June 13, 2011
Approval: 6/20/11

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 11/37-2

2:30 p.m., April 20, 2011

2. Review of the Fund's Income Position for FY2011 and FY2012

Documents: EBAP/11/32; EBS/11/53 and Supplement 1

Staff: Tweedie, Andrews, and Kabwe, FIN; Leckow, LEG

Length: 32 minutes

Executive Board Attendance

N. Shinohara, Acting Chair

Executive Directors	**Alternate Executive Directors**
M. Majoro (AE)	M. Saho (AE)
	A. Ismael (AF), Temporary
	B. Lischinsky (AG), Temporary
	H. Choi (AU)
	J. Prader (BE)
	F. de Melo (BR), Temporary
	Y. Luo (CC)
	L. Jimenez (CE), Temporary
	M. Sajkunovic (CO), Temporary
	A. Ducrocq (FF)
	S. von Stenglin (GR)
	N. Choudhary (IN), Temporary
	N. Giammarioli (IT), Temporary
M. Furusawa (JA)	
	S. Rouai (MD), Temporary
	S. Geadah (MI)
A. Bakker (NE)	
	A. Gronn (NO)
	A. Lushin (RU)
	A. Al Nassar (SA)
	E. De Leon (ST), Temporary
R. Weber (SZ)	
	D. Rediker (UA)
A. Gibbs (UK)	

J. Lin, Acting Secretary
V. Thakoor, Assistant

Also Present
African Department: J. Stotsky. European Department: L. Figliuoli. External Relations Department: A. Thomson. Finance Department: D. Andrews, M. Fisher, C. Hemus, G. Kabwe, T. Krueger, M. Manno, R. Powell, S. Prowse, G. Steinberg, A. Tweedie. Legal Department: R. Leckow, B. Steinki. Middle East and Central Asia Department: E. Gelbard. Office of Budget and Planning: H. Hatanpaa, M. Henderson, H. Trines. Office of Internal Audit and Inspection: G. Kincaid, D. Nelson. Secretary's Department: P. Martin, O. Vongthieres. Western Hemisphere Department: A. Toure. Senior Advisors to Executive Directors: W. Abdelati (MI), I. Ábel (BE), M. Di Maio (AU), M. Nomura (JA), J. Poulain (FF), S. Toh (ST), M. Zaher (MI). Advisors to Executive Directors: L. Alfredsdottir (NO), A. Gerdes (GR), K. Ismail (MI), B. Jajko (SZ), E. Lambregts (NE), N. Liu (CC), M. Makino (JA), J. Tucker (AE), R. Ward (UK).

2. REVIEW OF THE FUND'S INCOME POSITION FOR FY2011 AND FY2012

Mr. Majoro submitted the following statement:

We welcome the recent improvements in the Fund's income position which have been largely motivated by reforms to the income model and the marked increase in lending programs since the onset of the global financial and economic crises. The updated outlook of the Fund's net operational income for FY11, though below the midyear projection, represents a substantial increase (44.6 percent) relative to the outcome envisaged at the start of the financial year. We are pleased that the near-term income outlook of the Fund is favorable. While acknowledging the difficulty in predicting demand for Fund financing and the sensitivity of the projections to the timing of purchases and repurchases, we welcome the projected positive outturn in the Fund's income outlook for FY12 on account of continued strong demand for Fund financing and operations of the investment account.

The proposed decisions on the treatment of the Fund's accounts are consistent with the Articles of Agreement and practices endorsed by the Executive Board and we would thus support them. We nonetheless make the following comments for emphasis.

FY11 Income Position

We consider FY11 a milestone in the Fund's efforts at ensuring a diversified and sustainable income stream to finance its operations, with the winding down of the restructuring exercise and the completion of the limited gold sales partly aimed at the provision of additional concessional resources to low-income countries. In spite of the downward revision in the projected investment income on account of markets' concerns over resurging inflationary pressures and potentially less accommodative monetary policy stance in some major advanced economies, we are pleased that the net operational income of the Fund is on course to record a strong outturn for FY11.

We note that reimbursements to the General Resources Account (GRA) remain unchanged from the midyear projections and agree that the account be reimbursed for expenses relating to the conduct of the operations of the SDR Department and administering of the MDRI-I and the PCDR, in line with established Fund procedures. On the reimbursement for PRGT expenses, we recommit ourselves to the decision that such reimbursements be forgone and that the said amount be instead transferred from the PRGT

Reserve Account to the General Subsidy Account of the PRGT for financial years 2010 through 2012.

On the disposition decisions, we broadly agree with staff's proposals, including the transfer of income to the GRA to cover administrative expenses of the Fund in FY11, given that they are consistent with the Fund's Articles and established principles. With regards to the windfall profits from the gold sales, while we reiterate our preference for the entire portfolio to be used to increase subsidy resources in the PRGT, we support the decision to have it transferred to the general reserves in the interim pending a firm decision on its use, in line with the outcome of the recent discussion.

FY12 Income Outlook

We note that FY12 is projected to record a positive income outturn on account of continued high demand for the Fund's financing resources. We are, however, concerned at the potential weak performance or short-term risk of capital loss to the portfolio of investment account not funded by gold profits if monetary conditions are tightened to contain emerging inflationary pressures. Does staff see the need for increased diversification of this portfolio to mitigate the risk of potential capital loss?

On the rate of charge, we support maintaining the margin for the rate of charge at 100 basis points above the SDR interest rate for FY12 consistent with the exceptional circumstances clause of Rule I-6(4). We note that at this rate, the Fund's intermediation costs will be fully covered and that reserve accumulation is projected to be strong and consistent with expectations on the adequacy of the Fund's precautionary balances. Going forward, we expect staff to expedite work on the new rule for setting the margin on the rate of charge.

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

We thank staff for a thorough report and support all nine proposed decisions. Against the backdrop of high demand for Fund resources, lending income continues to contribute significantly to a strong net operational income position. Together with the proceeds from surcharges, these funds are appropriately being used to shore up precautionary balances. Furthermore, we welcome the further progress achieved toward the objective of the new income model to diversify the Fund's sources of revenue, not least since lending income will abate over the medium term as observed by staff.

We can accept non-reimbursement of PRGT-related costs to the GRA and transfer of the equivalent amount to the PRGT subsidy account under Decision No. 4 as part of the 2009 Board decision on LIC financing. At the same time, we would like to emphasize that this measure was intended to be temporary in nature.

While we take positive note of the build-up in precautionary balances, we would highlight staff's comment that—even at end-FY 2012—"they remain well below the indicative medium-term target of SDR 15 billion." We believe that strengthening reserves should take clear precedence over any other uses for the Fund's income. In this vein, we also welcome and fully share staff's comment that "further consideration could be given to whether a portion of surcharge income could be allocated to the special reserve." At any rate, we would consider any call for distribution among members to be premature as long as reserve targets are not fully met.

