pending future discussions on user fees, I propose that the costs of technical assistance continue to be treated as at present, and that "general" expenses to be shared in proportion to quotas include, on a net basis, all expenses for technical assistance. In any future review of the possibility of introducing user fees, perhaps on a graduated basis, I would consider that any such fee should be modest in size.

Financing of additions to the Fund's precautionary balances

10. The *financing of additions to the Fund's precautionary balances* is a very difficult issue on which we need to find the necessary consensus. While many Directors favored that at least part of the expenses relating to the Fund's exposure to the risk of nonpayment in connection with its provision of financial assistance should be covered by the users of the Fund's general resources (perhaps through a surcharge or premium on the rate of charge) and would, therefore, be regarded as an operational expense to be added to the rate of charge, other Directors considered such exposure to be more

systemic in nature which therefore ought to be borne by the membership as a whole through the unremunerated positions (the norm) under an amendment of the Articles.

11. In view of these differing views and approaches, the staff has prepared simulations of the impact of two alternative approaches to this issue. One alternative would provide that (a) a part of any agreed addition to precautionary balances would be borne in the form of a surcharge on the rate of charge and (b) remaining additions needed to achieve the desired level of reserves and of other precautionary balances would be financed through the norm under an amendment of the Articles. The other alternative would provide for the total of agreed additions to precautionary balances to be financed entirely through the variable norm, thereby spreading the cost of adding to the Fund's precautionary balances among the membership at large and in proportion to individual members' quotas. The staff's calculations regarding these alternatives are being issued concurrently with this memorandum.

<u>Surcharge added to the rate of charge</u>

12. The surcharge on the rate of charge would be paid by the users of the Fund's resources. Mr. Shields has suggested a surcharge of 50 basis points, which would yield approximately SDR 125 million at the current level of the use of the Fund's resources. 1/ As the rate of charge is uniform for all members, the surcharge would be paid by all members using Fund resources, independent of the progress made under their adjustment programs and the perceived risk of exposure to loss. In this context, it is worth remembering that the rate of charge on the use of Fund resources is based on short-term market rates of interest in the major money markets, while the use itself--three-to-five years under stand-by arrangements and four-and-one half-to-ten years under extended arrangements--has more of a medium-term character and therefore, justifiably might attract (somewhat higher) medium-term charges. 2/ Executive Directors' views are needed on this difficult issue of a surcharge. In coming to a conclusion on the issue of a surcharge, Directors may wish to take

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1/ Actual net income and the share of debtors in additions to the SCAs ranged from SDR 119 million to SDR 185 million in the financial years from 1990 to 1994, and is projected at SDR 134 million for FY 1995. The amount produced by an addition to the rate of charge of 50 basis points would increase by SDR 5 million for each increase in credit outstanding of SDR 1 billion.

2/ The term-structure of interest rates (the "yield curve") fluctuates substantially over the business cycle. For example, the difference between the five-year combined market rates and the three-month combined rate (the SDR interest rate) ranged from -104 to +277 basis points since July 1981, and averaged 95 basis points.

into account that use of Fund resources supports adjustment programs agreed by the Executive Board; that the Fund's assets are secured primarily by the quality and strength of the agreed adjustment policies; and that perceived risks differ widely from program to program. These considerations would, at best, call for a relatively small surcharge or premium on the rate of charge levied on the use of the Fund's resources.

Adequacy of the Fund's precautionary balances

13. At Informal Session 94/10, a number of Executive Directors indicated that, in their view, the Fund's precautionary balances had reached relatively comfortable levels, and that consideration might be given in the near future to some reduction of the rate of accumulation of these balances. This matter is raised in the documentation prepared for the forthcoming midyear review of the Fund's income position that is scheduled for the Executive Board's consideration on December 9. 1/ Developments in the Fund's income position and net income now projected for the current financial year will permit a reduction of the coefficient for the rate of charge even without a reduction of the target amount of net income and additions to the Special Contingency Accounts (SCAs) agreed at Executive Board Meeting 94/52 (6/8/94). Taking into account the uncertainties that the Fund presently faces regarding the expansion of the use of Fund credit and the time constraints which do not allow us to hold a full-fledged review of the adequacy of the Fund's precautionary balances at the time of the midyear review, it would seem reasonable to pursue a detailed consideration of the adequacy and possible reduction of the Fund's prudential expenses in March 1995 when any changes of the present system to share the Fund's "general" expenses could also be implemented.

