

**FOR  
AGENDA**

SM/12/318  
Correction 1

CONFIDENTIAL

January 23, 2013

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Broadening the Fund's Investment Mandate—Proposed Rules and Regulations for the Investment Account**

The attached corrections to SM/12/318 (12/28/12) have been provided by the staff:

**Typographical Errors**

**Page 6, para. 9(b), line 5:** for “financial institutions”  
read “international financial institutions”

**Page 20, para. 13, line 2:** for “prior to the liquidation by the Fund”  
read “prior to the liquidation of the Fund”

**Page 21, para. 17, line 5:** for “future” read “futures”

Questions may be referred to Mr. Steinki (ext. 38222) and Mr. Pham (ext. 34479) in LEG.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (3)

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Department Heads



7. **Any future transfers of assets to the IA will be decided by the Executive Board in accordance with the relevant provisions of the Articles.**<sup>7</sup> At the time of additional transfers, the Executive Board will determine the subaccount (Fixed-Income or Endowment) into which new resources shall be placed. The proposed Rules authorize the Executive Board to transfer assets between subaccounts (*paragraph 5*).<sup>8</sup>

**B. Fixed-Income Subaccount Investments (Section II, Paragraphs 16-19)**

8. **Under the proposed Rules, the objective, investment strategy, eligible investments and investment arrangements for the Fixed-Income Subaccount follow those that are in place for the existing IA assets not attributed to gold sales profits.** The Executive Board is expected to discuss possible changes to the investment strategy for the Fixed-Income Subaccount in the future. In the interim, staff proposes that the investment strategy under the current Rules remains in place for this subaccount. For purposes of clarity and transparency, the proposed Rules specifically incorporate a number of key elements of that strategy that are not included in the current Rules but are part of the investment strategy as implemented under the current Rules.

9. **The assets in the Fixed-Income Subaccount will be invested under a strategy that continues to emphasize liquidity and limited volatility.**<sup>9</sup> Accordingly:

- a) The investment objective for this subaccount remains to achieve investment returns that exceed the SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over a 12-month investment horizon (*paragraph 16*).<sup>10</sup> The assets in the subaccount will continue to be managed against the 1-3 year government bond benchmark, weighted to reflect the currency composition of the SDR basket (*paragraph 16*). While the 1-3 year government bond benchmark has been endorsed by the Executive Board outside of the current Rules, it is included in the proposed Rules as a key strategic investment decision.<sup>11</sup>

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<sup>7</sup> Decisions on additional transfers of currencies from the GRA in accordance with Article XII, Section 6(f)(ii) require a 70 percent majority of the total voting power while decisions to transfer profits from pre-Second Amendment gold sales under Article V, Section 12(g) require an 85 percent majority of the total voting power.

<sup>8</sup> A decision to move assets from one subaccount to another could be taken by a majority of the votes cast.

<sup>9</sup> See *Establishment of the Investment Account* (EBS/06/57, 4/17/2006), and Executive Board Decision No. 13711-(06/40), adopted April 28, 2006.

<sup>10</sup> *Id.*

<sup>11</sup> The Managing Director will continue to select the specific 1-3 year government bond benchmark index to be used by managers. For the details on the structure and customization of benchmark indexes, see *Establishment and Operation of the Investment Account*, (SM/05/317, 8/15/2005), at ¶34, and *Establishment of the Investment Account*, (EBS/06/57, 4/17/2006), at ¶¶14-15.

- b) Eligible investments will continue to be limited to marketable obligations of members and international financial institutions that are denominated either in SDR or in currencies included in the SDR basket (*paragraph 17*). As under the current Rules, marketable obligations of a member include obligations of its official agencies, and obligations of international financial institutions include without limitation deposits with the Bank for International Settlements (BIS) and Medium-Term Instruments (MTIs) issued by the BIS. Hedging would be prohibited, as would be certain investment activities and investments in specified instruments (*i.e.*, the use of forwards, futures, options and swaps, short selling or any form of financial leverage) (*paragraph 17*). Building on existing practice, the proposed Rules will now specifically require that investments be limited to government and agency bonds that have a rating of A or higher (based on Standard & Poor's rating scale) by a major credit rating agency (*paragraph 18*). The Managing Director will determine the specific operational modalities to implement the minimum credit rating requirements, including establishing a rule-based approach to deal with cases of split ratings between agencies. In the event that the rating threshold is breached, the proposed Rules require assets to be divested within three months (*paragraph 18*).<sup>12</sup>
- c) Regarding investment arrangements, the assets will continue to be invested by external managers and, with respect to BIS obligations, by the Managing Director (*paragraph 19*). It is expressly recognized in the proposed Rules that, consistent with current practice, the investment mandates for external managers will provide for active management against the subaccount's 1-3 year government bond benchmark, within risk parameters established by the Managing Director (*paragraph 19*).<sup>13</sup> Investments by the Managing Director with the BIS will also be guided by the subaccount's 1-3 year government bond benchmark (*paragraph 19*).