Under the prevailing market conditions, there appears to be a high probability of short-term capital losses in the investment account. It is discomforting to note that for the portfolio to break even, increases in bond yields would need to turn out significantly below market expectations, according to the Fund's scenario analysis. A comment on how staff intends to act against this background would be welcome.

Mr. Alkholifey submitted the following statement:

I thank staff for a well-focused paper on the review of the Fund's income position for FY 2011 and FY 2012. While the updated net operational income projection for FY 2011 is lower than the midyear estimate, key factors contributing to income and expenditure variances provide reasonable explanation. I also take note of the updated income outlook for FY 2012. Here, it is important to underscore that building precautionary balances remains a clear priority in light of heightened credit risk from the increase in Fund credit, especially the large financial arrangements for a number of countries.

Turning to the proposals in the paper, I support the reimbursement to the General Department for the expenses of conducting the business of the SDR Department in FY 2011 (Decision No. 1). I also support the proposals for reimbursement related to MDRI-I and PCDR Trusts (Decision Nos. 2 and 3).

I support the transfer of an amount equivalent to the estimated cost of administering the PRGT from the PRGT Reserve Account to the General Subsidy Account of the PRGT in accordance with the Board decision taken in July 2009 (Decision No. 4).

I agree with the proposed transfer of the investment income from the Investment Account (IA) to the GRA for meeting FY 2011 administrative expenses (Decision No. 5). This has been the practice since the establishment of the IA.

The placing of GRA net income to the special reserve is in line with the Fund's longstanding practice and I can endorse it. I also support the placing of SDR 650 million from FY 2011 gold profits in the special reserve that would bring the total transfer for gold endowment to SDR 4.4 billion, funded at an average sales price of $850 per ounce. Furthermore, the placing of remaining FY2011 gold profits in the general reserve is in line with the decision to provide additional resources to support the PRGT and the preliminary discussion on the use of windfall profits from the gold sales (Decision No. 6).

I endorse the proposal to transfer the full available amount to the IA (Decision No. 7). I note that the expectation is that the IA will over time achieve a higher return than the SDR rate, although short-term capital losses are possible.

Turning to FY 2012, I can support leaving the margin for the rate of charge unchanged at 100 basis points (Decision No. 8) for the reasons given in the paper and look forward to staff proposals that would allow a new rule to be in place for FY 2013. I also endorse the proposal to complete the review of the system of special charges (Decision No. 9).

Mr. Gronn and Mrs. Alfredsdottir submitted the following statement:

We can support the proposed decisions in the staff report and would like to reiterate that we still find it reasonable to maintain the basic margin at 100 basis points.

We take note of the information that the investment income is SDR 31 million lower than expected. The main reason is higher bond yields and market concerns over rising inflationary pressures. We also realize that over time higher average yields will benefit the IA's performance both in absolute terms and relative to the SDR rate as explained in Annex II in the staff report. Even though this part of the discussion is not focused on the IA portfolio funded by the gold profits, we would like to reiterate our position that we believe that the investment horizon of the endowment should be extended as achieving a 3 percent real return target without substantial risk taking may need a longer investment horizon than 3-5 years; a horizon of 10 years and beyond could be looked at.

In light of lower investment income, we would also like to emphasize our view that the windfall profits of the gold sale amounting to SDR 1.74 billion could be efficiently used if placed either in the endowment or to boost the precautionary balances.

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

We support the proposed decisions pertaining to FY2010. These decisions include the reimbursement of the General Department for the expenses of conducting the business of the SDR Department (Decision 1) and of administering the MDRI-I and PCDR Trusts (Decisions 2 and 3). Consistent with the Board's July 2009 decision in the context of the LIC facilities reform, we support the transfer of an amount equivalent to the estimated costs of administering the PRGT from the PRGT Reserve Account to the General Subsidy Account (Decision 4). However, we expect reimbursement of administrative costs to the GRA to resume after FY2012. Similarly, we agree to the transfer from the Investment Account to meet the FY2011 administrative expenses (Decision 5).

We agree to the placement of the GRA's net operational income to the special reserve, and the disposition of the net income from gold sales to the special and general reserve, but without its inclusion in the calculation of precautionary balances (Decision 6). We take note of the increase in precautionary balances to SDR 8.1 billion in FY2011, which is well below the floor of SDR 10 billion agreed under the framework for assessing Fund reserve adequacy (EBS/10/161). A more accelerated build up of precautionary balances is needed given heightened credit risks, as noted in the background paper on the Consolidated Medium-Term Income and Expenditure Framework. There is therefore merit in the suggestion that a portion of surcharge income be allocated to the special reserve in the future. When would such a decision be considered? We also favor raising the target for precautionary balances to SDR15 billion. This target was discussed in September when the Fund's credit outstanding was expected to peak at SDR 78 billion, consistent with an objective of covering 20-30 percent of a three year average of credit outstanding (excluding precautionary arrangements). Now that credit outstanding is expected to peak at SDR 92 billion, should not this target be reconsidered?

The scenarios in Annex II illustrate that an increase in yields in line with expectations over the next fiscal year could precipitate capital losses to the Investment Account. We are therefore somewhat cautious with regard to Decision 7 which calls for the placement of additional special reserve and general reserve resources in the Investment Account. However, we can go along with the decision since the expected higher bond yields and expanded investment mandate should raise the return on the Investment Account.

With respect to the decisions pertaining to FY2011, we agree to maintain the rate of charge on the use of Fund resources for FY2011 at 100 basis points over the SDR interest rate (Decision 8). This margin appears sufficient to cover the Fund's estimated intermediation costs, consistent with the principles under the new income model. It also appears reasonably well aligned with broader developments in long-term credit market conditions, as portrayed in Annex III. Similarly, we have no objection to maintaining the current special charges on overdue obligations, particularly in view of the absence of new arrears cases. Accordingly, we are ready to complete the review of special charges (Decision 9).

Ms. Vongpradhip, Mr. Toh and Mr. De Leon submitted the following statement:

We thank staff for its comprehensive review of the Fund's income position for FY 2011-2012 and broadly agree with the proposed decisions. The staff's proposals seem in line with previous decisions and principles established by the Board. Moreover, given that elements of the new income model have yet to be fully operational, introducing major changes in the disposition of the Fund's net income may not be timely. However, we would like to emphasize a few points in our comments.

Proposed Decision 5 suggests that an amount equivalent to the income from the IA's tranche not funded by gold profits be transferred to the GRA for meeting administrative expenses of the Fund in FY2011. This is expected to result in a modest improvement in the net income of the GRA thereby contributing to the buildup of precautionary balances that are needed in light of heightened credits risks. This, along with the proposal to maintain at 100 basis points the margin for the rate of charge would help bring the precautionary balances to the recently agreed minimum floor of SDR10 billion. Given this pace of accumulation of precautionary balances, staff could comment on how it will impact the timetable to achieve indicative precautionary balances of SDR15 billion.

