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CONFIDENTIAL

January 29, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Review of Valuation of Late Payments in the Fund

The attached paper on a review of procedures applied for the valuation of late payments to the Fund will be brought to the agenda for discussion on a date to be announced.

Mr. Dhruba Gupta (ext. 7627) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Review of Valuation of Late Payments in the Fund

Prepared by the Treasurer's Department

(In consultation with the Legal Department)

Approved by F. Gerhard Laske

January 28, 1988

1. This paper has been prepared in response to a request by the Executive Board for a review of the procedures that are applied for the valuation of currencies paid to the Fund later than the due date of the obligation involved. 1/ It summarizes the valuation procedures in the Fund, including the procedures followed to date when payments are received later than the intended value date, and discusses a possible revision of these procedures for consideration by the Executive Board.

2. The valuation of currencies in terms of the SDR in the Fund, including the valuation of the Fund's holdings of members' currencies for the purpose of maintenance-of-value obligations by members, is governed by Article V, Section 10(b) and Section 11 and Article XIX, Section 7(a). The general rule of valuation is that members should receive the same value in terms of SDRs on a particular day whatever currencies might be provided by any particular member. For the implementation of this general system of valuation, the Executive Board in 1977 adopted Decision No. 5590, and the O and P Rules. 2/ Decision No. 5590 prescribes that the exchange rate used in operations and transactions between the Fund's General Resources Account and members shall be the rate as of three business days before the value date of the operation or transaction. 3/ The O and P Rules apply to other operations

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1/ See Minutes of Executive Board Meetings Nos. 86/199 and 86/200 (12/16/86) and "Morocco - Late Payments to the Fund - Valuation" (EBS/86/262, Sup. 2, 12/16/86).

2/ See Selected Decisions, Thirteenth Issue, pages 139-140, and By-Laws Rules and Regulations, Forty-Third Issue, pages 55-62.

3/ If that rate cannot be used, the rate of the closest preceding day that is practical is used.

and transactions, and generally provide for the valuation of currencies in terms of SDRs based on the three business day rule. 1/

3. The system of valuation is based on the assumption that payments to the Fund are made when due. It is presumed that operations and transactions will take place on the intended or scheduled value dates, and the Fund normally issues its instructions three business days before that date. 2/ The procedures for valuing currencies in the General Resources Account are also used when payments to the various accounts in the Fund (including the Trust Fund and the Administered Accounts) are made later than the scheduled or advised value dates. 3/ In such cases, the amounts of currencies necessary to discharge given SDR obligations are adjusted on the basis of exchange rates three business days before the date of receipt. However, in the practice followed by the staff there have been two exceptions to this general rule, which were described in "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/46, 3/9/84). 4/ The reasons for these exceptions are twofold

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1/ In voluntary transactions involving transfers of currencies against SDRs members may agree to use the applicable exchange rate two business days before the value date (rather than the normal three business days).

2/ "Business days" mean business days of the Fund. However, business days in the country the currency of which is being used in the transaction and the country that is a party to the transaction are also taken into account, e.g., to avoid a value date falling on a holiday of a member that is party to the transaction or to ensure that adequate notice is given. (In valuations after the fact, because of late payments, three business days always means business days of the Fund.)

3/ It is worth noting that the responsibility for completing payments to the Fund rests with the member, and that any losses arising from negligence or delays by agents for a member would need to be resolved between the member and its agent. The Fund has assisted in resolving difficulties arising from late payments by commercial banks although instructions had been given on a timely basis by the member concerned, but on the understanding that responsibility to ensure timely payment rests with the member.

4/ No adjustment would be called for in the case of a delay, by the issuing member, in the exchange of a currency the Fund has sold into a freely usable currency. If such a delay arises, it is considered that the domestic currency was provided on the due date by the member whose currency is being sold in accordance with the Fund's instructions and that there was a delay in the exchange. (In contrast, the transfer of domestic currency in a repurchase cannot take place until the corresponding foreign asset is paid to the Fund.) The member that is responsible for exchanging to a freely usable currency under Rule O-4 is asked to compensate the purchasing member for loss of interest on the amount involved. Cases of delays in exchange of currency are rare and it is proposed to continue the current practice in such cases.

and relate (i) to administrative costs, and (ii) the distribution of exchange risks.

