May 9, 2011
Approval: 5/16/11

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 11/22-1

10:00 a.m., March 2, 2011

1. Salary Adjustment and the Budget—A Reform Proposal

Documents: EBAP/11/12 and Correction 1, and Supplement 1, and Supplement 2

Staff: Clarke, HRD; Fedelino, OBP; Rosa, SAC

Length: 2 hours, 34 minutes

Executive Board Attendance

J. Lipsky, Acting Chair

Executive Directors	**Alternate Executive Directors**
	M. Saho (AE)
	M. Sidi Bouna (AF), Temporary
A. Mac Laughlin (AG)	P. Garcia-Silva (AG)
	S. Bultitude (AU), Temporary
W. Kiekens (BE)	
	M. Arbelaez (BR)
	Y. Luo (CC)
C. Pérez-Verdía (CE)	
	M. Sajkunovic (CO), Temporary
	A. Ducrocq (FF)
	S. von Stenglin (GR)
	P. N. Weerasinghe (IN)
	N. Choudhary (IN), Temporary
	N. Giammarioli (IT), Temporary
M. Furusawa (JA)	
	S. Rouai (MD), Temporary
A. S. Shaalan (MI)	S. Geadah (MI)
A. Bakker (NE)	
B. Andersen (NO)	
	A. Lushin (RU)
	A. Al Nassar (SA)
	R. Pokharel (ST), Temporary
R. Weber (SZ)	
M. Lundsager (UA)	
	R. Elder (UK)

S. Tiwari, Secretary
I. Teodoru, Assistant

Also Present
African Department: C. Daseking-Frank, A. Kamaruzzaman, S. Khazai. Asia and Pacific Department: M. Loddo. European Department: K. Moran. Finance Department: D. Andrews. Human Resources Department: C. Clarke, E. Vanhee, M. Vicini, L. Weber. Institute: E. Clifton. Legal Department: J. Lester, M. Rosa Diaz. Middle East and Central Asia Department: S. George. Monetary and Capital Markets Department: N. Banerjee, M. O'Brien. Office of Budget and Planning: A. Fedelino, M. Henderson, G. Ulmschneider. Secretary's Department: S. Creane. Strategy, Policy, and Review Department: A. Demba. Statistics Department: B. Shannon. Technology and General Services Department: K. Letlaka Rennert. Western Hemisphere Department: J. Gold, A. Wolfe. Senior Advisors to Executive Directors: W. Abdelati (MI), I. Ábel (BE), E. Barendregt (NE), M. Choueiri (MI), O. Hendrick (AG), B. Lischinsky (AG), A. Ndyeshobola (AE), M. Nomura (JA), M. Peter

(SZ), I. Sicat (ST), P. Fachada (BR), A. Sutt (NO). Advisors to Executive Directors: K. Beaton (CO), K. Beaton (CO), J. Franco (UA), A. Gerdes (GR), L. Jimenez (CE), A. Maciá (BR), M. Makino (JA), T. Nguema-Affane (AF), A. Terracol (FF), J. Wang (CC), R. Ward (UK).

1. SALARY ADJUSTMENT AND THE BUDGET—A REFORM PROPOSAL

Mr. Weber submitted the following statement:

We approve the set of changes to the compensation system proposed by the Working Group on Salary Adjustments and the Budget as we consider these changes to be a substantial improvement over the status quo. The proposal addresses the key shortcomings of the current comparatio adjustment, in particular the fact that this adjustment has allowed internal cost drivers to expand the Fund's nominal administrative budget envelope. The replacement of the comparatio is thus very welcome and overdue.

Our support is based on our appreciation of the following:

The proposed system promises to be more transparent about how the overall salary budget is determined—including by making an allocation for skills upgrading explicit—and how the structural and merit increases are distributed among staff.

The merit pay allocation is proposed to be fully financed by the carry-over from the past fiscal year, meaning that the budgeted salary envelope is binding. We consider it reasonable that the agreed salary envelope can be fully used—but not exceeded. That said, we would find it appropriate to introduce an upper limit on annual merit pay increases as a safeguard against very large increases caused by exceptionally high staff turnover. Considering that the comparatio adjustment generally did not exceed two percent in the past, and given that the allocation for skills upgrading is being budgeted for separately under the new system, we consider a limit of 1.5 percent as reasonable. If the Fund's workforce remains stable, with turnover within the norm, we expect that this limit will not constrain the merit pay envelope.

The global external deflator for the determination of the nominal administrative budget will no longer include the comparatio adjustment. This change will likely be a significant disciplining factor for budget growth.

We acknowledge the empirical evidence supporting a supplementary annual budget allocation of 0.5 percent and can agree to it. We would nevertheless expect staff to include in future budget documentations an explanation of how this allocation was utilized. Such documentation will also provide a basis for assessing the control mechanisms—yet to be elaborated—for remaining within the approved limit.

While the proposal does not affect the way the structural salary increase is set, we perceive a need to also review this key component of the rules-based system of determining staff salaries. The full comparator-based review due in 2012 is the appropriate venue for proposing improvements to the Board.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

We thank staff for the proposals to modify the system of financing skill upgrades, promotions, and distribution of the merit pay increases. It is important that the new system does not erode the competitiveness of staff compensation, and that the resulting budget envelope does not compromise the quality of the Fund's work and its effectiveness. As often mentioned, "Fund staff is the institution's main asset," and we urge that modifications to the method of salary adjustments and budget allocation safeguard the acquisition and retention of this most important asset.

We can support the removal of the comparatio from the global deflator in the Fund's overall budget. The staff justified its inclusion since 2009 as a way to provide additional budgetary space to cover uncertainties related to the higher workload associated with the financial crisis and skill upgrade associated with restructuring. We would appreciate clarification from staff on what was financed by the additional allocation that resulted from this practice (about 1.7 percent of the budget) and what are the implications of suspending this practice? The answer could shed light on whether essential activities could be affected by the proposed change.

We also see merit in the proposal to separate the structural increase—to be distributed on May 1 based on position in the salary range—from the performance-related merit increase to be distributed on July 1. While we were comfortable with the previous practice, the separation should hopefully address possible negative perceptions over the size of the headline increase.

However, we are concerned about the proposed annual allocation of 0.5 percent for skill upgrading and new hires for the next three years. This allocation appears small compared with the average annual growth in structural cost during the past decade, which was around 0.6-0.7 percent, excluding one-off factors. Is this allocation sufficient to achieve our stated objective of hiring more mid-career economists and those with specialized skills, as well as to attract staff from more diverse backgrounds and shorter-term hires? While the downsizing provided a window of promotion opportunities, this window is now virtually closed. New hires, particularly at the A11-A15 levels, once more face relatively few opportunities for career progression, suggesting that greater salary increases within grade are needed to retain highly skilled staff.

Mr. Mac Laughlin and Mr. Garcia-Silva submitted the following statement:

We welcome the staff's proposal as it represents a good change from the current system. We are prepared to go along with it as long as it assuages the broad concerns the Executive Board has expressed in the past, particularly on the comparatio adjustment and the choice of the budget deflator. Thus, we will limit our comments to those dimensions that can be tackled in the future and where we see scope for further improvements.

We strongly appreciate the clearer distinction between the structural adjustment and the merit-based component of salary adjustment that the proposed system provides. However, it is still the case that, within the overall budget envelope, the distribution of these two components will remain dependent on factors that are outside the control of management and the Board (such as turnover).

Indeed, when turnover is low, less resources will be devoted to merit pay (and vice versa), a conjunction of events that can be appropriate only in few specific circumstances.

Thus, the importance of incentives for proper performance by the staff will remain somewhat weakened through the lack of an explicit signal from Board and management on the resources allocated for merit pay.

A more bold approach would be one that allows for separate and explicit budgeting of the structural adjustment and a fixed dollar allocation for merit pay. The financing of this fixed budgetary allocation for merit could come from the turnover process, with a cap on the overall salary budget so as to ensure budget-neutrality. Similar approaches were suggested by other offices at the informal session and by Mr. Weber in his gray.

This alternative is also consistent with the proposed calculation of the budget deflator in the current proposal by the staff (through excluding the comparatio adjustment).

An explicit budgeting for merit pay will require continued strengthening of the use of indicators for measuring performance at the staff level and also at the IMF's institutional level. We encourage the staff to proceed in this direction in the future.

Mr. Lushin submitted the following statement:

We approve the proposal regarding the method for determining and distributing the merit pay envelope as summarized in Box 1 of the staff paper. As we have already stated during the informal meeting on this issue, the new method for salary adjustments has a number of clear advantages as compared to the comparatio system:

It transparently separates merit increases from structure adjustments and, hopefully, eliminates the widespread confusion surrounding the concept of the comparatio. It shows clearly that the dollar amount to be used for merit increases represents just salary carry-overs from the previous financial year and is not associated with the new budget costs. This, and also the separation of merit and structural increases in time may put an end to the previous unconstructive discussion under the motto that staff's salary increases "are too big."

The new approach will also help better differentiate merit pay by disentangling it from the position in the salary range, thus better rewarding good performance and doing so more transparently.

Explicit budgeting for additional structural cost to provide space for the upgrading in skills also increases transparency and allows measuring this concept and dealing with it on a stand-alone basis.

Eliminating the comparatio adjustment from the budget deflator will better measure the cost drivers in the Fund's budget and produce substantial savings.

The issue of additional structural cost will require further analysis in order to increase our capacity to better measure and forecast it. Right now it is proposed to set it at the level of 0.5 percent, corresponding to the average in relatively "quieter" years of 2001-2006, while for the longer period of the last ten years this indicator is higher at 0.8 percent. There is a risk that setting a budget allocation for skill upgrading and promotions too low could excessively constrain the HR policies in the Fund and in the end appear counter-productive. Therefore, while we agree with the proposal in the paper to set it initially at 0.5 percent in anticipation that going forward the Fund will experience less volatility in the staff's grade profile, the developments in this area should be monitored closely. In this context, the allocation of 0.5 percent to reflect the upgrading in skills may need to be reviewed earlier than in three years.

Mrs. Budiman, Ms. Sicat and Mr. Pokharel submitted the following statement:

We agree that separating structural increase with merit increase would make the budget determination more transparent. The proposed approach of isolating the structure adjustment would make a more appropriate comparison with other organizations. Moreover, decomposing the and granting the increase separately, i.e., structure and merit increase would be distributed on May 1 and July 1, respectively, would reinforce the difference between the two elements. Moreover, the proposal would avoid volatility in the salary adjustments coming from the comparatio which is sensitive to hiring and separations. The proposal would also impose greater discipline over structural cost increases in salaries.

Technically, the funding for merit increase would be budget-neutral since funds would be drawn from the savings arising from the difference of budgeted and actual average salaries. More specifically, the difference would come about if there are vacancies and salaries that are below the average. Does staff envisage that there would always be a savings that would be generated from here? Would there be supplemental budget in the event of low savings given a full staff complement. Would putting a cap on the merit increase be feasible to ensure that there would be budget for this increase?

Given the above, we agree for the removal of the comparatio/merit increase from the global external deflator, while retaining the two components for personnel and non-personnel costs.

We suggest that the methodology be reviewed on a regular basis to account for areas that were not considered in the current methodology.

Mr. Sadun and Mr. Giammarioli submitted the following statement:

In the past two years, we have encouraged efforts to reform the Fund’s compensation system, especially in its comparatio component, which proved to be not fully transparent and proved to trigger salary increases beyond those in both the private and public sectors. Therefore, we welcome today’s proposal of a new system for determining and distributing the envelope for merit increase pay. While the proposed system addresses some shortcomings of the current one, we believe that there is still room for further improvement.

The key elements of the new system include the replacement of the comparatio adjustment with a dollar-based merit envelope equivalent to the previous year's salary erosion, the separation of the structure adjustment from the merit increase, and the removal of the comparatio adjustment from the budget deflator. All these factors will enhance transparency, lower the nominal budget envelop, and preserve budget-neutrality. Notwithstanding these improvements, we see merit in introducing a safeguard rule—in the form of a cap—to the total amount of resources available for the annual merit-pay increases. While such a limit would guarantee enough resources to reward the most productive staff, it will prevent unwarranted results such as those triggered by the recent downsizing.

We agree that explicitly budgeting for skill upgrading will increase transparency, and will allow more efficient hiring and promotion policies. In this respect we note that historical cost increases related to structural changes in the Fund's workforce compare favorably with those of other organizations and we also agree that the proposed size of the allocation (0.5 percent of budget salaries) can be considered conservative. However, we are concerned by the fact that an HR strategic policy on workforce planning is not yet in place and that the approval of the allocation for additional structural costs during the next three years will preempt the adoption of such a policy.

Accordingly we would like to be reassured by the HR Department that it will speed up its work on the strategic workforce plan, that it will monitor attentively how the allocation to the additional structural costs are utilized—paying particular attention to the mix between new hiring and promotions—and that it will report regularly to the Board on these matters. Furthermore, we would like staff to elaborate on how the eventual over or under-spending of the additional structural cost allocation will be dealt with.

Mr. von Stenglin and Ms. Gerdes submitted the following statement:

We thank staff for their report and the Working Group on Salary Adjustments and the Budget for their efforts and recommendations. In light of the importance and complexity of the issue at hand, we would have preferred a longer time span between issuance of the report and the Board meeting in order to review the proposal thoroughly and come to a well-informed decision. We offer the following comments.

The proposed new system enhances the transparency and comprehension of the salary adjustment process. Separating the structural and the merit increase mitigates the perception that salary increases in the Fund are unusually high. This also improves the comparability of salary adjustments in the Fund to other organizations and home authorities. Moreover, by comparing the actual salaries to the budgeted salaries, a merit envelope can be calculated that is budget-neutral. Furthermore, we welcome the proposed exclusion of the comparatio from the global deflator.

Having said that, we are disappointed that the other options to derive a merit envelope were not discussed further in the staff paper as required by us and others during the informal meeting. We are not entirely convinced that the dollar-based amount is preferable to a fixed or variable percentage. The staff's comments are welcome. In this regard, we support Mr. Weber's view that an upper limit on merit pay increases should be introduced in order to avoid very large increases at times with high personnel fluctuation. Furthermore, we would appreciate a staff comment on the percentage of staff that is eligible for merit pay in order to form an opinion about the appropriateness of the overall amount of merit pay.