The staff indicated that the Fund's practice since the 1970s has been to place GRA annual net income into the special reserve, which is the first line of defense for any income shortfalls, while surcharge income was placed to the general reserve in the period FY1998-2006. We understand that the special reserve is not available for potential distribution to the membership. In this regard, we look forward to future discussion on the merit of allocating a portion of the surcharge income in the special reserve taking into account the projected path and adequacy of precautionary balances.

We note that one of the principles observed for setting the basic rate of charge in the new income model which was endorsed by the Board in March 2008 is to ensure that such be aligned with long-term credit market conditions, including ensuring that the cost of borrowing from the Fund does not become too expensive or too low relative to the cost of borrowing from the market. As such, we agree with staff's observation that it would not be appropriate to offset what remains likely to be a short-term cyclical development with adjustments to the margin. However, we note that the current wide differential between borrowing costs from the Fund and the market has been unusually wide since 2009. The staff could comment if the SDR rate remains aligned with the perceived long-term market conditions.

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

We support the decisions as proposed in EBS/11/53 and at the same time—in accordance with the Fund's broadened investment authority—we urge staff to accelerate the full implementation of the new income model, including the establishment of the gold-funded endowment.

Decisions Pertaining to FY 11

Since it has been a long practice, we are in favor of reimbursing the General Department for the expenses of conducting the business of the SDR Department (Decision No. 1), for the cost of administering SDA resources in the MDRI-I trust (Decision No. 2), and for the cost of administering SDA resources in the PCDR Trust in FY11 (Decision No.3). Consistent with the Executive Board decision of July 2009, we also support Decision No. 4, which provides for the transfer of an amount equivalent to the estimated cost of administering the PRGT from the PRGT Reserve Account to the General Subsidy Account of the PRGT.

The overall objective of the Investment Account (IA) is to generate over time additional income to meet the Fund's administrative expenses in FY11. Therefore, we support the transfer of the income from the IA's tranche not funded by gold profits into the GRA (Decision No. 5) as well as the transfer of the Fund's net income for 2011 into the Fund's Special Reserve and General Reserve as specified in the Decision No. 6. This will help accelerate the build-up of precautionary balances to strengthen the Fund's financial position and safeguard it against increasing credit risks. In addition, we support the transfer of the full available net income attributable to GRA net operational income and surcharges to the IA (Decision No. 7).

Decisions Pertaining to FY 12

We share the staff's assessment that, although demand for Fund financing is difficult to predict and depends on a number of factors, including the timing of purchases and repurchases, the income outlook for FY12 points to a positive outturn. The staff's expectations are however based on somewhat conservative assumptions, since they include only lending from approved arrangements without changes to the planned phasing of purchases and advanced repurchases as well as the current SDR interest rate and the U.S. dollar/SDR exchange rate. In this respect, the sensitivity analysis summarized in Table 5 provides valuable additional information.

Against this background, we support proposed Decision No. 8 to maintain the lending margin at 100 basis points for FY12. This would guarantee the needed degree of stability and predictability to the framework; while, at the same time, it would generate acceleration in reserve accumulation necessary to protect the Fund against higher credit and liquidity risks. However, we encourage staff to develop a new rule for setting the margin soon. This rule would represent an important step in fully implementing the new income model.

Given that neither special charges nor new considerations have arisen during the current fiscal year, we support Decision No. 9, which proposes no changes to the current system of levying special charges on overdue repurchases and charges that are in arrears for more than 10 days. Nevertheless we should stand ready to review such a policy, should new arrears emerge.

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

We thank staff for the paper—we support all the decisions and limit our comments to the following:

The Fund's income position continues to be very comfortable, with precautionary balances expected to amount to SDR 9.6 billion by the end of the financial year, only marginally below the floor target. This provides a strong degree of certainty to the Board that precautionary balances are accumulating at an appropriate pace.

We support Decision 8 that the rate of charge be set at 100 basis points over the SDR rate. This would continue the strong trajectory of accumulation, reaching the SDR 15 billion target by around 2016, if not earlier. If other Directors favor an even more rapid pace of accumulation, then consideration could be given to 150 basis points, given how low the Fund's basic rate of charge is below current market rates. However, we consider this excessive and unnecessary given the already high level of accumulation.

We agree to Decision 6, which includes placing in the General Reserve the gold sale windfall profits above the SDR 4.4 billion agreed for the NIM. These should not be considered precautionary balances. We also believe that the strongest arguments favor using the additional windfall profits from gold sales to benefit low-income countries. However, this issue will be taken up in subsequent discussions.

We strongly support Decision 4, which defers reimbursement from the PRGT to the GRA for administrative costs. We continue to support a permanent cancellation of these costs.

Finally, we reiterate our concern over staff handling of the various elements of the budget, which have once again come to the Board in a plethora of papers and meetings. While we appreciate the challenge in presenting these, the complexity and interconnectivity of these issues makes consolidation, clarity and transparency all the more important. This is especially true of—though not at all exclusive to—the pay discussions that have required three separate decision stages this year. As stressed last year along with other Directors, we strongly urge staff to provide a more consolidated presentation of these complex and interlinked issues.

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

We thank staff for the very detailed analysis and reasonable suggestions in the paper and agree with the nine proposed decisions in the paper. Concerning the proposed decisions for FY2011, we agree that reimbursement to the General Department should be charged from SDR Department participants pursuant to the relevant articles of the Articles of Agreement. Similarly, we agree with the proposed Decisions 2, 3, and 4 to reimburse the General Department expenses of administrating MDRI-I Trust and PCDR Trust, and transfer the amount from the PRGT Reserve Account to the General Subsidy Account. We also agree with the proposed Decision 5 to transfer the income of the Investment Account to the General Resources Account to meet the administrative spending needs in FY2011. We support the proposed Decisions 6 and 7 as they are in line with past decisions and benefit the Fund income position as well. We support maintaining the rate of charge for FY2012 unchanged and the review of the system of special charges, which are the proposed Decisions 8 and 9.

The staff paper indicated clearly that, for FY2011, the administrative expenses were covered mainly by the Fund's lending income. Furthermore, the investment return of the Investment Account is on a downward trend. According to staff's projections, the lending income for FY2012 will envisage a 15 percent increase due to the strong demand for Fund resources. However, we should be aware of complacency as the increase in lending income is not permanent, and when the global economy recovers and uncertainties are reduced, the Fund will need to rely on investment income and other resources to cover the operations of the Fund. According to staff projections, investment income in FY2012 is about SDR 144 million, while for the same period, the expenses of the Fund are as high as SDR 678 million. Such a big gap between investment income and expenses means that the Fund will continue to rely on lending income to cover operational costs in the short term. The low investment return is due to the low interest rate environment on the one hand and, in part, the limited investment scope of Fund resources on the other. We would like to call for the Fund's acceleration of the implementation of broadened investment authority to generate steady long-term resources to maintain the Fund's self-sustainability.

