

November 21, 1974

To: Members of the Executive Board
From: The Acting Secretary
Subject: Draft Amendment on Investment

Attached for consideration by the Executive Directors is a revised draft amendment on investment based on Draft C of DAA/74/10, together with a commentary by the staff.

This subject will be brought to the agenda for discussion on a date to be announced.

INTERNATIONAL MONETARY FUND

Revised Draft Amendment on Investment

Prepared by the Legal Department

(In consultation with the Treasurer's Department
and the Research Department)

Approved by Joseph Gold

November 18, 1974

Part I. Revised Draft Amendment

The draft amendment that follows is based on Draft C of DAA/74/10 (8/8/74), and reflects the comments of executive directors at EBM/74/110 (9/7/74). The most important adaptation that has been made as a result of the earlier discussion is the extension of the power of investment to include investment of a portion of the Fund's holdings of currencies as well as the proceeds of the sale of gold. The commentary raises the question of the investment of the proceeds of the transfer of special drawing rights.

Article XII

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Section 6. Reserve and, distribution of net income, and investment

(a) The Board of Governors shall determine annually what part of the Fund's net income shall be placed to general reserve and what part, if any, shall be distributed. Net income shall include the income of any investment pursuant to (d) below. The Board of Governors [, by a [four-fifths] majority of the total voting power,] may decide at any time to distribute any part of the general reserve.

(b) ~~If any distribution is made of the net income of any year, there shall first be distributed to members eligible to receive remuneration under Article V, Section 9, for that year an amount by which two percent per annum exceeded any remuneration that has been paid for that year. Any distribution of the net income of that year beyond that amount~~ pursuant to (a) above it shall be made to all members in proportion to their quotas. Payments to each member shall be made in special drawing rights or its own currency as determined by the Fund.

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(c) The special reserve in existence when the second amendment of this Agreement enters into force shall be merged into the general reserve.

(d) (i) The Fund may invest in income-earning obligations or securities issued by members or international development finance organizations, provided that no investment shall be made without the consent of the issuer of the obligations or securities. The total amount of the investment, calculated on the basis of the value of the currencies invested at the time of investment, shall not exceed the general reserve.

(ii) Investment may be made with the following assets: currencies derived from the sale of gold, which the Fund may sell for this purpose in any market; currencies derived from disinvestment; currencies received as income of the investment or of assets awaiting investment; or the Fund's other holdings of currencies, provided that no investment shall be made with the Fund's other holdings of a member's currency without the consent of the member.

(iii) In order to minimize the effects of the investment on computations for the purpose of applying the provisions of this Agreement, the obligations or securities in which the Fund invests and currency awaiting investment in accordance with (i) and (ii) above shall be held by the Fund in separate investment accounts. The currency of a member held in these accounts may be used by the Fund in accordance with this Section without the consent of the member, provided that no transfer shall be made from the Fund's holdings of a member's currency to a separate investment account without the consent of the member.

(iv) Assets held in separate investment accounts shall not be subject to the provisions of Article IV, Section 8. The Fund may use assets in separate investment accounts to meet the expenses of conducting the business of the Fund.

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(v) The Fund may obtain with assets in the investment accounts the currencies it needs for the purposes of the investment or the second sentence of (iv) above, or in order to minimize the effects of the termination of any separate investment accounts on computations for the purpose of applying the provisions of this Agreement.

Part II: Commentary

A. Former Investments of the Fund

In order to understand certain aspects of the draft provisions on investment, it is necessary to recapitulate briefly the features of the investments made by the Fund in the past under an implied power.

1. From the time when the Fund came into existence until April 30, 1956, the Fund had a net deficit in each financial year except 1948. As of April 30, 1956, the net cumulative deficit amounted to US\$14.21 million. Faced with a continuous excess of the Fund's expenditure over income, the Executive Directors considered it to be in the interest of good administration and conservation of the Fund's resources to raise income in order to make good the impairment of capital resulting from the administrative deficit.

The 1956 Decision

2. An investment program was initiated by a decision of the Executive Directors taken on January 25, 1956 (Decision No. 488-(56/5), Selected Decisions Third Issue, pp. 112-114). This decision, which involved an interpretation of the Articles of Agreement pursuant to Article XVIII, declared that the Fund had the power to sell some of its gold to the United States for the purpose of investing the proceeds in U.S. Treasury bills having not more than 93 days to run, in order to obtain income reasonably related to the deficit of the Fund. The basis for this conclusion was that, even though there was no express provision for investment in the Articles, a power could be implied in order to enable the Fund to maintain its resources intact and to exercise its functions in relation to its resources in a proper manner under the express provisions of the Articles. It was decided that gold should be sold for the purpose of the investment because that action would not change the Fund's holdings of currencies and therefore would not affect the rights and obligations of members that are determined by the levels of the Fund's holdings. Moreover, there were legal difficulties that impeded the investment of the Fund's holdings of currencies.

