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September 15, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Financial and Operational Modalities of Off-Market Transactions in Gold by the Fund**

Attached for the information of Executive Directors is a paper that elaborates on the financial and operational modalities of off-market transactions in gold by the Fund and addresses a number of questions and concerns raised by Executive Directors during the discussion of the financing for the continuation of the ESAF and HIPC Initiative at EBM/99/95 (8/30/99). This paper is intended to serve as background material for the discussion on the ESAF and HIPC Financing Issues scheduled for tomorrow, Thursday, September 16, 1999.

Mr. Kuhn (ext. 36555) and Mr. Keuppens (ext. 37813) are available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

Financial and Operational Modalities of Off-Market Transactions in Gold by the Fund

Prepared by the Treasurer's Department
(in consultation with the Legal Department)

Approved by Eduard Brau

September 15, 1999

I. Introduction

1. During the discussion of the financing for the continuation of the ESAF and HIPC Initiative on August 30, 1999 (EBM/99/95), the Executive Board considered the feasibility of off-market transactions in gold by the Fund. The features of such a mechanism were described in the Statement by the Staff Representative on Off-Market Transactions in Gold Conducted by the Fund (BUFF/99/103, 8/25/99). During that meeting, there was broad support for off-market transactions in gold as a viable alternative to direct sales in the market to help assure the financing of the ESAF and HIPC Initiatives.

2. This paper further elaborates on the financial and operational modalities of the proposal and addresses a number of questions and concerns raised by Executive Directors. The operational modalities are detailed in Section II; the effect on the Fund's income and possible ways to mitigate this are discussed in Section III; valuation and accounting questions are reviewed in Section IV; other operational issues are listed in Section V; and the range of decisions that would be required, together with the required voting majorities, are presented in Section VI.

II. Operational Modalities

3. The off-market transactions in gold would entail a series of separate, but closely linked transactions between the Fund and one or more members with repurchase obligations falling due in the near future.[1]

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[1] A numerical example is shown in the Appendix.

- In the first leg, the transactions would consist of the sale of gold at the market price to a member that has repurchase obligations falling due. The quantity of gold sold would be calculated so that the total proceeds from the sale would be equivalent to the scheduled repurchase obligation falling due. The profits from the sale would then be placed in the Special Disbursement Account (SDA) for investment, with the investment returns transferred to the ESAF-HIPC Trust.

- In the second leg, the transactions would consist of the acceptance by the Fund of the same quantity of gold at the same price, previously sold to a member in payment of a repurchase obligation due, from that member.[2] The acceptance of gold in payment of repurchase obligations falling due would reduce the Fund's liquidity and affect the Fund's income position, since remunerated positions, and their associated cost, would be higher than they otherwise would have been.

4. These transactions are separate and independent in the legal sense and would need to take place in the order listed, but operationally they would be scheduled to be executed for value the same day. This would assure the Fund that the gold is indeed kept off market and assure the particular member country that it would incur no price or exchange risk in the transactions.

5. The detailed sequence of transactions would be as follows:

- Step 1. One or more cooperating members with obligations falling due in the relatively near term would agree in advance to buy gold at the market price[3] from the Fund, with an understanding that the Fund would be willing to accept the same amount of gold in payment of a repurchase obligation falling due. The exact quantity of gold to be sold would be calculated by reference to the market price on the value date of the repurchase falling due. The member would be asked to represent that it will not sell the gold so acquired in the market. The member would also indicate its intention to use this gold for a specific payment to the Fund in respect of a repurchase obligation falling due.

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[2] This second leg has a precedent. The Fund accepted, at the market price, 21,396 ounces of gold from Cambodia in 1992 in partial discharge of the member's overdue obligation. The origin of this gold was the share of Cambodia, held by the Fund on its behalf, of a sale of gold by the Fund to members at the official price prior to the effectiveness of the Second Amendment. It is recorded at SDR 240 per fine ounce in the Fund's balance sheet, which at the time of the transaction was equal to US$335.30 per fine ounce.