Recently, the Board discussed how to use the remaining windfall profits of gold sales. With the divergent views that came out of the discussion, we would like to call on management and our members to give priority to the financial sustainability and safety of the Fund and reach consensus through compromise so that the new income model could be implemented as soon as possible.

Mr. Lushin and Mr. Tolstikov submitted the following statement:

Review of the Fund's Income Position FY 2011 and FY 2012

We can agree with the proposed decisions concerning the Fund's income position for the current and next financial years. We welcome progress achieved in the implementation of the new income model, including the adoption of the amendment to broaden the Fund's investment mandate and completion of the limited gold sales. It is encouraging that given the current high lending levels, operational income is more than sufficient to cover all operational expenses of the Fund, allowing for accumulation of reserves broadly in line with the path, envisaged by the previous reviews of the income position.

Decisions Pertaining to FY 2011

We support all proposed decisions, as they are broadly in line with the established practices and previously adopted Board decisions.

Decisions Pertaining to FY 2012

With regard to the basic rate of charge, we look forward for staff's proposals that would allow the implementation of the governing principles for setting the basic rate of charge endorsed in 2008. In the meantime we can agree with the proposed margin of 100 basis points for FY2012, which allows for an increase of FY2012 net operational income to about SDR 0.5 billion and some acceleration of the reserve accumulation.

We note that the Fund's interest rate is also unusually low in comparison with current market rates. If such a situation prevails over a prolonged time period, the issue of increasing the margin for the rate of charge to 150 basis points could be considered. In view of increasing risks it may be desirable to further boost the accumulation of precautionary reserves, which are still well below the indicative medium-term target of SDR 15 billion.

Mr. Assimaidou submitted the following statement:

We welcome the paper on the review of the Fund's income position for FY2011 and 2012.

We note the downward revision of the Fund's net operational income for FY2011 to SDR 292 million (compared with SDR 328 million at the midyear review), mainly due to a lower than projected investment income.

Following the entry into force in February 2011 of the amendment to broaden the IMF's investment mandate, could staff elaborate on the potential impact on projected investment incomes—and more broadly the Fund's operational incomes—of investment in assets beyond those covered by the former investment mandate?

For FY2012, we welcome the projected improvement in the Fund's net operational income to SDR 482 million, thanks mainly to an increase in credit outstanding.

We support the proposed decisions outlined in page 20 of the paper.

Mr. Weber and Ms. Jajko submitted the following statement:

We agree with the proposed decisions for FY2011 and FY2012. We would like to make the following comments for emphasis, but we stress from the outset that the build-up of precautionary balances must have unambiguous priority in decisions on the use of Fund income at this stage. On this latter point, we fully share the view of Mr. von Stenglin and Ms. Gerdes.

Since the proposed Decision No. 4 pertaining to the foregoing of the reimbursement of the GRA for PRGT administration expenses implements the Board's decision of July 2009, we can accept it as a temporary arrangement. We emphasize, however, that this cross-subsidization is inconsistent with the new income model and must be allowed to lapse, as agreed earlier, in FY2013.

We welcome the proposed Decision No. 6 on the placement of FY2011 net income of the GRA to the Special Reserve and the General Reserve. This decision is in line with the Board's expectations, confirmed during the recent Board discussion on the use of gold profits, that at least SDR 4.4 billion of gold sale profits should be placed in the gold endowment. In addition, we agree with staff that the issue of allocating surcharge income to the special reserve could be further explored.

We support the proposed Decision No. 7 on the transfer of currencies to the Investment Account. We concur with staff that this is appropriate because a higher return than the SDR rate might be expected from this investment over time.

On the proposed Decision No. 8, we agree with staff that given existing market uncertainties, the margin for the rate of charge for FY2012 can be kept at 100 basis points. A higher margin would be warranted to achieve a faster accumulation of precautionary balances in view of the Fund's extraordinary financial commitments. However, any rushed and ad hoc changes in this respect should be avoided. Therefore, we welcome staff's intention to present to the Board a new rule for setting the margin. The rule is also to be seen as one element in implementing the Fund's new income model. We would appreciate further information on the progress made in terms of a new rule and on the timing of a Board discussion.

Mr. Bakker submitted the following statement:

I can agree to the nine proposed decisions pertaining to the Fund's income position in FY2011 and FY2012. I therefore limit my comments to the following:

Like Mr. Gibbs, I would welcome a more consolidated presentation and discussion of the income, expenditure and budget framework. The consolidated medium-term income and expenditure paper provides a good step in that direction and should serve as a basis for discussing the budget. I also welcome we discuss the income position and the budget on the same day. That said, I feel that further efforts could be made to bringing the relevant elements of the budget, including pay, expenditure and income together in a comprehensive paper and to discuss these matters in one meeting. This would facilitate getting a better grasp of the Fund's financial position from a multi-year perspective.

I particularly support placing FY2011 net income of the GRA into the reserves with the aim of increasing precautionary balances. I share staff's view that credit risks have heightened, and that larger precautionary balances are required to mitigate these risks.

I also agree to the transfer of currencies to the Investment Account, although I recognize the higher risk of underperformance, given the expected rise in bond yields. I would appreciate staff's views on the means to address these risks. Is any shortening in duration considered?

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

We thank the staff for a clear set of papers on the Fund's income position for FY2011 and FY2012. We support the nine proposed decisions and welcome the progress made to date in implementing the Fund's new income model.

We have taken note of the assessment in Annex II of the risks of capital losses or underperformance in the Investment Account (relative to the SDR rate) if bond yields increase in line with expectations. Similarly, we have also taken note that investment income in 2011 is now projected to come in SDR 31 million lower than expected for similar reasons. That said, we acknowledge that this will have a limited impact on the Fund's income position given significant lending income at this time and that the revised investment mandate should be a mitigating factor over the medium-term. Furthermore, we agree that episodes of short-term underperformance are to be expected.

However, like Mr. Gronn and Mrs. Alfredsdottir, we would see this and the recent period of low returns as an example that adverse income developments occur. Thus we would share the view that as we continue to discuss the allocation of windfall gold profits a conservative approach may be warranted. Therefore, we would reiterate that it may be prudent to consider using a portion of the windfall to add to the endowment in order to boost the buffer against future adverse income developments.

Finally, we also strongly support the decision to continue with the deferral of GRA reimbursement for PRGT administrative expenses. Similar to Mr. Gibbs and Mr. Ward, we would welcome a review of the PRGT re-imbursement policy.