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<sup>12</sup> The requirement of a minimum A rating from one major credit rating agency has been applied to the IA for government bond investments since the establishment of the IA in 2006. See *Establishment of the Investment Account* (EBS/06/57, 4/17/2006), at ¶21.

<sup>13</sup> External managers of the IA bond portfolio currently conduct active management mainly through adjusting the duration of the portfolio relative to the 1-3 year government bond benchmark. See *id.* at ¶¶12 and 24. They are currently allowed to deviate from the benchmark within the  $\pm 6$  month range of duration. See *Establishment and Operation of the Investment Account* (SM/05/317, 8/15/ 2005), at ¶34. External managers may also exercise active management through the investment in securities issued by eligible international financial institutions and certain national agencies. These instruments typically provide higher *ex ante* yields than comparable government securities included in the 1-3 year government bond benchmark. See *Establishment of the Investment Account* (EBS/06/57, 04/17/2006), at ¶12.

5. Transfers of assets between subaccounts may be made with the approval of the Executive Board.

### **Responsibilities of the Managing Director**

6. The Managing Director is responsible for implementing the investment policies for the IA set out in these Rules and Regulations.

7. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; and (c) establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.

8. The Managing Director shall consult with the Executive Board regarding (a) the key conflict of interest policies and arrangements in the Managing Director's responsibility referred to in paragraph 7 and (b) the key aspects of the investment strategy for the actively-managed portion of the Endowment Subaccount referred to in paragraph 23 of these Rules and Regulations.

9. The Managing Director shall provide semi-annual reports to the Executive Board on the investment activities of the IA. Ad hoc reports shall be prepared as warranted by market or other developments.

### **External Managers**

10. All assets of the IA shall be managed by external managers, except as otherwise set forth in these Rules and Regulations. The Managing Director shall only select external managers of the highest professional standards, in particular excellent compliance records, strong market reputation, and with sound investment processes. In selecting managers for passively-managed assets, the Managing Director shall take into account their ability to replicate selected benchmarks with minimal tracking error and cost, and in selecting managers for actively-managed assets, their proven skills and track record in generating excess returns after fees.

### **Custody Arrangements**

11. The assets of the IA shall be held in safekeeping by one or more custodian banks or the Bank for International Settlements (BIS). The custodian(s) shall hold the assets of the IA in safekeeping, periodically value the assets held, and hold and invest short-term residual cash balances.

**Use of Investment Account Income**

12. The income from investment shall be invested, retained in the IA or used to meet the expenses of conducting the business of the Fund. The Fund shall decide on the use of the IA's income for each financial year, including whether any portion of such income will be transferred to the GRA for use in meeting the expenses of conducting the business of the Fund, provided that income generated from the Endowment Subaccount shall not be used in meeting the expenses of conducting the business of the Fund pending the completion of the phasing period for the passively-managed portion of the Endowment Subaccount specified in paragraph 30.

**Termination or Reduction of the Investment Account**

13. The IA shall be terminated in the event of a liquidation of the Fund and may be terminated, or the amount of the investment may be reduced, prior to the liquidation of the Fund by a 70 percent majority of the total voting power. The procedures specified in Article XII, Sections 6(f)(vii), (viii) and (ix) of the Articles will apply in the event of the termination of the IA or a reduction in its assets. The Fund's decision to reduce investments in the IA shall specify the subaccount from which assets shall be used to fund a reduction in investments.

**Audit**

14. The assets of the IA shall be audited by the Fund's external auditors and included in the Fund's annual financial statements.

**Review of the Rules and Regulations and Conflict of Interest Policies**

15. The Executive Board shall review these Rules and Regulations at least every 5 years.

**II. FIXED-INCOME SUBACCOUNT****Investment Objective**

16. The investment objective of the Fixed-Income Subaccount is to achieve investment returns that exceed the SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over a 12-month investment horizon. The assets in the Fixed-Income Subaccount shall be managed against the 1-3 year government bond benchmark, weighted to reflect the currency composition of the SDR basket.