(i) First, in order to avoid administrative costs both for member countries and for the Fund, no adjustments (for shortfalls) are collected for small under payments that arise because of delays unless a member that issues the currency being used indicates that the adjustment should be made irrespective of costs. The size of adjustments that might be considered not to be cost effective is a matter of judgement; in the past, it had been set at SDR 5,000.

(ii) Second, payment instructions are not revoked if a late payment is expected to be completed within a short period of time (ten business days in practice). 1/ In these circumstances, an adjustment is made and new or supplementary instructions are issued when the currency used in the transaction has depreciated, but no adjustment is made if the currency used in the transaction appreciates in terms of the SDR. There are a number of reasons for this exception to the application of the three-day valuation rule. One is the intent to avoid any possible incentive to delay a payment for a few days in order to benefit from exchange rate developments, regardless of whether the resources involved are from the General Resources Account or from other Accounts of the Fund. 2/ Second, in case of an SDR transaction, it would appear inequitable if the member using SDRs not only did not receive currency on the date it was entitled to receive it, but in addition received a lesser amount. Third, investments of proceeds of payments to the Special Disbursement Account and the Borrowed Resources Suspense Account are generally initiated prior to the receipt of funds, in order to assure that the receipts of currency and their investment have the same currency value. The currency amount of the investment denominated in SDRs is thus fixed, and a refund to the member that settles an obligations only after the due date, would reduce the amount of currency available for investment. Accordingly, the currency amount of the investment would also be less and would be lower than the value of the obligation settled.

1/ If no payment is received within 10 business days, instructions are considered revoked, and new instructions are issued when a new payment date is indicated by the member then in arrears. If payment is made by a member without seeking the Fund's instructions the procedure is to value on the basis of the three business day rule.

2/ The exchange risk in terms of currencies would be borne by the member issuing the currency which is used in the operation or transaction, which would receive a smaller or larger amount of currency units for a given amount of SDRs than would be the case had the transaction been completed as scheduled. Thus, for example, in cases of surpluses arising from late payments to the General Resources Account in an appreciated currency, the benefit accrues to the member whose currency is used in the transaction.

As a consequence, the Special Disbursement Account would incur a capital loss and the assets available for disbursement to eligible members would be reduced, or the cost to the BRSA and hence charges on the use of the Fund's borrowed resources would increase. 1/

4. Some Executive Directors have taken the view that there should be no exceptions from the valuation procedures when payments are made later than their due date, i.e., that valuation on the basis of exchange rates in effect three business days before the actual value date of a transaction should apply to all operations and transactions, including those that are made after the scheduled value dates. Currencies received late would be revalued after the payment had been completed on the basis of the exchange rates three business days earlier. 2/ (In case of shortfalls in currency payments against provision of SDRs, the amount of SDRs transferred could be adjusted.) This procedure would ensure that virtually all payments in currency on any particular day have the same value in terms of the SDR, whether it be for purposes of transactions in the General Department or in the SDR Department, in the Trust Fund, or for valuation of the Fund's holdings of currencies for maintenance of value obligations. 3/ It could thus be considered a more consistent implementation of the system of valuation in terms of the SDR that is inherent in the Fund's Articles of Agreement.

5. Such a system would involve eliminating the practice of not refunding amounts to a late paying member within ten business days where the currency value had appreciated against the SDR. It would also eliminate the present practice of not collecting adjustments for shortfalls amounting to less than SDR 5,000. However, to avoid costs that may be considered large in comparison to the result, it might be considered desirable that small differences--either shortfalls or excesses--of, say SDR 500 or less be waived unless the party not at fault required otherwise. 4/ It should be noted, though, that such a revised procedure would result in certain costs for the membership at large and might be judged undesirable on other grounds. Its effects on aspects of the Fund's financial

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1/ See "Overdue Financial Obligations to the Fund - Six-Monthly Report," (EBS/86/98, 4/28/86) page 14.

