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AGENDA

EBS/85/284

CONFIDENTIAL

December 18, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Supplementary Financing Facility Subsidy Account -  
Investment and Subsidy Payments in SDRs

Attached for consideration by the Executive Directors is a paper on the Supplementary Financing Facility Subsidy Account - Investment and Subsidy Payments in SDRs. Draft decisions appear on pages 7 and 8.

It is proposed to bring this subject to the agenda for discussion on Wednesday, January 15, 1986.

Mr. Coats (ext. 8249) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)



INTERNATIONAL MONETARY FUND

Supplementary Financing Facility Subsidy Account:  
Investment and Subsidy Payments in SDRs

Prepared by the Treasurer's and Legal Departments

Approved by W. O. Habermeier and George P. Nicoletopoulos

December 17, 1985

I. Introduction

The Supplementary Financing Facility Subsidy Account was established in December 1980 to reduce the cost to eligible low-income members of using the Fund's resources under the Supplementary Financing Facility (SFF) and the policy on exceptional use of the Fund's resources. 1/ To date, five subsidy disbursements totaling SDR 307 million have been made, in December 1981, August 1982, September 1983, July 1984, and July 1985. 2/ All payments have been made in U.S. dollars. The Subsidy Account's undisbursed resources, amounting to almost SDR 197 million at the end of November 1985, are invested in SDR-denominated deposits pending their use. Future disbursements by the Subsidy Account, totaling a maximum of SDR 197 million, will continue until 1991.

This paper proposes certain modifications in the Subsidy Account's investment practices that would increase the yield on certain short-term investments of the Subsidy Account by opening an SDR-denominated investment account with the World Bank and allowing subsidy disbursements to be made in SDRs.

II. Investment of SFF Subsidy Account Resources

The SFF Subsidy Account's resources are at present invested in SDR-denominated deposits with the BIS. The Fund's practice is to invest these resources in deposits arranged to mature on anticipated subsidy disbursement dates or as close thereto as the arrangements with the BIS permit.

Prior to July 1985, such investments were made as repayments of Trust Fund loans, payments of Trust Fund interest, contributions in the

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1/ Decision No. 6683-(80/185) G/TR, adopted December 17, 1980, in Selected Decisions, Eleventh Issue, pp. 335-342. The provision of this Decision relating to the Subsidy Account's investment authority is reproduced in Attachment I.

2/ Excluding a total of SDR 5.9 million being withheld pending completion of payment by five members of their SFF charges for the period July 1984-June 1985.

form of donations, and investment income were received by the Subsidy Account. As transfers of Trust Fund reflows from the Special Disbursement Account are no longer necessary to meet the obligations of the Subsidy Account 1/, future investments of Subsidy Account resources will consist of the reinvestment of maturing fixed-term investments and the investment of interest paid on present investments. In many cases, these receipts are in amounts that are too small to be invested in fixed-term deposits with the BIS, for which the BIS requires a minimum amount of about SDR 2.5 million. While they accumulate, these receipts are therefore placed in an SDR-denominated two-day notice account with the BIS, the minimum required transfer to which is SDR 25,000.

The returns on funds placed in the two-day notice account have generally been significantly below the interest rate on SDRs because of transaction costs and low yields associated with very short-term investments. The Subsidy Account's short-term investments could yield higher returns if it were possible to invest in SDRs, because the interest paid on SDRs is based on three-month maturities and there are no conversion costs.

The Subsidy Account is not able to hold SDRs itself. 2/ However, it would be possible to make arrangements that would have similar effects by involving third parties, i.e., participants and prescribed holders of SDRs. 3/ After exploring the matter more generally, the Fund staff approached the staffs of the BIS and the World Bank regarding the possibilities of such arrangements to secure the rate of interest paid on SDRs. Following detailed discussions, the World Bank's staff has indicated that it would be willing to propose to its Management and Executive Board the opening of an investment account for the Fund, denominated in SDRs, against which the Bank would acquire and hold SDRs in its capacity as a prescribed holder and which would pay the SDR rate of interest. 4/ The World Bank would then be able to pay to the Subsidy Account a higher return than is currently earned on the two-day notice account or on very short-term deposits with the BIS. 5/ Such an investment account with the World Bank, which could be disinvested with two days notice, would normally be useful in three circumstances:

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1/ See "Suspension of Transfers to the SFF Subsidy Account and Investment of Balances Retained in the Special Disbursement Account," EBS/85/127 May 14, 1985, and Supplement 1.