Mr. Mac Laughlin and Mr. Lischinsky submitted the following statement:

We thank the staff for the comprehensive paper on the review of the Fund's income position. The current review exhibits a much better situation than that projected a year ago, due to a substantial increase in lending income, and a reduction in net administrative expenditures, which resulted in an improved net operational income position in relation to the initial projections, although smaller than the mid-year projections. Finally, the net income position is projected to be SDR 3.8 billion and has improved both initial and mid-year projections as a consequence of considerably higher than expected gold profit earnings.

FY2012 income projections seem to be more comfortable based on the assumption that demand for Fund financing is expected to be strong. Net operational income is predicted to be 65 percent higher than in 2011, while the net income position, this time without gold sale profits, will be 62 percent lower than the previous year, despite an increase of 97 percent in projected surcharges.

This review shows the importance of continuing the progress made so far on diversifying income sources at a time when expenditures should exhibit an appropriate balance between the Fund's critical role to help countries ameliorate the impact and avert the global financial and economic turmoil, while solving temporary income needs and avoiding expenditures becoming permanent. It is important to have a fully integrated income-expenditure structure and, in this regard, we praise the paper on the consolidated medium-term income and expenditure framework in order to see these issues in perspective and as a whole to ensure medium and long-term financial stability.

We recommend implementing the gold-sales-funded endowment and using part of the windfall profits from the gold sales to increase resources to the PRGT and the interest subsidy account and, in the meantime, placing them in the General Reserve Account (Decision 6). In the same vein, we agree with deferring administrative cost reimbursements to the GRA from the PRGT (Decision 4).

We support maintaining the margin for calculating the basic rate of charge in FY2011 at 100 basis points, over the SDR interest rate, under the clause of Rule I-6(4) (Decision 8). Nevertheless, we doubt it is consistent with long-term credit market conditions. We would like the staff to develop a mechanism to check this issue, as this basic charge is much higher than the present SDR interest rate, in order to ensure that the cost of borrowing from the Fund is balanced with the cost of borrowing from the market. At the same time "the market rate" to be applied as a comparison has to be defined accurately.

Finally, we agree with Decisions 1 to 8 to the extent that they are consistent with the Articles of Agreement and subsequent decisions and with Decision 9 to the degree that its wording is revisited and clarified to validate it as a proper and clear decision.

Mr. Fayolle submitted the following statement:

We thank staff for a comprehensive set of papers, as well as the Managing Director for his statement on the strategic directions underpinning the medium-term budget. This statement covers both discussions of the Fund's income position and of the medium-term budget.

Fund's Income Position for FY11 and FY12

Since last year's review, the amendment of the Articles of Agreement related to the new income model has become effective and gold sales have been completed. FY12 should therefore be the last exercise before the new income model starts to operate.

We take positive note that the Fund's income position remains quite comfortable and we support all the proposed decisions for FY2011 and FY2012, which seem to us consistent with the legal framework and past practices.

The accumulation of precautionary balances is accelerating and the floor of SDR10 billion is expected to be reached within the next two years. Given the remaining uncertainty surrounding the global economy, we see the projections of precautionary balances as conservative because the risk of massive early repayments is low and new programs triggering further charges and surcharges cannot be ruled out, eventually contributing to a faster accumulation. In this context, we reiterate the importance to use the windfall profits from gold sales to support LIC borrowers. We look forward to further discussions on the use of these excess profits, and agree in the meantime that they be placed in the general reserves provided they are not counted as precautionary balances, as stated in paragraph 13.

Like Mr. Gibbs and Mr. Ward, we would support a permanent cancellation of the reimbursement of the administrative costs from the PRGT to the GRA.

FY12-14 Medium-Term Budget

We can go along with the proposed decisions and would like to focus on the following comments.

The proposed increase in the structural budget is justified by the growing responsibilities entrusted to the Fund and seems indeed necessary starting from the post-downsizing level. It is however highly appreciable that the nominal spending path is contained, mainly thanks to the correction of the deflator formula and the revision of inflation assumptions. We also take note that that the new structural envelope provides for a structural increase in the OED budget and we look forward to a thorough needs assessment by the working group, as decided by the CAM.

We acknowledge the need to extend the crisis-related temporary envelope at a higher level than anticipated last year. However, we are concerned that the phasing out of this envelope is too slow and that these temporary expenditures are projected to last well beyond FY14. Similarly, as we had indicated at the COB in January, we regret that this temporary budget is not entirely crisis-related. We would therefore like to be reassured by management concerning the ability of the institution to implement a credible exit strategy. We also reiterate that we attach great value to maintaining a single budget framework and that the recourse to a temporary budget should be limited to exceptional circumstances for exceptional purposes. The staff's comments are welcome.

Lastly, we would appreciate more transparency and clarity in the presentation of the budget. Indeed, the documentation does not provide a consolidated picture and therefore requires thorough consultation and cross-referencing of the various annexes, which is not conducive to an easy understanding of the issues at stake.

Mr. Rediker and Mr. Meyer submitted the following statement:

We appreciate the clear set of staff papers, which highlight that the Fund's income position remains favorable in the near to medium term. This will allow for a continued strong increase in precautionary balances to almost SDR 10 billion by the end of the year. We also welcome the progress in putting the new income model into place. We also look forward to robust discussion of the new Investment Account mandate, and its implications for future discussions of income and budget expenditures.

We support all of the proposed decisions for FY11 and FY12. In particular, we agree to move the windfall gold sale profits to General Reserves, without counting these as part of precautionary balances. We look forward to future discussions on how to use these proceeds, and to working towards a consensus on how best to deploy the windfall.

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

We support all the decisions proposed by staff pertaining to FY2011. The Fund's finances continue to reflect the large surge in income derived from crisis related programs and arrangements, and strengthening reserves is on track. Net operational income must be sustained in the steady state, when the income derived from the gold endowment will be most relevant. In this respect, we maintain once again that the gold endowment must be increased beyond what amounts to the sale of gold, either through a period of reinvestment of gold-endowment returns or a partial transfer of the windfall profits. The shortfall of expected returns to the Investment Account for FY2011 highlights the impact volatility can have on short-term returns and thus the importance of achieving an optimal size and resource allocation for the gold endowment.

As other Directors have highlighted, and we have stated previously, all financial statements and the budget should be presented in a single document that facilitate their analysis.

We also ask staff to further analyze the proposals of Messrs. Gibbs and Ward, and others on the permanent cancellation of the PRGT administrative costs, which we would be prepared to consider.

We agree with the establishment of the rate of charge on the use of Fund resources for FY2012 at 100 basis points over the SDR interest rate and maintaining the current system for special charges.

Mr. Rouai made the following statement:

We thank staff for the thorough report and more generally for their work in advancing the entry into effect of the new income model. We have no difficulty supporting all the proposed decisions.

We welcome the improvement in the Fund's income position, and the continuous buildup of precautionary balances, which will hopefully contribute to mitigating the growing credit risk confronting the Fund.

