FOR AGENDA

SM/08/350
Correction 2

January 21, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Charges and Maturities—Proposals for Reform**

The attached corrections to SM/08/350 (12/12/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 11, Table 3, footnote 1: Missing text added: "Arrangements cover new arrangements and extensions and augmentations of existing arrangements."

Page 17, footnote 16, line 1: for "The mid-point of the repayment period for an SBA under the repurchase expectations schedule is three years" read "The mid-point of the repayment period for an SBA under the repurchase expectations schedule is 3 ⅛ years".

line 2: for "Setting the step increase of surcharges at that point" read "Setting the step increase of surcharges around that point".

Page 24, Box 2, para. 3, first bullet: for "The exceptional access SBA that was approved instead was treated as precautionary from the outset" read "Instead an augmentation and extension of the 2002 SBA with exceptional access was approved and was treated as precautionary from the outset"

Page 25, Figures 9.A–C: the shaded area has been corrected to improve visibility.

Questions may be referred to Mr. Giorgianni, SPR (ext. 35326) and Mr. Savastano, WHD (ext. 38545).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (4)

Other Distribution:
Department Heads

Table 3. Fund Arrangements with Exceptional Access, January 1995–November 2008 1/

	Date	Type of Arrangement	GRA Credit Outstanding Prior to Approval of Programs, in percent of quota	Total Arrangement Amounts: Under All Facilities: in SDR millions	Under All Facilities: in percent of quota	*Of which*: under SRF: in SDR millions	*Of which*: under SRF: in percent of quota
A. Not subject to surcharges							
1 Mexico	2/1/1995	SBA	149	12,070	688		
2 Russia I	3/26/1996	EFF	166	6,901	160		
3 Thailand	8/20/1997	SBA	-	2,900	505		
4 Indonesia I	11/5/1997	SBA	-	7,338	490		
5 Indonesia II	7/15/1998	SBA	196	8,338	557		
6 Indonesia III	8/25/1998	EFF	245	4,669	312		
7 Indonesia IV	3/25/1999	EFF	310	5,383	259		
8 Turkey I	12/22/1999	SBA	46	2,892	300		
9 Indonesia V	2/4/2000	EFF	359	3,638	175		
B. Subject to surcharges							
B1. SRF cases							
1 Korea 2/	12/4/1997	SBA	-	15,500	1,938	9,950	1,244
2 Russia II 3/	7/20/1998	EFF	248	15,363	356	3,993	93
3 Brazil I	12/2/1998	SBA	-	13,025	600	9,117	420
4 Turkey II	12/21/2000	SBA	107	8,676	900	5,784	600
5 Argentina I	1/12/2001	SBA	183	10,586	500	2,117	100
6 Argentina II	9/7/2001	SBA	307	16,936	800	6,087	288
7 Brazil II 4/	9/14/2001	SBA	97	12,144	400	9,951	328
8 Uruguay I	6/25/2002	SBA	122	1,752	572	386	126
9 Uruguay II 5/	8/8/2002	SBA	243	2,128	694	129	42
10 Brazil III	9/6/2002	SBA	359	22,821	752	7,610	251
B2. Non-SRF cases							
1 Turkey III	5/15/2001	SBA	445	15,038	1,560		
2 Turkey IV	2/4/2002	SBA	1165	12,821	1,330		
3 Argentina III	1/24/2003	SBA	498	2,175	103		
4 Argentina IV	9/20/2003	SBA	517	8,981	424		
5 Brazil IV 6/	12/12/2003	SBA	769	27,375	902		
6 Turkey V	5/11/2005	SBA	1357	6,662	691		
7 Uruguay III	6/8/2005	SBA	534	766	250		
8 Liberia 7/	3/14/2008	EFF	155	343	265		
9 Georgia 8/	9/15/2008	SBA	-	477	317		
10 Ukraine	11/5/2008	SBA	5	11,000	802		
11 Hungary	11/6/2008	SBA	-	10,500	1,015		
12 Iceland	11/19/2008	SBA	-	1,400	1,190		
13 Pakistan 8/	11/24/2008	SBA	1	5,169	500		
Number of arrangements			32				
Number of countries			15				
Number of arrangements with surcharges			23				
Number of countries that have paid surcharges			12				

Source: Finance Department, IMF.

