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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 15/41-1

10:00 a.m., April 27, 2015

1. Review of the Fund's Income Position for FY2015 and FY2016

Documents: EBAP/15/32; EBS/15/32 and Supplement 1

Staff: Andrews and Nana, FIN; Leckow, LEG

Length: 1 hour, 5 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
C. Kapwepwe (AE)	
	W. Diallo (AF)
	J. Corvalan (AG), Temporary
	I. South (AP), Temporary
	I. Oliveira Lima (BR)
Z. Jin (CC)	
	C. Hurtado (CE)
	M. Hough (CO), Temporary
	C. Just (EC)
	M. Farnoux (FF), Temporary
H. Temmeyer (GR)	
R. Mohan (IN)	
C. Cottarelli (IT)	
M. Kajikawa (JA)	
J. Mojarrad (MD)	
	S. Geadah (MI)
M. Snel (NE)	
A. Groenn (NO)	
	L. Palei (RU)
F. Alshathri (SA)	
	P. Tangcharoenmonkong (ST)
	M. Cavaliere (SZ), Temporary
M. Sobel (US)	
S. Field (UK)	

C. McDonald, Acting Secretary
T. Rumbaugh, Summing Up Officer
M. Guerra Bradford/D. Kovacevic, Board Operations Officers
M. Yslas, Verbatim Reporting Officer

Also Present
Finance Department: D. Andrews, D. Nana. Legal Department: R. Leckow. Strategy, Policy, and Review Department: M. Flanagan. Alternate Executive Director: H. Alogeel (SA), W. Kiekens (NE), P. Sun (CC). Senior Advisors to Executive Directors: A. Monajemi (MD), R. Ngugi (AE), C. Quaglierini (IT), S. Rouai (SA), M. Sidi Bouna (AF), K. Watanabe (JA). Advisors to Executive Directors: P. Ayissi-Etoh (AF), E. Boukpessi (AF), J. Clicq (NE), M. Govil (IN), S. Keshava (SA), M. Merhi (MI), T. Nguema-Affane (AF), X. Shi (CC), H. Zavarce (CE), F. Najjarian (BR).

1. REVIEW OF THE FUND'S INCOME POSITION FOR FY2015 AND FY2016

Mr. Sobel, Mr. Gruber and Mr. Haarsager submitted the following statement:

We appreciate the opportunity to review the Fund's income position in Fiscal Years 2015 and 2016. We support all of the proposed decisions at this time, except the proposed Decision 5.

Decision 5 would allocate all the net income from the General Resources Account for FY2015 to the special reserve, rather than following the long-standing practice of allocating only operating income to the special reserve while surcharge income was allocated to the general reserve. In our view, the staff has not provided a compelling reason to allocate this income to the special reserve.

The Board has already agreed that precautionary balances—which include both the special and general reserve—should exceed a floor of SDR 10 billion and aim to reach SDR 20 billion in the medium term. We fully support maintaining the floor, and robust precautionary balances. Indeed, precautionary balances, according to Table 1, are now projected at SDR 14 billion at the end of the 2015 fiscal year, well in excess of the floor. We continue to strongly support the build-up of precautionary balances to the Board's medium-term target of SDR 20 billion.

What is new, however, is that the staff now proposes that the SDR 10 billion precautionary balance floor, agreed by the Board, should be held entirely in the "special reserve," whereas previously, the Board had viewed balances held in both the general and special reserves as available to meet the objectives of precautionary balances. Under the staff's new proposal, there would be a need to build up the "special reserve" by another roughly SDR 6 billion to achieve the floor. The only difference, however, between the "special reserve" and "general reserve" is that the former cannot be distributed to the membership.

Again, we fully support the build-up of precautionary balances, as agreed by the Board. But we believe that the distinction being made between the "special" and "general" reserve is artificial, especially in light of the decisions already taken by the Board on the floor and medium term target and the fact that precautionary balances are well in excess of the floor. As such, Decision 5 strikes us as introducing unnecessary rigidity into the definition of precautionary balances and the Fund's income structure, and needlessly circumscribing the Board's discretion over the Fund's financial structure.

Absent a more compelling rationale, and given the closeness of the end of the fiscal year and thus the lack of time for a fuller discussion of this proposal, we would prefer that the practice of the previous two decades, with surcharge income being allocated to the general reserve, be continued for FY2015. We understand that the work program includes a review of the adequacy of the Fund's precautionary balances early next year; we believe that the staff could return to this proposal then with a more complete rationale and adequate time for a fuller discussion.

Mr. Cottarelli and Ms. Quaglierini submitted the following statement:

We thank staff for the very informative and well written set of papers (although, as noted in previous occasions, we continue to encourage a further consolidation of these papers to avoid unnecessary repetitions for example between EPAB/15/32 and EBS/15/32, as well as with some sections of EPAB/15/29).

We broadly support the proposed decisions with the exception of Decision 5, which we oppose in its current form, based on the considerations highlighted below.

We take note of the more muted income projections compared to those presented last April, due to lower revenues from both lending and interest as a result of an updated set of information. With regard to the precautionary balances, we are fully comfortable with a more gradual path of accumulation and wish to note that the SDR 20 billion target for them is only indicative.

Additionally, and with the benefit of hindsight, our feeling is that last year's discussion at the Board on the review of access and surcharge policies may have represented a missed opportunity to revise the high level of surcharges—indeed borne by a very limited number of countries—against the exceptionally low interest rates prevailing in the markets.

Concerning Decision 5, we are not convinced by the arguments put forward by staff to justify the transfer of the surcharges to the special reserve. More precisely, we did not find persuasive the argument in paragraph 12 that the floor of SDR 10 billion for the precautionary balances applies to the special reserve. As indicated in footnote 21 of the paper, precautionary balances comprise three items (special reserves, general reserves, and SCA-1) and the 10 billion floor applies to all precautionary balances. Moreover, over the past few years both the net operational income and the IAS 19 adjustment have been normally imputed to the special reserve while surcharges have been transferred to the general reserve. Indeed, as indicated in Box 2 of EBS/15/32, the practice above described has been quite common at the Fund (in FY1998-2006 and in FY2011-2014). The flexibility in the use of the special reserves is more limited than the flexibility in the use of general reserves and we do not see the case for adding additional constraints.

Accordingly, we would propose to amend Decision 5 by envisaging the transfer of the surcharges to the general reserve, by restating the rule existing last year.

We look forward to the next Review of the Adequacy of Precautionary Balances which will take place in early 2016. It will be an important step to have a more in-depth discussion of some of the issues discussed in EBS/15/32 (including the one related to Proposal 5 discussed above). Relatedly, we also look forward to the follow-up discussion of the investment strategy. In the current interest rate environment, it may be appropriate to consider a prudent revision of the current strategy to raise the income from the Fund's resources.

Mr. Hendrick and Mr. Corvalan submitted the following statement:

We thank the staff for the detailed work to update the projections for the Fund's income position this year and the next and the proposed decisions to be made. For FY2015 and FY2016 net income revised projections are down by 37.5 percent and 59.5 percent compared to last year review. This important downward revision is well explained in the document, and again teaches us how uncertain and sensitive this exercise could become to changes in the economic environment.

For FY2015 we are aware that IAS 19 deals with the accounting for pension and other employee benefits and its link to the employer financial statements. For this Fiscal Year, the projected loss adjustment is around SDR 847 million, in contrast with FY2014 where a positive adjustment of SDR 904 occurred. The report is very clear to say that most of these swings are attributable to the change in the discount rate. Given the importance of the swings in this specific account, would advise to present this case in the future, with more details (for example, a graph that plots probabilities of occurrence given different scenarios of discount rate).

Following FY 2015 and the disposition decisions, where the General Resources Account (GRA) is reimbursed annually for the expenses of conducting the business of the SDR Department, of administering the PRG

Trust, and of administering SDA resources in the MDRI-I and CCR trusts, we have the following position:

Decision 1: We support the reimbursement estimated of SDR 3.48 million for SDR Department.

Decision 2: We support the reimbursement estimated of SDR 0.06 million for SDA for administering in the CCR trust.

Decision 3: We support the reimbursement estimated of SDR 52.94 million for administering the PRGT trust.

With relation to the use of IA income, and understanding the income from the IA may be invested, held in the IA, or used to cover the expenses of the Fund for its normal operations, we have the following position:

Decision 4: We support the transfer of SDR 82 million from the Fixed-income Subaccount to the GRA, to cover part of the administrative expenses of the Fund.

Decision 5: Understanding that under the New Income Model (NIM) the Fund has a floor to reach for precautionary balances of SDR 10 billion, we support that GRA net income estimated in SDR 1.3 billion in FY2015, be placed to the special reserves. After this placement of SDR 1.3 billion, the special reserve would total SDR 5.2 billion. We will like more clarification from staff on the estimated total precautionary balance totaling SDR 14.0 billion (sum of Special Reserves SDR 5.2 billion, General Reserves US$7.6 billion and SCA-1 1.2 billion) and the projected level of General Reserves plus Special Reserves at the end of FY2015 of SDR 17.2 billion. What is the difference among these two figures?

Finally regarding Decision 6 and 7: For the former we agree to maintain the rate of charge on the use of Fund resources for FY2016 at 100 basis points over the SDR interest rate. For the latter, which relates to the GRA and Trust Fund special charges, we believe there is no need for changes to the current system.

Mr. Just and Mr. Kollar submitted the following statement:

We support the proposed decisions on the Fund’s income position for FY2015 and FY2016. The net income position remains strong, albeit with declining lending income, allowing for a steady build-up of precautionary balances. The higher than projected investment income in FY2015 is welcome, even though it reflects the current state of play in global bond markets and can therefore not be counted on in FY2016 in light of the expected monetary policy normalization in the United States.

We wish to provide the following additional comments:

We regard it as good practice to place the GRA net income to the special reserve, which is not distributable to members, in order to keep building precautionary balances. At the end of FY2015, total precautionary balances are projected at SDR 14 billion and the part that is not distributable (i.e. the special reserve) is projected at SDR 5.2 billion. We feel strongly about the need to achieve the indicative medium-term target for total precautionary balances at SDR 20 billion and to reach the floor of SDR 10 billion for precautionary balances that will not be considered as available for future distribution. We see the Fund's precautionary balances as a protection of the international reserve status of member countries' reserve positions in the IMF.