3. Under the decision this power of the Fund was subject to the following conditions:

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(a) The amount of gold to be sold could not be so large as to limit the ability of the Fund to make resources available to its members in accordance with the Articles.

(b) The Fund would be able to reacquire, whenever it wished, the same amount of gold as it sold for investment.

In addition, the Fund interpreted Article IV, Section 8 under Article XVIII to mean that the securities in which it contemplated investing would be maintained in gold value, and it was a condition therefore that gold value would be maintained in fact.

4. Pursuant to this decision the Fund sold the equivalent of approximately US\$200 million in gold to the United States and invested the proceeds in U.S. Treasury bills having not more than 93 days to run. The income from this investment was used to reduce the accumulated deficit, which was wholly eliminated by December 1957.

The 1957 Decision

5. After the elimination of the deficit, the Executive Directors amplified the original decision in order to provide a reserve toward meeting possible future deficits of the same character as that for which the program had been undertaken in the first place (Decision No. 708-(57/57), Selected Decisions, Third Issue, p. 114). The Executive Directors noted that the Fund had had in the past and might have again in the future an excess of expenditure over income and that the greater part of the Fund's administrative expenditure had been and would continue to be in United States dollars. The Executive Directors therefore considered that in the interest of good administration and conservation of the Fund's resources it would be appropriate to raise income and provide a reserve toward meeting possible future deficits. They decided, therefore, to continue the investment of a portion of the Fund's gold to produce an amount of income that would enable the Fund to establish such a reserve. They decided also that the income from the investment earned after October 31, 1957 would be placed to a special reserve and that any administrative deficit for any fiscal year of the Fund would be written off first against this reserve. Although the amount of income was placed to a special reserve, the currency received as actual income was not segregated from the Fund's other holdings of United States dollars, and therefore it did affect the position of the United States in the Fund.

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Subsequent Decisions

6. Under a decision of the Executive Directors taken in 1959 the amount of the investment was increased to \$500 million and the Articles were interpreted to permit investment in U.S. securities having a term to maturity not exceeding twelve months (Decision No. 905-(59/32), Selected Decisions, Third Issue, p. 115). In 1960 the amount of the investment was further

increased to \$800 million (Decision No. 1107-(60/50), Selected Decisions, Third Issue, p. 115). In 1961 the Executive Directors interpreted the Articles to permit investment in fifteen-month U.S. Treasury securities maturing on February 15, 1963 (Decision No. 1272-(61/53), Selected Decisions, Third Issue, p. 116). Action to reduce and then terminate the investment program was taken in 1970 and 1972 (Decisions No. 3132-(70/87) and No. 3573-(72/12)).

Maintenance of Gold Value of Investments

276 7. Under the 1956 and 1957 decisions, the dollar proceeds of the sale of gold before investment in U.S. Treasury bills, the U.S. Treasury bills invested in, and the dollar proceeds (up to the amount invested) resulting from the sale or maturity of such bills before the Fund reacquired gold with them were treated as representing gold and not as holdings of United States dollars. This rule did not apply to that part of the proceeds of the sale or maturity of securities that constituted the income of the investment, which, as stated in paragraph 5 above, was treated as part of the Fund's holdings of dollars (Paragraphs I(3) and II(2) of the 1956 decision). As noted in paragraph 3 above, the Executive Directors interpreted Article IV, Section 8(a) to require the United States to maintain the gold value of the dollar proceeds of the sale of gold before their investment, the U.S. Treasury bills in which the Fund invested, and the dollar proceeds resulting from the sale or maturity of the bills before the Fund reacquired gold with them, notwithstanding changes in the par or foreign exchange value of the U.S. dollar. The United States was also required to maintain the gold value of the income of the investment, after it was realized, because that income became part of the Fund's holdings of U.S. dollars.

The Special Reserve

8. The investment program was created for a defined and limited purpose, and the special reserve was established in order to ensure that only this purpose was served. Therefore, the amounts of income earned by investment were credited directly to the special reserve when received and did not enter into "net income" for the purposes of Article XII, Section 6 of the original Articles. Under Article XII, Section 6(c), which was introduced by the 1969 amendment of the Articles, the Fund was given the power to make transfers to the general reserve "from any special reserve". Under this provision, the Fund is authorized to transfer to general reserve all or part of the special reserve to which the yield of the investment has been placed. As the yield of the investment, however, is not "net income", it cannot be distributed under Article XII, Section 6(b). It can be used only for the purpose of meeting administrative deficits, although amounts transferred from special to general reserve are available to meet a deficit of any character, whether operational or administrative, including a deficit resulting from the payment of remuneration under Article V, Section 9. The power to make transfers is reserved to the Board of Governors (Article XII, Section 2(b)(x)).