We look forward to the work program, in particular on rules, regulation, and governance of the Fund expanded investment authority as well as on the use of the windfall profit from the gold sales.

We note with satisfaction the progress in consolidating Board consideration of the Fund budget and income position. While we take note of the reservations expressed by staff during this morning's Board discussion, we should continue to strive for a single Board meeting to discuss a consolidated staff paper, building on the current staff report on the consolidated medium-term income and expenditure framework.

Mr. Prader made the following statement:

We can support the proposed decisions. I have two points.

First, I note that a number of Directors appear content with the increase in precautionary balances to almost SDR10 billion by the end of the year. While this might look large, it is paltry when measured against the Fund's lending capacity of some SDR750 billion.

Second, before deciding on the issue of dividing the windfall gold sales profits—which we now want to put to general reserves—we should have a framework for precautionary balances. We should have an informed decision so as to avoid a situation whereby we have to raise the rate of charge because our precautionary reserves might turn out to be low due to the distribution of the windfall profits. This is an argument for those who have Fund programs and might have to pay the cost of the short-term fascination with windfall profits.

Mr. de Melo supported the proposed decisions and a consolidated presentation of the income, expenditure, and budget frameworks. The full implementation of the new income model was also appropriate.

Mr. Furusawa supported the proposed decisions. The improvement in the Fund's income position, and the progress made in implementing the new income model were well noted. He joined others in supporting the use of the windfall from the gold sales for the benefit of low-income countries. The permanent cancellation of the reimbursement of the administrative costs from the PRGT to GRA was also appropriate.

Mr. Geadah supported Mr. Prader's call for a framework for setting precautionary balances before deciding on what to do with the windfall profits from the gold sales.

The Director of the Finance Department (Mr. Tweedie), in response to questions and comments from Executive Directors, made the following statement: [1]

> We thank Directors for their focus on these issues so soon after the Spring Meetings, and for their support for the decisions. We have already responded to most of the questions raised in the grays in writing.
>
> There remains one question on which I wanted to pick up, and elaborate. Several Directors rightly pointed to the risks to the Investment Account (IA) if there is a sharp increase in interest rates. Some Directors asked what measures are available to mitigate these risks. We have also been focusing on this issue, as these risks are clearly real. We have been highlighting them for a while in the staff papers and in other papers related to the Fund's income. While so far these risks have not materialized, they may at some point.
>
> That said, it is important to keep things in perspective. Our current investment strategy for the investment account is a very conservative one—it seeks to achieve returns that exceed the SDR rate over time. In the paper, we assumed an average pick up of about 50 basis points over the SDR rate—this reflects the long-term shape of the yield curve. While the yield curve moves over time and the slope changes, our assessment has been that we could expect, on average, a rate pick up of about 50 basis points.
>
> The other aspect of our strategy is to minimize the frequency and the risk of losses. Relative to that, the actual performance since the inception of the IA in 2006 has been extraordinarily strong. Our latest numbers show that we have had an average annual excess return of about 165 basis points since the inception of the IA—well ahead of the 50 basis points assumption. We nonetheless need to acknowledge that the performance of the IA has been the product of a quite unusual interest rate environment, associated in particular with the crisis. We should not expect these levels of returns to be sustained.
>
> The question then arises as to whether we should do something now to lock in the higher returns and take some of the gains off the table. If we proceed down this route, the main option would be to shorten the duration of the portfolio, probably substantially. While we have considered this, we are very cautious about proposing that sort of change for several reasons.

[1] Prior to the Board meeting, SEC circulated the staff representative's additional responses by email. For information, these are included in an annex to these minutes.

First, it would involve a major change in the investment strategy based on short-term market considerations. In general, we do not think that is the approach the Fund should be following for this portfolio, or for the Fund's other portfolios. We do have an agreed strategy. It is expected to generate relatively modest gains over time. We need to be ready to accept that there will be periods when we will earn above average returns and there will be other periods when we will earn below average returns. This longer term focus is also going to be an important part of our ongoing discussions on the investment strategy for the gold endowment.

More generally, we do have some experience with making such a change. In 2002, the Fund shortened the duration on the PRG Trust portfolio in a similar environment where interest rates had fallen substantially, and the risks in terms of future movements were seen as being mainly on the upside. The duration was shortened to about five months. In hindsight, our assessment is that this was probably not an advisable strategy. Interest rates kept falling after we shortened the duration, and we were then faced with a difficult judgment of when to lengthen duration again in a rising interest rate environment. Hence, once an active strategy is adopted, the strategy is also subject to uncertainty on the timing to return to the long-run average duration.

We also have counterfactual experience from the last two years. In particular, we had a very similar discussion last year where the forward markets were predicting pretty much what they are predicting now—a rise in interest rates. If we had moved to shorten the duration then, we would have done worse as of now by around 30 basis points over the period. Earlier in the year, the under-performance looked like being a lot worse, though rates have since rebounded a bit and some of the gains from maintaining the current duration have been reversed. The difference in the previous year was even more marked. In the end, the over performance of the investment account over the SDR rate was over 200 basis points.

This is not to say we do not need to keep this under close review. I would not rule out at some point that we might propose some modest changes in duration—maybe we could lower it a bit from the current two years. However, it is not clear that we have the ability to successfully make major market timing judgments in what are the world's most liquid and deep markets. We also have the experience of our private managers, who are managing a relatively small part of the portfolio. They have some flexibility in their mandate to take duration positions within limits around the benchmark. Based on our observations, our general assessment is that these sorts of decisions have not consistently added value over time. Hence, our experience, and that of our managers, makes us cautious about making these sorts of judgments.

Turning to Mr. Prader's comment on precautionary balances and the link with future dividend payments, I completely agree that we would not make any proposals for a dividend unless we had a very comprehensive discussion of the adequacy of our reserves. That is explicit in the new income model. However, it is not the case that we do not have any framework for assessing the adequacy of precautionary balances. We had a discussion on precautionary balances last September when most Directors supported the framework proposed by the staff. A few Directors had misgivings, including Mr. Prader's chair, and we promised to come back to this issue before we reach the SDR 10 billion target—we will do that. So I want to assure Mr. Prader that we are not doing anything now that locks us in by putting these resources in the general reserve. The Fund would have the flexibility to decide to pay a dividend at some point, but that is an active decision that would require thorough analysis.

Mr. Prader noted the staff representative's remarks on the framework and reiterated his chair's reservations as to the suitability of the current framework given the change in the Fund's lending, both in size and content. The key variable remained the lending capacity of the Fund, and not the level of outstanding loans.

Mr. Lischinsky made the following statement:

First, I want to refer to the precautionary balances and the consolidated income and expenses. We can see that in 2017 we would have 73 percent of the Fund credit covered by the precautionary balances, and in less than ten years we will have 100 percent of the precautionary balances covered in the Fund credit.