We support retaining the funds available for transfer to the IA in the GRA until after the upcoming review of the investment mandate for the FI subaccount.

In line with the past Board decision on the endowment subaccount, we welcome the procedure of retaining the endowment's income in the IA during the phasing period.

We support keeping the margin for the rate of charge unchanged in order to continue building reserves and covering the intermediation costs. We note the uncertainties surrounding the lending income going forward.

Finally, we are concerned about the cost overruns of the ongoing HQ1 renovation and their impact on the Fund's expenses. We would like to request additional information on the status of the HQ1 renovation project before this year's Board recess.

Mr. Alshathri and Mr. Keshava submitted the following statement:

We thank staff for the review of the Fund's income position for FY2015 and FY2016. Against the backdrop of lower projected lending income over the medium term in comparison to earlier estimates, we note that precautionary balances are expected to remain below the indicative medium-term target of SDR 20 billion, which was reaffirmed in the last review held in February 2014. In this context, we look forward to the next review of the adequacy of precautionary balances expected in early 2016.

We support the proposed decisions and would like to highlight the following points:

First, following the revised income outlook, we are comfortable with the placement of FY2015 GRA net income to the special reserve. Given the firm support for a floor of SDR 10 billion for precautionary balances, it seems sensible to build special reserve till we reach this floor, which will add solidity to the Fund's balance sheet. Indeed, if we maintain the current practice of placing all surcharge income to general reserve, the special reserve is projected to remain well below the floor of SDR 10 billion over the medium term.

Second, the amended IAS 19 has continued to add greater volatility to the annual net income. It is therefore not inconceivable that this treatment may lead to negative net income position in certain years despite high income. For example, the projected net income for FY2016 is of the same order as the IAS 19 timing adjustment for FY2015. We therefore reiterate our call for added emphasis in the external communication on this source of volatility in the Fund's net income in the period ahead.

Finally, we need to recognize the importance of borrowed resources in strengthening the Fund's finances. Owing to the continued activation of the NAB, the Fund not only has been able to comfortably meet members' financing needs, but also to generate robust net income that has enabled accumulation of precautionary balances. We continue to see an important role for borrowed resources to supplement quota resources that will help generate income for the Fund and further strengthen its balance sheet.

Mr. Dupont and Mr. Hough submitted the following statement:

We thank staff for their review of the Fund's income position, which remains strong and continues to contribute to the buildup of reserves. We can support the proposed decisions, except for Decision 5, which proposes to allocate all of the net income for FY2015 to the Special Reserve.

With regard to Decision 5, we broadly agree with the statements from Messrs. Sobel, Haarsager, and Gruber; and Mr. Cottarelli and Ms. Quaglierini.

We note that in the past the typical practice was to transfer surcharge income to the General Reserve. While we are open to the suggestion that the SDR 10 billion, set as the floor for precautionary balances, could be held in the more restrictive Special Reserve, we do not feel that there has been an adequate discussion of the implications of this decision and therefore we oppose the proposed Decision 5 in its current form. Similar to Messrs. Sobel and Cottarelli, we suggest that Decision 5 be amended to reflect the normal split between the Special and General Reserve, similar to the rule followed previously.

In particular, the presumption that the SDR 10 billion floor of precautionary balances should be placed in the Special Reserve represents the view of staff, which has not provided any compelling rationale for this distinction between the Special and General Reserve for the purposes of precautionary balances. We consider that any decision on the best place to hold this SDR 10 billion should take place in the appropriate forum, which for us would be in the next discussion on precautionary balances. Finally, and without calling into question the need for the SDR 10 billion floor, placing the net income into the Special Reserve introduces an unnecessary constraint on the Board's discretion over the Fund's financial structure. Any proposal that would limit the Board's governance capacity to exercise control over the resources of the Fund should be subject to more detailed analysis.

Similarly, it is not clear why the medium-term net income projections in the companion paper EBAP/15/32 assume precautionary balances, upon which investment income will be earned, to be only SDR 10 billion in FY2025. Given that precautionary balances already exceed this and are projected to rise to SDR 19.4 billion in FY2024, it seems excessively cautious to assume that they will fall to SDR 10 billion for the purposes of making income projections.

Finally, same as last year, we continue to consider that the IAS 19 accounting adjustment for pension benefits adds an unwelcome element of volatility into the income statement. While we appreciate that this outcome is a consequence of preparing Board statements in compliance with IFRS rules, we consider that there is merit in finding a better way to present these IAS 19 adjustments so as to show a clearer picture of the underlying income and reserve positions.

Mr. Mozhin and Mr. Palei submitted the following statement:

> We thank staff for their report and for the informal discussion before the Board meeting. Similar to other Directors, at this stage, we do not see compelling reasons to switch from a long established practice and to place all FY2015 GRA net income to the Fund's Special Reserve. Therefore, we support the proposed decisions except for Decision 5.

Mr. Temmeyer, Mr. Groenn and Mr. Radziwill submitted the following joint statement:

> We agree with the proposed Decisions 1 to 7 pertaining to the disposition of the FY2015 income and the determination of the income in FY2016. We would like to make the following comments for emphasis:
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> We take note of the downward revision in (i) the net income projection for FY2015 and (ii) the projected reserve accumulation in FY2015 and later. The review of the precautionary balances scheduled in February 2016, which we look forward to, will provide an ideal opportunity to discuss these developments.
>
> We consider appropriate to maintain the rate of charge at 100 basis points over the SDR interest rate for FY2016 (Decision 6). Market developments do not provide a compelling reason for changing the 100 basis points margin in FY2016. In fact, long-term market conditions, measured as EMBI spreads adjusted for the risk and term premiums, have remained broadly unchanged compared to last year. Moreover, the decision of maintaining the 100 basis points margin unchanged is important to ensure a further build-up of precautionary balances in FY2016.
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> We support placing the surcharge income for FY2015 in the Special Reserve (as implied by Decision 5). The Special Reserve, which represents the first line of defense against income losses, is currently too low. The proposed allocation of the surcharge income is key to ensure that this important reserve can be increased in FY2015. That being said, we would like to underline that the established floor for precautionary balances doesn't apply specifically to the special reserve and there exists no general presumption to this effect.
>
> We welcome the reimbursement to the General Resources Account for the administrative costs of running the Poverty Reduction and Growth Trust (PRGT) in FY2015 (Decision 3). This decision is consistent with both

the 2008 New Income Model and the strategy for PRGT sustainability agreed by the Board in 2012. We expect that this practice will be maintained in the future.

We take note that IAS timing adjustments introduce substantial volatility into the Fund's income and reserve position. While it may be difficult to forecast future IAS timing adjustment with a satisfactory degree of certainty, an indication of likely future adjustments would still be welcome to illustrate that some of the volatility is likely to disappear when one looks at a longer time horizon. The staff's comments are welcome.

We note the higher estimate for investment income for FY2015 compared with initial projections and would appreciate some further elaborations on downside risks from a rise in interest rates.

Mr. Sun and Ms. Shi submitted the following statement:

We thank staff for the report on the review of the Fund's income position for FY2015 and FY2016, and broadly support the proposed decisions. We would like to provide the following comments for emphasis.

We support to retain the currencies available for transfer to the investment account in the General Resources Account (GRA) as an interim measure, in view of the upcoming comprehensive review of the investment mandate for the Fixed Income Subaccount. Until now, Fund operations are still financed mainly by lending income, while investment income continues to be constrained by the historically low global interest rates. Nevertheless, we encourage staff and management to provide concrete proposals to the Board on how to manage the investment account better.

We also support the proposed decision to place the GRA net income of SDR 1.3 billion for FY2015 to the special reserve which can serve as the first line of defense against income losses. In view of the early repurchases under way, maintaining the current practice of placing all surcharge income to the general reserve would leave the special reserve well below the SDR 10 billion floor of precautionary balance. Therefore, we support to place the GRA net income, including surcharges, to the special reserve for FY2015 to help restore the pace of accumulation of the special reserve.

In light of market developments and uncertainties over the future course of Fund lending, we can support to maintain the rate of charge on the use of Fund resources for FY2016 at 100 basis points over the SDR interest rate. As nonlending income is insufficient to cover nonlending costs due to the very low level of interest rates, we can agree with staff's proposal to use the exceptional circumstances clause. However, we are a bit concerned about the pace of accumulation of precautionary balance and are open to proposals that could help address such concern.

Mr. Snel and Mr. Clicq submitted the following statement:

We thank staff for the review of the Fund's income position for FY2015 and FY2016. We note that lending continues to be the main source of income and is declining. Also investment income remains constrained due to the low interest environment. The declining income position of the Fund warrants that the Fund's income and budget discussions are better integrated. We can support the proposed Decisions 1 to 4 and 6 and 7.

We agree that the Fund should have adequate buffers, but these buffers do not necessarily need to be in the special reserves. The Board has set a target and a floor for the balances, regardless whether these are met by the special or general reserves. Adding net operational income to the special reserves already provides for a stable increase in the special reserves over the medium term. Adding surcharge income to it creates an unwanted precedent by locking in all these resources. We therefore see no need to add surcharge income to the special reserves and to deviate from earlier policies and consequently we oppose Decision 5.

We are increasingly concerned about the negative net operation income position. The paper might give the perception that the Fund's income position remains comfortable, while we have doubts this is the case. We see merit in the precondition of a balanced budget before any surcharges income. Surcharges are designed to discourage large and prolonged use of IMF resources and should not seek to rebalance the income position of the Fund.

The high level of advanced repurchases has a signaling effect that Fund credit is too expensive. We have to keep in mind that if Fund credit is perceived as too expensive, other options might be considered by countries. Options that might not necessarily guarantee strong incentives to reform, and ultimately could lead to higher costs for the Fund and the world economy. In this context and especially with the low interest environment, we consider it timely to reassess the rate of charge.

We look forward to the Board's review of the mandate for the Fixed-Income Subaccount and the next review of the precautionary balances.

Mr. Choi and Mr. South submitted the following statement:

We thank staff for the clear papers on the review of the Fund's income position for FY2015 and for FY2016. We support the prudent accumulation of reserves by the Fund, given the expectations of lower lending income and a concentration of lending risks for the Fund.