[3] In line with the last transaction in gold conducted in 1992 with Cambodia, the U.S. dollar price of gold at the morning fixing price in London and the value of the U.S. dollar in terms of the SDR as determined under Rule O-2(a) would be used (see *Operational Aspects of the Fund's Financial Relations with Cambodia* (EBS/92/193, 11/30/92), and Supplement 1).

- Step 2. On the value date of each repurchase, the Fund would sell to the member the quantity of gold equivalent to the repurchase obligation, calculated at the market price.
- Step 3. Upon receipt from the cooperating members of the proceeds from the sale of gold, the Fund would, in accordance with the Articles of Agreement, place the equivalent of SDR 35 per fine ounce of gold in the GRA and the excess in the SDA. The resources held in the SDA would subsequently be invested in financial assets and the investment returns transferred to the ESAF-HIPC Trust.
- Step 4. The member would use the amount of gold bought from the Fund in payment of the repurchase obligation falling due on the same day. Upon completion of this transaction, the Fund would record the settlement in gold of the member's repurchase obligation. The payment to the Fund in gold would again be at the market price on the value date of the payment and this would be the book value of the gold, reflecting the acquisition cost to the Fund.

6. The overall net effect of the series of transactions in gold is that the Fund's holdings of usable currencies would be lower (and reserve tranche positions higher) than they would have been with a market sale and a repurchase in usable currencies. The value of the Fund's gold holdings acquired in payment would be recorded at a higher value in the Fund's balance sheet, although the Fund's physical quantity of holdings of gold would remain unchanged when all the transactions are completed.

7. Table 1 illustrates the effects on the Fund's financial position, assuming a sale of 10 million ounces at $260 dollars per ounce and an exchange rate of SDR 1= US$ 1.36464 (as in BUFF/99/103).

Table 1. Financial Effects on the GRA of Off-Market Gold Transactions

(In millions of SDRs)

	Gold (Book value)	Usable currencies	Profit
Off-market transactions			
a. Sale of gold, receipt of proceeds, and recognition of profits	-350	+1,900	+1,550
b. Placement of profits in the SDA	0	-1,550	-1,550
c. Acceptance of gold instead of usable currencies	+1,900	-1,900	0
Net effect	+1,550	-1,550	0

III. Effect on Income and Burden Sharing

8. The acceptance of gold instead of currencies in payment of repurchase obligations would enlarge remunerated positions and increase the Fund's net operating expenses, which, other things being equal, would result in a somewhat higher rate of charge on the use of Fund credit. At the current SDR interest rate and estimated reserve tranche positions at the end of the year, the additional operational expense resulting from off-market transactions is estimated to amount to SDR 52 million per annum (for a sale of 10 million ounces), requiring an increase in the rate of charge in the order of 9 basis points, on an annual basis. This effect would persist as long as the profits from these gold transactions would be held in the SDA, or as long as the accumulation of other interest-free resources, e.g., reserves, would not fully compensate for this additional cost.

9. Under the Fund's current mechanism for setting the rate of charge and the income target, the rate of charge is set at the beginning of each financial year so as to cover the cost of financing the use of credit (mainly remuneration expenses) and the administrative expenses, as well as to generate an agreed income target amount for placement to the Fund's reserves.[4] For this purpose, the Executive Board has decided that income from the Supplemental Reserve Facility (SRF) is to be excluded from the target and the mechanism to set the rate of charge, after meeting the cost of administering the ESAF Trust (SRF income is placed to the Fund's General Reserve, while regular income is placed to the Special Reserve).[5]

10. Since the rate of charge for FY 2000 has already been set, net income in FY 2000 would be lower as a result of the enlarged remunerated positions. Under the decisions agreed at the beginning of the year, lower FY 2000 income would result in either the income target not being met (with the shortfall being added to next year's target), or in lower net income in excess of the target. The latter would result in a reduction of the agreed refund of this excess to the debtors after the end of the financial year. For FY 2001, absent a mitigation mechanism, the rate of charge would need to be set higher than otherwise would be the case.