We welcome the explicit budgeting of skills upgrading. However, it should be ensured that the allocation of 0.5 percent will only be used for skills upgrading and not for merit pay. Moreover, we wonder how long the process of upgrading in skills needs to be continued. The staff's comments are welcome.

Finally, it is of utmost importance for us that a review of the new system is conducted after three years. This review should comprise a comprehensive comparison of the old and the new system. Moreover, the allocation for skills upgrading should be part of the review with a view to determining if it is still needed.

Mr. Alkholifey submitted the following statement:

I thank staff for a well-focused paper on the reform of the Fund's compensation system that builds on the recommendations of the Working Group on Salary Adjustments and the Budget and the discussions that took place in the informal Board session recently.

I welcome the reform proposal as it will address the long-standing issues related to the compensation system and enhance its transparency. At the same time, it will be essential to ensure that the Fund continues to be in a position to recruit and retain a diverse staff of the highest quality. In this context, I agree with the view expressed Mr. Shaalan and Ms. Abdelati in their gray statement that it is important that the new system does not erode the competitiveness of staff compensation, and that the resulting budget envelope does not compromise the quality of the Fund's work and its effectiveness.

The proposal to replace the comparatio adjustment with a clear system for determining a merit pay envelope is welcome as it will address the shortcomings of the current system, especially the inclusion of the comparatio adjustment in the external deflator for the Fund's administrative budget. Evidently, this has generated a larger budget envelope than necessary to accommodate increases in the salary structure. Furthermore, the comparatio adjustment has been volatile in the last five years with the increase ranging from 0.7 percent to 3.6 percent against an average of 1.7 percent over the last 20 years.

I also see the benefit in establishing a supplementary budget allocation to explicitly cover the cost of changes in the staff grade structure arising from the upgrading of skills. In this regard, I can go along with the proposal to initially set this allocation at 0.5 percent of budgeted salaries annually for a period of three years. Here, I note that the proposed size of the allocation is conservative, going by past experience. In this connection, I look forward to the annual report on the evolution of the grade profile of staff and related structural cost.

Mr. Majoro submitted the following statement:

We welcome the work of the Salary Adjustment and Budget Working Group in reviewing the comparatio system and for identifying options for a more transparent, rule-based, budget-neutral and efficient alternative approach. The retention of a compensation adjustment as part of the Fund's rules-based salary system is quite important for effectively distributing merit pay and preventing salary erosion. However, as currently defined, the comparatio is heavily fraught with shortcomings that have undermined its capability to serve as a transparent and consistent mechanism for effecting salary adjustments.

Against this backdrop, we can support staff's proposal for replacing the comparatio adjustment with an internal salary adjustment separately determined and distributed from the structure adjustment. The distribution of merit pay with effect from July 1 following completion of the Annual Performance Review (APR) not only underscores the merit basis of the Fund's compensation system, it provides an added incentive for improved staff performance. While not entirely immune from implementation challenges, the dollar-based approach provides a more effective and transparent means of distributing merit pay. The simulations undertaken by staff, though backward-looking, clearly demonstrate the merits of the proposed approach and its potential for accruing savings.

In light of our position above on the comparatio and as we approach completion of the restructuring exercise, we see merit in staff's proposal to eliminate the comparatio adjustment from the computation of the global deflator for the administrative budget. Further, maintaining the said adjustment in the deflator would unnecessarily inflate the overall budget envelope. Thus, its elimination from the deflator would help enhance budget transparency and generate much-needed savings.

Accounting for skills upgrade and promotions and budgeting for the subsequent changes in grade structure under the proposed approach is likely to pose a serious challenge. While we consider the working group's proposal of a budget allocation of 0.5 percent to cover these costs over the next three years an important stop-gap measure, we urge against making this target allocation a constraint against opportunities for promotion among young professionals. There is, therefore, an urgent need for streamlining HR policies and practices to ensure proper budgeting of the accompanying structural costs. In this regard, we encourage staff to expedite current HR reforms to be better positioned to clearly define the parameters for determining the required budget allocation.

Finally, there is need for a Board review of the new approach following a period of implementation so as to determine whether it effectively addresses the transparency, consistency and budget-neutrality concerns that have surrounded the comparatio adjustment. To this end, we propose a review of the new approach after three years of implementation. This notwithstanding, management should be able to make proposals to the Board for adjustment if that becomes necessary through annual reviews.

Mrs. Arbelaez and Mr. Fachada submitted the following statement:

We thank staff for the report and for providing illustrative backward-looking simulations that our chair requested at the informal meeting of the working group with Executive Directors on February 8. We can go along with the proposed changes to the Fund's compensation policy.

There is no doubt that the staff is the most important asset of the Fund. The institution must seek to retain its experienced professionals, increase the recruitment of both experts and young professionals and promote staff diversity. With these aims, implementing effective and dynamic human resources policies remains a priority, helping the Fund attract the right staff and allocating them to the right responsibilities. Nobody can disagree with the goals that are set out in the staff report in terms of ensuring competitive pay, internal progression, reward for merit, transparency and budget discipline, among others.

The staff argues twice in the report that the current adjustment policy has contributed to the perception that Fund's salary increases are "too large." However, this seems more than just a perception. According to the report of the working group (FO/DIS/11/21), Fund's salary adjustments in the last decade have been above other multilateral organizations headquartered in D.C. (the World Bank and the Inter-American Development Bank). They have also been well above the average adjustment in the U.S. public and private sectors and considerably higher than inflation in the D.C. region. We understand that part of the dynamics behind is a result of staff turnover and promotions, but in normal circumstances, we would not expect staff movements in the Fund to differ much from similar organizations (of course, this is not true in the post-2008 period, marked by the downsizing exercise).

That said, we can support more transparent rules for salary adjustments, with a specific merit increase allocated to individual salaries and an explicit budget allocation to address changes in the grade structure arising from turnover and promotions. We also support the proposed budget allocation (0.5 percent) for skill upgrading. The new policy would tend to reduce the volatility and the rise in salaries in recent years, which partly resulted from the downsizing and the associated impact on the comparatio. We are, however, not totally convinced about the proposal of separating the adjustments in two different months (May and July). Is this merely intended to reduce the "external perception" of the magnitude of the adjustments?

In paragraph 15, staff mentions that in case of unforeseen sizable structural changes, the size of the proposed budget allocation for skill upgrading could prove unduly constraining, and opens the possibility that a revised allocation be proposed to the Board in the annual budget cycle. It is important to stress, also, that sizable structural changes can potentially make the size of the proposed budget allocation unduly generous. In that case, the Board should also be able to review the budget allocation downwards.

Finally, we support the elimination of the comparatio adjustment from the deflator for the Fund's budget. Given the magnitude of the comparatio in the recent past, this practice has unnecessarily fuelled the budget in nominal terms.

Mr. Daïri and Mr. Rouai submitted the following statement:

We thank staff for their work and outreach and we broadly support the proposal to replace the comparatio adjustment with a new system that will provide for a more transparent budgeting of merit increase, to offset the expected salary erosion, and to establish an allocation for skill upgrade. We agree with Mr. Shaalan and Ms. Abdelati that the new system should not erode the competitiveness of staff compensation.

We can support the proposal to separate the structural adjustment from the merit increase and to distribute them on May 1 and on July 1 respectively. We can also support the removal of the comparatio from the global deflator in the Fund's overall budget.

The staff proposes to set the annual allocation for skill upgrade at 0.5 percent of budgeted salaries for the next three years. When compared to the annual growth in this component during the past decade in the Fund (0.7 percent) and also to the average level in the United States (1 percent a year over the last 10 years), the staff proposal seems to be on the low side. We are concerned that the proposed reduction may hamper the Fund's ability to upgrade staff skills and to hire and retain highly qualified financial sector experts and mid-career professionals with the required experience. The staff's comments are welcome. We propose to increase the annual allocation at least to 0.7 percent and to introduce some flexibility in the system to allow management to carry forward any unused portion of the annual percent allocation while keeping the envelope for the three years at 2.1 percent.

Mr. Ducrocq and Mr. Bakker submitted the following joint statement:

We thank staff and the working group for their paper and their work on this sensitive and complex issue.

We do think that, overall, the reform proposal constitutes an improvement in comparison with the current system, from both HRM and budgetary points of view. While the removal of the comparatio from the deflator is an appreciable return to normal, we also welcome the savings the proposed system is in itself supposed to generate. We would therefore be inclined to support the proposed decision.

At the same time, we regret that one of the main concerns we raised at the time of the compensation review last year has not been satisfactorily addressed. The proposed system would indeed maintain the possibility of large and unjustified salary adjustments as a pure consequence of high turnover. To curtail this risk, we ask that a cap be set on the dollar amount, for example in a range between 1.3 (the average simulated merit pay envelope in the new proposed system) and 1.5 (median between the averages of the actual comparatio adjustments and the simulated proposed envelope). Indeed, while we appreciate the budget-neutrality of the "dollar amount" system, we think that mandatorily spending the whole budgetary room of maneuver stemming from extraordinary events would not serve HR objectives and could reduce support for the system.

Besides, we would like to emphasize the following points:

We strongly support staff's willingness to improve and modernize the HR management and workforce planning. This is critical not only in the context of the 0.5 percent allocation for skill upgrade, but also for the efficiency of the IMF in general.

A performance-based approach should remain a major feature of the compensation system and we therefore invite management to ensure a real performance differentiation within the new system. This requires at the same time improving performance management, which should also value skills useful for the institution as a whole, like across-department collaboration.

We are reassured by staff's commitment that the proposed system, which encompasses a new timing and decision process on compensation, would enhance transparency. We therefore expect a process that preserves the oversight role of the Board and its ability to provide strategic guidance on these matters. In this regard, we reiterate that an HR committee of the Board would be useful.

Mr. Hockin and Mr. Sajkunovic submitted the following statement:

We thank the staff and the working group for their efforts in proposing modifications to the Fund's compensation system. On balance, we find the proposals to be a step in the right direction and we are prepared to support the proposed decision. That being said, within the proposal there are some elements that can be further improved, and we suggest some ways to strengthen the new compensation framework below.

Separating Decision Points

We support the proposal to separate the decision points on the structural increase and the merit increase. When deciding on the structural increase, it is indeed important that we are comparing apples to apples.

In principle, we also appreciate the fact that the new framework will allow for a more strategic focus for the Board through the delegation of the merit increase to management. That said, a prerequisite for a more hands-off approach by the Board needs to be confidence in the broad parameters of the merit increase system and strong transparency. Both of these elements have room for improvement in the proposal.

Additional Structural Costs

We understand the rationale for establishing a basic budget allocation for staff grade changes. Indeed, in any organization, it is important to ensure that resources are available to allow for career progression opportunities for more junior staff based on merit and a clear promotion system. In addition, we fully support the efforts to diversify the Fund's skill set and bring in more financial sector or technical assistance-related mid-career hires.

In our view, the additional structural cost proposal could be strengthened in two ways. First, transparency on how the 0.5 percent is allocated will be important. We would expect clear reporting on the allocation of these resources, including details on the division between internal promotions and hiring mid-career experts. Our expectation is that we will see a healthy balance between the two. Second, we believe that there needs to be a closer link to the necessary HR changes (i.e., systematic workforce planning, reformed and clearer promotion policies, etc.) noted in the report. We would see merit in having a very clear work plan, timeframe and progress report linked to the annual budget decisions on these additional 0.5 percent structural increases.

Merit Pay System

In terms of the proposed merit pay system, we welcome the evolutionary improvements over the comparatio adjustment, particularly the real budget-neutrality and better transparency. However, many of the design-related shortcomings of the comparatio system still remain. This includes the perverse situation where the departure of experienced staff automatically translates into a higher merit pay envelope.

We were disappointed that the suggestion by a number of directors during the informal discussion to explore the idea of a percentage cap on the annual size of the merit envelope as a safeguard was not pursued in the staff report. Therefore, we would support Mr. Weber's suggestion to introduce an upper limit on annual merit pay increases as a safeguard against very large increases caused by exceptionally high staff turnover.

Future Review

Finally, one element that was noticeably absent in the report was any mention of a timeframe for a future Board comprehensive review of experience under the proposed new system. We would see merit in including a provision in the proposed decision for a formal review sometime in the next 3 or 4 years. Such a review would also allow the Board to take stock of the functioning of not only our own system, but also the World Bank's new system in light of the more fundamental changes that they have adopted. Such a future comprehensive review should also have an aspect of independent external assessment. Finally, we would support Mr. Weber's suggestion that additional possible improvements that are gleaned over the next year or so could be proposed as part of the full comparator-based review due in 2012.

Mr. Andersen and Mr. Sutt submitted the following statement:

We welcome the discussion on the salary adjustment mechanisms and highly value the intention of creating a compensation system that is more transparent and subject to greater budget discipline. We appreciate staff's efforts to address the concerns previously raised, although we are somewhat surprised that the current paper does not look into other alternatives, as we expected after the recent informal meeting. While on the whole, we consider the reform proposal a step in the right direction and can go along with the proposed decision, we note there is scope for further improvements. We support the ambition of putting the new system into place starting with the 2011 compensation round.

We welcome the decomposition of salary adjustments into structure adjustments and merit increases as this would make it easier to identify what drives the salary increases. However, we do not think that the proposed dual timing is appropriate, as the Board should decide on the overall increase in salaries. Separating Board considerations on structure adjustments from the overall salary budget considerations, including the merit pay envelope, reduces the Board's oversight on the overall salary increases. We consider as a step in the wrong direction; staff comments are welcome.

Linking the merit-based increases to last year's "salary erosion" complicates matters unnecessarily and is not well justified. Within the overall increase, decided by the Board, one specific portion can be assigned to performance based increases and the rest to structure adjustments. This will facilitate focusing on both the overall wage increases and on consciously deciding to what extent increases should be performance based.

While the proposed dollar merit envelope is simpler and has a stronger foundation in the budget than the current practice, it de facto continues the practice of ensuring a comparatio adjustment of 100. We would clearly prefer annual merit envelopes based on deliberations on a suitable emphasis on performance differentiation. An option, which would correspond to the recent changes to the World Bank's compensation system, would be to not let the full annualized dollar amount equivalent to salary erosion be automatically distributed as merit pay and thus allow for savings. We see therefore value in introducing a cap for the nominal increase in the annual merit-pay envelope.