While we can go along with the proposed decisions, we note that the placement of GRA net income to special reserves is a departure from recent practice. In light of this, we look forward to the consideration of a more durable framework for the future placement of different forms of income as part of the New Income Model, and the next review of precautionary balances in early 2016. We have the following additional points to note.

The framework for precautionary balances adopted by the Board in 2010, and reaffirmed in 2012 and 2014, is for total precautionary balances—including the special and the general reserve—to exceed a floor of SDR 10 billion. Table 2 indicates that under any allocation of net income in FY2015 the total balance of precautionary balances of SDR 14.0 billion will continue to exceed the agreed floor. We welcome this outcome.

Allocation of Net Income to Reserves

Recent practice has been to place surcharge income to the general reserve and to place any remaining net income to the special reserve. For the FY2015, staff proposes that all GRA net income (including surcharges) be placed to the special reserve (Decision 5). Our understanding is that this would reduce the flexibility with which the Executive Board could decide to deal with these balances in the future, as the Articles of Agreement provide that distributions cannot be made from the special reserve. The staff has indicated that this proposal is aimed at building special reserves, rather than precautionary balances overall, towards the SDR10 billion floor. We would welcome a further explanation as to why staff sees the need to particularly accumulate special reserves (rather than precautionary balances generally).

Accounting for Employee Benefits Under IAS 19

The implementation of the amended international accounting standard IAS 19 has resulted in an increase of the actuarial liability for the pension scheme of SDR847 million in FY2015. While we welcome staff's clarification that this does not represent the funding requirement to support the pension plan, it nonetheless has an immediate impact on the net income that can be placed in reserves. We understand that previously these adjustments have effectively been incorporated in the amounts allocated to the special reserve, net of the surcharges that have been placed to the general reserve.[1] Would staff expect that these IAS 19 adjustments would always be reflected in the net amounts that are available to be placed to the special reserve?

Margin for the Rate of Charge

In April 2014, the Executive Board set the margin for the rate of charge at 100 basis points, on the expectation that this would remain the case for FY2015 and FY2016. In the absence of fundamental changes since that time, we agree that this margin should continue for the remainder of the two-year period.

Finally, we welcome staff's effort to explore alternative measures of long term credit market conditions for the purposes of cross-checking the alignment of the margin on the basic rate of charge. In particular, we encourage staff to monitor the usefulness of the EMBI-based cross-check given that EMBI spreads do not include data for advanced economies, which represent a significant portion of the Fund's lending portfolio.

Mr. Yambaye and Mrs. Boukpessi submitted the following statement:

We thank staff for an informative report on the Fund's Income position for FY2015 and FY2016. We are in general agreement with the proposed decisions as set out at page 26 of the paper. We note that the proposals are for the most, consistent with past practices and are aligned with rules set in past Board decisions and would like to make the following remarks.

FY2015 Income Position

We note the downward revision of the Fund net income for FY2015 from an estimated SDR 2.4 billion last year to a current projection at SDR 1.5 billion notably due to the impact of IAS 19 adjustment of SDR 0.8 million and the impact of the surcharges of SDR 0.3 million reflecting the advance repurchases by Ireland and Portugal and Greece not

[1] In 2013, the SDR1.4 billion loss resulting from the change in accounting for employee benefits under IAS 19 was charged against the special reserve. Likewise, the SDR976 million gain resulting from a timing adjustment under IAS 19 was also incorporated in the special reserve.

making further purchases under its current arrangement compensated by the positive profits SDR 0.1 million of the investment account portfolio thanks to the decline in interest rates.

On the disposition of the FY2015 net income, we broadly support the proposed decisions. Consistent with established Fund procedures, we support Decision 1 which provides for the assessment on SDR department participants for the reimbursement of the General department for the expenses of conducting the business of the SDR department in FY2015. We agree that the General resources Account (GRA) should be reimbursed for the cost of administering SDA resources in the CCR Trust in FY2015 (Decision 2), and for the cost of administering the PRGT in FY2015 (Decision 3). We support the transfer of Investment Income for FY2015 to the GRA (Decision 4).

Finally, we note the change from previous years in the treatment of FY2015 GRA net income as staff proposes to transfer GRA net income including surcharges income to the special reserves. We take note of staff analysis and can support the Decision 5.

FY2016 Income Outlook

For FY 2016, net income is now estimated at SDR 0.85 billion in comparison with SDR 2.1 billion projected last year. These estimations taking into account the level of global interest rates, the timing of purchases and repurchases of the current arrangements, new arrangements, the U.S. dollar/SDR exchange rate and the impact of the IAS19 remains sensitive first to the implementation of the 14th General Review of Quotas which will decide on the level and structure of surcharges and second to the results of the ongoing review of the investment strategy for the Fixed-Income Subaccount.

We welcome staff's scenarios with the three different levels of the margin (50, 100, and 150) for the rate of charge on the pace of reserve accumulation with the SDR 20 billion indicative medium-term precautionary balances target. We are comfortable with the current level and agree with staff to keep unchanged the rate of charge on the Fund resources at 100 basis points margin for FY2016 (Decision 6) in a context of continued reserve accumulation and reservations regarding Fund lending.

Finally, we support Decision 7 given that no special charges, and no new considerations have arisen during FY2015.

Mr. Kajikawa, Mr. Watanabe and Ms. Yanai submitted the following statement:

We support the proposed decisions pertaining to the Fund's Income Position for FY2015 and FY2015-2016; therefore, we will limit our comments to the following points for emphasis.

Concerning Decision 5, in principle, we find it reasonable to transfer the net GRA income to the Fund's Special Reserve given its nature as the first line of defense against income losses. Having said that, some chairs have expressed concerns regarding additional constraints that such a change could bring about. We, therefore, would like to invite staff to further clarify the following points: i) why it finds merit in accelerating the pace of accumulation of the Special Reserve rather than that of the General Reserve, although both reserves are part of the Fund's precautionary balances and no explicit overarching rule requires that the Special Reserve accumulation be prioritized this year; ii) whether there are other reasons, from a financial accounting viewpoint, behind the proposed decision; and iii) whether any concrete demerits could arise if the Fund were to proceed with the transfer of 1.3 million SDR to the Fund's General Reserve.

The objective of the New Income Model (NIM), endorsed by the Board in 2008, was to broaden income sources to secure sustainable financing for the institution in the long run; thus reducing the Fund's heavy dependency on income from lending. As the staff has noted, the current global economic and financial outlook is very different from the underlying scenario that existed when the NIM agreement was reached. In this regard, the staff currently assesses that the steady state outlook has not changed significantly; but could be subject to downside risks in an environment of protracted global low interest rates. Bearing in mind that many factors, including the pending review of surcharges, would affect the Fund's income-expenditure position in the long run, we would appreciate receiving staff's comments regarding to what extent the doubling of quota resources, under the full implementation of the 14^{th} General Review of Quotas, would contribute toward increasing non-lending income.

In terms of the Fund's review of surcharges and commitment fees, it would be beneficial for the Board to benefit from additional informal engagement in order to reach consensus on the level and structure of the thresholds for surcharges, as well as commitment fees, so as to facilitate a smooth transition to the new framework after the 14^{th} General Review of Quotas becomes effective.

Ms. Tangcharoenmonkong, Mrs. Ahmad Ariffin and Ms. Mohd Radzuan submitted the following statement:

> We thank staff for the report on the review of the Fund's income position for FY2015 and FY2016. We are in general agreement with the proposed decisions as set out in the paper. We offer the following remarks for emphasis.
>
> We note that despite declining lending income, the Fund's net income position remains strong and the investment returns for FY2015 were higher than expected. We note that, with the exception of the proposed Decision 5, the proposals are broadly consistent with past practices and are aligned with rules set in past Board decisions.
>
> We recognize that while average credit outstanding is expected to be lower, the Fund's existing lending portfolio is still subject to risks and uncertainties. Therefore we can go along with the proposal to place the FY2015 GRA net income, which includes surcharges, to the Fund's Special Reserve (Decision 5). This would support the build-up towards the medium-term target for precautionary balances to be at SDR 20 billion. In this regard, we seek staff's assessment of credit risks to the Fund's lending portfolio for FY2015 in comparison to the lending portfolio for FY2014.
>
> We also agree to maintain the rate of charge on the use of Fund's resources for FY2016 at 100 basis points over the SDR rate. This would ensure a satisfactory pace of reserve accumulation for the forthcoming years.

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

> We thank staff for this update of the Fund's income position for FY2015 and projections for FY2016-17. Net income remains relatively high for FY2015, notwithstanding a significant decline from projections on account of advance repurchases. We take note of the adjustment to FY2015 net income to take account of the revaluation of pension obligations. This revaluation follows accounting standard IAS 19 on the treatment of employee benefits, and reflects a decline in the discount rate.
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> We support staff's proposed decisions. We can go along with staff's proposal to retain currencies available for transfer to the Investment Account (IA) in the General Resources Account as an interim measure. We look forward to the forthcoming Board review of the mandate for the Fixed Income Subaccount.

We take note of the anticipated decline in net income next year, again as a result of advance repurchases, while recognizing that considerable uncertainty is associated with these projections. As noted in the staff report, non-lending income continues to be constrained by the low interest rate environment, and lending income is being used to finance non-lending operating costs. Meanwhile, the level of credit outstanding remains high, as well as the concentration of credit exposure to a few members. Taking account of these factors, we continue to see merit in raising the target for precautionary balances from SDR 20 billion to SDR 25 billion over the medium-term, the upper end of the indicative range implied by the current framework. Accordingly, we continue to favor accelerating the pace of reserve accumulation. Decision 5 would allow precautionary balances to reach SDR 14 billion at the end of the current fiscal year, and helps to reassure us that the target of SDR 20 billion could be reached as agreed.

Mr. Mohan and Mr. Govil submitted the following statement:

We thank staff for their report on the Fund’s income position for FY2015 and FY2016. We generally agree with all the proposed decisions mentioned on page 26, except Decision 5, and have the following observations.