1/ As of November 30, 2008. All arrangements were approved for amounts above annual and cumulative limits, with the exception of Russia's EFF in 1996 which exceeded only the annual limit and Indonesia's EFF in 2000 which exceeded only the cumulative limit. Arrangements cover new arrangements and extensions and augmentations of existing arrangements.
2/ Total amount approved on December 4, 1997 as an SBA. A portion was then converted to an SRF on December 18, 1997.
3/ EFF amount includes 50 percent of quota approved under the CCFF along with the augmentation.
4/ Brazil's 1998 SBA was cancelled and replaced with this arrangement.
5/ The SRF approved at the previous augmentation was cancelled and the SBA augmentation was increased by the equivalent to the undrawn amount.
6/ Arrangement turned precautionary from this point forward.
7/ Liberia's exceptional access arrangement was granted in the context of Liberia's clearance of arrears to the Fund. It excludes the credit outstanding and approved arrangement under PRGF trust.
8/ Excludes the credit outstanding to the PRGF trust.

10. **Many members with high levels of outstanding Fund credit made large advance repurchases during this period** (Table 4). Key factors behind those large repurchases, aside from the benign global financial market conditions, included the incentives for early repayments embedded in the TBRE policy and in the surcharges. In some cases, factors other than global liquidity and cost differentials were at play—including stigma associated with borrowing from the Fund and a perceived positive signal from fully repaying the Fund—as some members decided to repay early all credit outstanding, including amounts not subject to surcharges.

Table 4. Advance and Early Repurchases by Large Users of Fund Credit 1/

	Years of Advance/Early Repurchases	Total Advance/Early Repurchases (SDR million)	Fund credit outstanding following last advance repurchase (SDR million)
Argentina	2006	6,655	0
Brazil	2000, 2002, 2005	20,786	0
Indonesia	2006	4,704	0
Korea	1999, 2001	10,113	0
Mexico	1996, 1997, 2000	4,897	0
Russia	1999, 2001, 2005	4,413	0
Thailand	2003	269	0
Turkey	2002	4,483	13,643
Uruguay	2004, 2005, 2006	2,304	0

Source: See Annex II, Table 1.

1/ Advance repurchases are voluntary payments made by the member at least five days ahead of the date scheduled for repayment. Early repurchases are payment expectations that arise under the Fund's early repurchase policy.

11. **The recent turmoil in global financial markets has increased sharply the demand for Fund arrangements involving high access**. Since mid-2008, access to international capital markets has become more expensive and challenging for many members, and the global process of deleveraging has impacted particularly hard members that were heavily dependent on external financing or had other vulnerabilities. Against this backdrop, during September-November 2008, the Fund has approved arrangements involving exceptional access for five members (Georgia, Hungary, Iceland, Pakistan, and Ukraine) for total commitments of SDR 28 billion.

12. **Aside from the high access-arrangements listed in Table 4, the broader evidence on Fund repurchases shows the TBRE policy has contributed to shorten repayment periods**. From April 2005 to June 2007, about two-thirds of all repurchases to the Fund adhered to the expectations schedule (compared to a ratio of 44 percent in the previous two

step adjustments. On balance, staff chose a single step adjustment for simplicity considerations. The choice of three years as a trigger point for the step increase was guided by the objective of trying to replicate through price incentives the one-year reduction in the repayment period attained by the TBRE policy.[16]

c. **Alignment of thresholds with access limits**. The access threshold that would trigger surcharges in the proposed system (300 percent of quota) would be the same as the cumulative access limit that currently defines exceptional access under the credit tranches and the EFF. While this alignment would disappear if access limits are increased from current levels, as proposed in a companion paper, there is no alignment at present as level-based surcharges (and surcharges under the SRF) apply within the current cumulative access limit.[17]

21. **Size of surcharges**. The single-tier schedule of surcharges proposed by staff complies qualitatively with the guiding principles discussed in paragraph 14. Even so, choosing the precise size of the surcharges is ultimately a matter of judgment. A key element to inform this judgment is the comparison between the costs of borrowing large amounts from the Fund and borrowing from market sources. In practice, the wedge between the maximum level of surcharges and the (median of the) cost of borrowing from the markets faced by members that have had Fund arrangements involving high access has been very large at the time of approval of the Fund arrangement, remained large for up to 24 months following approval of the arrangement, and narrowed more rapidly starting in the third year (Figure 6). Based on this evidence, staff concluded that, on balance, setting the second (duration-triggered) level of surcharges at 300 basis points three years after the approval of the arrangement could provide adequate incentives to induce early repayments of Fund credit outstanding.