We support the proposal of distributing merit increases solely on the basis of staff performance evaluation. This would contribute to ensuring a more incentive-based compensation system in the Fund. We would, however, have liked staff to also consider distributing parts of the structure adjustment based on performance (and not solely on position within the salary ranges). This would be in line with the practice in the World Bank.

We can agree with a supplementary annual budget allocation of 0.5 percent set for three years. Like Mr. Weber, we expect that future budget documentation will include an explanation of how this allocation was used.

We fully support the proposal to exclude the comparatio adjustment from the global external deflator of the salary budget. It will improve transparency and ensure a better match between the administrative budget envelope and increases in the salary structure, thereby allowing for potential savings.

Finally, we look forward for an in-depth discussion of the compensation and related HR policies at the 2012 full comparator-based review. We strongly support increased transparency of the overall compensation systems in the Fund and other IFIs, including non-salary components of total compensation packages (benefits, etc.). We encourage staff to work towards that objective. We fully agree with staff that the budgetary impact of HR-related policies and decisions should be made clear and transparent. We welcome the work being done to strengthen strategic workforce planning and to align policies and practices with core business needs and budgetary realities.

Mr. Luo and Ms. Wang submitted the following statement:

We thank staff for the paper and the proposed changes to the Fund's compensation system.

To recruit and retain high-caliber and a highly-diverse staff, the Fund's compensation system should remain competitive and rules-based. We can go along with the proposed system for determining and distributing merit pay for enhanced transparency and budget discipline. We also agree with staff's recommendation to eliminate the comparatio adjustment from the global deflator for the Fund's budget.

It is crucial that the new system maintain the working momentum of staff, and also ensure that the Fund is competitive among comparator institutions as an employer. To this end, key features of the new system, including a budget allocation of 0.5 percent annually for a period of three years for the cost arising from upgrading skills, should be reviewed by the Board on the occasion of the annual staff compensation review.

In the proposed system, the envelope for merit pay is determined within a predefined salary budget, with an explicit allocation for the cost of changes in the grade structure of staff arising from external hire, promotions, and separations. Obviously, the actual cost for merit pay is dependent on staff turnover. This chair has always supported a greater role for merit pay going forward as incentive to maintain the Fund's competitiveness. What measures does the staff envisage to strengthen the role of merit pay within the salary budget?

Mr. Assimaidou submitted the following statement:

We thank staff for the paper on the reform of the Fund's compensation system, which takes into account some of the recommendations made at the informal meeting on February 8, 2011.

At the outset, we would like to reiterate the utmost importance of having a strong rules-based compensation system which is not only competitive and attractive for prospective staff but also transparent and consistent in the eyes of actual staff. In this regard, we welcome the proposals in the staff report, aimed at addressing weaknesses in the present compensation system. In particular, we agree that the comparatio element of Fund salary adjustment has been confusing and complex in many aspects. We therefore support the proposal to eliminate this element from the salary adjustment system—and in the process from the global deflator for the Fund's budget—and its replacement with a merit pay envelope equivalent, which will be budget-neutral and more transparent.

We support the principle of separating salary adjustment in two distinct elements, a structure adjustment and merit pay, and hence a different timing for their distribution, in line with practices of comparator organizations. Consistent with this principle, we support:

- the continuation of the current system to determine the structure adjustment from a salary survey of a comparator market, which will be distributed to all staff based on position in the salary range on May 1 each year; and

- the proposed measure to determine the merit pay envelope to be distributed to all eligible staff on July 1 each year, based solely on performance following the completion of the annual performance review.

That said, from the simulation of the new system in Table 5, we note the very small merit pay envelope in 2007, which begs the question of whether there might be instances in which the envelope might become null (equal to zero) and even negative, and therefore instances in which the Fund might not be in a position to distribute merit pay despite the staff's positive performance assessment and eligibility for merit pay. The staff's comments are welcome.

We still have reservations regarding the proposed budgeting for additional structural cost. There remain gray areas on the exact causes of this additional cost and most importantly on the responsibility for its protracted occurrence in a context of structural vacancies. We understand that the additional structural cost resulted mainly from uncoordinated human resources decisions on skill upgrading. Given that this paper is not proposed for publication, further details on the exact nature of the human resources practices which led to such development would have been welcome to better assess the appropriateness of the proposed budget allocation. That said, we note that there are some reforms underway which we hope will strengthen human resources management at the Fund. We would particularly appreciate staff's elaboration on the reforms being undertaken, their consideration by the Board and the timeline for their completion.

Mr. Gibbs and Mr. Elder submitted the following statement:

Fund staff is by far the most important asset of the institution and is central to delivering the mandate. In our view, staff is highly skilled and well motivated, and it is important that the pay system adapts over time to ensure that this continues. Therefore, we welcome staff's review of the comparatio system, especially in light of increasing concerns voiced by Directors over the last few years. That said, it is also important that the Fund demonstrates highly cost-effective use of scarce public resources. And we cannot set aside the context of extreme pay restraint being exercised in public sectors around the world, including in many countries that have IMF programs.

Although some aspects of the reforms proposed go in the right direction, we are not convinced they go far enough, and we are not comfortable with other aspects. Overall, therefore, we do not expect to support the package. Below we consider the four elements of the new proposal:

Budgeting for Additional Structural Cost

We support increasing diversity among IMF staff, including recruiting people with previous experience working in government and in the financial sector. Before we can judge whether 0.5 percent is an appropriate allocation for additional structural cost, we would like to see more information on what has been achieved so far in terms of this goal, and approximately how much that increased the wage bill.

Determining the Merit Envelope

We are pleased to see a greater focus on performance in the system and efforts to improve transparency. We see advantages in ensuring that the new system is budget-neutral, especially when staff turnover is low. But we have yet to be convinced that the new proposal significantly departs from the existing system and adequately addresses our concerns. For example, in the event of high turnover, staff's proposal will continue to generate high merit pay awards. In recent years, we have not been able to support those high merit pay awards and so we are reluctant to agree to a proposal that builds them into the pay structure in a way that—as discussed below—gives management the responsibility for a decision currently taken by the Board.

At the informal discussion, we asked that alternative options remain on the table, including considering some sort of cap to the merit pay award. We believe that such a cap would be an improvement on the current proposal and can support calls from other chairs for that change. We note that every three years pay levels are reassessed against appropriate comparators, so there is little danger that such a cap could meaningfully damage pay competitiveness. Nevertheless, we would not expect to support even a capped version of the current proposals for reasons discussed below.

Separating the Structural Adjustment and the Merit Increase

We understand the challenges in presenting the structural adjustment and comparatio adjustment to an external audience, and so we can go along with distributions at different times of the year. However, we would have preferred all elements of pay to have been brought to the Board for decision, and ideally at the same time.

It is proposed that merit pay increases will not be brought to the Board for approval from this year on. We agree in general that the Board should aim to exercise a more strategic role within the institution, but after the relatively large pay increases of recent years we are not yet sufficiently confident in the pay system to be ready to agree that the Board should step back from part of the annual pay round. Therefore, we strongly advocate continued annual review by the Board of merit pay increases.

This may be our only opportunity to express our view on the merit award for staff in the coming pay round. We have reservations about approving a new system without knowing what it will deliver for a merit pay award in the coming year. We understand that in many countries the merit award has not been included in government worker's pay freeze. Nonetheless, we judge that it is something that should be adjusted to reflect economic circumstances and in the current climate we urge pay restraint.

Removing the Comparatio Adjustment from the Budget Deflator

We are strongly in favor of removing the comparatio adjustment from the global deflator. However, we believe that it was hard to justify including the adjustment in the first place, so do not consider this to be a genuine 'saving.'

Finally, we note that the Board meeting is scheduled just six business days after circulation of the paper. While we understand the specific circumstances that have made this necessary, we caution that this is a sensitive subject and there are reputational risks if staff were perceived to have rushed through this decision.

Ms. Lundsager and Mr. Meyer submitted the following statement:

Changing aspects of the staff compensation methodology to improve transparency and better reflect existing market conditions is long overdue. Replacing the comparatio and eliminating it from the global GDP deflator are significant improvements. These changes are long overdue, given how these distortions have undermined confidence in the Fund's budgeting and salary methodologies. The changes that the staff proposes now should serve as the first steps to turning around this situation and building a framework that member governments can understand and support. While the reform proposals before us may not go as far as we would have liked, they represent a significant step forward. We are therefore prepared to support today's proposals subject to the following comments.

We welcome the elimination of the comparatio and can support the introduction of a new budget-neutral internal adjustment. We join other Directors though in seeking a cap on the size of the overall internal adjustment pool to avoid perverse incentives and to add an element of smoothing in the event of unexpected volatility in staffing. In looking at how to set such a cap, it strikes us that the average past comparatio, less the new structural supplement, provides a reasonable starting point (1.2 percent). We also ask the staff to comment on how it will report to the Board on the determination of the internal salary adjustment pool and how this will be awarded.

We can also support the addition of a supplemental 0.5 percent of the budget to be allocated to a salary pool, remaining outside the GDP deflator base, for critical skills upgrading. Recent information seems to indicate that such funds are more likely to be used to finance internal pay grade promotions. This is in contrast to our earlier understanding that such a pool was needed to bring new skills to the Fund staff, for example, by hiring mid-career staffers with market and/or policy making expertise. Thus, full transparency of tracking and reporting for this funding pool will be key to ensure that it finances the desired expansion in skill sets. Such reporting is an important element to inform the future review of the supplement and the level at which it is set, as well as building Board confidence in the salary mechanism.

In looking at the annual salary adjustment decisions, it will be important to ensure that these reflect staff performance. We strongly support management's efforts to align compensation decisions better with performance and would urge care that the revised approach does not serve to undermine this objective. In particular, underperforming staff should not benefit under the new approach relative to currently existing flexibility. We welcome the staff's comments on how a strong performance link will be maintained and monitored.

We also note that further work on the structural element of the compensation adjustment should be incorporated into the work program. Doing so before the next review of comparator markets seems reasonable. We share the concerns of several other chairs that the select market comparators are too narrow and do not accurately reflect the typical career options chosen by most Fund staff. Likewise, we reiterate again our call for a more comprehensive look at the benefits component of staff compensation. Relative to other organizations, Fund benefits have not been markedly changed despite widespread changes in comparator markets and institutions. We note that the higher pace of such increases in the budget necessitates a timely review.

Mr. Legg and Ms. Bultitude submitted the following statement:

We support the reforms to the salary adjustment system put forward by the Working Group on Salary Adjustments and Budget. We consider that these will improve the transparency and accountability of the Fund's salary adjustment system. In particular, we welcome the removal of the comparatio from the budget deflator, the explicit budgeting for changes in the wage grade, and the introduction of internal staff management mechanisms to ensure promotion and recruitment practices are consistent with a pre-established and budgeted strategic workforce plan.

Given that we support the broad thrust of the proposals, we limit our comments to the following:

We support the proposal to replace the comparatio adjustment by a merit envelope equivalent, ensuring budget neutrality. While the size of the merit envelope will be affected by turnover in the previous year, we would expect that the merit envelope will be relatively stable under normal conditions. Moreover, we would support a cap on the merit adjustment as a safeguard against very large merit increases caused by exceptionally high staff turnover, as suggested by a number of other chairs.

We can go along with a supplementary allocation of 0.5 percent for 'skill upgrading and promotions,' to be considered in the context of annual budget discussions in each of the next three years. However, further information on the overarching strategy—such as the targeted skills enhancement and the basis for exerting 'some downward pressure on growth promotions'—would put us in a better position to assess the proposed size of the allocation. Additionally, like Mr. Weber, we would appreciate further reporting on how this allocation is, and is intended to be, utilized. This could include, for example, information on the portion that can be attributed to the hiring of mid-career experts versus internal promotions.

Finally, we see merit in taking stock of the outcomes of the reforms and reviewing the new system as the strategic workforce plan is bedded down. For example, staff's feedback on the distinction between the structural and merit pay increases, and the new discipline on aggregate promotions across the Fund, would be useful in gauging the impact of the reforms on staff retention and performance incentives. And we continue to be interested in an overarching discussion in due course on how these reforms, and others more generally in the human resources area, will contribute to efforts to address the institutional cultural issues highlighted by recent Independent Evaluation Office reports.

Mr. Furusawa and Mr. Nomura submitted the following statement:

The Fund's remuneration policy is one of the most important tools toward preserving its overall performance by means of maintaining first-rate human resources; therefore, the Fund's salary structure needs to be competitive and transparent. We acknowledge that the staff proposal addresses recent concerns, mainly related to the comparatio system, while maintaining the current rules-based approach to structural adjustment. Therefore, we support the proposed reform on salary adjustments and the budgeting system, and our comments will focus on the following points:

The new system of capping internal salary adjustments by means of a dollar-based approach to merit pay, which substitutes the comparatio adjustment, is an appropriate approach toward enhancing budgetary discipline. Separating the structural adjustment and the merit pay will also contribute toward increasing transparency and provide the appropriate basis for a fair comparison with other private and public organizations. In addition, recognizing the fact that the current inclusion of the comparatio adjustment in the global external deflator (GED) was an exceptional approach, adopted to address the uncertainty of the Fund's restructuring period, we highly welcome the proposal to eliminate internal salary adjustments from the GED.

Regarding the new budgeting approach related to the upgrading of skills, we support the proposal to explicitly budget for the cost of upgrading skills, which would significantly increase the transparency of the system. We also welcome the conservative budget proposed by the staff for the initial three years, which is below the historical average. We emphasize that, at the same time, the proposed annual reports on the future evolution of the grade profile of staff are essential in order to track developments in the actual salary increases and to enable timely adjustments to the system.

Regarding the degree of differentiation of merit pay among staff, it would be crucially important to reflect in the performance assessment of managerial-level staff, the progress made with regard to staff diversity within his/her division or department.

Mr. Pérez-Verdía and Mr. Jiménez submitted the following statement:

We can support the proposal to modify the compensation system presented by the staff working group. After several discussions on this issue, we are convinced that the proposed system represents an improvement in terms of transparency, and it will also contribute to budget discipline.

While we never regarded the use of a comparatio adjustment as inadequate, we can understand that this mechanism may be contentious for some. For example, the use of the comparatio in the deflator may have led to extremely large budget envelopes. At the same time, the current system to determine the general salary increase in the Fund could lead to a public perception of higher salary increases relative to other public and private sector organizations. In this regard, the proposed changes seem beneficial.