We had raised a concern last year that the application of the amended IAS 19 standard to the accounting of employee benefits would increase the volatility of Fund’s net income. The one-time application of the amended IAS 19 resulted in an estimated loss of SDR 1.4 billion in FY2013 and an estimated gain of SDR 0.905 billion in FY2014. We had supported the decision in this regard as the adjustment due to this amendment was of a one-time nature. This year, the ‘loss’ on account of IAS 19 timing adjustment is estimated at SDR 847 million, out of which SDR 600 million is attributed exclusively to the change in discount rate during the year. We understand that the staff does not have control over the discount rate, and future discount rates may also be difficult to predict. However, we would appreciate it if staff provides detailed comments about the factors behind the timing adjustment of the remaining SDR 247 million. Further, given this large figure of SDR 247 million on account of non-discount rate related factors, we are not entirely convinced about staff’s argument made on page 8 that ‘The resulting timing differences can be substantial but should net to zero over the life of the pension and benefit plans, as from an accounting perspective the IAS 19 adjustments necessarily equal the employer’s funding over time.’ We would invite staff to elaborate.

Here, we would like to underscore that unforeseen changes in the interest rate environment could result in huge annual income/expenditure implications for the employee benefits that could be more than the Fund's annual net administrative budget. This continues to pose a significant risk to the annual budget of the Fund. We reiterate our call to the staff to explore ways to ring-fence the annual budget of the Fund from such drastic unforeseen fluctuations. We would also like to see some analysis of the impact of future discount rates and other relevant variables, on IAS 19 timing adjustments.

Given the large changes in net income of the Fund, amounting to close to 1 billion SDR, on account of IAS 19 timing adjustments, we are surprised to see that little detail of these adjustments is provided in the staff paper. In particular, we would like to know the baseline actuarial assumptions, changes made this year, and the individual contributions of these changes to the timing adjustment. We would also encourage the staff to organize an informal session to explain these changes.

We agree with staff's proposal to retain currencies available for transfer in the investment account in the GRA as an interim measure pending the review of the investment mandate for the fixed-income subaccount. We hope that staff would soon bring this review paper to the Board.

We are skeptical about the proposed Decision 5 to transfer all of the GRA net income (including net operational income and the surcharge income) in the special reserve. As per past practice, net operational income is to be placed in the special reserve and the surcharge income is to be placed in the general reserve. Unlike special reserves resources, the general reserve resources can be distributed to the membership should the Executive Board decide so with a 70 percent majority of the total voting power. The two reserves (except gold sale profits) and the SCA-1 balances constitute the precautionary balances. Overall, the precautionary balances are expected to reach around SDR 14 billion at the end of FY2015, which are comfortably above the floor of SDR 10 billion established by the Board. In particular, the Board has not yet made a decision to increase the special reserves to SDR 10 billion. There is no special need to increase the rate of accretion of special reserves to the detriment of general reserves. The staff's proposed Decision 5 would constrain the flexibility available to the membership about distribution of reserves, should the membership so decide. In any case, at the present juncture, we consider the probability of the membership opting for a distribution of reserves as being very low, and therefore the risk of having low precautionary balances, should the general reserves be distributed, is very low.

In view of these considerations, we would prefer to go along with the past practice and place the surcharge income in the general reserve.

With regard to the setting of the margin for the rate of charge (proposed Decision 6), the margin was set at 100 bp last year for both FY2015 and FY2016 under the exceptional circumstances clause, on account of Fund's reliance on lending income to finance a portion of its non-lending activities and the prevailing environment of low investment returns. We agree with the proposal to continue with the margin at 100 bp for FY2016 as this would help in speedy accumulation of precautionary balances. However, we are concerned that repeated use of the exceptional circumstances clause may be seen as imposing an additional burden on the countries under a Fund program, and look forward to a full review of intermediation costs and the margin setting next year.

Mr. Guyon submitted the following statement:

We thank staff for a clear set of reports on the review of the Fund's income position and the consolidated medium-term income and expenditure framework. We support all the proposed decisions, with the exception of Decision 5. We also would like to offer one comment on Decision 7.

We do not support the proposed Decision 5. We hold the view that there has been so far no presumption that the SDR10 billion floor would apply only to the special reserve. This floor, like the objective of SDR 20 billion, applies to the precautionary balances in their entirety, i.e. including the SCA1 as well. In addition, both the special and the general reserves are likely to be used to meet administrative losses, even if the special reserve would be the first line of defense, and therefore the differences between special and general reserves should not be overstated. Thus, we would rather not depart from the constant practice applied since 1998, with the exception of the period between 2007-2010 where the surcharge income was used towards meeting the expenses of conducting the business of the Fund (but not placed in the special reserve).

While we agree with the proposed Decision 7 not to change the margin for the basic rate of charge on the use of Fund resources, we continue to believe it would be helpful to assess the appropriateness of this margin in the broader context of the review of access policy and surcharges. The completion of this review has been delayed due to the protracted delay in the effectiveness of the 14th review of quotas; as a result the loans above normal access limits continue to be priced at a fairly high level, particularly in the current context of very low interest rates, and this led some debtors to proceed to early repurchases. This can be seen as a positive development, but it evidently has a negative impact on the Fund's income position. We therefore suggest resuming the review of access policy and surcharges, with the aim to correct for the erosion of absolute access limits relative to GDP and trade since 2009.

Ms. Kapwepwe and Mr. Tucker submitted the following statement:

We thank staff for the comprehensive set of papers on the Fund's income position. We support the proposed decisions on the treatment of the Fund's accounts, outlined in EBS/15/32, that are consistent with the Fund's Articles of Agreement and practices endorsed by the Executive Board. We thus make the following statement for emphasis and some clarity.

FY 2015 Income Position

We welcome the strong performance of the Fund's finances in FY2015, with a projected net income of SDR1.5 billion. Though compared to initial estimates (April 2014) this represents a downward revision of about 38 percent, mostly on account of timing adjustments in line with the amended international accounting standard (IAS 19), we are encouraged that operational lending income remains strong and that investment income is on course to outperform market expectations.

On the proposed decisions (1-3), consistent with established Fund procedures, we agree that the General Resources Account (GRA) be reimbursed for expenses of conducting the business the SDR Department, of administering SDA resources in the CCR Trust, and of administering the PRG Trust. However, we reiterate our view that, as in the recent past, due consideration should be given to a temporary suspension of this reimbursement if and when the long-term sustainability of the Trust becomes questionable.

The implementation of IAS 19 in FY2014 to account for pension and other employer benefits has clearly introduced immense volatility into the Fund's income as reflected in the shift of SDR 904 million recognized in FY2014 to a projected loss of about SDR 847 million in FY2015. While recognizing the fact that the funded status of the plan is mostly determined by the discount rate, which itself has been influenced by recent volatile trends in market interest rates, we would welcome staff comments on options, if any, for moderating the volatility to allow for better budgeting.

On the disposition of the FY2015 net income, consistent with past practices, we agree with the transfer of income to the GRA to be used towards meeting the expenses of the Fund. On the transfer of GRA net income to the special reserve (Decision 5), while noting that it represents a departure from the usual practice, we see some merit in the proposal especially in strengthening the balance sheet of the Fund. However, given that it is a fundamental change to the approach employed by the Fund, it would be more appropriate for the issue to be discussed within the context of the next review of the adequacy of the Fund's precautionary balances. We would thus withhold support for the proposed decision.

FY2016 Income Outlook

We welcome the projected positive net income position of the Fund for FY2016, driven mostly by strong surcharge incomes. We observe, however, that the outlook is sensitive to a myriad of factors, including the outcome of the ongoing review of the investment strategy for the Fixed-Income Subaccount, and to the decision on the level and structure of surcharges following the implementation of the 14th General Review of Quotas. Furthermore, with the outlook in recent years significantly influenced by IAS 19 timing adjustment, we would expect a speedy completion of the actuarial analyses to get a better picture of the income position for FY2016.

On the decisions pertaining to FY2015-2016, we would support both proposals. That said, we note with concern that in spite of the projected strong reserve accumulation in FY2016, the slower than anticipated pace implies that the indicative medium-term precautionary balances target of SDR 20 billion will not be attained by FY2024. While staff's simulation, illustrated in Figure 2, indicates that by increasing the margin for the basic rate of charge by 50 basis points, the indicative target could be attained by 2021, we would go along with the proposal to maintain the margin for the rate of charge at 100 basis points for FY2016 given that the Fund's intermediation costs are covered and that it does not significantly diverge from long-term market conditions. That said, we look forward to staff revisiting the medium-term projections in light of the review of the investment strategy for the Fixed-Income Subaccount of the Investment Account.

Mr. Hurtado and Ms. Sanchez Rodriguez submitted the following statement:

We thank staff for their thorough and informative review of the Fund's income position both for FY2015 and 2016, as well as for the medium term. We support the proposed decisions except for Decision 5.

We favor the Fund's conservative approach in assessing the evolution of income as well as the prudent implementation of the new income model. We note that in the coming years the improving economic environment will result in a marked reduction of outstanding credit and consequently a large reduction of lending income. The staff rightly acknowledges the high degree of uncertainty affecting these projections. However, if they were to materialize, careful monitoring of the Fund's financial position would be necessary.

In this context, and with respect to Decision 5, we concur with what we think is the spirit of staff's proposal to transfer surcharge income to the special reserve, which we understand is intended to make a more conservative use of the Fund's resources in view of a more uncertain and compromised perspective for its income. Nevertheless, we have concerns about the process proposed. On the one hand, the withdrawal of funds from the general reserve is not immediate and requires a large qualified agreement of the Board in order to provide the proper assurances about the pertinence of any withdrawal. On the other hand, as noted by other chairs, there has not been an adequate discussion of the implications of this decision. We therefore suggest that any allocation of income to the general and special reserves which would be different to previous practices be discussed appropriately in advance.

We note that resources in the reserve accounts are at around SDR 14 billion for FY2015. Can staff comment how these funds are invested and, if it is the case, in what way the investment regime differs from those of the IA?

Under the new income model, the financial soundness of the Fund would rely heavily on a projected large increase in investment income—mainly from the fixed income sub-account, according to staff projections—which seems difficult to assess in the current interest rate environment. In this vein, we would kindly ask staff to clarify further the drivers for the increase in fixed income subaccount returns in the medium term and, more specifically, if reinvestment of income is being factored in and how this is different from proposed Decision 4 and previous practice.