2/ The Subsidy Account is not considered to be an official entity qualified for prescription as an SDR holder under Article XVII, Section 3.

3/ See "Possible Further Improvements in the Existing SDR," SM/82/92, May 7, 1982, page 20.

4/ The Fund would reimburse the Bank for out-of-pocket expenses. Any such expenses would be negligible.

5/ The Decision on SFF Subsidy Account Investments (Decision No.6854-(81/78) SBS, May 8, 1981, reproduced in Attachment II) permits the Managing Director to make proposals for alternative investments if he considers that the terms offered by the BIS on an intended deposit are not sufficiently attractive. While the BIS offers satisfactory terms for most of the Fund's investments, the return on very short-term investments of the type described above could be improved somewhat.

(i) when receipts of funds in very small amounts are invested pending consolidation into a higher-yielding fixed term deposit with the BIS, which requires a minimum amount of SDR 2.5 million; 1/

(ii) when funds need to be held for quick (though uncertain as to timing) disbursement to members that had unpaid SFF charges outstanding at the time of the regular subsidy disbursement; and

(iii) when funds are available for reinvestment for a short period immediately before disbursement of the subsidy.

At the initiation of an investment, the Subsidy Account would provide U.S. dollars to the World Bank to constitute an SDR-denominated investment. Simultaneously, the World Bank would use these U.S. dollars to acquire the SDRs in the SDR amount of the investment, in a transaction by agreement arranged by the Fund. The World Bank would hold those SDRs for the duration of the investment to cover its SDR-denominated obligation to the Fund. It would earn interest on such SDRs and would, therefore, be in a position to pay interest at the SDR interest rate on the investment. Hence, the amounts invested would be held by the World Bank at all times in the form of SDRs, which could be transferred only when the investment was liquidated by the Fund, as discussed in Section III below. The investments would therefore not be available to the World Bank for the financing of its own operations.

The amounts invested in such an account with the World Bank would be limited, as follows: (i) Investments in the account with the World Bank would normally not exceed approximately SDR 2.5 million, at which point the funds would be placed in a fixed-term deposit with the BIS. (ii) Investments would, however, exceed this amount by the amount of any subsidy payments withheld pending members' settlement of overdue SFF charges. The magnitude of any such payments withheld would depend upon the promptness with which members entitled to receive subsidies pay SFF charges in the future. In 1984 the subsidies payable to five countries otherwise entitled to SFF subsidies in July 1984, but which failed to pay SFF charges on time, amounted to SDR 8.5 million. The subsidies withheld were placed at two-day notice with the BIS until the relevant charges were discharged. At the end of November 1985, SDR 5.9 million of subsidies was withheld in the two-day notice account in relation to the unpaid SFF charges by five members. (iii) The fixed-term deposits of the SFF Subsidy Account with the BIS are timed to mature shortly after SFF charges are due to be discharged in early July of each year, allowing sufficient time for a Board decision on a lapse-of-time basis to authorize disbursement of subsidies. If a disbursement date is delayed for any reason beyond the maturity date of the deposit

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1/ Following the suspension of the transfer of Trust Fund reflows to the SFF Subsidy Account, these receipts will consist of investment income, which will have to be reinvested.

with the BIS, the maturing deposit would have to be reinvested on a short-term basis. 1/ The SDR-denominated call account with the World Bank would be a potential avenue for such an investment. Although the amount of any such investment would depend on the arrangements for disinvestment, as discussed in Section III below, it could potentially cover the total annual subsidy payment. The largest remaining annual subsidy payment is SDR 75.4 million. Any such peak investment in the call account with the World Bank before an annual subsidy disbursement would, however, be expected to be held for only a brief period.