Rebate of the surcharge on the rate of charge

14. Some Directors have suggested that a surcharge on the rate of charge, or the part of additions to precautionary balances that were contributed by members making use of Fund resources, be rebated to members as and when these members complete repurchases of outstanding drawings--akin perhaps to the refunding of the commitment fee as purchases are made under an arrangement. Such rebates would have the advantage of providing additional incentives to meet financial obligations to the Fund on time and would also reduce the cost of using Fund resources over time. As mentioned at Informal Session 94/10, while it has been agreed to "refund" precautionary balances (in the SCAs) that are no longer needed to members that contributed them (by way of a retroactive reduction of the rate of charge and retroactive increase of the rate of remuneration), it would not be possible under the

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1/ See EBS/94/232 (12/2/94).

present Articles to adopt rebates to individual members linked to repurchases by them. Under the present Articles, the Fund has no authority to make payments to member countries except by retroactive adjustments of the rate of charge, and rebates that would result in nonuniform rates of charge on the use of Fund resources are not permissible under the present Articles of Agreement. It would of course be possible to amend the Articles in such a way as to allow such rebates. Such an amendment would seem to raise rather difficult issues regarding uniform charges (and possibly differentiated "risk premia") as well as regarding the retention by the Fund of prudential balances. If the Fund needs a faster rate of additions to its precautionary balances, the complications associated with rebates of the proceeds of the surcharge would be a nontransparent method of dealing with the issue.

Consolidation of the Fund's precautionary balances into reserves

15. Another suggestion made at Informal Session 94/10 was that the Fund consider a consolidation of existing precautionary balances (the Fund's Reserves (General and Special) and balances held in the SCAs and perhaps--in the view of some Directors--including deferred charges). Resources currently held in the SCAs (and deferred charges) will have to be refunded to members that contributed them when they are no longer needed, and therefore could not be taken into the Fund's reserves. 1/ The application of general accounting principles would also argue against a consolidation of the Fund's precautionary balances into a single Reserve. Different balances are intended, at least in part, to cover different types of risks. Financial institutions generally retain a portion of their earnings in reserves, inter alia, to protect the institution against general risk, in addition to setting aside specific provisions against the impairment of assets, e.g., in loan loss reserves. The Fund has established accounts that protect the Fund against the contingency that losses would arise resulting from specific claims, a risk that is evidenced by the existence of arrears, in the Fund's SCAs. These accounts function as a de facto protection against the risk of loss and allow the Fund to present its balance sheet in accordance with generally accepted accounting principles. The Fund's Reserves, in contrast,

1/ While some members might voluntarily relinquish their claim on balances in the SCAs (and on the proceeds of the settlement of deferred charges), others would be prevented by domestic legislation or might be unwilling to do so.

fulfill a more general role, in protecting the Fund against all risks, including the risk of loss resulting from the extension of credit. 1/

Treatment of future additions to precautionary balances

16. The Executive Board could decide to put future additions to precautionary balances either to the Fund's Reserves or to SCA-1 (or a similar Account), or to add to both of these prudential balances. In the event that the Executive Board concluded that members using Fund resources should carry part of the cost of providing for the risk of loss through a surcharge on the rate of charge and Directors also concluded that "rebates" to individual members in line with repurchases were undesirable, it would seem reasonable to place the proceeds of such a surcharge to the SCA or a similar account. In contrast, if future additions to precautionary balances would be shared on the basis of quotas by way of unremunerated positions after adoption of a uniform norm under an amendment of the Articles, it would seem appropriate to place such additions to the Fund's precautionary balances in the Fund's Reserves, which are owned by members in proportion to quotas and can be distributed, if at all, only in proportion to quotas.

New financing mechanism

17. In the light of these considerations, Executive Directors may wish to focus on the following course of action in the context of their discussion of an amendment of the Articles to introduce the uniform but variable norm for remuneration as an instrument in the financing of the Fund's expenses: (i) to determine a surcharge on the rate of charge which would finance part of the addition to the Fund's precautionary balances that would cover both the medium-term maturity of Fund credit and the Fund's exposure to risk, but which would not be closely linked to new purchases that may represent widely differing perceived repayment risks; (ii) the size of such a risk premium would be of a magnitude that would not significantly exceed the burden-shared amount borne now by debtor countries, 2/ say, 50 basis points (SDR 125 million at present balances subject to the rate of charge of approximately SDR 25 billion); (iii) the appropriateness of the size of the surcharge should be revisited from time to time in the light of

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1/ For a detailed discussion of the role of precautionary balances in the context of the Fund, see *The Fund's Precautionary Balances*, EBS/94/53 (3/11/94), and *The Fund's Precautionary Balances and the Factors bearing on Their Adequacy*, EBS/93/84 (6/2/93).