Mr. Oliveira Lima and Mr. Najjarian submitted the following statement:

We thank staff for the review of the Fund's income position for FY 2015 and 2016 and for the companion paper on the consolidated medium-term income and expenditure framework. We support the proposed decisions, except for Decision 5.

Increased Volatility in the Fund's Income and Reserves

FY2015 net income is now estimated at SDR 1.5 billion, compared with the previous projection of SDR 2.4 billion. The majority of the adjustment reflects a revaluation of SDR 0.8 billion pension obligations, as determined by the international accounting standard IAS 19. With the implementation of IAS 19 in FY2014, all actuarial gains and losses related to employee benefits must be recognized in the year they occur instead of being deferred and amortized over time, which results in additional volatility in the Fund's income and reserves. We note that the income outlook for FY2016 has also been revised downwards, with net income now estimated at SDR 0.85 billion, vis-à-vis SDR 2.1 billion in the previous review. Losses could be even higher, possibly affecting reserves, depending on how interest rate movements influence the timing adjustment in FY2016.

Placement of FY 2015 GRA Net Income to the Fund's Special Reserve

The staff proposes placing GRA net income for FY2015 (including surcharge income) to the special reserve. This would help compensate for a slower pace of accumulation of the special reserve due to the advance repurchases by some large borrowers, and bring the special reserve closer to the established floor for precautionary balances. We note that staff's proposal departs from the current practice of placing surcharge income to the general reserve. Moreover, the link between special reserves and the floor for precautionary balances has not been formally established. Therefore, we see no compelling reason for changing the current practice as this will reduce the Executive Board's flexibility in managing reserve resources without bringing any material benefit in terms of building up precautionary balances.

We welcome staff's proposal to retain the currencies available for transfer in the GRA pending the completion of the review of the investment strategy for the Fixed-Income Subaccount, noting that such option does not require a Board decision.

The Rate of Charge on the Use of Fund Resources for FY2016

According to staff projections, precautionary balances will peak in FY2024 at SDR 19.4 billion, below the indicative mid-term target of

SDR 20 billion. The staff estimates that a 50 basis points increase in the margin for the basic rate of charge would allow the indicative target to be reached by 2021, but, in Decision 6, staff proposes that the margin remains the same, at 100 basis points. We are also of the view that no change in the basic rate of charge would be necessary at this juncture.

Mr. Mojarrad, Mr. Daïri and Mr. Monajemi submitted the following statement:

We thank staff for the paper on the Review of the Fund's Income Position for FY2015 and FY2016. We support the proposed decisions.

We are pleased to note that the overall income outlook for the Fund remains broadly positive. There has been a downward revision of the operational income that reflects lower credit levels and a further downward shift in SDR interest rates. However, operational income plus surcharges, despite being lower than projected in April 2014, would continue to contribute significantly to the accumulation of precautionary balances, even though they are still well below the indicative medium-term target of SDR 20 billion that was reaffirmed at the last review of the adequacy of precautionary balances in February 2014. An accelerated pace of reserve accumulation remains an important priority for the Fund.

In compliance with established Fund procedures, we agree that the General Resources Account (GRA) be reimbursed for expenses relating to the conduct of the operations of the SDR Department and administering SDA resources in the CCR Trust in FY2015. While we can support the reimbursement of the GRA for PRGT administrative expenses in FY2015, a temporary suspension of reimbursement should be considered in the event of heightened demand for PRGT borrowing in excess of the base envelope. We support the proposal to place the FY2015 GRA net income to the special reserve.

We support the proposal to retain currencies available for transfer to the Investment Account in the GRA, pending completion of the Board's review of the mandate for the Fixed-Income Subaccount. We also support the transfer of income from the Fixed-Income Subaccount of the Investment Account to the GRA to help meet the Fund's administrative expenses.

The margin for the rate of charge should cover the Fund's intermediation costs, contribute to reserves, and help maintain a reasonable alignment with long-term credit market conditions. Given the continued reserve accumulation and uncertainties over the future course of Fund lending, we agree that there is no need for a change in the margin of 100 basis points agreed in April 2014 for FY2015-16.

We share the concerns expressed by Mr. Alshathri and Mr. Keshava about the high volatility of the annual net income as a result of the amended IAS 19 and their call for adequate communication in this area. Like Ms. Kapwepwe and Mr. Tucker, we look forward to staff indication on potential options for moderating this volatility.

Mr. Field expressed interest in the staff's response to Directors' views on Decision 5.

The Deputy Director of the Finance Department (Mr. Andrews), in response to questions and comments from Executive Directors, made the following statement:[2]

In responding, I am in effect also responding to questions that were raised in the gray statements by Mr. Kajikawa and Mr. Choi, which we did not address in the written responses to technical questions. Decision 5 is more of a policy issue. In the same vein, I also recognize that many Directors were not convinced by the arguments that we presented, so I want to lay out the thinking in more detail.

I should begin by stressing, as some have noted, that Special and General Reserves serve the same function—to add strength to the Fund's balance sheet in addressing financial risks. They are both part of the Fund's precautionary balances, which provide protection for the value of the reserve assets that the membership places with the Fund and, thus, underpins the exchange of international reserve assets through which the Fund provides assistance to members with financing needs. From a perspective of dealing with those risks, credit risks in particular, Special and General Reserves can be seen as equivalent.

Similarly, from an income perspective, the accumulation of Special and General Reserves adds equally to the pool of resources that are available for investment by the Fund, and both provide the same contribution to the Fund's income model.

Against that background, why did we propose this change of policy which would have entailed placing more to the Special Reserve? As we noted in the paper, the practice that has been followed for many years of allocating

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

operational income to the Special Reserve and surcharge income to the General Reserve is an artifact from the old income model. It reflected a distinction between two types of income. What was then called “regular income” we would now call “operational income” and “surcharge income” is not relevant under the current income model.

The paper explains that this had to do with the manner in which the margin for the rate of charge was set, but the basic point is that that allocation decision reflected old practices. It is difficult to argue that it is relevant under the current income model. That led us to question if other criteria could be considered more relevant in present circumstances?

The General and the Special Reserve provide the same protection against financial risks and afford the institution the same scope for generating income. The key distinction between the two reserve pools is the General Reserve is available for distribution and the Special Reserve is not.

On distributions themselves, over time, the issue of possible distributions to the membership has assumed greater prominence. Over the last three years, there have been two distributions to the membership out of the General Reserve. These were both of profits from gold sales so it was part of the General Reserve attributable to those profits. It was specifically for the purpose of generating resources to allow the Poverty Reduction and Growth Trust to be put on a sustainable footing. It is a very specific usage, but nonetheless, there were distributions.

The other reason that the question of distribution is more prominent is that in the development of the New Income Model, there was broad support for the view that in future circumstances, when precautionary balances are considered adequate, it would be appropriate for the Board to consider possible dividends, as they were termed in the discussion of the New Income Model, but are essentially distributions.

The logic behind that was a concern that there might be circumstances in which the institution was judged to have more income than it needed, so it was seen as a desirable feature of budget discipline to have distributions so that the institution had a clear budget constraint or there was not a problem that excess income might translate into rising budgets. That was the broad philosophy with the income model, and distributions were clearly considered to be part of that.

Another factor in our consideration was that this long-standing practice of placement of surcharge income in the General Reserve predates the Board's discussion and acceptance of a floor for precautionary balances. This was first adopted in 2010. In subsequent reviews of the adequacy of precautionary balances, Directors have reiterated the importance of maintaining a floor for precautionary balances to protect against an unexpected increase in credit risks, particularly after periods of low credit.

The broad idea is that we can only accumulate precautionary balances when we are lending, which in a sense is unfortunate. It is only when we are facing credit risks that we can build up the buffers to protect ourselves against them. The idea is when we come out of the credit cycle into an environment of low credit, we should be mindful of future risks, and therefore, maintain some floor level of precautionary balances to be ready for the next crisis.

That floor has been fixed at SDR 10 billion. There has been strong support for that. In the last review, there were some calls for raising it. We will consider that at the next precautionary balance review early in 2016.

Another reason for the strong support for the floor was a recognition that a certain level of precautionary balances was needed to maintain the Fund's sustainable income position. When the income model was put together, it was quite a low figure, about SDR 6 billion. That was the then-existing precautionary balance.

That left the income model vulnerable. It only barely hung together. We now believe, and the Board has agreed in past reviews, that a level of SDR 10 billion is needed for that to generate the income. Against this background, we considered that the question of whether reserves are available or are not available for distribution was a more pertinent consideration in determining the placement of reserves.

We recognize that when the Board established the floor for precautionary balances, it did not establish separate floors for the Special Reserve or the General Reserve; it was just a floor for precautionary balances. The move to targeting a particular level of Special Reserves or adopting a decision to boost Special Reserves would be new. This would be a break with past practice.

Nonetheless, we considered that such an approach would be entirely consistent with the strong and sustained support the Board has shown for maintaining a floor level of precautionary balances, recognizing that it is needed to support risk management and a sustainable income position for the institution. As is clear from the views expressed in the gray statements, many Directors were not comfortable taking this step, so it is reasonable to think through whether there is any particular urgency to do this now

What would be the implications of not doing it now? The easiest way of showing that is to think through what may happen to the different reserve pools. If for 2015 the net income of SDR 1.3 billion is placed to the General Reserve—so this would be effectively reverting back to the long-standing practice—the General Reserve would stand at close to SDR 9 billion and the Special Reserve would be just under SDR 4 billion.

If in future years the same practice were continued, and this is based on the current projections in the consolidated paper, past practice would imply that the Special Reserve over the medium term would rise to about SDR 5 billion and the rest of the accumulation in reserves—getting up toward the SDR 20 billion target, at least over SDR 19 billion—would be in the General Reserve.

Staying with the present process means that special reserves would not rise significantly from current levels. However, if the Board were to decide subsequently that in 2016, surcharge income should be placed to the Special Reserve, over the medium term there would still be scope within our current projections for the Special Reserve to approach SDR 10 billion. There is clearly uncertainty about these projections. It could be that the pace of reserve accumulation is more rapid. We do not include within the projections arrangements that have not been approved so far.

At a more technical level, as we have noted in some of our responses on this question of the IAS 19 adjustment, we do not make a projection for the future course of this adjustment. But to the extent that the low discount rate used in calculating the adjustment is reversed over the medium term, one would expect that to give some boost to income and the potential for Special Reserves to be accumulated.