2/ If an exchange rate is not available for a currency on the third business day before the value date, the rate of the closest preceding business day is used, in accordance with Decision No. 5590.

3/ The word "virtually" is meant to provide a limited degree of flexibility, e.g., for transactions by agreement on the basis of two-day value, or for de minimis cases which are discussed further below.

4/ The waiver would apply only if the payment otherwise cleared all overdue obligations. If this were not the case, the de minimis argument would not apply as the difference can be added to or deducted from remaining overdue obligations.

operations other than valuation must therefore also be considered. The most important of these are discussed in the following paragraphs.

6. Adoption of these alternative procedures for valuation of late payments in Fund-related transactions would result in some exchange rate exposure in terms of currencies for the Fund as regards investments made in anticipation of payments falling due. The staff would continue to evaluate maturing obligations to ensure that decisions regarding the investment of the proceeds of payments falling due would be initiated prior to receipt only when there appeared no doubt about payments being received on time. 1/ Nonetheless, late receipt of payments cannot be precluded altogether and any exchange losses due to late payments of amounts whose investment has been initiated prior to receipt of funds could reduce amounts available in the Special Disbursement Account or reduce net investment income in the Borrowed Resources Suspense Account thereby increasing EAR charges.

7. A related, and perhaps more important, question arises in SDR transactions. Delay in making a payment of currency when due to a member using its SDR holdings will result not only in the unavailability of currency when anticipated but, under a strict three-day value rule, also possibly in a lesser currency amount eventually being paid to the user of SDRs. There have been very few late payments in SDR transactions involving designation, and payment delays in practice have been more likely to occur in voluntary transfers of SDRs among participants. It is hence for consideration whether in the case of voluntary transfers among participants and prescribed holders in the SDR Department, the manner of distributing the costs of late payments could not also be left to agreement between the parties to the transfer. The absence of prescriptions in these cases would leave the parties to the agreement to follow customary market practices, which could be expected to contribute to the quality of the SDR as a reserve asset. The staff is still reviewing this issue and if needed would return to it in a separate paper. In the meantime, these transactions would be treated analogously to other Fund-related transactions.

8. The question was raised in the earlier Board discussion about the possibility of retroactive adjustments should the system of valuing currencies received after a due date be changed. Records do not currently exist in a form that would permit ready identification of the transactions and operations that would be affected by a policy of retroactive adjustment. The administrative costs involved in compiling such data would be considerable and would require the allocation of additional budgetary resources. Nevertheless, should the Executive Board decide to change the procedures, the staff would suggest that adjustments be made for

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1/ In other cases investments would continue to be made, as at present, only after the payments had actually been received by the Fund.

transactions that have taken place since October 1986 at which time the question discussed regarding adjustment arose. The staff would suggest that members should make the claims and identify the particular transactions that would need retroactive adjustment. The Fund would have to verify the claims.

9. In summary, it is proposed that the Executive Board approve a procedure under which the three business day rule would be applied to all payments including those that are delayed, subject to adjustment of not more than SDR 500 being waived for payments that would settle all overdue obligations of a member. The staff would not normally issue new instructions for payments that are delayed by less than ten days, because to do so could be most confusing for paying members, particularly if the members' instructions to their paying agents had already been issued. The valuation of all payments that are made late, whether by a few days or after a more protracted period, would be made after the payments had been completed on the basis of the applicable exchange rate three business days before actual payment. In comparison with present procedures, the main difference would be discontinuation of the exception from the three-day rule of valuation that disallowed an exchange rate advantage to a member making a payment shortly after the due date.

Should the Executive Board decide that changes should be made in the Fund's procedures for valuing late payments, the staff would suggest that adjustments be made for transactions that have taken place since October 1986 at which time the question discussed regarding adjustment arose. The staff would suggest that members should make the claims and identify the particular transactions that would need retroactive adjustment. The Fund would have to verify the claims.