Second, my comment is related to Decision 9, which from my point of view is not a decision. While it can be mentioned in the summing up, or linked to paragraph 23—the decision that gives rise to this decision—we would suggest a rewording of the current decision.

Mr. Bakker made the following statement:

Let me first of all say that I would like to associate myself with what Mr. Prader said on the precautionary balances. While I do note that we have an indicative target—which we will still take some time to get to—I would like to underline that that target level is the very least we need.

In that respect, I would also like to associate myself with Mr. Luo, Mr. Gronn, and Mr. Hockin, who have asked for a cautious approach when it comes to the allocation of the windfall of the gold profits. We should give priority to the financial sustainability of the IMF.

In this regard, it is important to come forward with early staff proposals. There is no need to put this on the back burner for too long. We should at least before the Annual Meetings get a proposal which is able to obtain broad support. The proposal should entail a combination of the options we discussed for using excess profits. As I mentioned, one option might be to set aside part of the profits for low-income countries support, when we get distinctively closer to where we need to be on the financial buffers.

The other point I would like to make is on where we are regarding the investment authority. I am very concerned that in the staff paper it is now assumed that we would only put in place our gold endowment in fiscal year 2013. This would be a big setback compared to what we discussed last time when many Directors urged that we have it in place before the Annual Meetings. I would very much support those Directors, including Mr. Luo, who have said that we need to accelerate our decision on rules and regulations to implement or expand the investment authority, and on the investment strategy. I believe we owe this to our member countries as we have asked them to speed up the Fifth Amendment. I think we should have had this in place when the amendment was agreed. Putting this on the back burner and only implementing it at the start of the next fiscal year is too long. I urge that we get the staff papers before the Annual Meetings.

The Acting Chair (Mr. Shinohara) remarked that staff was working hard on the investment mandate so as to enable a Board discussion at the earliest feasible. The staff was encouraged to expedite the process.

The Deputy General Counsel (Mr. Leckow), in response to questions and comments from Executive Directors, made the following statement:

In connection with the question raised about the drafting of Decision 9 and the legal reason why the decision is being adopted, I would like to point out that the language before Directors is the same language that we have been using for many years—it goes back to the mid-1990s. It is in connection with a requirement that was set out in a Board decision on charging that was adopted in the 1980s.

> To the extent that Directors prefer to refer to the decision calling for a review of special charges, we could redraft the language accordingly.
>
> For that purpose, we have prepared a redraft of the decision. Rather than referring to reviewing the system of special charges applicable to overdue obligation, we would simply note that the Fund has reviewed the relevant decision on special charges and overdue financial obligations.

The Director of the Finance Department (Mr. Tweedie), in response to Mr. Bakker, said that there had been no slowdown in the timetable for the staff's work program. One of the key issues to be dealt with following an agreement on the broadened investment mandate is the strategy for the phasing of the actual investments, which may need to be done over time. The staff paper simply assumed that this would be completed in fiscal year 2013, which if anything is probably optimistic.

The Deputy General Counsel (Mr. Leckow) read out the revised Decision 9.

Mr. Luo made the following statement:

> In terms of the Fund's income position, I can go along with Mr. Prader, Mr. von Stenglin, Mr. Weber, and others. We should adopt a very cautious approach. Since we provide advice to member countries on similar issues, we should adhere to the best principles as well so as to ensure the credibility of our advice. This should be kept in mind.
>
> Regarding the gold endowment, during the initial discussions, staff was considering to expand the investment to emerging markets to raise the return. What has been the progress on this issue? I hope that we can take a decision on that as soon as possible. I support expanding our investment to emerging markets.

The Acting Chair (Mr. Shinohara) said that specific issues on the gold endowment could be taken up as part of the ongoing discussions on the investment strategy.

The Director of the Finance Department (Mr. Tweedie) said that following the initial feedback from Directors, staff was working on a follow up paper regarding both the investment strategy and the governance arrangements. Further information on the timing of the next meeting would be made available as part of the work program.

The Executive Board took the following decisions:

Review of the Fund's Income Position for FY 2011 and FY 2012—Assessment Under Article XX, Section 4 for FY 2011

Pursuant to Article XVI, Section 2 and Article XX, Section 4 of the Articles of Agreement and Rule T-2 of the Fund's Rules and Regulations, it is decided that: (i) The General Department shall be reimbursed for the expenses of conducting the business of the SDR Department for the period of May 1, 2010 through April 30, 2011; and (ii) An assessment shall be levied on all participants in the SDR Department. The special drawing right holdings accounts of participants shall be debited on April 30, 2011 with an amount equal to 0.00134050 percent of their net cumulative allocations of special drawing rights. The total assessment shall be paid into the General Department. (EBS/11/53, 04/07/11)

Decision No. 14893-(11/37), adopted
April 20, 2011

Review of the Fund's Income Position for FY 2011 and FY 2012—MDRI-I Trust Reimbursement for FY 2011

In accordance with paragraph 6 of Decision No. 13588-(05/99) MDRI, adopted November 23, 2005, effective January 5, 2006, the General Resources Account shall be reimbursed the equivalent of SDR 0.755 million by the MDRI-I Trust in respect of the expenses of administering SDA resources in the MDRI-I Trust during FY 2011. (EBS/11/53, 04/07/11)

Decision No. 14894-(11/37), adopted
April 20, 2011

Review of the Fund's Income Position for FY 2011 and FY 2012—PCDR Trust Reimbursement for FY 2011

In accordance with paragraph 3 of Decision No. 14649-(10/64) PCDR, adopted June 25, 2010, the General Resources Account shall be reimbursed the equivalent of SDR 0.493 million by the PCDR Trust in respect of the expenses of administering SDA resources in the PCDR Trust during FY 2011. (EBS/11/53, 04/07/11)

Decision No. 14895-(11/37), adopted
April 20, 2011

Review of the Fund’s Income Position for FY 2011 and FY 2012—PRGT Reserve Account Transfer to Subsidy Account

In accordance with paragraph 19 of Decision No. 14354-(09/79), adopted on July 23, 2009, in lieu of reimbursement to the General Resources Account, an amount equivalent to SDR 46.411 million, representing the cost of administering the Poverty Reduction and Growth Trust (PRGT) for FY 2011, shall be transferred from the Reserve Account of the PRGT (through the Special Disbursement Account) to the General Subsidy Account of the PRGT. (EBS/11/53, 04/07/11)

Decision No. 14896-(11/37), adopted
April 20, 2011

Review of the Fund’s Income Position for FY 2011 and FY 2012—Transfer of Investment Income for FY 2011 to General Resources Account

The income of the Investment Account for FY 2011 that is not attributable to earnings from gold profits transferred to the Investment Account shall be transferred to the General Resources Account for use in meeting the expenses of conducting the business of the Fund during FY 2011. (EBS/11/53, 04/07/11)