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B. The Draft Amendment

9. The main purpose of the draft amendment of Article XII, Section 6 set forth in Part I of this memorandum is to provide the Fund with express authority to invest a part of its gold or currency assets in the obligations or securities of international development finance organizations or of its members. The draft provisions would not be subject to some of the limitations that affected the implied power and they would avoid the consequences of the investment made under the implied power that appear disadvantageous now. The draft amendment would merge the present special reserve into the general reserve, and the amount of the reserve would then be the maximum amount valued in terms of SDRs that could be invested at any time. The draft would also introduce certain changes in the rules governing the distribution of net income.

Net Income and its Distribution

10. Under Article XII, Section 6(a) of the draft amendment the income from any investment that the Fund might embark upon would be taken into account, along with income from other sources, in determining the Fund's net income. As a result, income from investment could be distributed to members or placed in the general reserve. This treatment of income from investment would be different from the treatment of the income of past investments, which was credited to a special reserve and could not be distributed as net income.

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11. Under Section 6(a) of the draft amendment the Fund would be able to distribute net income at the end of the year in which it was earned or after it had been placed in the general reserve. The provision states that the Board of Governors could decide at any time to distribute any part of the general reserve. Under the phrase in brackets the decision would have to be taken by a four-fifths majority of the total voting power.

12. The present legal position is that if any distribution is made of the net income of any year, there must first be made a preferential distribution to members eligible to receive remuneration for that year (i.e., members that had super-gold tranche positions during that year) in an amount that would bring the total of distribution and remuneration for that year to two per cent. If the Fund were to decide to distribute in a later year net income placed to reserve in an earlier year, it would have to determine the year in respect of which it was making the distribution and then make a preferential distribution to members that were eligible to receive such a distribution from the net income earned in the chosen year if they had not already received 2 per cent per annum as remuneration. Any distribution of net income beyond the preferential distribution would be made to all members that were members of the Fund in the year selected and on the basis of quotas at that time.

13. Section 6(b) of the draft amendment provides that any distribution, whether made from the net income of a year after the end of that year or from the general reserve, would be made to all members in proportion to their quotas at the time of distribution. Under the draft amendment, members that had super-gold tranche positions in past years in respect of which the Fund had decided not to make a preferential distribution would no longer have the right to receive that specific distribution if the Fund were to decide to make a distribution out of the general reserve. The amendment would eliminate the legal necessity to determine what remains of the undistributed net income of each year of the past after the charges that have been made against the general reserve and not allocated against the net income of any specific year. The Fund might find these difficulties a deterrent should it ever be willing to consider a distribution under the present legal provisions. It might decide, therefore, to distribute only the net income of the most recent year, and in that event members would lose no rights in practice.

14. Section 6(b) of the draft amendment would enable the Fund to make distributions in special drawing rights as well as in the currencies of the members receiving the distributions. Under present provisions, distributions must be made in the currencies of the recipients, but Article XXV, Section 7(f) enables the Fund, by agreement with these members, to substitute special drawing rights for currencies.

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Termination of Special Reserve

15. Under Section 6(c) of the draft amendment the special reserve would be merged into the general reserve. The effect of this merger would be to make the special reserve available for all purposes for which the general reserve could be used, including distribution to members on the basis of quotas and in accordance with the other provisions of the Section.

Investment

16. Section 6(d) of the draft amendment would give the Fund an express power to earn income by investing in obligations or securities issued by international development finance organizations (such as the IBRD or regional development banks) or by member governments. The Fund could establish policies by which it would be determined in which obligations or securities it would invest. The word "obligations" is used in addition to "securities" to avoid any suggestion that the form of the investment must be secured by paper or must be marketable.

17. The total amount invested by the Fund could not exceed the size of its general reserve. For this purpose, the value of the amounts invested would be determined on the basis of the SDR value of the currencies used for investment at the time of investment. The limitation of the amount that could be invested would require the Fund to disinvest if its general reserve was reduced because of a deficit or a distribution to members pursuant to draft Section 6(a) and (b). If there were to be a disinvestment, the Fund would be able to make it in an orderly manner.

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18. Another possibility that should be considered as an alternative is that the amount of an investment would not have to be reduced because of a reduction in the general reserve. Market conditions might be unfavorable for disposition of the securities held by the Fund. If the reserve were reduced by a deficit, the financial situation of the Fund might be worsened still further by disinvestment. It is conceivable, therefore, that the investment should not be reduced to match the level of the general reserve but should not be increased until the general reserve was increased to the level of the amount invested. To give effect to this principle, there could be added to the end of the second sentence of draft Section 6(d)(1) the words ", provided that the investment shall not be reduced because of a reduction in the general reserve but shall not be increased until the general reserve exceeds the amount invested."