2/ That is, that part of the financing of the Fund now borne by the users of the Fund resources: the target amount of net income, one-half of additions to SCA-1, and one-quarter of additions to SCA-2, accumulating to SDR 134 million or 52 basis points in FY 1995.

circumstances, including the overall financial position of the Fund; (iv) an *additional* target amount of net income would be added to the Fund's reserves. It would seem reasonable to establish such a target at, say, 3 or 5 percent of reserves (of the order of SDR 53 or SDR 88 million per annum), and the cost of which would be shared by all members by way of unremunerated positions (the norm) after an amendment of the Articles; and (v) the cost of deferred charges would also be shared by all members (through the establishment of unremunerated positions after an amendment of the Articles).

Operation of the uniform but variable norm

18. The broad principles that would underlie a more equitable and more efficient mechanism for sharing the Fund's expenses could be implemented only through an amendment of the Articles that allowed the Executive Board to set a uniform norm that could be reviewed periodically, say each year, and adjusted if necessary in the light of the Fund's projected income and expenses. As outlined above, the new proposed system of a uniform but variable norm could include the following nonoperational expenses of the Fund: (i) the total of Fund's administrative expenses apart from those met by the proceeds of the service charge and by various reimbursements to the GRA or from special user fees 1/--would be paid by all members in proportion to their quotas and (ii) the additions to the Fund's precautionary balances could be financed through either (a) in part from a surcharge on the rate of charge of the order, say, of 50 basis points, and which would be refundable when no longer needed; and in part through the uniform but variable norm; or (b) entirely through the uniform but variable norm. The distribution of the shares between different groups of members in the financing of the general expenses of the Fund, including financing additions to the Fund's precautionary balances, would depend on the size of the surcharge, and would vary somewhat with the level of the SDR interest rate. 2/

Other issues in the implementation of the uniform but variable norm

19. The introduction, through an amendment of the Articles, of the uniform but variable norm as a means of financing the Fund's general expenses raises a number of issues, as noted by Executive Directors, which have a bearing on, for example, the self-executing nature of the mechanism, whether there should be a floor to the norm,

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1/ Such as reimbursements of the costs of administering the SDR Department and the ESAF Trust, the commitment fee, and charges and other receipts for technical assistance.

2/ The changing shares among countries in the financing of the Fund depends to a considerable extent on the level of the SDR interest rate. This issue is discussed in detail in *Reform of Financing the Fund's Expenses--Further Simulations*, which will be issued soon.

the voting majorities that would be needed to change the norm, the treatment of members that do not hold reserve positions in the Fund, and the cost of introducing the uniform but variable norm on the low-income members of the Fund (e.g., the members eligible for access to ESAF resources). These issues are discussed briefly in the following paragraphs:

Self-executing mechanism

20. It has been suggested that following an amendment of the Articles, the new mechanism of a uniform but variable norm should be largely self-executing. Such a mechanism would help avoid the disagreements that so frequently have arisen in the Executive Board in past years during discussions of the size of shares that groups of members contributed to the expenses of operating the Fund. While rules that lead to automaticity clearly have their advantage, they also have draw-backs. For example, the exact delineation of categories of expenses to be borne by specified groups of members, and perhaps of amounts to be so attributed, might leave little flexibility to the Executive Board to adapt the system, with the appropriate majority, to evolving circumstances. Moreover, as has been mentioned to the Executive Board, a self-implementing mechanism would require that decisions affecting the rate of charge and the rate of remuneration (such as decisions on administrative expenditures) be taken with the qualified majority (70 percent of the voting power) necessary for decisions regarding the rate of charge and rate of remuneration. 1/ To avoid these difficulties, the Executive Board may wish to provide that under a new mechanism, a uniform but variable norm would be set each year by a decision of the Executive Board, taken with the same qualified majority now needed for decisions regarding the rate of charge and the rate of remuneration (70 percent of the voting power). The system also would include a safeguard clause, in case the necessary majority were not achieved, under which any shortfall would eventually affect the rate of charge. Once the Executive Board had reached an understanding and agreement regarding the distribution of the burden of financing the Fund, it would not be expected that the annual discussion on the Fund's income position would continue to be as difficult as they have been in recent years. Moreover, an annual review would also maintain the possibility for the Executive Board to take into account developments that are not foreseeable at the present time.

1/ A self-implementing mechanism implies that the rate of charge or the norm are set in accordance with a formula.

