FOR AGENDA

EBS/87/253
Supplement 1

CONFIDENTIAL

December 9, 1987

To: Members of the Executive Board

From: The Acting Secretary

Subject: Enhancement of the Structural Adjustment Facility - Proposed Modifications to Draft Trust Instrument and SAF Regulations

The attached paper proposes certain modifications to the provisions of the draft Trust Instrument set forth in EBS/87/253 (12/2/87), which is scheduled for consideration by the Executive Board on Friday, December 11, 1987.

Mr. Leddy (ext. 8332), Mr. Boorman (ext. 7858) or Mr. Munzberg (ext. 6675), is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Enhancement of the Structural Adjustment Facility--Proposed Modifications to Draft Trust Instrument and SAF Regulations

Prepared by the Exchange and Trade Relations, Legal, and Treasurer's Departments

Approved by L.A. Whittome, F. Gianviti, and Thomas Leddy

December 9, 1987

This supplemental note proposes certain modifications to the provisions of the draft Trust Instrument and SAF Regulations circulated with EBS/87/253 (12/2/87) as explained below.

1. Exceptional provisions relating to timing of interest payments by the Trust

As mentioned in EBS/87/245, a lender had asked that its loans to the Trust be denominated in local currency rather than in SDRs. Following further discussions and examination of the issues, this lender has determined that it would be prepared in principle to lend on the basis of SDR denomination and to make its own arrangements to cover the exchange risk arising from such loans through market operations, provided that interest proposed to be paid by the Trust is judged adequate to cover the cost of funding its loans to the Trust and the cost of protection against exchange risk.

This latter question remains under consideration. However, it has become evident in the discussions that, in executing the arrangements contemplated for coverage against exchange risk through market operations, it will be necessary for the lender to receive interest from the Trust on the six-monthly anniversaries of the Trust's drawings on the lender, rather than at two fixed times (end-June and end-December) each year corresponding to receipts of interest by the Trust, as has been proposed by the staff and provided for in the draft Instrument. Payment of interest by the Trust on dates keyed to the dates of drawings on a lender would require payments during the course of the interest periods for loans extended by the Trust. This would involve, on the one hand, the holding (and investment) of certain interest receipts by the Trust pending payment to the lender and, on the other, a temporary use of the Reserve to finance the balance of the payment of interest to the lender in anticipation of further interest receipts from borrowers. (For example, an interest payment by the Trust on September 30 would be financed in part from interest received on the preceeding June 30 and in part from the Reserve, in anticipation of interest receipts at end-December. Investment earnings on the interest received and held between June 30 and September 30 would be transferred to the Reserve.)

Such arrangements would also imply use of funds available in the Subsidy Account at various times during the year, based on the six-monthly anniversaries of drawings on the lender, rather than on two fixed occasions in connection with interest payments to lenders in general.

The following points may be noted regarding such temporary use of the Reserve.

(i) The maximum amount that could be involved at any time could not exceed the equivalent of 5 1/2 months interest, at the anticipated lending rate of 0.5 percent on Trust loans, applied to the amount outstanding from the lender. 1/ Even if this system were applied to the total of the Trust's lending, which is not proposed, the amount of such temporary use of the Reserve could not exceed approximately SDR 13.7 million (SDR 6.0 billion at 0.5 percent interest for 5 1/2 months) at any time. In practice, the staff would expect that the amount would not exceed SDR 4-5 million and would normally be substantially less.

(ii) Such arrangements would not be expected to result in any net cost to the Reserve, apart from the possible effects of variations of investment yields during an interest period. Any investment earnings forgone as a result of temporary use of the Reserve for interest payments in advance of the corresponding receipts would be matched by earnings on prior receipts of interest held by the Trust pending payment to the lender; these earnings would be placed to the Reserve (Section V, Paragraph 1(c) of the draft Trust Instrument). 2/

1/ It has been proposed that disbursements be made on two dates each month. This maximum would occur if a drawing were made on the lender's commitment on June 15 or December 15, i.e., 1/2 month before an interest payment date on Trust loans.