We made this proposal today, but if it is something that will be revisited later, and there was acceptance that it is the way the Board wanted to go, then we would be able to still build up levels so that they are close to the floor in the Special Reserve.

Mr. Cottarelli made the following statement:

It is important to look at Decision 5 and the other decisions that we are taking today, and more generally the income position of the Fund, with a longer-term perspective than what we have been doing until now and what is in the papers.

The two papers give a somewhat gloomy picture of the Fund's income position in relative terms. For example, the paper on the Medium-Term Income and Expenditure Framework points to the lower levels of net operational income over the coming years, lower credit levels, net lending income projected to be lower, the pace of reserve accumulation expected to be slow, precautionary balances projected to be below the projected target.

These facts suggest the need for caution in taking a decision on the rate of change, and caution is appropriate. What I am going to say does not change the views I expressed in the gray statement, which is to support all decisions except Decision 5.

This being said, with a view to future discussions on these related topics, for example the forthcoming review of reserve adequacy, it is important to put these facts into a longer-term perspective, as it is appropriate for an institution like the IMF that should be driven and is driven by long-term considerations and not short-term profit goals.

The long-term evidence I am referring to was summarized by this chart, which shows the ratio between net income and our operational expenses starting in 1983, and is available to those that are interested. The chart shows the ratio between net income of the Fund and its operational expense. Thanks to the data provided by the Finance Department, we were able to draw this chart.

Why is this ratio important? Net income is what we take from our membership. The operational expense is a measure of what we give to our membership in terms of services. I realize there is something else that the Fund provides to the membership that cannot be measured simply by looking at operational expenses, and that is the confidence that we give to our members in having a strong Fund that can support them in case of need. This is a partial indicator; I recognize this. Yet it is worth looking at the long-term movement over time.

This chart shows that throughout the 1980s and 1990s, and perhaps even before, the ratio between our net income and our operational expenses was stable at about 30 percent. Net income was about one-third of operational expenses. This clearly was regarded as an appropriate level by our predecessors.

The ratio rises in the first half of the 2000s, exceeding the 100 percent mark probably for the first time in the Fund's history. After a short decline into negative territory, the ratio surges to new record levels of several hundred percent in recent years The ratio remains at about 100 percent over the medium term, three times what was regarded as adequate for the Fund in the early 1980s and in the 1990s. It stayed above or close to 100 percent for another five to six years before declining below that level. In the meantime, the Fund is accumulating reserves to a level that is clearly unprecedented.

Our critics may say that this is not too bad for an institution that is a nonprofit institution. However, this would be a cheap shot. It is also true that the Fund is now facing sizable risks, perhaps unprecedented risks. Therefore, we do need to accumulate reserves, and therefore, I support the decisions proposed today, except Decision 5. I support all decisions, including maintaining the rate of charge at 100 basis points.

It seems clear that the income position of the Fund remains pretty strong, and the current outlook does not even take into account the possibility of raising investment income by changing our investment policies, something that I believe would also be discussed over the next few months. In the future, there may be scope to revise our views on the surcharges, the pace of accumulation of reserves, and perhaps the level of reserves.

As to Decision 5, I reiterate that I do not see a reason to introduce an additional element of rigidity on the possible use of reserves by deviating from the rule we followed in the past and accumulating the net income into the less flexible Special Reserve. I believe the arguments I made regarding the strength of the Fund's income position in a historical perspective strengthen this conclusion.

Mr. Oliveira Lima noted that the staff's proposal to place this year's net income in the Special Reserve was related to the floor that was established at SDR 10 billion. It was true that there was a significant amount of support for the floor, but he asked about the process required for the Board to change this floor. He asked whether a simple majority of the Board could decide to change the rate or lower the floor.

Mr. Snel made the following statement:

I also thank the staff for the explanations and their answers in the papers. I agree with Mr. Cottarelli that this institution has an uncertain future ahead, and caution is one of our best weapons and instruments. Normally, I would always go for cautionary arguments to look at staff proposals. Maybe for that reason, I support all decisions except Decision 5.

Like Mr. Field, I was ready to listen to the arguments and see if there were compelling arguments for why we should change our long-standing policy. We heard many factual explanations about things that were in the paper, but I still miss the compelling arguments for why we should change it now. As I noted before, we can change it if we want to, but it is still hard to see why we should change this long-standing policy. Perhaps I missed something and maybe other Directors can find other arguments. If not, I will stick to my guns and we will not support Decision 5.

The Deputy Director of the Finance Department (Mr. Andrews), in response to further questions and comments from Executive Directors, made the following additional statement:

On the question of the majorities needed to change the floor level of precautionary balances, it is just a simple majority of the Board.

On the question of providing convincing arguments, there are two levels to this. What I sense was some discomfort of taking what many would see as a momentous decision in the sense that once the resources are in the Special Reserve, they stay in the Special Reserve; it is not reversible. I believe that is why the arguments we have put forward do not convince all.

The logic of applying the old rule is not clear. It would be better to have a rule that is more firmly based on the difference between Special and General Reserve offers. To the extent that there is strong agreement that the institution needs at least SDR 10 billion in reserves to be able to function effectively to deal with credit risks and generate enough sustainable income, it seems to be a robust reason as to why those resources should be put in the Special Reserve. It is entirely consistent with that and it would make the entire system more robust.

I recognize on the other side that there are concerns about a more conceptual philosophical question of whether the Board should have flexibility to change. But from the point of view of putting in place a financially strong arrangement for the future of the Fund to be able to deal with risks, that is why we put this proposal forward.

I would like to provide one clarification for Mr. Cottarelli. On the question of the investment mandate for the investment of the Fixed-Income Subaccount and investment of the reserves, the projections do build in assumptions of higher returns. These reflect what was initially in the Crockett Report when the New Income Model was developed, an assumption that the Investment Account could generate a higher premium over the SDR rate.

It was working with an assumption of 50 basis points. The assumption is that it rises to 100 basis points. Given current market conditions, the medium-term projections assumed that that is only achieved in the out years. Clearly, right now it is difficult even to earn the SDR rate.

Mr. Cavaliere made the following statement:

I thank the staff for the explanations. I would like to provide some additional explanation for our position on Decision 5. Before this, I would like to underscore that we agree that a floor of SDR 10 billion was intended to apply to the precautionary balances, not only to the Special Reserve. That is an important point.

Turning to the surcharge income, we have two options. We stick to the practice that we adopted in the past to put it in the General Reserve, or put it in the Special Reserve. In assessing the merits of the two options, we have considered two points.

The first one is that the contribution of the Special Reserve to the precautionary balances is only SDR 3.9 billion, which is about half of the contribution of the General Reserve. The contribution of SDR 3.9 billion is limited, and also in light of the fact that the Special Reserve is supposed to be the first line of defense against income losses. This was a decision that was taken by the Board.

The second point is there is a significant difference between this fiscal year, FY2015, and the period of FY2011 and FY2014, which means in the most recent cases we stick to the standard practice. The difference is that in FY2015, there is a heavy negative adjustment that we have to take, which is SDR 850 million. This heavy adjustment combined with lower lending income implies that if we follow the same practice, we would not be able to increase the level of the Special Reserve this year.

The staff's decision to place the surcharge income of FY2015 is justified because it takes this important difference into account. It ensures that we continue to gradually raise the Special Reserve to a level which we consider more adequate.

Mr. Field asked whether the Legal Department to clarify whether the Board could take a decision in the future to move resources from the General Reserve to the Special Reserve.

The Deputy Director of the Finance Department (Mr. Andrews) responded that according to the Legal Department, the Articles of Agreement were silent on that issue and did not indicate if it would be permissible. The basis for doing so would have to be developed on using implied powers. The Legal Department had assessed that it would be difficult to reach that conclusion, so it would likely not be possible.

The Deputy General Counsel (Mr. Leckow) noted that the Legal Department was still looking at whether it would be legally possible to take such a decision in the future. One of the complications was that the original Articles of Agreement included an express provision that allowed for transfers between different types of reserve accounts. However, that provision was removed at the time of the Second Amendment. There was, therefore, a question as to whether the membership, in removing that express provision, intended to eliminate the power to make such transfers in the future or whether there would still be an implicit power within the Board to continue to make those types of transfers. The legal Department was examining the legislative history and hoped to clarify the matter soon.

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

I thank Directors for the attention they have given to this issue, particularly at this busy time of the year. We have studied the gray statements carefully and it is clear that many Directors did not support Decision 5. There is also significant support for this decision from a number of chairs, but I recognize that many Directors would have appreciated more time to consider the possible change in the long established practice for the placement of the reserve.

Against this background, I propose replacing Decision 5 with a revised decision that would revert to the past practice so that the surcharge income for FY2015 would be placed in the General Reserve. The future policy for the placement of net income and the question of whether it would accelerate the

> accumulation of the Special Reserve could then be discussed as part of the next review of the adequacy of the Fund's precautionary balances early in 2016.
>
> In this context, if the Board were then to decide to accelerate the accumulation of the Special Reserve, as the staff has noted, the current medium-term projections suggest that there would still be scope over time to accumulate special reserves of SDR 10 billion. We hope all Directors can support this proposed way forward that will allow us to revisit this issue with greater time for deliberation.

Mr. Temmeyer asked whether management and the staff would come back to the Board with a revised decision. The decision was important for his authorities and they would need time to reconsider it. He had been instructed to support the old decision, but his authorities should be given the time to reflect on the discussion and the new amended decision. He would be happy to have the new decision on a lapse-of-time basis.

Mr. Mohan supported Mr. Temmeyer's request. He also noted that the volatility that was a result of the move to IAS 19 was almost equivalent to the Fund's total operational expenses. He remarked that it would be useful to have an informal session to explain issues related to IAS 19, particularly the large fluctuations observed in the previous year and the current fiscal year.

The Deputy Director of the Finance Department (Mr. Andrews), in response to further questions and comments from Executive Directors, made the following additional statement:

> The decision is not identical to the decision that was used last year. The reason for that is because we are in this unusual situation where, given the current size of the IAS 19 adjustment, which is an estimate at this stage and the final figure may be different, it is not clear that there would be any income other than surcharge income to place into reserves. In fact, the amount going to reserves would be the surcharge income less an amount needed to cover the difference between positive net income and the IAS 19 adjustment.
>
> The language of the old decision could be read as covering that, but one had to read it a number of times for it to be clear that it did work. In discussion with the Legal Department, we thought it better to provide a decision which is the same in substance as the application of last year's decision, but is much clearer.