Investments with the World Bank are of a type that would fall within the existing guidelines for investing the resources of the Subsidy Account provided in the Instrument establishing the SFF Subsidy Account. 2/ However, they would involve a modification of the Investment Decision governing the SFF Subsidy Account, as the present decision provides for the investment of SFF resources only with the BIS. In order to allow for investments with the World Bank, it is proposed that the text of this decision be amended accordingly. 3/ As required by the Subsidy Account Instrument, 4/ consultations have been held with the U.S. authorities on the use of U.S. dollars for the new type of investment proposed, and they have indicated their agreement with the proposal.

The proposed amendment of the decision and the consultation with the United States' authorities cover the investment of the assets of the SFF Subsidy Account only. As indicated earlier, transfers to this Account of repayments of and interest payments on Trust Fund loans have now ceased and are accumulating in the Special Disbursement Account. In the event that it appeared desirable to utilize an SDR-denominated call account with the World Bank for similar investments by the Special Disbursement Account, a separate proposal would need to be brought to the Executive Board, and the concurrence of the United States' authorities in the use of U.S. dollars for this purpose would be required. 5/

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1/ Disbursements were delayed beyond their originally scheduled dates on several occasions. A delay of a disbursement may arise unexpectedly, for example, because the finalization of the amounts of the charges may require more time than usual, or the schedule of Management or the Executive Board warrants the disbursement on a date later than envisaged. The most recent example is the delay in the disbursement date for 1985 subsidies totaling SDR 87 million for three days, which necessitated a very short term reinvestment of that amount.

2/ See Attachment I.

3/ See Attachment III.

4/ See the last sentence of Section 14 of the Instrument establishing the SFF Subsidy Account, which is reproduced in Attachment I.

5/ See Article V, Section (12)(h).

### III. Disinvestment of SFF Subsidy Account Resources

The willingness of the World Bank to open an SDR-denominated investment account and acquire SDRs with the invested resources is dependent on assurance by the Fund that the World Bank will be able to dispose of the SDRs at the time of disinvestment. The Fund, for its part, would wish to be able to disinvest when it suits the interests of the Subsidy Account. Therefore, investments in the proposed account would be made only when the staff is assured that the SDRs to be held by the World Bank could be disposed of when the Fund would wish to disinvest. For this purpose, the following arrangements are envisaged.

#### (i) Subsidy payments in SDRs

Disinvestment at the time of subsidy payments could take the form of direct transfers of SDRs from the World Bank to the recipients of subsidies, provided that the Fund would authorize disbursement of the subsidies in SDRs and the beneficiaries would agree to accept payment, wholly or partly, in SDRs. Such transfers, which would be effected by debiting the investment account with the World Bank and crediting beneficiaries in the books of the SDR Department, would, pro tanto, discharge both the obligation of the World Bank to pay the proceeds of disinvestment to the Subsidy Account and the obligation of the Subsidy Account to make payment to subsidy recipients. <sup>1/</sup>

This procedure would be simpler than the one applied thus far. Currently, the proceeds of maturing SDR-denominated deposits have to be converted into U.S. dollars and transferred to the Federal Reserve Bank of New York, from which they are disbursed to subsidy beneficiaries. For beneficiaries a subsidy disbursement in SDRs could also imply an administrative simplification: arrangements need not be made for their investment as they already earn interest; and they can be used immediately i.e., without having first to convert U.S. dollars into SDRs, to make payments to the Fund for charges that must be paid in SDRs, and for repurchases, which, at the discretion of the member, can be made in SDRs.

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<sup>1/</sup> The possibility of transfers of this nature was envisaged when the Subsidy Account was established. Section 13(a) of the Instrument establishing the Subsidy Account permits the Fund to accept resources for the Account in the form of donations and loans in SDRs in accordance with arrangements made by the Fund for the holding and use of such SDRs, the understanding being that SDRs accruing by way of gift or as interest on loaned SDRs would be retained in the account of the donor or lender until needed and then transferred directly to the accounts of the beneficiaries on the instruction of the Fund. In the proposed arrangement, the holder would be an entity with which the Fund has invested resources, rather than a donor or a lender, and the transfer would be made in discharge of the Fund's claim arising from disinvestment rather than its claim arising under the terms of a donation or loan agreement.