2/ Assuming unchanged yields on the Trust's investments, earnings on receipts of interest held pending payment will equal earnings forgone on temporary use of the Reserve. This can be illustrated by the following example, applied to a drawing of SDR 120 million with interest payable on June 15 and December 15. Interest on loans corresponding to the drawing would be received by the Trust on June 30, in the amount of SDR 25,000 (SDR 120 million at 0.5 percent interest for 1/2 month). This would be invested at, say, 6 percent to December 15, to yield SDR 687.50, which would be transferred to the Reserve. On December 15, payments to the lender totaling SDR 0.3 million (i.e., apart from amounts drawn from the Subsidy Account) would be made from (a) accumulated interest receipts in the amount of SDR 25,000 and (b) the Reserve in the amount of SDR 275,000. The advance from the Reserve would be outstanding 1/2 month until end-December, implying investment earnings forgone (also at 6 percent) of SDR 687.50, which is equal to the earnings on the investment of SDR 25,000 to December 15. The Reserve would, in addition, earn a small amount on the investment of the amount of SDR 687.50 transferred to it on December 15.

A generalization of such arrangements would lead to a multiplication of the number of interest payment dates and interest payments and consequently to increases in operational difficulties and costs of administering the Trust. However, and only where necessary to facilitate the arrangement of exchange cover, it is proposed that the Trustee be authorized to pay interest at times other than those specified in the draft of the Trust Instrument circulated with EBS/87/253. For this purpose, it is proposed that paragraph 5(c) of Section III of the draft Trust Instrument be modified to read as follows:

"(c) The Trust shall pay interest on outstanding borrowing for Trust loans promptly after June 30 and December 31 of each year, unless the particular modalities of a loan to the Trust make it necessary for the Trustee to agree with the lender on interest payments at other times."

The use of resources in the Reserve Account for interest payments to lenders that are due and payable prior to interest receipts on Trust loans, in accordance with the arrangements discussed above, would be consistent with the existing draft of Paragraph 2 of Section V of the draft Instrument regarding the use of resources of the Reserve Account, since sufficient interest receipts would not yet be available in the Loan Account. However, it would be necessary to assure that as soon as the interest is received from the borrower the Reserve Account would be restored. Consequently it would be necessary to modify the provisions of Section V on the Reserve Account regarding resources to be received by that Account. It is proposed to modify Section V, Paragraphs 1 and 3 as shown below. The modified language would also provide for the transfer to the Reserve of interest received on any overdue obligations to the Trust.

Paragraph 1. Resources

"(d) payments of overdue principal or interest or interest thereon under Trust loans, and payments of interest under Trust loans to the extent that payment has been made to a lender from the Reserve Account."

Paragaraph 3. Payments to the Reserve Account

"Any payments of overdue principal or interest or interest thereon under Trust loans, and any payment of interest under Trust loans to the extent that payment has been made to a lender from the Reserve Account, shall be made to the Reserve Account."

2. Timing of disbursements of Trust loans and calls on lenders

It was proposed in EBS/87/228 that Trust loan disbursements and the associated calls on lenders be made on two occasions each month, as is the case with respect to use of borrowed resources under the Fund's enlarged access policy. In addition to the reasons given in support of this approach in the earlier paper, the staff understands that it may be of particular importance in connection with possible arrangements for coverage of exchange risk in connection with loans to the Trust. In order to provide clarity for both borrowers and lenders, it is proposed to add the following provision, which is comparable to Rule G-4(b) regarding the timing of purchases of borrowed resources under the Fund's enlarged access policy, to Section II, Paragraph 3, of the draft Trust Instrument:

"(c) Disbursements shall normally be made on the fifteenth and the last day of the month, provided that if these days are not business days of the Trustee, the disbursement shall be made on the preceding business day. Following a member's qualification for a disbursement, the disbursement shall be made on the first of these value dates for which the necessary notifications and payment instructions can be issued by the Trustee."

In order to harmonize the disbursements of loans financed from the Trust and from the SAF, it is proposed to add the following paragraph 2(iii) to the new Paragraph 14 of the SAF Regulation (p. 8 of EBS/87/253):

"2(iii) Disbursements will be made at the same time as the corresponding disbursements under Trust loans."

With respect to the period for notice of calls on lenders, it was noted in EBS/87/245 that a lender had raised a question regarding the feasibility of arranging to meet calls on the basis of the proposed five business days' notice by the Trustee. This has been discussed further. It has been agreed in this case that ten business day's notice will be given, but that the Fund will also have the right to cancel a call within five business days after notice is given if, for example, in the intervening period a proposed disbursement is disapproved by the Executive Board or the borrower falls into arrears to the Fund. In practice, therefore, this arrangement provides the Trust with the equivalent of a five business day notice period, while giving the lender sufficient time to initiate procedures for meeting a call. Accordingly, the staff anticipates that disbursement will be made on the first disbursement date following a borrower's qualification so long as the date of qualification preceeds the disbursement date by at least six business days.