A floor to the norm and voting majorities

21. Under a uniform but variable norm, the rate of remuneration would be equal to the SDR interest rate, and the present floor to the remuneration in terms of the SDR interest rate would become redundant. As mentioned, like changes relating to charges and remuneration under the present system, changes of the uniform norm would require a qualified majority of 70 percent of the voting power. Moreover, reductions of the norm below an agreed floor could require a qualified majority of, say, 85 percent of the voting power. In the absence of the qualified majority being reached, the uniform unremunerated positions (i.e., the norm) then existing would remain in effect. As is the case under the present system, these unremunerated positions may not be sufficient to produce the amount of income necessary to cover agreed administrative and prudential expenditures. As mentioned in the previous paragraph, the new system should also include a safeguard clause to avoid income shortfalls, as does the present system.

Proposed treatment of members that do not hold reserve positions in the Fund

22. Under the proposed new system, and following an amendment of the Articles, all members would, in principle, maintain an unremunerated reserve position with the Fund. Members that make use of the Fund's resources normally do not hold reserve positions, whether unremunerated or remunerated, and it would be necessary for them to establish such a position, e.g., through repurchase in the reserve tranche. However, many of these members may not easily have available the foreign exchange resources needed to establish the necessary unremunerated position through a repurchase. The same financial result could be achieved by the imposition of a rate of charge on the unremunerated reserve tranche position of a member making use of Fund resources (or neutral members) that it should establish but which in fact the member has drawn; to the extent that the uniform norm would change from year to year (and perhaps at midyear), the levying of a rate of charge on a member's (changing) unremunerated reserve tranche position would be easier to implement than requiring the member to make annual repurchases in the reserve tranche.

Position of ESAF-eligible members

23. Some Directors have noted that adoption of a uniform norm would result in the sharpest (relative) impact on member countries least able to afford bearing a larger share of the Fund's general expenses--namely those members that largely or exclusively rely on access to ESAF resources rather than the Fund's ordinary resources,

and therefore pay very little or no charges. 1/ The amounts are not very large: the share of the quotas of ESAF-eligible members in total Fund quotas is about 11 percent, and the amount of "general" expenses that would have been borne in FY 94 by these countries is SDR 85 million (11 percent of total "general" expenses). It would be for consideration whether other member countries would be willing to absorb these expenses some agreed (and voluntary) manner in order to provide relief for members that are least able--as measured by per capita income--to meet part of the Fund's general expenses.

II. Interim Period

24. Section I above has discussed the broad outlines of how the financing of the Fund's operations and expenses could develop in the context of a system containing a uniform but variable norm, which would be introduced through an amendment of the Articles. An amendment normally takes a considerable amount of time (on average over two years), and it is also a somewhat uncertain course. Consequently, many Executive Directors suggested at the Informal Session held on November 15, 1994 (IS/94/10) that the principles underlying such an amendment to enable the Fund to establish a uniform but variable norm for the purpose of financing the Fund should, to the extent feasible, be put into effect under the present system of financing the Fund's expenses. As noted earlier in this memorandum, the present system of financing the Fund contains a number of limitations, including, in particular the floor to the rate of remuneration of 80 percent of the SDR interest rate and that a number of countries--those in a financially neutral position in the Fund--do not participate in the financing of the Fund's expenses. Nevertheless, the present system can technically be modified to bring the Fund's financing mechanism more into line with members' share in quotas, but the residual element in the financing of the Fund's expenses in case limits are reached would remain the rate of charge. 2/

25. The application of agreed principles to guide a more equitable and efficient mechanism could be implemented, to certain extent, under the present system of determining the rate of charge and of burden sharing. The category of "general" expenses (as defined in

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1/ The proceeds of the charge of ½ of 1 percent per annum on outstanding use is applied towards meeting the cost of operating the ESAF Trust, which otherwise are reimbursed by the Trust and thus not reflected in the Fund's "general" expenses.

2/ For a full analysis of these matters, see *Cost of Fund Credit - Principles of Burden sharing - Concessionality in Fund Operations and Related Matters*, EBS/92/108 (6/15/92) and Sup. 1 (6/15/92); and *The Cost of Financing the Fund and its Distribution - Review of Burden Sharing*, EBS/94/28 (2/18/94).

Section I of this memorandum) could be financed under burden sharing--that is, through adjustments of the rate of charge and the rate of remuneration--until the floor to the remuneration coefficient is reached. The distribution of these expenses could be based *on the aggregate quota shares of those members making use of Fund resources and of those members receiving remuneration*. As mentioned, the adjustments to the rate of remuneration would be limited by the floor to the remuneration coefficient; the amount that could be financed through a reduction of remuneration payments thus depends both on the level of "general" expenses and on the level of the SDR interest rate. Moreover, under the present system "general" expenses can be shared between the group of debtor members and the group of creditor members only in proportion to the aggregate quota shares of these groups, and not in proportion to the quota share of individual member countries, and members that neither pay charges nor receive remuneration would not participate in the sharing of general expenses.