All subsidy payments to date have been authorized and paid in U.S. dollars. The Instrument establishing the Subsidy Account leaves it to the Fund, however, to determine the medium of payment, and it is open to the Executive Board to authorize payment of the subsidy in SDRs. 1/ Even though the SFF Subsidy Account may not hold SDRs itself, such payment can be made by a third party (in this case the World Bank) at the request of the Trustee. In order to facilitate the proposed investment in SDRs with the World Bank, it would therefore be proposed that in the future SFF subsidies may be paid, at the discretion of the Fund, either in SDRs to beneficiaries agreeing to receive them, in U.S. dollars, or in a combination of the two assets.

In addition, before SDRs could be transferred from the Bank to Subsidy beneficiaries in this way, the Board would need to prescribe a new operation under Article XIX, Section 2(c) for this purpose. None of the present prescribed operations fits this situation. For example, use of SDRs to settle a financial obligation requires that the obligation be to the recipient on the part of the user. In this case, the World Bank would be using SDRs to settle an obligation to the Fund as Trustee of the Subsidy Account, rather than to the recipients. 2/

Article XIX, Section 2(c) authorizes participants (or prescribed holders) to agree among themselves on a prescribed operation in SDRs. In this case, agreement by the subsidy beneficiaries would take the form of their prior consent to receive SFF subsidy payments in SDRs. The staff has informally consulted with the beneficiaries, and virtually all have indicated that they would be agreeable to such arrangements. The World Bank's agreement to the operation would be part of the Investment Agreement between the two institutions.

(ii) Reinvestment of funds with BIS

With regard to the accumulation of funds in the proposed account and the subsequent disinvestment to constitute a fixed-term deposit with the BIS, the staff would arrange, prior to any such investment, for the World Bank to sell the corresponding SDRs to participants in the SDR Department or to prescribed holders.

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1/ Each year the Executive Board has determined the amount of the SFF subsidies to be disbursed and the means of payment. (See, for instance, "SFF Subsidy Account - Proposed Subsidy Payments for the Period July 1, 1984 through June 30, 1985", EBS/85/168, July 15, 1985.)

2/ It may be noted that the adoption of the staff proposal on simplifying SDR operations in SM/83/187, August 15, 1983 and Supplement 1, would permit a transfer by a simple instruction from a transferor and would obviate the need for a special decision.



(iii) Liquidation of Investment Account

Upon completion of its subsidy operations, expected to take place in 1991, the Subsidy Account will have to be terminated by the Fund and any remaining resources not needed for the disbursement of subsidies transferred to the Special Disbursement Account. <sup>1/</sup> It is therefore necessary to insure that the proposed SDR-denominated investment account can be liquidated in full at that time as well. The staff would plan to operate the Investment Account in a way that would assure that there is a zero balance in the account following the final subsidy payment. This could be facilitated by making the final subsidy disbursement on the day interest is paid on the SDR holdings of the World Bank so as to use any residual balance in the account (including accrued interest), and by keeping the investment with the World Bank within the amounts for which sales of SDRs that would be held by the World Bank could be arranged in advance.

IV. Proposed Decisions

As noted above, the Subsidy Account Investment decision would need to be amended to permit investments with the World Bank. Subsidy payments in SDRs are also subject to authorization by the Executive Board. In addition, the transfer of SDRs from the World Bank to beneficiaries of the SFF Subsidy Account would require the prescription of a new operation under Article XIX, Section 2(c).

Accordingly, the following three draft decisions are proposed for adoption by the Executive Board. The first two decisions could be taken by the Fund, in its capacity as Trustee of the SFF Subsidy Account, by a majority of the votes cast. The third decision, which pertains exclusively to the SDR Department, would need a seventy percent majority of the total voting power under Article XIX, Section 2(c).