11. The Fund could adopt measures to mitigate the impact on the rate of charge, and BUFF/99/103 discussed the possibility of mitigation through a reduction in the rate of remuneration. Under such a mechanism, members with remunerated reserve tranche positions in the Fund would receive reduced remuneration so as to neutralize the effect of their larger remunerated positions. Such a mitigation could be implemented on a quarterly basis after the off-market transactions have started. The reduction in the rate of remuneration was estimated

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[4] For a full discussion of factors affecting the rate of charge, see the latest projection of Fund income in *Review of the Fund's Income Position, Precautionary Balances, Burden Sharing and Special Charges for FY 1999 and FY 2000* (EBS/99/53, 4/6/99).

[5] The main difference between the Special Reserve and the General Reserve is that the latter can be distributed to all members in proportion to quota, while the former cannot be distributed, but is used to absorb operational losses.

at 9 basis points, with the exact amount depending on the level of actual average remunerated positions (which would vary as a function of the prospective use of Fund credit) and the SDR interest rate.

12. The mitigation could also take other forms. In parallel to the burden sharing mechanism currently in effect, the cost could be shared by both debtor and creditor members, by increasing the rate of charge and by reducing the rate of remuneration. In this context, as mentioned in the Managing Director's Statement of September 9, 1999 (BUFF/99/111), one Director proposed a sharing of the burden with one third of the cost being absorbed by debtors and two thirds being borne by the creditors, resulting in a proportion of 2 to 1. (Table 2 illustrates the adjustments that would be required under these combinations.) Unlike the current mechanism under burden sharing, the adjustments would not be refundable.

Table 2. Mitigation of Off-Market Gold Transactions[1]
for 10 Million Ounces

(In basis points, rounded)

	Adjustments in basis points	
GRA credit (SDR billions)	Rate of Remuneration	Rate of remuneration and rate of charge 2:1 split
40	13	9 and 4
57	**9**	**6 and 3**
80	7	5 and 2

[1] Assumes off-market transactions with profits of SDR 1.55 billion and SDR interest rate of 3.38 percent. Adjustments would vary according to the prevailing SDR interest rate.

13. As a third option, the possibility exists for the Fund to absorb part of this additional cost, thereby reducing the additional burden on debtors or creditors. Under this alternative, it *could be decided to isolate some part of the effect of the off-market transactions by excluding* this effect from income. For the current financial year, part of the additional operational cost could be taken into account when determining income for FY 2000. The shortfall resulting from these transactions in FY 2000 would then not be added to next year's target and the refund of FY 2000 income in excess of target would be calculated by excluding the effect of these transactions. The result of such a mechanism would then be that net income (and the allocation of income to reserves) would be lower than it otherwise would be and that the Fund would carry the burden by achieving lower income.

14. A portion of the total cost could be mitigated in this manner. For example, as proposed in BUFF/99/111 (9/9/1999), the cost of gold sold in excess of 10 million ounces could be mitigated in this way, should the Executive Board decide to increase the amount of gold sold in order to secure full financing for the ESAF-HIPC Initiatives. The cost to mitigate the effect of a sale of 4 million ounces would be in the order of SDR 20 million per annum. Given this year's target of SDR 128.5 million, there is likely to be sufficient room to accommodate such a reduction.

15. In future years, such a mechanism would mean that the target—previously assumed to continue at 5 percent of reserves at the beginning of the year or SDR 143 million in FY 2001—would also be reduced by an agreed amount. In this context, it should be noted that the General Reserve has been enlarged in recent years through the accumulation of income derived from the SRF (by an estimated total amount of SDR 560 million at the end of this financial year). The absorption by the Fund of part of the cost of the off-market transactions would spread the burden—on a quota basis—among all members rather than on debtors and creditors only.