On IAS 19, I recognize the concerns that have been raised about the scale of this adjustment. When the accounting standard was introduced last year, we recognized that this would likely introduce volatility in the Fund's income. It is an unfortunate consequence of the new standard, which does not allow us to smooth out these fluctuations in valuation. The unfortunate reality is there is not an alternative. We cannot take it off-balance sheet. It is a requirement of the standard that it feeds through to income.

This adjustment does not reflect corresponding financial flows to the pension plan. Those flows are covered by the contribution that the Board considers annually. This year was paid into the pension reserve because, based on the actuary's assessment, there was no need for a direct contribution to the plan.

In that context, I also recognized that there is an unfortunate disjunction between the actuary's assessment that the pension plan is fully funded and this assessment that we need to carry this loss. Why does that happen?

What the IAS 19 adjustment does is a snapshot. What the pension plan funding does is to look at the entire life of the pension plan, including factoring obligations that the Fund has not yet taken. In my personal case, under the Staff Retirement Plan, it would factor in the obligations that the Fund would take on through the point when I retire or resign.

For the IAS 19 adjustment, it only takes into account what has been committed so far, so in my case, my history of service to the Fund up to the end of the fiscal year. It is taking slices at any one time. It is doing something different, but the most important factor is that it is required to use different assumptions. We highlighted the discount rate, which is the key difference. It is so fundamentally different from what is used in the funding exercise. The pension plan assets under the current assumptions that are used are 6.5 percent a year. Because it goes down in the future, those are discounted back at 6.5 percent. For this assessment, the actuaries are required to use a commercial discount rate, which currently stands at just under 4 percent. It is a full 2½ percent lower than the discount rate used in the pension plan. It leads to a completely different conclusion.

Why is all this done? Much of it has to do with the unfortunate reality of private institutions not funding their pension plans adequately. The logic of the financial reporting standard is that this should be a conservative estimate put against annual income as to what the obligation would be if the institution were wound up tomorrow. That philosophy leads it to use current data, including, most importantly, this current discount rate, which from a funding perspective is considered not relevant. We use a different approach on the funding side, so it produces a different result, and I recognize that causes some concern. The reality is we cannot shield the income statement from this. But it is a book entry. There are no financial flows corresponding to it.

What are the implications of this? To the extent that in any one year we record lower income, we have a smaller increase in reserves and that would mean that the amount that we could place within the Fixed-Income Subaccount of the Investment Account through reserve accumulation is lowered. There is a loss corresponding to that in the years when we have to record a loss under IAS 19.

Given that, I do not believe it should be seen as having direct budgetary implication. Maybe one angle that we should consider in the next precautionary balances review, given that this does impose a volatility to income, is whether this is a factor that we should take on board in considering an adequate level of precautionary balances, particularly on the floor. If the floor were SDR 10 billion and it was accepted in any one year there could be large movements around that, maybe that is a reason for having a higher floor.

It is unfortunate that this standard was adopted in present circumstances because we are clearly living in an unusual world with interest rates where they are. We have to live with what it gives us. We will do our best to explain this in future years.

There was one issue I wanted to also bring to Directors' attention. This relates to the publication of the papers. On page 4 of the consolidated income paper, there is a reference to further purchases by Greece. The revised projections now reflect actual and expected advanced repurchases by Ireland and Portugal and do not at this point incorporate any further purchases under the current arrangement with Greece.

There is a concern that this could be misconstrued by readers. It is purely a technical assumption made for the purposes of this paper. It is not meant to in any way prejudge where things come out on Greece. In the current environment, we are concerned that there are no misconceptions. We would propose to add language to clarify that this is a technical assumption.

This would conform to the standard Transparency Policy. We see this as a case of evident ambiguity, a possibility of plausible specific misinterpretation.

Mr. Kajikawa noted that the fluctuation resulting from IAS 19 was more SDR 800 million in FY2015, and was equivalent to the total personnel cost for FY2015. He asked whether a fluctuation of that magnitude could be expected every year if there was a movement in the interest rate, as it would affect the required reserve level.

The Deputy Director of the Finance Department (Mr. Andrews), in response to further questions and comments from Executive Directors, made the following additional statement:

Yes, implicitly it does impose the likelihood of fluctuations in future years. On the positive side, on the assumption that we are at the bottom or close to the bottom of the current interest rate cycle, it is reasonable to expect that the shocks will be in the other direction.

There was a large adjustment when this new standard was introduced. We had to make a retroactive adjustment to take on board all the changes that had not been brought into the balance sheet using the old corridor method, which effectively smoothed the adjustments. There was a large adjustment taken at the beginning of the last fiscal year, which was partially reversed by the end of FY2014. This year, there is a downward adjustment again. Had we made the projection for the adjustment, I would have been fairly confident that it would be in the other direction. That speaks to why we should not make projections as to what this adjustment will be.

Why is the figure so large? What it is doing is looking at the pension obligations that have so far been taken on through existing staff service. It covers a stream of pension payments for a large population extending in the future. That stock number is sensitive, or the impact of the adjustment using that stock number and a discount number can result in a large figure.

As we have indicated, the actuary's rule of thumb is that a 1 percent change in the discount rate can bring a 17 to 19 percent change in the valuation. That is the logic of it. It is a discount applied to a large stock figure representing pension obligations spreading out over future decades.

Mr. Mohan made the following statement:

> Given the magnitude that has been explained, SDR 1.4 billion on this account in 2013, a gain of SDR 0.9 billion last year, and then the numbers this year, every year it is equivalent to more than the total operational expenses of the Fund. Therefore, it seemed that there ought to be Supplement or an Annex that explains much more clearly and also provides projections for what might happen in the future, because it is not 10 percent of the Fund's expense, not 20 percent, but 100 percent of the Fund's expenses.
>
> We ought to be provided the baseline actuarial assumptions, changes made this year, annual contribution of these changes to the timing, adjustment, because it is such a large number. My request is that every year there ought to be a detailed explanatory statement of these numbers. Otherwise, it is difficult to follow the numbers, what is causing what, why such a large number, what will happen with certain expectations in interest rates.

Mr. Cottarelli made the following statement:

> On the IAS 19, the explanations provided were helpful. I support this request to have a more in-depth discussion in the future. However, I wanted to make a somewhat related point.
>
> The magnitude of this item is huge—as huge as the magnitude of the net income position of this year compared to the level of operational spending. We spent a good part of the recent budget discussion on the need for streamlining Article IV consultations. That was a controversial decision. It cost US$4 million.
>
> That again calls for the need to have a single discussion of all these items. We cannot have a discussion on the budget four days ago, take some decisions, and then later on take a decision about the level of the surcharge. All these items relate to a single budget. The beauty of a single budget is that it implies a budget constraint. All items are related to one another. In the future, we should have a single discussion of all these issues in a comprehensive way.

The Deputy Director of the Finance Department (Mr. Andrews) stressed that the IAS 19 adjustment was purely a book entry. If it was a large positive number next year or in a future year, that did not in any way affect the budget position or the institution's contribution to the Staff Retirement Plan. It was entirely separate and only a requirement for financial reporting.

The Acting Chair (Mr. Furusawa) noted that Directors supported the proposed decisions on the Fund's Income Position for FY2015 and 2016 with the exception of Decision 5 on the placement of net income to the reserves, on which views were divided. Against this background, Directors agreed to consider on a lapse-of-time basis a revised decision to revert to the past practice of placing surcharge income to the General Reserve. Directors also supported a proposal to consider the practices for the placement of net income to the Special and the General Reserve in the context of the review of the adequacy of the Fund's precautionary balances early in 2016. This review would also consider the floor for precautionary balances.

The Executive Board took the following decisions:

Review of the Fund's Income Position for FY2015 and FY2016—Assessment Under Article XX, Section 4 for FY 2015

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, 2014 through April 30, 2015; 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, 2015 with an amount equal to 0.00170655 percent of their net cumulative allocations of special drawing rights. The total assessment shall be paid into the General Department. (EBS/15/32, 04/06/15)

Decision No. 15768-(15/41), adopted
April 27, 2015

Review of the Fund's Income Position for FY2015 and FY2016—Catastrophe Containment and Relief (formerly Post-Catastrophe Debt Relief) Trust Reimbursement for FY 2015

In accordance with paragraph 3 of Decision No. 14649-(10/64) CCR (formerly PCDR), adopted June 25, 2010, as amended, the General Resources Account shall be reimbursed an amount equivalent to SDR 0.066 million by the CCR (formerly PCDR) Trust in respect of the expenses of administering SDA resources in the CCR (formerly PCDR) Trust during FY 2015. (EBS/15/32, 04/06/15)

Decision No. 15769-(15/41), adopted
April 27, 2015

Review of the Fund's Income Position for FY2015 and FY2016—Poverty Reduction and Growth Trust Reimbursement for FY 2015

In accordance with paragraph 3 of Decision No. 8760-(87/176), adopted on December 18, 1987, an amount equivalent to SDR 52.94 million, representing the cost of administering the Poverty Reduction and Growth Trust (PRGT) for FY 2015, shall be transferred from the Reserve Account of the PRGT (through the Special Disbursement Account) to the General Resources Account. (EBS/15/32, 04/06/15)

Decision No. 15770-(15/41), adopted
April 27, 2015

Review of the Fund's Income Position for FY2015 and FY2016—Transfer of Investment Income for FY 2015 to General Resources Account

The income of the Fixed-Income Subaccount of the Investment Account for FY 2015 shall be transferred to the General Resources Account for use in meeting the expenses of conducting the business of the Fund during FY 2015. (EBS/15/32, 04/06/15)

Decision No. 15771-(15/41), adopted
April 27, 2015

Review of the Fund's Income Position for FY2015 and FY2016—The Rate of Charge on the Use of Fund Resources for FY 2016

Pursuant to Rule I-6(4)(b) of the Fund's Rules and Regulations, the Fund has conducted a comprehensive review of the Fund's income position and decided to leave unchanged for FY 2016 the rate of charge determined by Decision No. 15585-(14/37), adopted April 28, 2014. (EBS/15/32, 04/06/15)

Decision No. 15772-(15/41), adopted
April 27, 2015

Review of the Fund's Income Position for FY2015 and FY2016—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/15/32, 04/06/15)

Decision No. 15773-(15/41), adopted
April 27, 2015

APPROVAL: May 3, 2016

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

General

1. ***We note the higher estimate for investment income for FY2015 compared with initial projections and would appreciate some further elaborations on downside risks from a rise in interest rates.***

- Investment income projections are highly dependent on expectations of the future path of interest rates. Initial projections of FY2015 investment income made in April 2014 were lower than the current projections, as markets were expecting rising interest rates over the period. During the year, the upward pressure on interest rates caused by the tapering of quantitative easing measures in the United States was more than offset by new monetary easing policies elsewhere, particularly in the euro area. As a result, SDR interest rates marginally declined, bringing higher than expected investment performance for the Fixed-Income Subaccount. Given that interest rates remain close to historical lows, there is limited income protection against capital losses if interest rates rise even moderately in the near future. While the short-term risk of very low (or negative) returns, or underperformance against the three-month SDR rate remains, the Fixed-Income Subaccount follows a long-term investment strategy and over time, higher average yields will benefit the Fixed-Income Subaccount's performance both in absolute and relative terms, compared to the SDR rate. Further information is provided in Annex III of the paper.