The separation of structural costs into structure adjustments (price effects) and changes in the profile of staff (grade composition effects) may indeed enhance transparency. It could also help the Board to better target the desired level of upskill upgrading within the Fund. Nevertheless, we would hope that determining a budget allocation to this end does not become a cumbersome and time-demanding exercise. To avoid this, it could be useful to establish a staffing framework as soon as possible. As an example of our concerns, we wonder whether the allocation of 0.5 percent of budget salaries to this end is indeed too restrictive, or not.

On the other hand, we concur with the separation of the structure adjustment and the merit increase as a way to increase transparency and because, as mentioned, it will eliminate the erroneous perception that the Fund's salary increases are too large. The separation of the merit increase will also help to better reward, in a more transparent fashion, good performance, although the new system will require to be assessed closely. Budget neutrality is also a positive element in the proposal. However, as other directors have indicated, merit increases in a determined year will be influenced by the carry-over from the previous fiscal year, and thus will be dependent on elements such as turnover. In this sense, some degree of control in the range of merit increases or the use of other criteria might be required in order not to compromise future flexibility in hiring new staff or upgrading skills.

Finally, the removal of the comparatio adjustment from the budget deflator seems also to contribute to transparency and will help to reduce the nominal budget envelope. In this sense, the measure may greatly contribute to budget discipline.

Mr. Virmani and Mr. Choudhary submitted the following statement:

We are in broad agreement with most of the proposed changes to the compensation system as they are substantial improvement over the existing system and more transparent as well. We wish to make only two brief points.

Though we are supporting the proposed annual allocation of 0.5 percent for scale upgrading and new hires, like Mr. Shaalan and others we have a feeling that this figure is quite conservative and may hamper acquisition of new skills required in this period of fast changing policy issues. In this context, while we would support 0.5 percent allocation for the current year, we would like the Board to review this next year instead of after three years as proposed in the staff paper.

We support the delinking of merit pay from the structural adjustment and are also happy to note that merit pay envelope will be budget-neutral. However, we would caution against putting a cap on merit pay at this stage, as suggested by some colleagues, without having experience of how this new system actually works. It is also to be kept in mind that high turnover, like at the time of down-sizing, is not expected any more in the near future. Further, this could have implications for maintaining staff morale and should be carefully considered. We would support the proposal as contained in the staff report and review it after three years to determine whether any cap is required to be put in place based on experience.

The representative from the Staff Association Committee (Mr. Rosa) made the following statement:

> Thank you very much for allowing me to share our views on this important issue. SAC supports the technical design of the proposed system, but also acknowledges that it brings with it a number of HR implementation challenges. It may lack proper and adequate buffers as well. SAC also questions whether the resulting wage restraint is indeed consistent with both the current heavy work load, which is likely to continue to be severe over the medium term, as well as stated HR policies regarding specialized mid-career hires and diversity. Let me elaborate on those points.
>
> In terms of the guiding principle, in its contribution to the task force to the task of the working group, SAC was guided by a set of core principles. The new system should closely align average salaries with our market comparators as expressed by salary midpoints. Two, it should continue to be rule-based, and in particular aim at restoring a comparatio of 100 percent over time. Three, it should ensure that the implementation of reasonable hiring and promotion policies is possible without the need of arbitrary ad hoc adjustment.
>
> That said, as I said before, SAC supports the proposal of the adjustment system from a technical standpoint. By ensuring that the structure increase is distributed to staff with midpoint control, it preserves the link between average salary and market comparators, which is vital to ensure that the Fund can recruit and retain the best talents. By explicitly budgeting for skills upgrade, it makes sure that the resource envelope is consistent with a reasonable promotion space and the possibility to hire the talent we need to keep the Fund competitive. Moreover, ex ante budgeting for skill upgrades with a strong HR rationale backing it will strengthen the credibility of the budget, which is key to us. Next, defining a merit budget based on salary erosion will strengthen the link with actual dollar budget resources. It makes sense that those savings are distributed back to staff based on performance.
>
> While management would have as always latitude to determine the degree of differentiation of the merit pay, SAC believes that the key to continue to motivate strong performance is not by further tilting the merit pay but, rather, preserving a reasonable and credible promotions base going forward.
>
> I will outline the challenges I see ahead. While SAC supports the new system, we want to highlight our concerns regarding some of the proposed

parameters as well as implementation challenges. First, SAC is concerned that the proposed skill upgrade is unrealistically low and would run counter to other stated policies. Table 1 of the staff report shows that the cost of upgrading skills in U.S. companies has been around 1 percent. If the calculation had focused on the top high value-added institutions maybe more comparable to IMF, it is likely that the cost of upgrading skills would have been higher than that. It is therefore difficult to understand how the Fund can remain competitive with respect to those high-skill markets when its skills upgrade budget is less than half of theirs. Thus, we call on the Board to consider raising the skills upgrade budget to at least up to 1 percent.

Second, the paper recognizes that we are entering new territories and uncertainties. Nevertheless, it does not provide, in our view, for sufficient buffers to cope with them. The suitability of the proposed skills upgrade budget depends on a number of HR policies, which in turn respond to specific requests from the Board over time. As we move to tighter dollar budgeting, it is fair to say that we do not know how such firm budgets and HR policies will square immediately.

For instance, if turnover drops in a given year because perhaps the current crisis is more severe or prolonged than originally anticipated and staff is asked to deliver more to come to help, there will be simply no sufficient space for growth promotion. This would be counterproductive and even counterintuitive.

If, meanwhile, new hires are brought in at higher pay in response to the need to recruit specialized experts or attract diverse candidates, this would erode both promotion space and merit allocations, particularly if the wage budget is unrealistically tight. We therefore ask the Board to approve a contingency fund around the skills upgrade envelope over the coming three years which could be used to address unforeseen needs and developments.

Third, dollar budgeting requires a more thorough understanding of the link between Board demands, available resources and output reprioritization. To a large extent, there is no satisfactory metric which links output requests from shareholders with available resources. As a result, staff and their time becomes the uncompensated buffer.

Data show that uncompensated overtime is on the rise. The staff faces an increasing amount of multiple and at times conflicting demands. The quality of the work or its underlying analysis is at times at risk. So far we cope, but it is difficult to cope. Past budget allocation within a growing institution effectively provided a basis to compensate staff for these over and ever-growing demands. This calls for realistic budget allocations, including for promotion as well as a more concerted effort to prioritize work across the institution.

I have a final remark. We know that some chairs support including a cap. We remain convinced that the current proposal as is provides an excellent package to address the concerns of the Board and is consistent with the views and requests expressed during the Committee of the Budget deliberations.

We also understand that some chairs are concerned about the volatility of the system and look for a stronger link between merit budgets and actual performance. Likewise, staff is very concerned about the stability of the merit budget in case, for instance, of sudden one-off drops in turnover. The argument for a cap, therefore, calls for a corresponding floor with a band designed to pass the test in terms of normal turnover and of a band in the constraining case of one-off structuring or an unlikely drop in turnover. Thank you very much.

Mr. Elder made the following statement:

I have got some happy news to report. After we had issued our gray, I got the opportunity to look through other grays, and we saw that there was considerable support for the proposed amendment for a cap, so we consulted with our authorities again and explained to them that there seemed to be a growing consensus for this. Although they did have concerns about the proposal, they were minded to support the consensus, so I can report that if we agree on a cap today, I would be able to support that decision.

That said, they were only able to support a cap if it was reasonably modest. Now, the number suggested by the United States was for 1.3 percent. We could certainly support that. We could support something perhaps a very little bit higher, but only very slightly higher. So I am in a situation where we would be able to change what we suggested in the gray if the cap was agreed at a modest level close to what the United States suggested.

In terms of the people who argued against a cap, I just wanted to make the following point, which is that, as we said in our gray, we believe that next year there will be an opportunity to re-discuss the level of pay. If it is felt that the cap is too modest and causes problems in terms of retention and recruitment, that is an issue that can be re-discussed next year during the decision about the level of pay, and it also will be possible to have that sort of discussion frequently every three years.

So in our view, being relatively conservative in terms of a cap need not cause a problem in terms of retention and recruitment, because those issues can be re-discussed when levels are discussed every three years.

Mr. Shaalan noted Mr. Elder's point in regard to the cap that, if the cap was reviewed every two or three years, it would not have any negative impact on recruitment and retention; however, he disagreed with that point, because there would be an impact during the year the cap was being placed.

The Acting Chair (Mr. Lipsky) noted that some Directors had asked for a floor and wondered whether any Director wished to modify what was in their grays. If not, he would propose to turn to the staff.

Mr. Lushin made the following statement:

I cannot resist adding a point to the cap issue right now, because my position will also depend on how the cap is decided. My overall concern about the cap is the one-sided approach to this issue. If we introduce the cap for the reasons of fending off excessive turnover risks and the merit budget being too large, I am wondering why we do not look at the other end of the distribution, as the staff representative just alluded to, and not introduce the floor for the cases when we have turnover very low to provide sufficient resources for a merit-based increase.

Second, and this is important, if we adopt the cap only and apply it consistently over a number of years, our comparatio will fall behind 100 percent, and this will be a radical deviation from the current system and what we were looking at when modifying the previous comparatio system.

Having comparatio below 100 percent means that average salaries by grades follow behind midrange points, and this would be a blow to competitiveness. Therefore, either we skip the cap altogether, or, if we decide on the cap, it should be complemented by the floor, so that those savings that the cap produced in the periods of high turnover could be returned back to the merit budget in the periods when turnover is low, in this way making the comparatio on average 100 percent.

A question may arise: do we need all these complications with a cap and the floor? In my view, the answer is clear: we do not. And we do not, because, if we look at the chart that was distributed during the slide show in the informal meeting, we can see that the comparatio adjustment is remarkably stable over the years if we exclude the periods of high volatility as with downsizing. For this reason, caps and floors will only introduce unnecessary complications to the system.

Mr. Furusawa made the following statement:

As I mentioned in the gray, we are ready to support the staff proposal, but I just have one comment. I did not touch upon the cap, so I have just one comment on the cap idea. I think, needless to say, the merit base should not be distributed more than necessary as a consequence of high turnover. There is no doubt about it. But at the same time, we should also address the controversial issue on how to deal with the situation of when the size of the merit pay envelope turned out to be insufficiently small, as Mr. Lushin said.

In order to judge an appropriate level of the merit pay, we should go back to the fundamental question of what the rationale and the objective of the merit pay are, and I would like to hear staff's view in this regard.

The staff representative from the Human Resources Department (Mr. Clarke), in response to questions and comments from Executive Directors, made the following statement:

There were a very large number of questions and comments to staff in the grays, most of which I think fall under five broad themes. My colleague Annalisa Fedelino and I will organize our responses around these themes.

The first is the proposed budget allocation for skill upgrading; questions varied along the lines of is the 0.5 sufficient to meet our HR objectives, what has it bought us in the past in terms of skills and diversity, how long will this process requiring skill upgrading continue. I will present a few thoughts on these questions. First, we meet our HR objectives in this area in two main ways. First, there is the long run trend in upgrading the work force, when, for example, separating staff are replaced systematically by more experienced professionals at higher grades, or, as we saw during the downsizing, when lower graded functions are eliminated or outsourced or staff at those levels are simply not replaced. The second of course is the internal upgrading of our own staff, which, as we discussed in the previous meeting, helps to ensure that the Fund has the capability it needs in terms of skills and experience.

In the past year we have had good success on these fronts. The Fund hired more specialists with financial sector skills relative to previous years as well as more experts with fiscal and debt policy skills. Generally, these experienced professionals are recruited higher up the grade structure, typically around A14, well above the average grade. Additional information on recruitment we can provide in the paper for the 2011 compensation round which is coming up next month.

As we explained in the paper and in our earlier discussions, these internal promotions and the acquisition of new skills are critical components of the Fund's business model and the way we manage our talent. In some combination, these elements are an enduring feature of the Fund's staffing strategy. What this exercise that we are undertaking at the moment has underscored is the need for these underlying individual personnel decisions to be grounded in our strategic work force plan, supported by HR policies on promotions and hiring that enable the Fund to meet its strategic objectives in a cost-effective and, I would say, coordinated way.

In this vein, again as we have mentioned, a great deal of work is under way in the building to introduce work force planning at a corporate and a departmental level and to recalibrate our promotion policy to be sure that those who are promoted in this proposed more constrained framework have the performance, the potential and the readiness to advance in the organization. But this is a work in progress, and 0.5 percent is really only a first best estimate of the expected additional structural cost of these developments over the coming years. This is why we propose that the allocation be reviewed every three years so that we can indeed learn as we go.

A second broad theme was the link to pay for performance, will the proposals maintain the strong link to performance, what share of staff will be eligible for merit pay, and then we had a more almost philosophical question a moment ago. The thrust of the changes will preserve the strong link that has existed for some time between pay and performance in the Fund. By separating the overall increase into its two component parts, the structure increase and the merit increase, and allocating each according to one of the two distribution methods that we currently use to allocate the overall salary increase currently, that is the position and the salary range and performance, the overall degree of differentiation can remain unchanged. I say "can remain unchanged" because distribution of merit pay is a matter that is taken up with management every year, and it is not part of the system that we are proposing to reform today.

What we can say more definitively is that the new system will heighten awareness among staff of the rewards for strong performance. This is the case, because with a structure increase awarded to all satisfactory performers on May 1 and a smaller merit envelope distributed on July 1 purely on the basis of performance, the differentiation of merit increases will by design be significantly sharper under the new system.

Underlying this, the Fund has a very robust performance assessment system which was changed a few years ago to sharpen the focus even more on top performers in any given year as well as to encourage ongoing feedback on performance. There are three rating categories, with 15 percent in the outstanding category, 15 superior, and up to 70 percent effective. Merit pay is directly linked to these ratings.

As we indicated in the paper, staff whose performance is considered unsatisfactory will not receive a structure increase and will not receive a merit increase. That is the policy currently, and that policy will not change.

The staff representative from the Office of Budget and Planning (Ms. Fedelino), in response to questions and comments from Executive Directors, made the following statement:

The third theme was the role of the Executive Board in the proposed system. A few Directors expressed concerns in the grays that separating decisions on structure adjustment and merit pay would undermine the oversight role of the Board on salary increases. This is not our view and certainly was not our intention. Not only would the proposed system preserve the current level of Board oversight but it would actually enhance it. The proposed system will also give an opportunity to the Board to play a stronger role in defining the salary budget and also provide more strategic guidance on matters related to salary management.