IV. Valuation of Gold in the Fund

16. The valuation of the Fund's gold would remain consistent with the requirements of generally accepted accounting principles and international accounting standards. The Fund values its gold holdings at cost, an accounting concept known as the historical cost concept. The acceptance of gold from members in payment of their repurchase obligations would have to be recorded at the market price of the gold accepted in payment of the repurchase obligation. In accordance with International Accounting Standards (IAS) 25—Accounting for Investments, the Fund's gold holdings classify as long-term investments. IAS 25 permits long-term investments to be carried on the balance sheet either at cost (the preferred treatment), or at revalued amounts. When a long-term investment is carried at cost, any decline in the market value below cost is to be recognized as an expense in the income statement. Since gold holdings are fungible, cost for the purposes of this market value test is determined with reference to the total holdings, i.e., at the average cost of all gold holdings.

17. Using the historical cost concept, different components of the Fund's gold holdings would be carried in the Fund's balance sheet at different values, corresponding to the cost at which gold was acquired. After the proposed off-market transactions, the accounting value of the Fund's total gold holdings at average cost would remain significantly below the market value, and it is unlikely that the market value would decline to such a point that an adjustment to the carrying cost of the Fund's total gold holdings would be required. For this to take place, with gold sales up to 10 million ounces, the market value of gold would need to decline below SDR 50 per fine ounce or, at the current exchange rate, to US$68 per fine ounce.

18. The details of these transactions would be fully transparent and fully disclosed, including in the Fund's financial statements.[6] The Fund's financial statements would reflect a breakdown of the composition of the Fund's gold holdings, and their associated cost. As at present, the valuation basis would be fully discussed in the notes to the financial statements, together with the disposition of the gains.

19. Although IAS 25 permits the Fund to revalue its gold holdings periodically, such a revaluation is not permitted under the Fund's Articles since the provisions of Article V, Section 12(f), require a valuation of gold held by the Fund on August 31, 1975 at SDR 35 per fine ounce and that profits be disposed in accordance with the Articles.

20. Despite a growing tendency by central banks to value official gold reserves at market prices or at a value related to the market, a significant number of central banks continue to value their gold at substantially less. For example, the United States values its gold at the last official gold price in 1971 of US$42.22 per fine ounce. Recent developments in international accounting standards may require central banks that follow those standards to value their gold at "fair value" if their gold holdings are akin to an investment in other financial assets such as currencies, i.e., when such holdings are freely disposable.[7] For the Fund, however, this treatment would not apply since the nature of the Fund's gold holdings is such that it could not be construed as equivalent to a holding of currency, in terms of liquidity or in terms of realizability (and disposition) of the profits.

21. Off-market transactions and their subsequent effect on the increase in the carrying value of gold also result in exclusion of the gold used in the transactions from possible future restitution by the Fund, at the price of SDR 35 per fine ounce. Since this part of the Fund's gold would not be covered by the restitution provisions, the Fund could thus not incur possible losses in this respect.

V. Operational Considerations

22. In principle, the acceptance of gold in payment of an obligation could be conducted with all members with financial obligations falling due. In practice, however, and from an operational point of view, it would be preferable to conduct these transactions with a limited number of members with large single repurchase obligations falling due in the near future. A

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[6] See the memorandum from the Secretary to the members of the Executive Board on *Effects on the Fund's Financial Statements of Off-Market Transactions in Gold* (FO/DIS/99/119, 9/1/99)

[7] Fair value is determined taking into account, inter alia, restrictions on sale and the possible impact on the market price of selling large amounts at once, e.g., a fair value of 90 percent of market price could be justified if a sale is likely to realize less than the market price.

more limited number of participants is also preferable, given the technical operational issues that would need to be agreed between the cooperating members and the Fund. The two members with the largest repurchase obligations falling due in the remainder of CY 1999 and through the end of CY 2000 (Brazil and Mexico) are actively considering possible participation in the off-market transactions. If all necessary decisions were adopted before November 5, 1999, all transactions up to an amount of 14 million ounces could be completed within three months. If agreement by the membership to proceed with the gold sales were only to be obtained by early 2000, all transactions could be executed during the first half of CY 2000.