V. Implications of Reform Proposals

A. Precautionary Balances

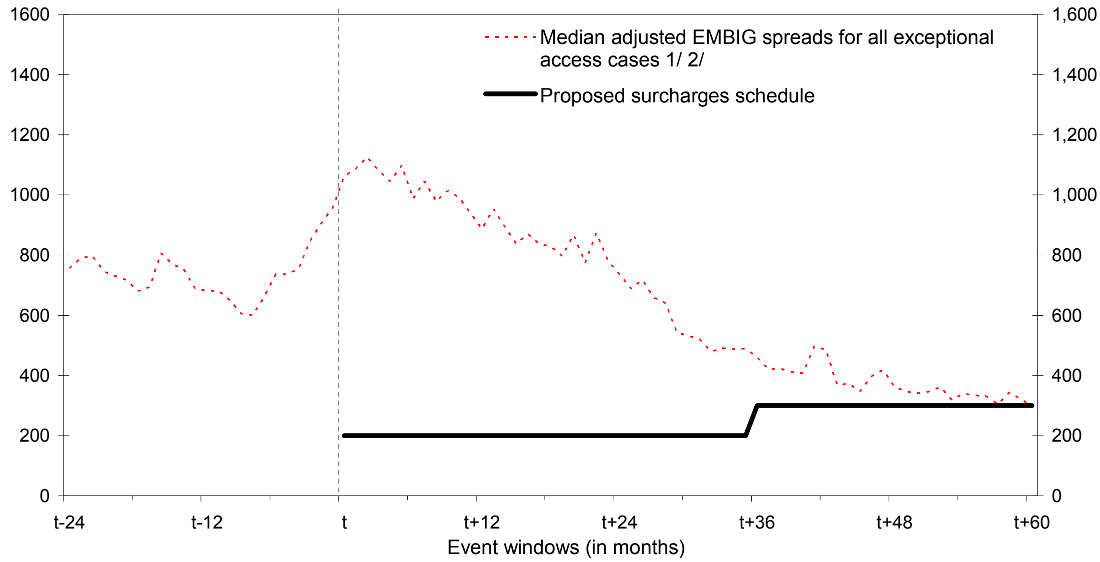
22. **As noted, income from surcharges plays a key role in contributing to the Fund's precautionary balances, thus helping to mitigate the higher credit risk associated with arrangements involving high access**. Income from surcharges was the most important contributor to the increase in precautionary balances during 2002–05.[18] As discussed in

[16] The mid-point of the repayment period for an SBA under the repurchase expectations schedule is 3 ⅛ years. Setting the step increase of surcharges around that point is intended to provide a similar incentive to shorten the repayment period as currently provided by the expectations schedule (see Section V.B).

[17] See *Review of Access to Financing in the Credit Tranches and Under the Extended Fund Facility, and Overall Access Limits Under the General Resources Account* (EBS/08/102, 9/3/08).

[18] See Figure 2 in *Review of the Role and Adequacy of the Fund's Precautionary Balances* (EBS/08/110, 9/24/08).

Figure 6. Proposed Surcharges and Adjusted EMBIG Spreads



Sources: J.P. Morgan; Bloomberg; and Finance Department, IMF.
1/ Exceptional access cases are listed in Table 3. The adjusted EMBIG spreads are defined as the EMBIG yields net of the adjusted rate of charge. The dotted line is the median for all exceptional access cases since 1995 (including under the SRF), subject to data availability.
2/ Episodes refer to the dates when there were exceptional access programs approved by the Fund. In the event window, t corresponds to the month when exceptional access was granted. The window shows 24 months prior to each episode and 60 months after. EMBI series are available only for 3 of the arrangements recently approved (Hungary, Pakistan, and Ukraine) and only for the period prior to the program approval. See Annex I.