(i) Supplementary Financing Facility:  
Subsidy Account - Investment

Decision No. 6854-(81/78) SBS, May 8, 1981 shall be amended to read:

The Managing Director shall place in deposits, denominated in SDRs, with the Bank for International Settlements, or in investments in a call account, denominated in SDRs, with the International

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<sup>1/</sup> See Section 18 of the Instrument establishing the SFF Subsidy Account, reproduced in Attachment I. According to Section 4(b) of the Instrument establishing the SFF Subsidy Account, any resource of the Account not needed for the disbursement of SFF subsidies should be transferred to the Special Disbursement Account.

Bank for Reconstruction and Development, the currencies received by the SFF Subsidy Account, unless the Managing Director considers that the terms offered are not sufficiently attractive. In that event the Managing Director shall inform the Executive Board promptly and make other proposals to it for investment in SDR-denominated obligations.

(ii) Means of subsidy payments

Subsidy payments made after the effective date of this Decision with respect to charges paid on holdings of currency referred to in Section 7 of the Instrument establishing the SFF Subsidy Account may be made, at the discretion of the Fund, in SDRs to beneficiaries agreeing to receive them, or in U.S. dollars, or in a combination of these two assets. Subsidy payments in U.S. dollars shall be made on the basis of the SDR/U.S. dollar exchange rate in effect three business days before the payment date.

(iii) Use of SDRs in payment of subsidy from the Supplementary Financing Facility Subsidy Account

In accordance with Article XIX, Section 2(c), the Fund prescribes that:

1. A prescribed holder, by agreement with a participant, may transfer SDRs to the participant in discharge of subsidy payable from the Supplementary Financing Facility Subsidy Account, at the instruction of the Fund as Trustee of that Account.

2. The Fund shall record operations pursuant to this prescription in accordance with Rule P-9.

Supplementary Financing Facility:  
Subsidy Account - Instrument

Section 14. Authorized Investments

Investments pursuant to Section 6 may be made in any of the following: (a) marketable obligations issued by an international financial organization and denominated in special drawing rights or in the currency of a member of the Fund; (b) marketable obligations issued by a member or by a national official financial institution of a member and denominated in special drawing rights or in the currency of that member; and (c) deposits with a commercial bank, a national official financial institution of a member, or an international financial institution that are denominated in special drawing rights or in the currency of a member. Investment which does not involve an exchange of currency shall be made only after consultation with the member whose currency is to be used.

Section 18. Termination Arrangements

Upon completion of the subsidy operations authorized by this Instrument the Fund shall wind up the affairs of the Account. Any resources remaining in the Account after all outstanding liabilities of the Account have been discharged in full shall be applied first to reimburse the Special Disbursement Account up to the full amount transferred to the Account under Section 4, net of any previous re-transfers, and then to reimburse donors pro rata, up to the amounts of their donations. Any remaining balance in the Account shall be transferred to the Special Disbursement Account.

Decision No. 6683-(80/185)G/TR  
December 17, 1980

Supplementary Financing Facility:  
Subsidy Account - Investment

The Managing Director shall place in deposits, denominated in SDRs, with the Bank for International Settlements the currencies received by the SFF Subsidy Account, unless the Managing Director considers that the terms offered by the BIS on an intended deposit denominated in SDRs are not sufficiently attractive. In that event the Managing Director shall inform the Executive Board promptly and make other proposals to it for investment in SDR-denominated obligations.

Decision No. 6854-(81/78)SBS  
May 8, 1981

Text Showing Changes Proposed  
in Decision No. 6854-(81/78) SBS, May 8, 1981

Supplementary Financing Facility: Subsidy Account - Investment

The Managing Director shall place in deposits, denominated in SDRs, with the Bank for International Settlements, or in investments in a call account, denominated in SDRs, with the International Bank for Reconstruction and Development, the currencies received by the SFF Subsidy Account, unless the Managing Director considers that the terms offered ~~by the BIS~~ on an intended deposit denominated in SDRs are not sufficiently attractive. In that event the Managing Director shall inform the Executive Board promptly and make other proposals to it for investment in SDR-denominated obligations.