Decision No. 14897-(11/37), adopted
April 20, 2011

Review of the Fund’s Income Position for FY 2011 and FY 2012—Placement of FY 2011 Net Income of the General Resources Account to the Special Reserve and the General Reserve

The net income of the General Resources Account for FY 2011 other than net income from surcharges shall be placed to the Fund’s Special Reserve and General Reserve as follows: Net income not attributable to gold profits shall be placed to the Fund’s Special Reserve. Of the net income attributable to gold profits an amount of SDR 650 million shall be placed to the Fund’s Special Reserve, and an amount of SDR 2,450 million shall be placed to the General Reserve. (EBS/11/53, 04/07/11)

Decision No. 14898-(11/37), adopted
April 20, 2011

Review of the Fund's Income Position for FY 2011 and FY 2012—Transfer of Currencies to the Investment Account

Pursuant to Article XII, Section 6(f)(ii) of the Articles of Agreement, the Fund shall transfer from the General Resources Account to the Investment Account currencies in an amount equivalent to the difference between the Fund's general and special reserves as of April 30, 2011 and the cumulative amount of previous transfers of currencies from the General Resources Account to the Investment Account. This transfer of currencies to the Investment Account shall be effected in the context of the Financial Transactions Plan covering the period March through July 2011. The currencies transferred to the Investment Account pursuant to this decision shall be used for immediate investment in accordance with the provisions of Article XII, Section 6(f)(iii) of the Articles of Agreement and the Rules and Regulations adopted thereunder. (EBS/11/53, 04/07/11)

Decision No. 14899-(11/37), adopted
April 20, 2011

Review of the Fund's Income Position for FY 2011 and FY 2012—The Rate of Charge on the Use of Fund Resources for FY 2012

Pursuant to Rule I-6(4)(a), last sentence of the Fund's Rules and Regulations, the rate of charge for FY 2012 shall be 100 basis points over the SDR interest rate under Rule T-1 of the Fund's Rules and Regulations. (EBS/11/53, 04/07/11)

Decision No. 14900-(11/37), adopted
April 20, 2011

Review of the Fund's Income Position for FY 2011 and FY 2012—Review of the System of Special Charges

The Fund has reviewed Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, effective February 1, 1986, as amended, on Special Charges on Overdue Financial Obligations to the Fund. (EBS/11/53, Supplement 1, 04/25/11)

Decision No. 14901-(11/37), adopted
April 20, 2011

APPROVAL: June 20, 2011

SIDDHARTH TIWARI
Secretary

Annex

The staff representatives from the Finance Department (Messrs. Andrews and Kabwe), in response to technical questions from Executive Directors, circulated the following written answers prior to the Executive Board meeting:

Investment Account (IA)

1. Is there a need for increased diversification of the investment account portfolio to mitigate the risk of potential capital loss? What other policy measures could be implemented to avert such losses?

- The Executive Board has yet to decide on the rules and regulations necessary to implement the Fund's expanded investment authority following the entry into force of the Fifth Amendment of the Articles of Agreement. Until such time, the resources held in the IA are invested under existing rules and regulations, which restrict investments to marketable obligations of member countries and international organizations.

- The Board has endorsed an investment benchmark for the IA anchored to the SDR weighted 1-3 year government bond index as this segment is best positioned to exceed the return of the SDR 3-month interest rate over time whilst minimizing the risk of capital losses in both rising and falling interest rate cycles. Faced with changing market conditions, staff, in theory, may recommend to the Executive Board changes to the duration of the portfolio. Such tactical market timing moves are, however, difficult to implement successfully, involve opportunity costs in terms of lost income and also incur some transaction costs.

Investment Mandate

2. What is the potential impact on the projected investment income—and more broadly on the Fund's operational mandate—of investments in assets beyond those covered by the former investment mandate?

- The staff's income projections assume that the gold endowment would be put in place beginning in FY2013 and, based on a pay-out ratio of 3 percent, the contribution to the Fund's operational income would be some SDR 132 million in that year (Table II.1 in EBAP/11/32). The income from the pay-out is projected to grow in nominal terms, since the real value of the endowment would be maintained over time.

- The staff's projections for the IA tranche not funded by gold profits, have consistently taken a long-run assumption with a fairly modest investment return of 50 basis points above the SDR rate, in line with historical averages. Under the new income model, staff's projections have again consistently assumed that the return for this tranche would increase to 100 basis points above the SDR rate following the broadening of the Fund's investment authority. However, it should be noted the Board has yet to consider the appropriate investment strategy for this tranche of the IA.

- The staff's projections for the medium-term (EBAP/11/32) assume that the broadening of the mandate on the above tranche also takes effect from FY2013. Thus, under the projections, for every SDR 5 billion in this tranche, the additional income would be about SDR 25 million per year. As noted in the paper, this is a long-run assumption and actual year-to-year performance would vary with market conditions.

Rate of Charge

3. What has been the progress regarding the development of a new rule for setting the margin for the rate of charge and when is this expected for Board discussion?

- As noted in the gray, approval of a new rule for the rate of charge is an important step toward implementing the new income model. Work is underway to develop a new rule for Board consideration during the first half of FY2012, and should be completed before the midyear income review.

4. Given that the current wide differential between borrowing costs from the Fund and the market has been unusually wide since 2009, does the staff consider that the SDR rate remains aligned with the perceived long-term market conditions?

- As noted in the paper, staff considers that the current low level of the SDR rate is likely to be a short term cyclical development. As such, this three-month rate is not considered to be reflective of likely long term conditions.

Precautionary Balances

5. What is the impact of the current pace of accumulation on the timetable to achieve indicative precautionary balances of SDR 15 billion? Should the target for the increase in precautionary balances be increased in line with the increase in the expected peak of outstanding credit?

- Under current projections, the indicative medium-term target of SDR 15 billion for precautionary balances could be reached in FY2016 (memorandum item in Table II.1 of EBAP/11/32). Taking into account arrangements approved since the last review of the adequacy of precautionary balances in September 2010, the current indicative target remains within the 20-30 percent band of the framework proposed by the staff at that time. Directors may also recall that in this proposed framework there was no presumption that the target should be at the mid-point of the range, which was intended to serve as a guide for decisions on where to set the target over time. At the time a few Directors preferred to revisit the target when the agreed floor of SDR 10 billion had been reached.

Surcharge Income

6. When would a decision pertaining to a proportion of surcharge income being allocated to the special reserve be considered?

- The decision to place a proportion of surcharges to the special reserve would be taken in the context of the annual Board discussions on the Fund’s income position. Factors that could influence the timing include the actual level of surcharges, which are projected to rise substantially beginning in FY2012, and the overall level of reserves relative to the agreed floor, and the indicative medium-term target, for precautionary balances.