EBS/08/110, the role of precautionary balances will remain essentially unchanged under the new income model for the Fund. Going forward, the pace of accumulation of precautionary balances will still be driven by two factors: the number of arrangements involving high access and the structure of surcharges. However, to the extent that the low demand for SRF resources persists and most of the future high access arrangements are not subject to SRF surcharges, the pace of accumulation of precautionary balances is likely to be considerably slower than in the 2002–05 build up.[19]

23. **Will the proposed schedule of surcharges yield higher or lower surcharge income than the current system?** While the size of surcharges in the proposed system (200/300 basis points) will be higher than the existing surcharges (100/200 basis points), under the proposed system, surcharges will start to apply at a higher level of credit outstanding. In the end, the answer will depend on key parameters of each arrangement, such as the amount of access (in percent of quota), the phasing of purchases, and the size of the initial purchase. The comparison will also depend on whether repurchases are made according to the expectations or the obligations schedule.

24. **Staff estimates suggest that, for "typical" high access arrangements, surcharge income under the proposed schedule would tend to be lower than under the existing system for arrangements with access below 800 percent of quota (under the obligations**

[19] See Figure 5 in EBS/08/110.

29. **What are the implications of *full alignment of surcharges* across GRA facilities?**

- ***SRF***.[22] If the proposed system of surcharges were to be applied to the SRF, the cost of SRF resources would be lowered significantly (Table 1, Figure 5a), including because the proposed time-based surcharge would never apply to the SRF, given its short maturity. The co-existence of SRF and high access arrangements in the credit tranches subject to the same surcharges could thus give rise to arbitrage opportunities as borrowing from the SRF would, in effect, become cheaper than borrowing from the credit tranches.

- ***EFF***. The EFF was designed to provide medium-term financing to countries with structural impediments to sustained economic growth, where balance of payments problems were expected to take a long time to resolve. Accordingly, the repayment period for purchases under an EFF arrangement is significantly longer than for purchases under an SBA (Table 2). Applying the proposed surcharges schedule to the EFF would thus generate the undesirable outcome of members with a high-access EFF arrangement being levied the highest surcharge for a much longer period than countries with a high access SBA.

30. **What are instead the implications of *not aligning surcharges* across facilities?**

- ***SRF***. Maintaining the existing system of surcharges for the SRF would essentially imply preserving the large cost differential between the SRF and high-access arrangements in the credit tranches. This may imply that the demand for the SRF would remain low (Box 2).

- ***EFF***. If the proposed system of surcharges were not applied to the EFF, borrowing costs under a high access (i.e., above 200 percent of quota) EFF would be higher than under the credit tranches during the first three years of the arrangement. Moreover, the concurrent elimination of the TBRE policy would extend the repayment period of EFF arrangements by three years on average without providing any incentives for early repurchases (Table 2). One way to mitigate these undesirable effects would be to establish the principle that the EFF would not be used as a vehicle to provide high access to members with balance of payments difficulties.

[22] An amendment of the SRF would be needed to modify its surcharges or to eliminate the expectations schedule.

Box 2. Experience with the Supplemental Reserve Facility

The SRF was established in December 1997 to meet a large short-term financing need. Sudden losses of market confidence had led to massive outflows of capital in Mexico (1995) and in Asia (Thailand, Korea, and Indonesia (1997)), and required financing on a much larger scale than the Fund had previously provided. The SRF Decision defines the circumstances under which SRF resources can be used (i.e., the "circumstance test"): to "provide financial assistance to members experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves, if there is a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result, within a short period of time, in an early correction of such difficulties."[1/] Consistent with this, the SRF offers financing on a short-term basis and with significant surcharges (Tables 1–2). Financing under the SRF is made available to members under a stand-by or extended arrangement. Financing is committed for up to one year, even if the corresponding arrangement is for longer, and will generally be available in two or more purchases.