23. The Fund's gold holdings are held with four depositories (Bank of England–London, Banque de France–Paris, Federal Reserve Bank of New York, and Reserve Bank of India, Nagpur). Since physical quantities held by these depositories would, in the end, not be affected, member countries are not expected to have a preference about the use of depositories. From an operational perspective it would be technically simpler and more expedient to agree all operational aspects with one single depository. In view of the large share of U.S. dollars in total operational transactions, the staff would also suggest to conduct these transactions with the Federal Reserve Bank of New York, with the understanding that any increased use of the U.S. dollar that would result from these transactions would remain within the limits of the operational budget.

VI. Decisions Required

24. Several decisions would be required to give effect to the proposed off-market gold transactions.

25. The first decision, requiring an 85 percent majority of the total voting power, is to sell up to 14 million ounces of gold at the market price to members. It would be recognized that the sale of gold would take place in several transactions, and the decision would specify the basis for the market price.

26. The second decision, also requiring an 85 percent majority of the total voting power, is to accept up to 14 million ounces of gold from cooperating members in payment of their repurchase obligations to the Fund. This decision would specify that the gold accepted be valued in terms of the SDR on the basis of prices in the market by using (i) the agreed basis for setting the market price, and (ii) the value of the U.S. dollar in terms of the SDR as determined under Rule O-2 (a) on the same date.

27. A third decision would be required to decide on the use of the proceeds placed in the SDA for the benefit of the ESAF-HIPC Trust. This decision requires an 85 percent majority of the total voting power.

28. Finally, decisions would be required to adjust the rate of remuneration and the rate of charge in order to mitigate the increased operational expenses. These decisions would also

adjust any shortfall or excess income in FY 2000, and could adjust the income target to take account of that share of the burden that would fall on the Fund. These decisions would require a 70 percent majority of the total voting power.

Illustration of the Mechanism

This appendix provides a numerical example of the steps involved in the off-market gold transactions. It is assumed that a member has a forthcoming repurchase obligation of SDR 100 million on October 15, 1999. The member agrees to cooperate with the Fund in the off-market gold transactions. The Fund would therefore sell gold to the member in an amount equivalent to SDR 100 million valued at the market price of gold determined by the morning fixing price of gold in terms of the U.S. dollar in London and the value of the U.S. dollar in terms of the SDR. As is standard operational practice in the GRA, the value of gold and the U.S. dollar exchange rate in terms of the SDR would be determined three business days prior to the value date. There would be a transfer of ownership of the physical gold from the Fund to the member in exchange for usable currencies. On the same day, the Fund would accept gold, valued on the same basis as for the sale, in payment of the member's repurchase obligation of SDR 100 million; ownership of the physical gold would be transferred from the member to the Fund. The following operational steps would apply:

- The U.S. dollar equivalent of the SDR 100 million would be determined in the usual way—in accordance with the Fund's Rules and Regulations, the SDR exchange rate of three business days prior to the value date would be used. Assuming an exchange rate of SDR 1 equals US$1.36464, the U.S. dollar equivalent amounts to $136.5 million.

- Assuming the market price of gold on October 12, 1999 of $260 per fine ounce, the cooperating member's repurchase obligation is therefore equivalent to 524,861.54 ounces of gold (repurchase obligation of $136.5 million divided by $260 per fine ounce).

- The cooperating member agrees to buy 524,861.54 ounces of gold from the Fund at a price of $260 per fine ounce for value October 15, 1999 and on that date the member transfers $136.5 million to the Fund in return for 524,861.54 ounces of gold.

- The Fund agrees to accept gold from the cooperating member in payment of the repurchase obligation due October 15, 1999.

- On October 15, 1999, the Fund accepts 524,861.54 ounces of gold valued at SDR 100 million in payment of the member's repurchase obligation. Since the cooperating member is repurchasing its own currency, the Fund's holdings of the repurchasing member's currency would be reduced by the equivalent of SDR 100 million.

Since the transactions would take place on the same day and involve the same gold, the transactions would involve no price risk or exchange rate risk.