2. ***To what extent the doubling of quota resources, under the full implementation of the 14th General Review of Quotas, would contribute toward increasing non-lending income?***

- The Committee of Eminent Persons that was established in 2006 to study the sustainable long term financing of the Fund, included in its recommendation the use of quota resources for investment by the Fund. However, this proposal was not included in the key elements of the Fund's New Income Model approved by the Board of Governors in 2008. Against this background, the implementation of the 14th General Review of Quotas is not expected to make any direct contribution towards the Fund's non-lending income.

3. ***Could staff clarify further the drivers for the increase in fixed income subaccount returns in the medium term and, more specifically, if reinvestment of income is being factored in and how this is different from proposed Decision 4 and previous practice?***

- The return on the Fixed-Income Subaccount is estimated from the projected SDR interest rate plus a premium. This premium over the SDR interest rate is assumed to gradually reach 50 basis points in FY2019, rising to 100 basis points by FY2021. As staff note in the paper, the reasonableness of these assumptions will need to be revisited in the light of the outcome of the Executive Board's review of the investment strategy for this subaccount in mid-2015. Net income of SDR 2.5 billion comprising actual income from FY 2014 and FY 2015 income is projected to be retained in the GRA and currencies corresponding to this amount are only expected to be transferred to the Fixed-Income Subaccount following the review of the mandate of the subaccount. These transfers will increase the value of the underlying investment. This differs from previous practice when currencies equivalent to the net income were transferred shortly after year-end into the subaccount.

- In line with past practice, the income earned by the Fixed-Income Subaccount in FY 2014 would not be retained in the subaccount, but instead transferred back to the GRA, to be used in meeting the expenses of conducting the business of the Fund (Decision 4).

IAS 19

4. ***While it may be difficult to forecast future IAS timing adjustment with a satisfactory degree of certainty, an indication of likely future adjustments would still be welcome to illustrate that some of the volatility is likely to disappear when one looks at a longer time horizon. Could staff comment?***

5. ***We would also like to see some analysis of the impact of future discount rates and other relevant variables, on IAS 19 timing adjustments.***

- The discount rate is the single most important actuarial assumption that has a material effect on the valuation of the present value of future pension payments and thus the timing adjustment. The discount rate, which is derived from high grade U.S. corporate bonds, cannot be projected with any degree of certainty. A rule-of-thumb on the impact of volatility of the discount rate is that a 1 percent change in the underlying discount rate yields a 17-19 percent change in the defined benefit obligation.

- The discount rate reached a historical low in FY 2015. Against this background, it is reasonable to expect an upward move in the discount rate over the medium term but the timing and magnitude of such an increase, and its relationship to movements in other rates such as the SDR interest rate, remains highly uncertain. Other variables affecting the timing adjustment computation are also subject to uncertainty and volatility.

6. ***We are not entirely convinced about staff's argument made on page 8 that 'The resulting timing differences can be substantial but should net to zero over the life of the pension and benefit plans, as from an accounting perspective the IAS 19 adjustments necessarily equal the employer's funding over time.' Could staff comment?***

- The IAS 19 expense is separate and distinct from the funding of the pension plan. The effect of IAS 19 is not expected to result in a change to the funding framework of the pension assets. In theory the funding should equal benefits paid and thus net to zero over the life of the plan. Annual variations in assumptions give rise to changes in the IAS 19 adjustments, which similarly should cancel out over time.

7. ***We would like to know the baseline actuarial assumptions, changes made this year, and the individual contributions of these changes to the timing adjustment. We would also encourage the staff to organize an informal session to explain these changes.***

8. ***This year, the 'loss' on account of IAS 19 timing adjustment is estimated at SDR 847 million, out of which SDR 600 million is attributed exclusively to the change in discount rate during the year. We understand that the staff does not have control over the discount rate, and future discount rates may also be difficult to predict. However, could staff provide detailed comments about the factors behind the timing adjustment of the remaining SDR 247 million?***

- The principal assumptions used in the IAS 19 actuarial valuations are recommended by the Fund's Actuary annually and for the most part do not fluctuate significantly each year. These demographic and financial assumptions are in line with those reviewed by the Pension Committee every five years, with the exception of the discount rate which is determined by reference to corporate bond rates. The principal assumptions are as follows: (i) the general rate of inflation is assumed to be 3 percent; (ii) future salary increases are estimated at an average of 4.6 percent to 9 percent per annum spanning the overall careers of staff with younger staff assumed to have higher increases over time; (iii) future health care costs increases are expected to range from 7 percent to 5 percent per annum in the longer-term; (iv) the expected rate of return on plan assets is the same as the discount rate under the amended IAS 19; and (v) life expectancy is based on the 2007 United Nations mortality tables. These actuarial assumptions are disclosed in the annual financial statements.

- The assumptions remain the same as in prior years except for the discount rate which is now projected to be below 4 percent, down from 4.4 percent at end-FY 2014, and this had the most significant impact on the timing adjustment. The remaining difference of SDR 247 million is a combination of the both positive and negative movements. In net terms this amount mainly reflects an exchange rate loss (from the conversion of the adjustment from U.S. dollar to SDRs) and a difference in timing between Fund's budgeted contribution to the plan and the calculated benefit expense for the year, which reflects the increase in obligations for an additional year of staff service.

9. ***While recognizing the fact that the funded status of the plan is mostly determined by the discount rate, which itself has been influenced by recent volatile trends in market interest rates, we would welcome staff comments on options, if any, for moderating the volatility to allow for better budgeting.***

10. ***Would staff expect that the IAS 19 adjustments would always be reflected in the net amounts that are available to be placed to the special reserve?***

- The Fund presents its financial statements under International Financial Reporting Standards (IFRS) and in FY2014 adopted the amended IAS 19. Previously, the old IAS 19 allowed actuarial gains and losses to be smoothed, however this option has since been revoked. Under the amended IAS 19, actuarial gains and losses will have to be reflected fully in the Fund's income statement. As such, for financial reporting purposes, the Fund's reserves will be affected annually by fluctuations resulting from changes in actuarial assumptions. Therefore, going forward, the full impact of actuarial gains and losses has to be added to or deducted from operational income. While this adds volatility to annual income, we would stress that the adjustment is a book entry and is distinct from the funding of the plan and the budgetary process.

- The effects of the IAS 19 will be presented annually in the context of the income position, and will reflect the effects of changes in actuarial assumptions. The IAS 19 adjustments are treated as administrative expenditures and thus included as part of net operational income. Under this practice it is therefore taken to special reserve.

Decision 5 and Precautionary Balances

11. ***We note that resources in the reserve accounts are at around SDR 14 billion for FY2015. Can staff comment how these funds are invested and, if it is the case, in what way the investment regime differs from those of the IA?***

- The projected precautionary balances of SDR 14 billion comprises Special Reserve of SDR 5.2 billion, General Reserve of SDR 7.6 billion, and SCA-1 of SDR 1.2 billion. Of this, SDR 10.3 billion from the special and general reserves is invested in the Fixed-Income Subaccount. The Investment Account (IA) balance of SDR 14.7 billion comprises the amount in the Fixed-Income Subaccount as well as SDR 4.4 billion of gold profits in the Endowment Subaccount. For further background to the IA see Rules and Regulations for the Investment Account, as set forth in the Annex to SM/12/318, Supplement 1 (1/25/13).

12. ***Regarding the estimated total precautionary balance totaling SDR 14.0 billion (sum of Special Reserves SDR 5.2 billion, General Reserves SDR 7.6 billion, and SCA-1 SDR 1.2 billion) and the projected level of General Reserves plus Special Reserves at the end of FY2015 of SDR 17.2 billion, could staff clarify what accounts for the difference between these two figures?***

- A reconciliation of the reserves and the precautionary balances is presented below:

Projected Reserves and Precautionary Balances

	In billions of SDRs
Special Reserve	9.6
General Reserve	7.6
Projected Reserves	17.2
Less: Endowment (gold profits) included in Special Reserve	4.4
Add: SCA-1	1.2
Precautionary balances	14.0

13. ***What is staff's assessment of credit risks to the Fund's lending portfolio for FY2015 in comparison to the lending portfolio for FY2014?***

- While credit outstanding is falling, Fund lending remains highly concentrated. At the last precautionary balance review, the stock of outstanding credit stood at more than SDR 80 billon (end-April 2014), with high portfolio concentration in the euro area (see SM/14/21). Since then, credit outstanding has fallen to around SDR 55 billion (end-April 2015) and is projected, absent any new programs, to fall to SDR 47 billion by end-FY16. That said, the concentration of risks remains very high. Also, global risks remain high, with the emergence of persistent dollar strength and continued sluggish growth in emerging markets and Europe, as well as the possibility of a super taper tantrum. The Executive Board will have an opportunity to assess the adequacy of the Fund's reserves in the next precautionary balances review, expected to be brought to the Board in early 2016.