The use of the SRF has been limited due to the varying nature of capital account crises, both in terms of causes and duration. Since its creation, the Board has approved 27 arrangements involving exceptional access, of which 10 involved SRF resources for six members (the last one in 2002), notwithstanding the presumption that exceptional access in capital account crisis be provided under the SRF (Table 3). In general, there have been few "V-shaped" capital account crises, and in many cases, countries have satisfied the SRF circumstance test as noted above, but the expected or actual duration of the crisis was longer than the SRF repayment schedule:

- In some cases, SRF resources were replaced with financing under SBA/EFF terms. In Turkey (2002), and Uruguay (August 2002), the recovery from capital account crisis took longer than initially anticipated, leading to a medium-term balance of payments need.
- In other cases, SRF/SBA/EFF blends were used where a higher share of resources was provided in the credit tranches. In Argentina (2001), Brazil (2001, 2002), and Uruguay (June 2002), blends of resources on credit tranches terms (beyond normal access levels) and on SRF terms were justified on the basis of the expected longer-term nature of the financing need.

More recently, all exceptional access has been provided in the credit tranches. After 2002, the Board has granted exceptional access in the credit tranches in 11 cases because the need for exceptional access arose outside circumstances for which the SRF was created:

- For Brazil (2003), uncertainties about the nature and duration of the balance of payments problem precluded the use of SRF resources. Instead an augmentation and extension of the 2002 SBA with exceptional access was approved and was treated as precautionary from the outset. Under the terms of the SRF, no access can be approved in the absence of an actual balance of payments need of the type the facility is designed to address, although a member could indicate its intention not to draw under the SRF, despite the existence of an actual balance of payments need.
- In Argentina (January and September 2003), Turkey (2005), and Uruguay (2005), the Fund-supported programs dealt with the legacies of past capital account crisis, which were seen as requiring a longer time to resolve.
- In Georgia, Ukraine, Hungary, Iceland, and Pakistan (all 2008), exceptional access was provided on SBA terms, including because uncertainties related to the re-establishment of normal global financial markets created a risk that the balance of payments difficulties may require a longer time to resolve than the SRF maturity.
- Liberia (2008) was a special case. Liberia is a PRGF-eligible country that was granted exceptional access from the GRA on EFF terms, but it was granted in the context of Liberia's clearance of its arrears with the Fund.

1/ Decision No. 11627-(97/123), SRF, December 17, 1997.

31. **Partial alignment of surcharges**. Another possibility would be to apply the proposed system of surcharges to the SRF and the EFF but with a different time-based surcharge trigger—shorter than 36 months in the case of the SRF and longer than 36 months for the EFF (Figure 9). For example, in the case of the SRF, the duration-based trigger could apply two years after the access threshold has been exceeded, rather than the three years proposed for the credit tranches. This modification would make the SRF more expensive relative to access in the credit tranches (though the cost differential would be much lower than at present) and would thus preserve a key distinguishing feature of the SRF. For the EFF, the duration-based trigger could come into effect after five years (instead of three). This would avoid unduly increasing the cost of borrowing under the EFF, while introducing a useful (price-based) incentive for inducing early repayments. A partial alignment of surcharges along the lines suggested, however, would undermine the reform's fundamental goal of simplifying the system.

Figure 9.A Proposed New Surcharge Schedule for Credit Tranches
(in basis points)

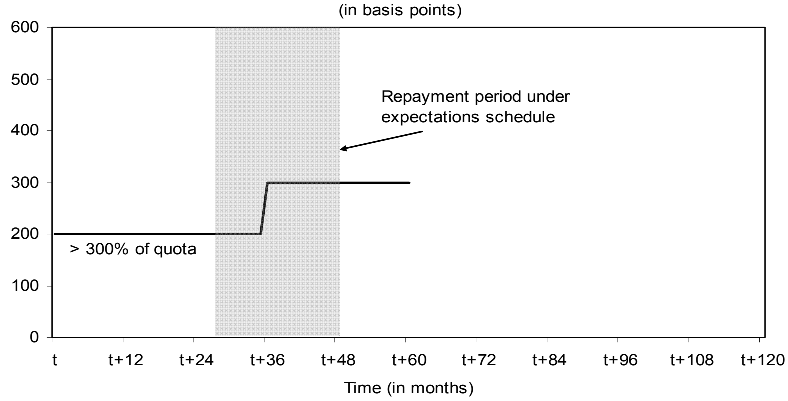


Figure 9.B Possible New Surcharge Schedule for SRF
(in basis points)