The proposed system would continue to require the Board to approve the structure adjustment, as my colleague just mentioned. The Board will also approve an allocation for skill upgrade, and a salary budget that ensures that the envelope, the dollar amount that is generated through salary erosion, is distributed in a budget-neutral way as a merit increase to staff.

So, we are now identifying and costing the salary components more distinctly and more transparently; the Board will thus have a stronger role in monitoring, assessing and reviewing those costs. Finally, we will report to the Board on a regular basis about the merit envelope, and its use.

The fourth theme was the deflator. This appears to be one element of the proposed system that everybody approves of. There was one question, though, about the extra margin generated by the inclusion of the comparatio adjustment in the staff component of the deflator, what that margin was for, and whether eliminating it would now undermine the delivery of essential activities of the Fund. It is useful to recall why that comparatio adjustment was included in the deflator. We faced exceptional circumstances at the beginning of the restructuring and an exceptional level of uncertainty. We had the certainty, though, that we were entering the restructuring with a staff profile in terms of skill mix and grade composition that was not as rich as the one we aspired to have for the Fund today. So that extra margin built in the deflator was precisely to accommodate those costs. As my colleague just said, we hire specialists, we hire experts, and these people come in at higher than average grade levels.

Having said this, these exceptional circumstances have now receded with the restructuring behind us. We are now asking for an explicit budget allocation to cover the costs of skill upgrades, which incidentally is significantly lower than the margin in the deflator. Thus we can safely revert back to a more tightly defined inflator. This also implies that we do not expect this change to undermine the delivery of essential activities of the Fund.

The staff representative from the Human Resources Department (Mr. Clarke), in response to further questions and comments from Executive Directors, made the following additional statement:

There was one final group of questions on the issue of a possible ceiling for the annual merit increase. There were not as many questions as there were comments. Several Directors suggested an upper limit on this annual merit increase. Some Directors also suggested a specific number for the ceiling on the order of 1.2 percent to 1.5 percent. On the notion of a ceiling itself, we continue to be of the view that a ceiling is not necessary. As Mr. Lushin just reminded us, there were only a very few occasions in the past with a significantly larger comparatio adjustment, with most years fluctuating fairly tightly around this 1.7 percent average. Directors remember very well the chart, the paper, and the presentation that we offered in the informal session.

Introducing a ceiling could also undermine the shift to a dollar envelope that is directly linked to the budget. And finally, just in terms of upticks if nothing else, introducing a percentage ceiling as part of the system itself would again invite false comparisons if the percentage number is inevitably going to be added to the structure increase.

Having said this, if the ceiling were to be introduced, we would have some concerns about the proposals in the grays on both methodological grounds and also in terms of the size that is being proposed. On the methodology of the proposed 0.5 allocation for skill upgrading, it is important to understand that it is quite different in nature from the proposed merit envelope. The allocation for skill upgrading simply provides room in the budget for salary growth commensurate with the institution's needs. This is very different from the annual merit envelope, which is defined simply in our system by the salary erosion arising from turnover. Thus, the ceiling on merit pay cannot meaningfully be defined by deducting a 0.5 structural allocation from the merit envelope itself. On the level of the ceiling, we believe that any limit on the size of the merit envelope should allow a reasonable confidence interval around the expected average size of the merit increase going forward.

As we noted in the paper, the expected average size going forward is equivalent to about 1.5 percent of salaries. This is lower than the historical average comparatio adjustment of 1.7 percent. This already is, even though the system has not been adopted or implemented, a suggestion that an immediate dividend would be a moderation in the size of the merit increase going forward. And this is a direct result of the proposed limit on skill upgrading to 0.5 percent, eliminating the knock-on effect of structural cost increases on salary adjustments.

To ensure symmetry, that is, to avoid both an exceptionally large but also an unduly small merit envelope which would also pose HR challenges, a ceiling should probably also be accompanied by a floor. As we heard this morning, this is evidently an important point for the staff association as well.

Mr. Elder made the following statement:

Could I just ask a couple of questions about the final points made, please, just for my understanding? Can the staff explain to me again whether the comparatio averaging of 1.7 over the past included skills upgrading? I am still a bit confused about that.

The second point is on the floor. Would not there have been an issue with the current proposal of not having a floor? I have not understood why there is the need for a floor since the current proposal does not include one. Presumably, the current proposal would have implied a small merit increase if turnover was low, and that was your proposal, so I have not understood why the staff now no longer thinks that that would be okay.

Mr. Weber made the following statement:

These are very good questions. I thank the staff working group on salary adjustment on the budget for proposing a package of measures that offer a net improvement over the current comparatio system. I have two additional comments to what I put in my gray. First, Mr. Bakker and Mr. Ducrocq made an interesting proposal for forming a Board HR committee that I would like to see discussed further. As strategic HR and work force planning will get under way, it would be desirable to have the Board more closely involved, at least for the duration of key HR reforms. I would be interested to hear Directors' views on this.

Second, I continue to believe that a small addition to the staff's proposal in the form of a ceiling of annual merit pay increases would provide the needed comfort to many Directors and make it more broadly acceptable. I would like to stress that from my point of view such a ceiling would not be meant to constrain salary development, but to prevent spikes in merit pay which are in essence tail risks as we see in the tables. That assumption of a cap not introducing a constraint in my view invalidates the case for a floor.

I also have a problem understanding why Mr. Lushin is insisting that the comparatio would fall continuously below 100 percent if there is no constraint. Some clarification would be necessary. The rationale for a ceiling is not only to prevent very large aggregate merit pay increases due to exceptionally high turnover, but also, as emphasized by Mr. Elder in his gray, the Board will no longer approve this portion of annual pay increases, and the cap provides a safeguard against unwarranted surprises and reputation risks.

At the same time, a cap would be an adequate answer to Mr. Elder's call for annual merit pay reviews by the Board. While I understand that there may also be undershooting in exceptional circumstances, with very low turnover and very small merit pay envelopes, as Mr. Garcia-Silva has pointed out, in my view such a situation would call for a discussion at the time of the budget approval. Again, this would be preferable to a floor.

I have proposed a level for a cap of 1.5 percent that I believe is reasonable and not constraining in normal times. I would readily suggest review of such a cap at the same time with the 0.5 percent skill upgrade in three years. That seems to have garnered broad support also.

The staff representative from the Human Resources Department (Mr. Clarke), in response to additional questions and comments from Executive Directors, made the following further statement:

> Mr. Elder asked a couple of questions on the comparatio adjustment. So the 1.7 did include the skills upgrading, but only the knock-on effect. It is this floating versus fixed anchor metaphor that we used in the presentation for Directors. The fact that the skill upgrading occurred during the course of the year had the effect on the comparatio system that, at the end of the year, when we measure the comparatio, the average midpoint was higher than it was at the beginning of the year. So it is the knock-on effect and that increases the difference from average salaries.
>
> The question about why a floor now, we are not proposing a floor and we are not proposing a ceiling. The notion of symmetry is probably important here, inasmuch as we want to avoid excessively large or you may want to avoid the happenstance of excessively large turnover generating very large merit pay in a given year. The reverse could be true.
>
> From an HR perspective, I think we would want to have some certainty that it would be a reasonable amount of merit pay to reward the people for the previous financial year. I think it is in the context of the notion that some element of merit pay is going to be held back in a given year when a ceiling binds, which by definition would temporarily draw us away from our competitiveness, the notion that there would be a floor to assure ourselves that we do not get so far away from competitiveness grounds in any period of time. So it is not a proposal that we made in the paper, and it is, I would say, a logical counterpart to the ceiling.

Mr. Kiekens made the following statement:

> I am the 24th Director that has not yet spoken or issued a gray, probably even on purpose. I was very comfortable with the existing system, and there was no need to have confusion about the existing system. It was simple and straightforward, and, in my view, transparent. I am not even sure that the widely praised transparency that we have now adds to transparency. I simply remind Directors that Mr. Clarke felt compelled to explain once more and warns once more the Directors that there is a significant difference between this additional budget of 0.5 for a skills increase and the merit envelope. This only shows that there are serious risks of confusion going forward.

The system was very simple. When the comparator market indicated an increase in average salaries of, say, 3 percent, the Board took one decision: we will increase our budget allocation for staffing costs by 3 percent, full stop. That was it, and I think that will continue.

In addition, we saw, because we recruit people below a midpoint, that the Managing Director had latitude to give merit increases, the so-called comparatio, as there was erosion when people left the Fund and so forth. Yet there never should have been the confusion that salary increases are excessive by making the addition of the structural increase and the so-called comparator increase. I always took care not to confuse my authorities about that. If the structural increase was 3 percent, I reported that the salaries midpoints increased by 3 percent and not by 4.7 percent, full stop. Those that did not take that precaution were indeed adding to the confusion. That's the first observation.

My second observation is that we agreed on a policy over the last couple of years of the so-called constant real budget. That is a matter of convention. We need to agree on what the constant is. We agreed last year on what the deflator should be, and that agreement was the structural adjustment plus an additional amount that the Managing Director in our judgment needed in order to keep the staff as it is skillful enough to do the job. If that is a convention about what the real budget is, I was perfectly comfortable with that.

Some Directors were not comfortable with that, and we welcome now something more complex, which is to say we have a budget explicitly dedicated for a skills increase set this time at 0.5. And I hear that some say, "Well, this 0.5 is not enough." Certainly it is not enough, but will it prevent the Managing Director from upgrading the staff? Absolutely not. If the Managing Director sees the need to upgrade the skills of the staff, he should do so, and he will do so. Even if the budget for skills upgrade is only 0.5, he can use 1 percent or 1.5 percent or 2 percent or 3 percent, whatever he finds appropriate, but within a given budget, and that budget is whatever we decide. If we decide it is conventional or real, that will be the budget of last year plus 3 percent of structural increases.

How can he upgrade the skills? Simply by recruiting less and more expensive staff. That is what he did in the past as well. If the budget is reached and he wants more skillful or more costly staff, he has a policy of vacancies. All this should not constrain too much the Managing Director in managing the staff in accordance with the needs. The only thing that we, as a Board decide on is what the amount of dollars is the Managing Director can spend. The rest is for him, in my opinion.

Now, I do not care too much whether we spend US$700 million or US$800 million on the staff. For me, there is a much more important issue, which is whether we have value for the US$700 million or the US$800 million. Here again, this is a matter of confidence in the Managing Director and in the staff team, the HR team, whether for the amount that we make available we have the skills and the quality that is deserved. I think that should be the focus of our policies.

Now, Mr. Bakker and Mr. Ducrocq propose an HR committee of the Board in order to work on that. I am quite reluctant to support it. There is often the complaint that we micromanage. If we set up an HR committee, I think that would be a clear example of micromanaging. We do not and no longer discuss surveillance topics, as we should. We have lapse-of-time basis. If we have no time to discuss surveillance, we should certainly not spend our time on issues and details on the renovation of buildings and HR business. I think we have management for that, and I expect the Managing Director to do the job as well.

I can broadly agree with all the proposals that are on the table, even if I do not see an urgent need for them, but for me it is fine. I think that separating in time this new comparatio which is now called a merit envelope and the structural increase will help avoid the confusion. I agree with that, but we should not deny that it will add administrative costs, because we will have two rounds of distributing the structural increase based to some extent on merit, and then another round to distribute the merit envelope and two rounds for adjusting the salaries. All this will not be costless, but if this is necessary to avoid confusion, let it be so.

The Acting Chair (Mr. Lipsky) made the following statement:

Perhaps in light of Mr. Kiekens's remark it might be worth reminding Directors of the report of the working group of Executive Directors on Executive Board committees that was chaired by Ms. Lundsager. With regard to the idea of a human resources policy committee, I will read from the report:

"The working group considered but did not recommend reestablishing the HR policy committee." And parsing through to the end: "The working group does not recommend the establishment of such a committee, since the issues that would be addressed would be expected to be considered by the full Board, in any event."

Mr. Lushin made the following statement:

In response to Mr. Weber's question, I have two remarks. If the proposal on the cap is to protect the system against spikes caused by excessively or extremely large turnover episodes, then I would understand this. If the cap is proposed at the level of, say, 2.5 percent, this will give us the protection about the tail events indeed. But the proposal of 1.5 percent is below the average of 1.7 percent comparatio adjustment, which means that if we set the cap at 1.5 percent it will systematically cut the dollar amount allocated for merit increases derived as a carry-over from the last year. I can understand the idea of looking at the tails and eliminating spikes, but for this reason the cap should be of a different magnitude.

Turning to the link between the comparatio and the cap, and the staff can correct me if I am wrong, but my understanding is that a comparatio of 100 percent is only possible if we allocate all our salary savings in the previous financial year to the merit increase for the next year, and the cap could prevent us from doing this. If for several years in a row, even if in one year we use the dollar amount for the merit increase below what was saved from the previous year, this will give us a comparatio below 100 percent. Maybe the staff could comment on this idea.

Mr. Kiekens made the following statement:

Mr. Lushin is right and to the mark. One of the most fundamental principles of our remuneration system is that on average salaries are paid at the midpoint, period. I do not see a need to change our practice of the past, since we never applied a cap formally, although there have been years where the full comparatio has not been paid because we had a significant structural change and delayed the comparatio; we limited the comparatio. That was accepted by the Board, and I am sure that that will be accepted in the future, too.

If we want to formalize that, we could do that, but that would then set a formal cap at clearly above the average of the comparatio, maybe a standard deviation above the comparatio, and probably with the provision that a capped or not paid comparatio is then carried over for the time that the comparatio appears to be below the average.

That was informally the practice in the past already. I can certainly not agree with a cap set at the level as proposed by Ms. Lundsager, because then we would indeed have the outcome that Mr. Lushin outlines, that the average salaries will become below the midpoint, and that is a deviation from the present system that I strongly oppose.

Mr. Weber understood that the comparatio included not all but part of the 0.5 skills increase, meaning that the average 1.7 comparatio adjustment included what was budgeted for explicitly under the new system, at least partially. So the 1.7 comparatio adjustment could be a high cap, but it was not the one that would reflect the erosion.