19. The draft amendment would provide that the Fund might use two kinds of assets in connection with investment: holdings of gold and holdings of currencies. In addition, the Fund could reinvest the proceeds of disinvestment and the currencies received as income of the investment. As a result of the adoption of draft Article XII, Section 6(d), it would seem to follow that the Fund would be able to use special drawing rights for the purpose of investment by agreement with a participant under Article XXV, Section 7(f). If this form of investment were considered undesirable, language should be introduced in Article XXV, Section 7(f) to prevent the use of special drawing rights in this way. For example, the clause ",except under Article XII, Section 6(d)," might be introduced after the word "Fund" in Article XXV, Section 7. The draft of Article XII, Section 6 in Part I assumes the adoption of this limitation. By contrast, the question arises whether an amendment should go in the other direction and authorize the Fund to invest special drawing rights under an authority that did not involve the agreement of any participant. One result of the investment of special drawing rights would be that the Fund would cease to earn interest on the special drawing rights that it transferred. The yield would be less, therefore, than if it invested the proceeds of the sale of gold or its holdings of a member's currency that the Fund continued to hold in an amount above 75 per cent but below 100 per cent of quota. Another consideration might be the Fund's liquidity. Special drawing rights may be used to replenish the Fund's holdings of any currency, but the use of gold for investment would involve a similar loss of flexibility. It might also be argued that provision should be made for the investment of the proceeds of the transfer of special drawing rights as a matter of the prestige of the asset. If the draft provision were broadened in this way, it would be necessary to give the Fund an appropriate power to transfer special drawing rights for this purpose.

20. The Fund would be able to sell a part of its gold and invest the proceeds, as it did in the investment program that began in 1956.

A sale of gold under the draft amendment would be unlike the earlier sales of gold in two respects. The Fund would be able to sell the gold in any market and therefore at any price prevailing in that market. (A decision to sell could require a special majority if that safeguard were desired.) Moreover, the Fund would not be required to ensure that a purchaser of the gold would resell an equivalent amount to the Fund on demand.

21. The Fund would be able to reinvest the proceeds of disinvestment and the income of the investment (including any income from funds awaiting investment) as well as the currencies into which the proceeds of disinvestment and the income were converted under draft Section 6(d)(v).

22. If the Fund wished to use a part of its "other" holdings (i.e., holdings not referred to in paragraph 21 above) of the currencies of members to make an investment, it would have to obtain the consent of the issuer of the currency to be invested. The consent of the issuer would not be required in respect of a currency that represented the proceeds of the sale of gold or disinvestment, or was received as income of the investment.

23. The securities in which the Fund invested would not be protected against changes in the value of the currency in which they were denominated even if the Fund had not established separate investment accounts. Section 6(d)(iii) states that the securities would not be regarded as holdings of currency or as other assets subject to the maintenance of value clause of Article IV, Section 8.

24. Under draft Section 6(d)(iv) the Fund would be required to establish separate investment accounts and to hold in them the assets to be invested or resulting from investment. The proceeds of disinvestment and the currencies received as income would be placed directly in these accounts. The Fund would be able to transfer to such accounts amounts from its other holdings of a member's currency, but only with the consent of the member. The assets held in the separate investment accounts, whether currencies or securities, would not be covered by the provisions of Article IV, Section 8 on the maintenance of value. The Fund would have the power to use any assets in these accounts, including currencies, for the purposes of investment and also in order to meet the expenses of conducting its business, including operational expenses such as remuneration. The Fund would have the power to change assets in the accounts into the currencies desired for any of these purposes.

25. If the Fund decided to terminate the investment, the assets in the separate investment accounts would have to be transferred to the accounts in which the Fund has its other holdings of currencies, and the investment accounts would be terminated. In order to minimize the effects of these transfers on members' positions in the Fund, draft Section 6(d)(v) would give the Fund the power to convert the assets in the investment accounts before these accounts were liquidated. For example, if the assets in an investment account were largely in the currency of one member, the Fund might decide to have some of these assets converted into other currencies so that the transfer to the Fund's other holdings of currencies that would

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occur upon liquidation of the account would not bring about a substantial increase in the Fund's holdings of one member's currency.

26. The Fund would have to adopt implementing rules and procedures that would govern the establishment and operation of the separate investment accounts on the basis of the provisions of the draft amendment.

27. The powers granted by draft Article XII, Section 6, other than those conferred directly on the Board of Governors, would be vested in the Board of Governors but could be exercised by the Executive Directors under a delegation by the Board.