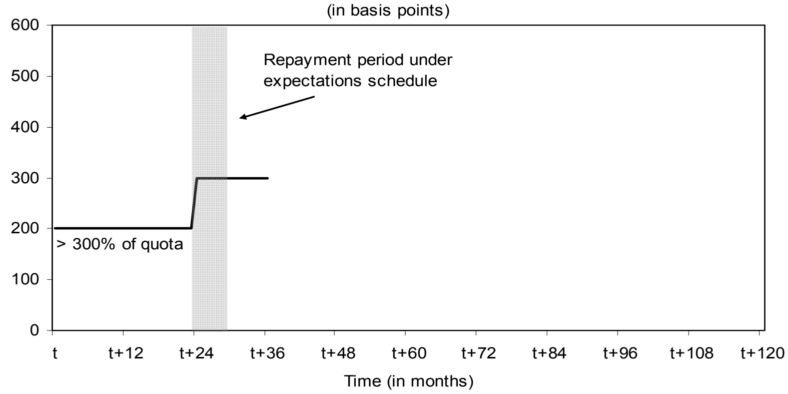
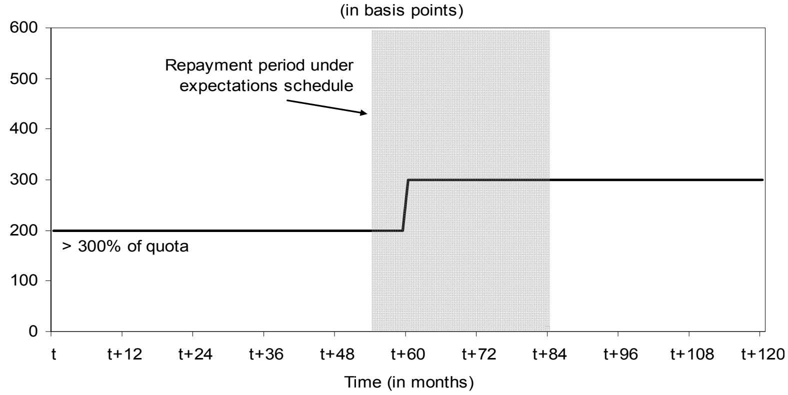


Figure 9.C Possible New Surcharge Schedule for EFF
(in basis points)



32. **In light of these considerations, staff is of the view that the goals of simplifying and aligning the Fund's system of surcharges would be best achieved through the elimination of the SRF, and possibly also the EFF**. As noted, most members do not seem

to regard the SRF as a very useful instrument.[23] Moreover, since its creation more than a decade ago, there have been only a handful of cases where, either ex ante or ex post, a member's balance of payments problem and resolution has conformed with the "V-shaped" capital account crises that the SRF is supposed to help address (Table 3). In fact, in many cases, the expected and/or actual duration of the crisis has been longer than the SRF repayment schedule. As for the EFF, while staff recognizes that it may still be useful in some circumstances (for instance, for low-income members that are transitioning toward market access), its usefulness as a facility for providing high access is much more doubtful.

D. Voting Majorities

33. **Approving the reform proposals contained in this paper requires different voting majorities at the Board**. Modifications to surcharges would require the support of 70 percent of the total voting power. The abolishment of the TBRE policy would require a majority of the vote cast. Elimination of the SRF or the EFF would also require a majority of the votes cast.

VI. Issues for Discussion

34. **In their discussion, Directors may wish to comment on the following issues**:

- Do Directors agree that the TBRE policy should be abolished? Do they see a need to replace the TBRE policy with other procedures in addition to a time-based surcharge?

- Do Directors consider that the staff's proposal on surcharges strikes an appropriate balance between providing incentives to repay exceptional access early without unduly deterring members from seeking Fund financial support?

- Do Directors view the proposed system of surcharges adequate in relation to the need to build precautionary balances?

- What are Directors' views on whether to align surcharges across facilities? Do Directors see benefit in aligning surcharges across facilities for which there has not been demand?

- How do Directors see the role of the SRF and the EFF going forward?

[23] The SRF has not been used since 2002. At the September 2008 discussion of the *Review of the Fund's Financing Role in Member Countries*, some Directors felt the SRF should be retained, while many were prepared to consider its elimination. See *Review of the Fund's Financing Role in Member Countries* (SM/08/283, 8/29/08) and *The Chairman's Summing Up—Review of the Fund's Financing Role in Member Countries* (BUFF/08/136, 9/15/08).