Mr. Sidi Bouna, referring to paragraph 17 on how the merit envelope was calculated, asked whether it was possible theoretically that, for any year, the budgeted salaries would be equal to the actual salaries, and therefore there would be no merit budget to be distributed.

Mr. Bakker made the following statement:

I think it might be important to again remind ourselves where we are coming from. This chair has always been in favor of a rule-based system. I think that is extremely important. At the same time, we have to take into account the political reality outside this building. And while we may ourselves at times see the determination of a merit envelope as a technical exercise, we need to be mindful that our governments are under scrutiny in their parliaments on this and that they look at this with a critical eye.

Where we are coming from is that last year I had to abstain. I think that might have been one of the first times this chair has ever abstained from a salary proposal, although it was based on rules, because the rules led to an outcome which I felt I could not explain to my capitals. So I think it is very important to remind again that we need—and I am very grateful for the work in the working group—to come up with a rule-based system which might depoliticize as much as possible the discussion.

But we need to be comfortable with that. We cannot have proposals which will not exclude unforeseen, unexpected outcomes, as we had last year, which was an unexpected outcome. The staff had indicated a very different outcome. We cannot have a system where we do not know whether such an unexpected outcome will come again, so I would ask management to reconsider and accept a proposal for a cap. If management feels it is needed to have a smoothing mechanism by way of a floor or something, I would be open to look into that, but I think that we would be well-advised to reconsider the proposal and have a ceiling.

Now that I have the floor, on the HR committee which Mr. Ducrocq and I proposed, I was aware of the discussion last year in the committee. We should remind ourselves that the World Bank has an HR committee. I am told that they have a lot of meetings, which actually helps to make the Board meeting more smooth, so there is always a tradeoff on what we think is the most useful. But my intention, and I am sure Mr. Ducrocq's intention, was not at all to have a committee to micromanage; quite the contrary. I feel that there are so many strategic issues which are closely aligned to HR policies that they merit more attention of Board members.

We will have a new Deputy Managing Director, Minouche Shafik, and it might be a good idea to at a certain time, when she is a little bit more accustomed to how the Fund functions, to have an informal meeting with the Board with her in which we might, for instance, discuss the outcomes of the staff survey. I am not sure what the outcome is, but if, for instance, the staff survey would show that staff morale still is not very good that is not only an issue for management but also for the Board.

So I think it would be useful to have an informal discussion with the Board and make an inventory of issues to take up, and, in that vein, whether then we will decide to come to an HR committee or not. We could see that further, but I think that this Board is well-advised to stay closely aligned with HR policies.

Mr. Luo made the following statement:

I thank the staff for the paper and the response. I would especially like to take this opportunity to thank Mr. Portugal for his efforts and contribution on this issue. We appreciate that. I notice that the staff paper actually is a product of a compromise of all parties, and I notice that some Directors still take a very cautious attitude on some issues. I would say that this cautious attitude should be encouraged. In this institution, we should pay special attention to our expenditure, especially for the lending facilities, and also including the staff salaries. However, that said, I would like to remind Directors that we should always keep in mind that we need to keep the competitiveness of this institution, like Mr. Shaalan and Mr. Kiekens mentioned. We should think about how to keep that competitiveness. There was a tradeoff on that. Should we keep that or should we downgrade that?

If we downgrade this institution to a second-class institution we still have a lot of room to cut. We still would not have enough. But if we want to keep it as a first-class institution, we have to pay first-class salary. That is common sense. So I would say that we should think that over. I heard that right now the Fund's salaries are lower than the Federal Reserve or the FSA in the United Kingdom. I do not think that was the case more than ten years ago, when I worked here.

I think Messrs. Shaalan, Kiekens, and Lushin have worked here much longer, so they could make the comparison. I would say that is an erosion of our competitiveness. I do not want to see this trend continue, and, if that trend continues, someday our institution will be downgraded to a second-class institution. Nobody will care what we say or what we advise to other people, so we should keep that in mind.

But there is a tradeoff. That is not to say that we should pay much higher salaries to our staff, but paying reasonable salaries is warranted. As the staff mentioned, the staff morale is also our concern. I have heard some feedback from staff from time to time and the morale is a problem right now; I have heard questions such as whether to work here or there. New EPs should be more competitive here, but we face the problem of low morale.

That said, I would say that on the cap and floor issues, generally speaking I could go along with what Mr. Lushin suggested. I do not think the cap is a necessity, as Mr. Shaalan mentioned, but if somebody insists that we should have a cap, we could be flexible on that. The midpoint definitely is not a proper level for that. We should set a higher cap on that and also a floor on that. There is a band that should be flexible.

In terms of the 0.5 percent budget allocation, like Messrs. Shaalan, Sidi Bouna, and Lushin, this chair still thinks that it is a little bit conservative based on what I just mentioned—the competitiveness of this institution.

Mr. Ducrocq made the following statement:

I thank the staff for the technical answers this morning. Mr. Kiekens reminded us of the functioning of the previous system. On our side, we had considerable difficulties in explaining it and convincing our authorities. Like Mr. Bakker, we had to abstain last year, and many other chairs had to do the same choice, so I think there is no need to come back to that old system. There was clearly wide discomfort at the Board with the system, and this led to reviewing it and setting up the working group and the proposed reform that we are considering today.

On this basis, we think that management's proposal is a step in the right direction, it is clear, but it is not enough to command broad support. With Mr. Bakker, we advocated for a cap in our gray, and I think Mr. Weber elaborated on this proposal this morning very clearly. He explained very clearly that there is not any constraint we want to put on management and that it is about giving a broader element of comfort that would enable us to reach a consensus.

And I do not think that the argument of a floor, of the symmetry, is convincing at this stage, because it would basically lead to come back to the option two of the first staff paper, the range that was ruled out by staff at that time, and I do not understand why we should go back to the previous discussion we had a few weeks ago. So like Mr. Bakker, I would ask management to reconsider its proposal and include a cap, as many other Directors asked in their grays.

I just have a last point on the HR committee. Very much like Mr. Bakker, we think indeed that HR issues are strategic issues. It is customary in Board farewells to say that the best asset of this institution is the staff. But currently the Board basically meets twice a year on HR issues, once on salaries, where we barely discuss HR issues, and once on diversity at an informal Board meeting, not even a formal Board meeting, so there are no summing up and therefore no guidelines for management and staff. I think it is hard to say that the Board is involved in HR policy issues, that is why we suggest thinking again about it, and we will probably have this conversation again with Ms. Shafik when she is among us.

Mr. Rouai made the following statement:

We did not address in our gray the issue of the cap because we did not see its usefulness. Since now we are discussing this idea, I agree with Mr. Lushin and Mr. Kiekens that if the issue will be on the table, the level of the cap should be at least higher than the average level of the comparatio adjustment, and it should also allow for the possibility of carry-over.

In addition, I would like to put on the table the contribution of our staff to the financing of the budget through the non-compensated overtime. I would like the staff to assess this amount and see why it is not a liability in our budget. Perhaps there will be an increase in merit for the staff in some year, but we never talk about what the staff is contributing. I would like to discuss this issue in the same manner.

Mr. von Stenglin made the following statement:

I would also like to thank the staff for their clarifications this morning, but I have two remarks still. As we stated in our gray, we would have preferred more time to assess the proposal in depth, and therefore a timely review of the new system is key to my authorities. I can only support a decision today if I am assured that a review would take place within three years, as also requested by some other Directors, and I would also like to request now that this could be or should be incorporated either in the decision or in the summing up at least.

Like many Directors, I am also in favor of a cap on merit increases, and I believe that it should strike a balance between a meaningful merit envelope to provide an incentive to the staff and avoiding overly high merit increases. Having seen Table 5 on page 14, I draw the conclusion that 1.5 percent seems to be a reasonable figure for this cap, and I hope we can agree on that.

The Special Advisor to the Managing Director (Mr. Portugal) made the following statement:

I think it is a bit of an anticlimax after so many good farewells to be here again speaking, but I hope that this is the last time because I hope to travel on Friday, so I very much hope that we finish this discussion today. I would like just to explain a little bit what we did when we started this exercise. We had three overarching objectives to achieve, and I think with this proposal we achieved the three of them. One is to ensure that our salaries remain competitive by aligning the actual average salaries to the midpoints through a rules-based system; the second one was to ensure budget discipline and budget neutrality; and the third one was to ensure that there are sufficient funds available for this process of skills upgrades, but budgeted in a transparent way, which would allow the financing of both growth promotions and hiring of people above the midpoint.

There was a fourth objective, which we also achieved, which was to try to avoid this mistake of people summing the structure increase with the comparatio, an issue that has led Board members to abstain in the past. The way to do that was to have a dollar budget envelope, rather than a percentage.

We discussed also the fifth objective, which is to avoid volatility. But in the end we did not pursue that objective, because, as Mr. Lushin has said, it appeared to be of a lower priority, since this high volatility happened only twice in the period of ten years with the comparatio increase being above 2 percent, and only once when it was below 1 percent. Because these were rare events, we thought that was maybe a lower priority objective, and, if we pursued it, probably we would not achieve the fourth objective of avoiding this idea of people summing the percentage of the comparatio with the structure increase.

But this issue was discussed in the working group, and one of the proposals of the working group was exactly to have an interval, which is a cap and a floor between 1 percent and 2 percent. The reason why we did not go through that proposal was exactly to avoid the compromise that this would create with the fourth objective of not having a percentage.

Now, it has been said here that a cap would provide comfort to the Board. In fact, we have a cap, which is a dollar amount that the Board approves, and the Board will continue to approve that. There is a dollar amount. What nobody approves, neither the Board nor the staff, because it is not in our control, is what the turnover is going to be. The turnover is exactly what determines that dollar amount or that percentage, but we did an overall cap which the Board has already approved.

Now, I see that there is a lot of support for the idea of having a cap, and I think we should always try to reach a compromise. I would very much like to gain the support of Mr. Elder on this, but not to the cost of losing the support of Messrs. Lushin, Kiekens, Luo, or Rouai and many other Directors who have mentioned it. I think the important thing here, if you go for this idea of a cap and a floor would be what the numerical value of that is. Mr. Weber said that it should not be constrained, that it should only avoid tail risks and unexpected outcomes.

My impression is that if we use the average it would be too constraining. If we project what the average comparatio adjustment would have been with the skills upgrade being limited to half a percentage point that would give an average of 1.5 percent. And then if we, for instance, add one standard deviation, as Mr. Kiekens had suggested, that would go to 1.9 percent, which is close to 2 percent which this working group had discussed. Mr. Lushin had proposed 2.5 percent.

I think we would also need to include a floor, as the staff has mentioned here. If we want to avoid unexpected outcomes, maybe we should avoid unexpected outcomes in both directions—an unexpected outcome of having too much money to distribute and then an unexpected outcome of not having any money or not enough money to distribute. I think that was a point that the staff made very clearly.

I think if we have the caps in the percentage that have been indicated of 1.2 or 1.5, probably it would lead to what Mr. Kiekens had said, a breaking of this rules-based system of getting the average salaries adjusted to the midpoint. It would be kind of a back-door and non-transparent way of limiting the salaries, where what we really want, as I understand it here, is to limit unexpected events and to limit tail risks. If that is the case, then I think we have to be somewhere above what the average has been. Those are my comments, and I do hope that a compromise can be reached today.

The Acting Chair (Mr. Lipsky) made the following additional statement:

Speaking for management, I can say that our Special Advisor has been eloquent and persuasive and recognizing that there is support by many Board members for a cap; it is also clear there were many Directors that were reluctant to move this way. It seems that in the spirit of compromise in reaching a solution we could accept a cap if it was clear, as Mr. Portugal has said, that it was not perceived as a back-door way of deviating from the basic goal of the salary adjustment system, of the rule-based system, and by including a floor that makes it sensible and perceived as fair. We could go along with that. I will turn to staff to discuss what we might be able to see.

The staff representative from the Human Resources Department (Mr. Clarke) noted that, looking at the expected average going forward, based on simulations using the data from the past, the result would be a 1.5 percent average. One standard deviation was exactly 0.4, according to calculations, which would give a calculated ceiling of 1.9, very close to 2.0, and, on the other side, that would give a floor of 1.1, again quite close to 1.0.

Ms. Lundsager made the following statement:

I want to thank Mr. Portugal for all the work he did on this. I know he has been quite dedicated and that, having been on the Board, he appreciates our need for something transparent, and, as many of us have said, something that we can explain back to our capitals. Thank you for his efforts on that.

It is a key point, what we can explain back to our capitals. This was Mr. Bakker's point earlier, and it is very important, especially in the current environment when we are all going to be going back for the next set of reforms that we approved just this last year to get our legislatures to approve those as well. So it is very important. We continue to get intense scrutiny on the budget, on the salary structure here, so we do have to find a way to go forward so that we can defend it and get the support we need to be able to go forward on the broad support for the institution.

It is very important that what the staff has proposed is a lot more transparent, so I very much hope we would see regular reporting. It would be helpful to get a sense of what is happening on the vacancies recruitment during the year. If we can find a way to do that, that would be appreciated by all of us.

Regarding the cap, I do think it is very important that we have one. This comes back to maintaining the political support. I just cannot go up to what staff and Mr. Portugal are proposing here. I can go only a little bit above what I proposed in my preliminary statement. I do not think we need a floor, either. This comes back to the point Mr. Weber made earlier. If we really end up in a situation for several years where we have no money for structural because there had been very few departures the year before and yet management feels the staff has been performing in a stellar fashion, I have no doubt that we will see a request for a supplemental budget, and then the Board will consider it. I do not see a problem with that. I am not in favor of including a floor in that, too, but 1.9 is just much too far for me to be able to go.

As we go forward, I do think it is important we continue to review. As Mr. von Stenglin was saying, we have the 2012 compensation benefits review. I think it is good to come back and look at the whole package of compensation here as well, not just the salary structure.

Mr. Kiekens made the following statement:

I can agree with the proposal formulated by Mr. Portugal, but I would like to point out two things. When we adopt a cap, in fact we expect that the full budget allocation appropriation for staffing will not be fully used because there is erosion and there is more erosion than we expect, and then we say okay, we are not going to cover that erosion fully by the comparatio, and so we expect the Managing Director to not fully spend the budget that we are comfortable with, unless the Managing Director then decides to spend it otherwise by recruiting more, if we do not set a cap on the number of people, or by promoting more than he would have done. There is ample room still with a cap to spend fully.