The following paragraphs discuss the feasibility of such a modification in the present system of financing the Fund:

Operational expenses

26. Operational expenses of the Fund would continue to be financed through the rate of charge, which in principle would be set equal to the SDR interest rate.

Administrative expenses

27. The only major areas of flexibility for the Fund's expenses lie in the size of its administrative expense and the rate of accumulation of its precautionary balances, which to some extent are within the discretion of the Fund. As regards the financing of the Fund's administrative expenses, some part would be covered by the service charge. I do not propose a change in these charges at present, though we should keep them under review in the light of information on the cost of negotiating programs with member countries. While it may be possible to consider an extension of user fees for the use of technical assistance and to encourage members to help finance this important and rapidly growing activity of the Fund, I believe these issues should, as indicated above, be considered in the Board's review of the Fund's technical assistance program. Furthermore, consideration should also be given to review carefully the basis for calculating the assessment on participants in the SDR Department. It would also be reasonable to review the basis for calculating the costs to the GRA of conducting the business of ESAF, with respect to which the GRA is reimbursed from the ESAF Reserve Account.

28. I believe we can go somewhat further in spreading the cost of the Fund's administrative expenses by adding these expenses to those already included under burden sharing under the present system.

However, the burden would be shared on the basis of the aggregate quota shares of the group of debtor countries and the group of creditor countries, particularly if we discontinue additions to the SCA-2 as discussed below and thereby create more leeway for the sharing of these costs. The extent of the sharing of the costs between the two groups of countries would be limited by the floor of the rate of remuneration in terms of the SDR interest rate. Moreover, the part related to administrative expenses and additions to reserves would not be refundable, which differs from the present system under which all burden-shared amounts will be refunded when no longer needed.

The Fund's precautionary balances

29. As indicated earlier, and as more fully explained in the staff's paper on the *Midyear Review of the Fund's Income Position*, EBS/94/232 (12/2/94), it would seem reasonable to have a full-fledged review of the adequacy and possible reduction of the Fund's prudential expenses in March 1995. As regards the sharing of the cost of adding to the Fund's precautionary balances, it will be recalled that under the present system the cost of meeting the target amount of net income (i.e., additions to the Fund's Reserves) which currently amounts to 5 percent of the Fund's Reserves at the beginning of the financial year falls, at the margin, on those members using the Fund's resources. It would be reasonable that this cost, pending an amendment of the Articles, also be shared in proportion to the aggregate quotas of debtors and creditors under the present burden sharing system. As discussed above in connection with the uniform norm (paragraph 12), part of the addition to precautionary balances could be met through a surcharge or premium on the rate of charge, if Executive Directors so decided.

Discontinuation of contributions to SCA-2

30. To make possible the broader sharing of the Fund's "general" expenses as discussed in the preceding paragraphs, I would also propose that contributions to SCA-2 would be discontinued at the end of the present financial year (that is, after end-April 1995), except that the shortfall of contributions from members receiving remuneration (which presently amounts to SDR 183 million) would be made up as and when the floor to the rate of remuneration so permits. Taking into account the shortfall, balances in the SCA-2 by that time will be close to the agreed amount of SDR 1 billion and would appear reasonably adequate to cover foreseeable use of general resources to finance the encashment of rights. As Directors know, burden sharing of prudential expenses in the past three years has fully exhausted the reduction of remuneration permissible under the Articles. Discontinuation of additions to SCA-2 by the creditors would create room as regards the amounts paid in remuneration which could be used to finance at least some of the Fund's administrative costs and

additions to the net income target under the present system of burden sharing, subject to the 80 percent floor, and before an amendment of the Articles entered into effect.

31. The effects of the redistribution of the costs of financing the Fund's administrative expenses and additions to the Fund's precautionary balances, including the net income target, on the basis of the aggregate quotas of creditors and debtors will be discussed in more detail in the accompanying staff paper dealing with the simulations that were requested by the Executive Board.

Conclusion

32. These are difficult, and highly sensitive matters. Your views on how best to proceed, both as regards our future work on a possible amendment of the Articles and on an essentially parallel modification of the working of the present system (subject to its inherent limitations), are of critical importance if we are to make further headway. I believe the main principles underlying the reform of the financing of the Fund are broadly agreed. We now need to consider how they may be implemented.