I wonder what the purpose of the Directors is to limit the budget spending on staffing or to say, "Well, we cannot agree that a well-performing staff member receives a merit increase which is above a certain number," even if the Managing Director has nonetheless ample latitude to say, "Well, since staff performed well, I will reward staff with not only a comparatio adjustment increase which is capped to 1.9, but with a promotion." We should be aware of the limitations and of the flexibility that the Managing Director has.

Second, when we would set a minimum for the comparatio, that would require in principle that the Managing Director asks for an additional budget, unless, again, he is smart and says, "I do not ask for an additional budget and I will keep a little bit more vacancies so that I can pay a comparatio which is higher than what is normal and I will manage nonetheless."

My third observation is that we want to have in principle salaries that on average are at a midpoint. When we set a cap, we agree that at least for that year it will be below the midpoint. And then we have two instruments to compensate for that over time, either by setting a minimum or by carrying forward what we do not pay this year to the next year.

My preference is for the carry-over rather than to set the minimum, which also avoids the Managing Director needing to ask for an additional budget. What I fear is that many Directors will say, "Well, we cannot agree with an additional budget, the comparator market indicates an increase of 3 percent, we will have to do it with 3 percent more, the rest is not our problem." If we set a cap, the Board will say, "Well, we should save it." I think we should allow, when we set a cap, the carry-over, and we should not use a minimum, but I leave it to the judgment of the Board as a body to decide on this.

Mr. Shaalan wondered what the use of the cap was, as the Fund lived without it for many years. The staff should explain why or in what way the new system would be a better system than the one in the past.

The Acting Chair (Mr. Lipsky) explained that the new proposal for a cap was considered in a desire to reach a solution and a compromise. It was not the staff's proposal.

Mr. Lushin made the following statement:

Let me make just one observation from the beginning. It is often said that we are now discussing a new system. I think that this is not true. What we are now discussing is a new presentation of the old system, so nothing has been changed in essence; only the way we are presenting changes to the outside world. The cornerstone of the current system would modify the presentation of the system. The cornerstone of both systems is a comparatio of 100 percent, so we maintain average salaries by grade at the midpoints. This is, in my view, the backbone of the whole approach.

The introduction of the cap, to my understanding, is a transition to a wholly new system, a system which deviates from the major assumption of the previous one, which is a comparatio of over 100 percent. This is what is being promoted through the back door. The introduction of the cap is a back-door introduction of a radically new system which is difficult to agree with.

Now, what about the possible compromise? The range of 1 to 2 percent is acceptable, but Mr. Kiekens has a better proposal; that is, to have a cap of 2 percent, which would definitely help us to deal with the tail events, and at the same time have carry-over. That is, what we remove with the cap in one year should be distributed to staff in the merit pay increase the next year. This is the way to at least have a comparatio equal to 100 on average. It may be below 100 percent in any single year, but on average it will be restored to 100 percent in the next year.

If this is acceptable I can go along with this. But again, a 1.5 percent cap, or even lower, is a new system. It is a new system which we are not prepared to discuss right now because it undermines the whole basis of our approach to keep the competitiveness at midpoints in grades.

Mr. Elder made the following statement:

I would like to say that we agree with what Ms. Lundsager said: we would not be able to go along with the compromise as suggested, I am afraid. I told management and the Board where I can go to, and I cannot go any further. I have checked, and I am confident on that.

The second point I would like to make is that I think we are getting slightly bogged down in points of principle, and perhaps we need to focus a little bit more on points of actual change. Although it may be true that having a cap that is close to the average may cause very small downward drift. It would be very small based on the numbers. It would be tiny. The idea that this would cause a great problem I think is overstated. In point of fact, it would be imperceptible.

I think that in principle I accept the point; but in practice, based on the numbers that have been shown to us, it seems as though the cap is set above the average. It would be unlikely to constrain too often, and, if it did, I think the difference would be small. And therefore, although I accept the principle, I do not accept the practice, particularly as in a year's time, we will be reviewing the level of pay and there will be ample opportunity at that point to correct any problems.

Now, when we talk about downgrading the organization, there is no desire whatsoever for this chair to achieve that. Our desire is to make sure that pay is ample to deliver the objectives that we all share. One of the difficulties I have when we discuss levels is that I am not being given any information about what is happening in terms of staff morale, in terms of hours, in terms of turnover, in terms of retention and recruitment.

The United Kingdom would be the first to respond to any warning from management that there was a genuine issue with any of those in terms of pay. I think that when we have a pay review next year we would very much welcome all of that information; and then, if it is clear that pay is not sufficient to deliver this first-class organization that we all welcome and value, then we would be the first to respond to that. But I find it difficult to respond to respond to anecdote, and I would much rather have proper management information that tells us there is a problem with pay, and I would very much encourage management to share that information with us when we have a proper levels discussion.

All we are talking about now is the transition from one levels discussion to another, and if it is slightly conservative and causes a slight bit of drift, that can easily be corrected at three-year intervals, and I fail to see that that would generate a significant problem for this organization.

Mr. Weber made the following statement:

Mr. Kiekens pointed out very pertinent issues. It is not our intention to complicate actually what is in essence a very good proposal. Introducing a band would complicate the proposal, especially the fact that if we have a floor that is non-zero we would not stay within the approved budget.

That said, and starting from what we discussed on what the goals should be to avoid surprises that could also have a political fallout, I could go along with a somewhat higher ceiling, too. That is not so much the issue. It is not about constraining and trying to introduce a system that would cause downward drift, in our point of view, so anything that is below 2 percent would actually be acceptable for this chair.

Now, on the midpoint issue that was mentioned, in my view this would be an issue that the structural increase would have to address, because under this new system also the structural increase would be about moving people to the midpoint, so maybe more information on that would be helpful.

Mr. Rouai was willing to join the consensus if there was a cap with a ceiling of 2 percent and, as was mentioned by Mr. Kiekens, to allow for a carry-over. He did not accept a floor in that case.

Mr. Pérez-Verdía made the following statement:

Every time we discuss issues on salary I come in to the meeting thinking I have fully understood them, and I learn something new from people that have been around for a while, the obvious experts around the table. Let me abstract for a little bit and tell Directors how I am thinking about it. If we were producing apples here and we had a 50 percent drop in our work force, we would look at the marginal product of the workers left over and adjust their salary likewise. If the marginal product stayed the same, we would see a 100 percent increase.

When I see the work that the Fund is doing, what we are focusing on is an unusual turnover that might happen once in a blue moon, and what we are trying to do here is telling the Managing Director or management how to spend that part that is left over from the turnover. I think, like Mr. Kiekens pointed out, it should not be binding anyway, because this pot of money can be distributed in many different ways. A Managing Director that faces a 50 percent drop or a large drop in staffing would probably not distribute all that money to the people that are left on staff. There is the issue of also carry-over. We should be able in principle to distribute it in the following years.

But I also understand the problem that other Directors face in terms of perception and worrying that this is going to happen. My question is whether a suitable compromise would be to leave the proposal as it is on paper, but put a cap around where some of our colleagues are talking about, take this cap as temporary, and discuss it in the three-year review that Mr. von Stenglin talked about. So temporarily, and probably in a period that we will not even need to use this cap because we are currently hiring, we could then maybe review it with more experience.

The Acting Chair (Mr. Lipsky) noted, in order to give some perspective to the discussion for those who were new to the Board, that the current level of real salaries was down 13 percent from before the downsizing, so the Fund was producing the output during the crisis while spending in real terms 13 percent less on compensation than it did previously.

Mr. Luo noted that his chair could go along with Mr. Portugal's proposal and Mr. Kiekens's proposal was worth considering. Once the decision was made, the Fund should be prepared on how to communicate with the outside world, as it was a very subtle issue that needed to be handled properly.

Mr. Bakker made the following statement:

> Let me once again say, if it is not clear, that this chair also believes, like Mr. Luo, that we should pay staff well. That is not the issue. We discussed that at the review every fifth year, so we should not confuse this discussion with whether we pay staff well or not. That comes up at another time.
>
> Second, I think the discussion shows that there might be some merit in having an HR committee, because we are all learning that some of these issues could be prepared maybe a little bit better.
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> Third, I was wondering whether there is not a lot of merit in Mr. Kiekens's proposal to have the possibility of using the carry-over. If that is the case, then my view would be that we can deal with a substantially lower cap than is proposed by Mr. Portugal, because then the system in itself would smooth out and would ensure that we reach the effects which are intended by that smoothing mechanism. If we use that carry-over, we will come out, as far as I can see—but if that is not the case, please explain it to me—at the average.
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> I was wondering whether it would not be possible to take as a starting point the 1.3 percent, which is the average under the new system, but then have some leeway there, by putting the cap at 1.5 percent, while having the smoothing mechanism which Mr. Kiekens proposed. So we do not need a floor, but we would have a system which on the whole would deliver what we would like to achieve.

The Acting Chair (Mr. Lipsky) noted that, whereas the idea was certainly understandable that every three years there was a major review and a re-pegging, in fact the review in recent years had shown that salaries were under the comparators and the adjustment had been incomplete; so in fact there was an issue because the staff felt that, although the principle was easy to enunciate, in practice it had not been followed.

Mr. Bakker noted that, if that was the case, it was useful that the Board come back to that issue. Like Mr. Elder, the Board should learn about that, but the Board should not confuse that with the discussion on merit pay, which should be linked to performance evaluation. It should not be linked to whether staff was underpaid as compared to comparator markets. The Board should be informed on that at the time of the review.

Mr. Sajkunovic noted on the issue of the cap that he saw a lot of merit in what Mr. Bakker just said, and he would encourage a close look at that idea. Like Mr. von Stenglin, he raised the issue of having a more comprehensive review of the system in a few years' time, and he would very much like to see that included either in the decision or in the summing up. And finally, like Ms. Lundsager, he would like to hear a little bit more on reporting and transparency and how that could be improved, especially around the additional structural increase.

Mr. Andersen made the following statement:

> I would also like to support the remarks just made by Mr. Bakker. And while having the floor, let me also express my agreement with those of my colleagues who have stressed that the HR issues are strategic issues and of importance also for this Board. I understand that the idea of an HR committee as we have in the World Bank was not supported last year. I think we definitely care about the output of that institution, and it is only natural to care also about the input, so somehow to have the Executive Board more involved in the oversight of HR-related issues I think makes a lot of sense. Perhaps, as also suggested earlier, to start out by having a Board meeting with the presence of our new Deputy Managing Director has a lot of merit, and we would support that.
>
> I also think that more frequent involvement of the Board gives an opportunity for the Board also to share some experience from the institutions they come from on HR-related issues, and I see many policy issues discussed in this Board that benefit from external views.

Mr. Ducrocq made the following statement:

First, I think it seems we are making progress here because now it seems clear that the cap does not have to come with a saving and that the floor would be less consistent with the budget-neutrality objective we have here, so we have solved this issue.

The second point is that obviously Mr. Bakker's reasoning is very sound in terms of what would be the level of the cap if we think in terms of saving versus carry-over. I think that is very clear.

The third point is to support Mr. von Stenglin's suggestion to have a closer review, as it would probably be helpful in making more chairs comfortable with the introduction of a cap, because with experience we would have an opportunity to come back to it and see if there is any problem and then address those problems. I think, based on these elements, if I were a special advisor to management, I would say we are converging towards a solution.

Mr. Lushin made the following statement:

I am sorry to disappoint Mr. Ducrocq, but I think that the proposal to have the cap at the level of the average makes no sense at all. Coupled with a carry-over, it would result in a situation where we will have this carry-over every second year, when actually in fact we would need to have this carry-over only for the tail events when we have very large turnover and the comparatio shooting close to way above 2 percent.

Therefore, I see merit in having a cap only as a protection from tail events, and for this reason the cap should be 2 percent with carry-over. Anything below is just the introduction of a new system which makes literally no sense. My ideal preference would be to accept management's proposal.

Mr. Elder made the following statement:

With apologies, I have one question to the staff. On page 14, Table 5, and correct me if I am wrong in saying this, but if we subtract 0.5 from Column D, we get what we believe the proposed system would deliver in past years. I do not count many occasions when the proposed cap would bind; I only count one, and that is the 2006 outlier. Now, if that is incorrect, then that would be useful information for staff to clarify.

My reading of this table is that the cap would very rarely bite, and it is an overstatement to say it would bite frequently. If it is the case that it would bind frequently, then I think that is very useful information, because I believe we are asked to consider a proposal which we expected to deliver something like an average of 1.3 percent; and if the staff is expecting the cap to bind frequently, then it would be interesting to know why the staff is expecting that.

Mr. Giammarioli made the following statement:

As other Directors, we are in favor of a cap, and in our gray we did not mention the size of this cap. After listening to the discussion today, I think 1.3 is on the low side, but 2 percent is on the high side, so we are ready to reach a compromise, and we hope to find a middle way which is comfortable for everybody.

On the issue of the floor, I think we are more sympathetic on this carry-over Mr. Kiekens alluded to, but we would like to listen to staff on what the implication for the budget of the two options, the floor and the carry-over, is. And finally, like Mr. von Stenglin and other Directors, we are in favor of a review in three years' time.

The staff representative from the Human Resources Department (Mr. Clarke), in response to additional questions and comments from Executive Directors, made the following further statement:

I have a couple of questions which we will try to address together. On the actual average of 1.3 percent—and now we are getting into more technical areas, so I apologize in advance—that 1.3 was indeed the average that we constructed using this backward-looking simulation of what would happen if we applied this new system with a constraint of 0.5 rather than a random structural increase over time. That would impart a downward bias on the merit increase from 1.7 percent on average to 1.3 percent.

There is a methodological footnote in all of the papers that we sent to Directors which makes it very clear that there is an outlier in that time series, which is 2006, when the Board changed the shape and the level of the pay line quite dramatically, and that was accompanied by a very large salary increase that year, which was not grounded entirely in the comparatio system itself. So during the education phases, if I can put it that way, of our discussion, we excluded that outlier to have a truer sense of what that average number is over time.

Now we are going forward. Now we are setting the parameters for a new system which perhaps might not be looked at again for another three years. We need to be very careful. If we look at that time series, the only other outlier there is the year immediately following 2006, which was an outlier on the other side, and that represents the overshooting of average salaries relative to the midpoints as a result of the award given in 2006. In 2006, the pay line was reduced on average by 0.4 percent and we had a very large salary increase on average, so average salaries now became for that moment in time very competitive, if I can put it that way. In the following year we had a structure adjustment, which is whatever it was. In the table, it is in the order of 3.3 percent. But because average salaries had been boosted so much the previous year, the difference between the calculated average salaries and the new midpoints was quite small; 0.7 percent is the number.

So if we are going to look at a long time series to develop an average as a basis around which we develop some confidence intervals, I think we need to exclude also the overshooting that followed that 2006. If we do that, we get an average of 1.5 percent, which is basically the starting point I would suggest that we are going to start developing the parameters of a ceiling. Ms. Fedelino may want to add something.

The staff representative from the Office of Budget and Planning (Ms. Fedelino), in response to additional questions and comments from Executive Directors, made the following further statement:

Mr. Elder had a question—we are going again into this issue of whether we can subtract the structural costs from the comparatio adjustment. The answer is no, because they are conceptually two distinct concepts. One is the cost above the structure, which is given by the changes in the grade composition of staff, while the other one is just the measurement of the salary erosion over the year at one point in time.

Now, going back to the chart that we had used in the presentation at the informal session, we have called these two systems (with uncapped and capped structural cost) the floating anchor and the fixed anchor. When we look at the column that we were referring to in Table 5, that column gives the comparatio adjustment that we would have had in the past if we had capped the structural cost at 0.5 percent.

What is missing from this table, which we had in the previous report, is the fact that staff in those years would have received the structural adjustment and also the comparatio adjustment the way it is computed, but because of the changes in the grade composition of staff, this would have cost the Fund budget a little bit more than 0.5 percent because there was no ceiling on the cost of the change in the grade composition of staff. We cannot simply subtract that cost from the comparatio adjustment. That is why we state that the average is 1.5 percent, and we cannot simply take away 0.5 percent from that amount.

The Special Advisor to the Managing Director (Mr. Portugal) made the following additional statement:

Mr. Kiekens made a valuable proposal to solve the problem of a floor, which is to have a cap around 2 percent with a carry-over, and I think that perhaps would be something that we would like to consider. I am not sure about the argument that Mr. Bakker has made, that, if we have the carry-over, then we do not need to have a cap that is large enough. Because if we have a carry-over and then, if we have a too-constraining cap, we never use the carry-over, because every time we hit the cap again, and then for several years perhaps the average salaries are going to be below the midpoint.

The other point that I would like to mention to all of you is that it is true, as Mr. von Stenglin mentioned, that there is not enough time between the time this paper has been distributed and this meeting. But perhaps Directors would remember that we had informal discussions about this, when we consulted extensively with Directors. All this has been discussed with the staff as well. We had the working group internally, and the staff association had participated on this working group, so I would be very reluctant to have a cap that deviates very substantially from 2 percent. We have seen that the average, if we exclude these two outlier years, and if we include the constraint of having a skills upgrade which is not higher than 0.5 percent, that average is 1.5 percent, so then the standard deviation around that average gives 1.9 percent. If we want to be precise about the number, that is 1.9 percent. I would be more comfortable if we could go for 2.0 percent, because that is the number that has also appeared in the working group in which staff has participated.

We are trying to reach consensus here at the Board, and I think it is very important, and we should always be prepared to change. There is a change here including the concept of the cap, but we should also think about consensus more widely with the work force. SAC had participated in this working group. They had asked for a floor which perhaps we are giving up here, but if we give up the floor and also have a cap that is well below what the average plus a standard deviation is, I think it could be a problem.

Mr. Al Nassar saw merit in Mr. Kiekens's proposal, which he was ready to support.

Mr. Elder made the following statement:

I am ever so sorry about this. I am struggling to understand it, and it seems to be the fundamental point around which we can negotiate this number. My reading of Column D is that it includes a 0.5 percent grade structural adjustment. Footnote 1 implies, does it not, that it includes the staff structural change of 0.5 percent? It seems to me that the average the staff is quoting includes 0.5 percent, and then separately we have another 0.5 percent. It sounds as though there is double counting.

I have not understood whether the numbers in Column D are higher than they would be if, for example, the staff structural change was set to zero. If those numbers would have been lower, then since we have a 0.5 percent in addition which is another part of the proposal, it seems to me that the numbers in Column D need to be lower. I am sorry I am being slow on this. It is confusing for me, and it seems real important that we have clarity on that.

Mrs. Arbelaez supported a cap of 2 percent and no floor.

The staff representative from the Human Resources Department (Mr. Clarke), in response to additional questions and comments from Executive Directors, made the following further statement:

I am not entirely confident that I am going to be able to satisfy Mr. Elder. They are two different animals, as Ms. Fedelino has explained. The merit envelope that is generated from the current system and the proposed system is in part a function of the structure within which that envelope is defined, which is to say that these simulations which cap the structural increase at 0.5 percent against a pattern in which there was some variation around that will impart a downward discipline on the size of that envelope.

But it is a budget allocation for something different. It is not an allocation for merit pay or promotion. It is the consequences of all of these underlying staff movements that generate higher structural cost for the institution within which salaries erode over time and generate a merit envelope of a certain size.

The staff representative from the Office of Budget and Planning (Ms. Fedelino), in response to additional questions and comments from Executive Directors, made the following further statement:

> Can I maybe offer an additional observation? Mr. Elder asked what would have happened if the structural cost had been zero. Obviously, the comparatio adjustment would have been lower than shown in Table 5, probably by 0.4 or 0.5 percentage points (it is not exactly a linear calculation, but close enough). Now, given that the system we are proposing includes a cost for this element (skill upgrades) of 0.5 percent, the average to look at is indeed 1.5 percent, not 1.5 minus 0.5 percent, because we are assuming that our grade structure will continue to increase by 0.5 percent every year. If we assume this cost is zero, meaning, for example, we have total control on promotions, positions and so on (or in other words, the grade composition of staff is fixed and does not change), then the equivalent comparatio adjustment will be lower. However, this is not the system we are proposing.
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> Mr. Ducrocq made the following statement:
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> Since we are talking about numbers right now, I find the 2 percent cap quite high, frankly speaking. When we have an average based on a ten-year period which is 1.5 percent, I think it is solid enough to use it as a benchmark. And if we take the average based on the old system and we eliminate the two outlier years, their range would be, if I am correct, 1.8 percent, not 2.0 percent.
>
> I would find it strange that with a reform that is supposed to improve the system, we would end up with a cap that would be even higher than the average that comes out of the old system. Frankly, the 2 percent cap is way too high and it is not convincing to me.
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> The Acting Chair (Mr. Lipsky) made the following additional statement:
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> Well, listening to my Special Advisor, he recommended a 2 percent cap. First of all, it seems clear, in the interest of reaching an agreement, that management can accept the notion of a cap without a floor with a carry-over provision. I would like to propose to go back to the original logic, which was 1.5 percent plus a standard deviation, which is 1.9 percent. It seems very easy to explain, very straightforward, and it provides the protection that Directors are looking for, and that would not run a risk of being perceived as an attempt to deviate from the basic principles of the salary system through opaque

means. I think that would represent a fair decision around which I would hope that we could reach consensus. So I entertain comments.

Messrs. Al Nassar, Andersen, Choudhary, Furusawa, Garcia-Silva, Kiekens, Luo, Lushin, Pérez-Verdía, Pokharel, Rouai, Saho, Shaalan, Sidi Bouna and Mrs. Arbelaez all voiced their support for the new proposal: a 1.9 percent cap plus a carry-over.

Mr. Weber found the logic quite compelling. Looking at the 2006 and 2007 years, he noted that there was an overshooting in one year and an undershooting in the other year and wondered whether there was a need to put a three-year time limit on the carry-over. With an exceptional year, and then an exceptional downside year in the next or the next two years, after which the system would revert to normalcy, there might be a need for a three-year carry-over period.

Ms. Lundsager noted that the proposal was too much for her, so could not go along with it.

Mr. Elder noted that he had a limit as well and could not support the proposal.

Mr. Sajkunovic would have preferred a lower number, but he could go along with the proposal. He called for a comprehensive review hardwired into the decision or the summing up.

Mr. Bakker noted that he was not able to explain the issue of a standard deviation, and asked for more information on why that was needed. His preference would be for a 1.5 percent cap. He was not certain whether he was mandated to go to the middle, to 1.7 percent, but he could not explain a standard deviation of 0.4.

Mr. Ducrocq, noting Mr. Bakker's comments, stressed that the number on the World Bank side was 1.7 percent and suggested management to consider that amount.

The Acting Chair (Mr. Lipsky) made the following additional statement:

> We conferred after the discussion. The decision that we had circulated to Directors before the meeting needs some modification, but we believe that, on the basis of our discussion before the break, we have a basis for a decision that will achieve a significant majority. I will now ask the Secretary to circulate the proposed revised decision based on our earlier discussion.
>
> We will just pause for a few minutes and give Directors a chance to read it. Hopefully, the meaning is clear. It is our understanding that this text would have the support of all but four chairs, and I would like the Secretary to

clarify the position if our understanding is correct, and we can clarify the position of those chairs.

The Secretary noted that there were four chairs that did not support the proposal. He asked them to indicate whether they were abstaining or opposing.

Ms. Lundsager and Mr. Elder each clarified they were abstaining.

Mr. Ducrocq could support the proposal.

Ms. Barendregt would have appreciated a little more information on the standard deviation.

The staff representative from the Office of Budget and Planning (Ms. Fedelino), in response to additional questions and comments from Executive Directors, made the following further statement:

> There is nothing special about the use of the standard deviation we are proposing here. It is a methodological tool for building confidence intervals around forecasts. We do this all the time with economic variables. We are simply assuming that there is an underlying normal distribution—and maybe that is not the case, but nonetheless it is a simplifying assumption.
>
> We usually build confidence intervals by taking the average or the expected average of a variable and then 1 or 2 percent standard deviations around this average. Now, as Mr. Clarke explained, the average excluding 2006 and 2007 would have been 1.5 percent. The standard deviation of the ten-year series that we computed in the backward-looking simulation is 0.4 percent. This gives a confidence interval of 1.5 plus 0.4, which is the proposed 1.9 percent.

Ms. Barendregt reluctantly went along with the proposal in the spirit of compromise.

Mr. von Stenglin had one difficulty with the revised draft decision. He was not certain whether the review clause contained all the features he would like to see reviewed. The revised draft decision contained only two features: the allocation for skill upgrading and the cap. His instruction was that the whole system—the system of the merit envelope, the new system, should be compared with the comparatio adjustment, the old system. Therefore, he could not give his approval yet, and so therefore he would like to know if the relevant sentence in the proposed decision could be changed.

Mr. Weber agreed to the proposal, noting that, on the draft decision, none of the paragraphs 11-22 and 29-30 referred to the change applied to the global deflator. He would like to see that change in the decision, too, because it was part of the package.

The staff representative from the Office of Budget and Planning (Ms. Fedelino) explained that the draft decision did not include the deflator because that would be included in the budget paper to be presented to the Board in April. That change had already been presented to the Committee on the Budget in January and endorsed by Executive Directors. It was just a procedural clarification and that was the reason why the current paper, which was more compensation related, did not include this change in the decision. Overall, the deflator was more related to budget matters.

Mr. Weber noted that the clarification was that the global deflator would only include the structural increase.

Mr. Rouai suggested taking the last sentence in paragraph one as paragraph three, because paragraph one dealt with the merit pay, and the review dealt with the merit pay and skill upgrading, so it was better to have it in a separate paragraph at the end.

Mr. Sajkunovic voiced his support for the point made by Mr. von Stenglin. He would very much like to see a reference to a more comprehensive review.

Ms. Barendregt supported Mr. Sajkunovic's point.

Mr. Kiekens noted that the merit envelope in any financial year should be no greater than 1.9 percent of the salaries of eligible staff at the end of "the" financial year and clarified that his understanding was that it was "the previous financial year."

Mr. Lushin went along with the proposal and noted that there was a sentence saying that under the methodology for determining the merit envelope, the amount greater than 1.9 percent ceiling would be carried over into the next financial year. He assumed that the amount of carry-over would be applied to the merit payment envelope in that next year and wondered if that could be stated explicitly in the decision and they could add that it would be carried over into the next financial year and be added to the merit pay allocation for that year.

The Acting Chair (Mr. Lipsky) noted that his understanding was that the wording was for clarification, but in fact was actually redundant, that through the standard methodology that would have happened even in the absence of this wording.

Mr. Kiekens agreed with that point. When referring to "carried over into the next financial year," that was understood within the limits of the 1.9 percent cap. He agreed that they would exhaust the carry-over, which could also be carried over to the second financial year, but that was logical and well understood.

Mr. Ducrocq supported the proposal by Mr. von Stenglin to clarify the scope of the review.

The Acting Chair (Mr. Lipsky) read out the revised decision and asked the Board again for its approval.

Ms. Bultitude might have misinterpreted, but her understanding was that the review was now confined just to the merit pay envelope. She did not think skills upgrade was also mentioned, and she wanted the review to cover the whole system.

The Acting Chair (Mr. Lipsky) restated the relevant part of the decision, now including the mention of skill upgrading. He then thanked the Board for its sense of compromise during a difficult meeting, and determined the conclusion was one that would be broadly acceptable to the Board and staff.

The Executive Board took the following decision, with two abstentions from Ms. Lundsager (UA) and Mr. Elder (UK):

Salary Adjustment and the Budget—A Reform Proposal

1. The Executive Board approves the proposal regarding the method for determining and distributing the merit pay envelope, including the transition steps for implementing the new system in FY2012, as set forth in paragraphs 11 to 22 and paragraphs 29 to 30 of EBAP/11/12, provided, however, that the size of the merit pay envelope in any financial year shall not be greater than 1.9 percent of the actual salaries of eligible staff at the end of the previous financial year. Under the methodology for determining the merit envelope, any amount greater than the 1.9 percent ceiling will be carried over into the next financial year.

2. The Executive Board authorizes the Managing Director to implement this system with effect from May 1, 2011.

3. The experience with the application of the method for determining the merit pay envelope and the budgeted allocation for skill upgrading will be reviewed in three years. (EBAP/11/12, Sup. 2, 03/02/11)

Decision No. 14861-(11/22), adopted
March 2, 2011

APPROVAL: May 16, 2011

SIDDHARTH TIWARI
Secretary