**Eligible Investments**

17. The assets of the Fixed-Income Subaccount may be invested only in marketable obligations of members or in marketable obligations of international financial institutions. Marketable obligations of a member shall include the obligations of its central bank and

official agencies. Marketable obligations of international financial organizations shall include without limitation deposits with the BIS and Medium-Term Instruments (MTIs) issued by the BIS. IA investments in the instruments specified above may only be made directly in the cash markets. Hedging is prohibited, as is the use of derivative instruments (including forwards, futures, options and swaps), short selling, or any form of financial leverage. Investments are limited to eligible investments that are denominated in SDRs or in the currencies included in the SDR basket.

18. Government and government agency bonds in which the Fixed-Income Subaccount invests shall be subject to a minimum credit rating by a major credit rating agency equivalent to A (based on Standard & Poor's rating scale). If the respective rating threshold is breached, assets shall be divested within three months from the rating downgrade.

### **Investment Arrangements**

19. The assets of the Fixed-Income Subaccount shall be managed by external managers, provided that assets may also be invested by the Managing Director in marketable obligations of the BIS. The investment mandates for external managers shall provide for active management against the 1-3 year government bond benchmark within risk parameters established by the Managing Director. Investments in BIS obligations shall be guided by the 1-3 year government bond benchmark.

## **III. ENDOWMENT SUBACCOUNT**

### **Investment Objective**

20. The investment objective of the Endowment Subaccount is to achieve a long-term real return target of 3 percent in U.S. dollar terms. The subaccount's real return shall be calculated by using the deflator that is used for purposes of the Fund's administrative budget, the Global External Deflator (GED), provided that the U.S. consumer price index (US CPI) component of the GED shall be adjusted to use the actual US CPI instead of the projected US CPI.

### **Strategic Asset Allocation and Investment Strategy**

21. No less than 90 percent of the Endowment Subaccount assets shall be managed passively (the "passively-managed portion") under mandates that require the external managers to closely track benchmark indices selected by the Managing Director, with up to 10 percent of the Endowment Subaccount assets managed actively in accordance with paragraph 23 below (the "actively-managed portion"). Upon effectiveness of these Rules and Regulations, an amount equivalent to 95 percent of the Endowment Account assets shall be allocated to the passively-managed portion and an amount equivalent to 5 percent to the actively-managed portion.

22. The passively-managed portion shall be invested pursuant to the following strategic asset allocation (SAA) benchmark: 20 percent in developed market sovereign bonds; 20 percent in developed market inflation-linked bonds; 15 percent in developed market corporate bonds; 10 percent in emerging market bonds; 25 percent in developed market equities; 5 percent in emerging market equities; and 5 percent in real estate investment trusts (REITs).

23. The actively-managed portion may be invested only in the same asset classes as the SAA benchmark for the passively-managed portion, with a 65 percent share of fixed-income instruments and a 35 percent share for equities (including REITs) but no specific allocation requirements for each asset class within these two categories. The Managing Director, in consultation with the Executive Board, shall determine the investment strategy and investment arrangements for the actively-managed portion of the Endowment Subaccount, including the selection criteria and risk parameters for external managers, benchmark indices, the scope and instruments for currency hedging, the phasing of the actively-managed portion of the Endowment Subaccount, policy bands and rebalancing procedures, and additional key measures to avoid actual or perceived conflicts of interest.

24. The asset allocation benchmarks for both the passively- and actively-managed portions above shall not apply to temporary holdings of cash, bank deposits or short-term investments in cash instruments.

### **Rebalancing of the Passively-Managed Portion**

25. The passively-managed portion of the Endowment Subaccount shall be rebalanced to the SAA benchmark (a) annually, either in the context of implementing the Fund's annual income disposition decisions or, absent such disposition decisions affecting the Endowment Subaccount, at end-July of each year, and (b) when the actual weight of any of the asset classes of developed market sovereign bonds, developed market corporate bonds, developed market inflation-linked bonds or developed market equities deviates by more than 8 percentage points from the SAA benchmark, or by more than 4 percentage points for any of the asset classes of emerging market bonds, emerging market equities, and REITs. A scheduled annual rebalancing under (a) shall not take place if a rebalancing under (b) is completed within three months prior to that scheduled annual rebalancing.

### **Prohibited Investment Activities**

26. Short selling and any form of financial leverage as well as direct investments in gold are not permitted for the Endowment Subaccount. Derivative instruments, including options, forwards, futures and swaps, are only allowed for hedging operations authorized under these Rules and Regulations or to minimize transaction costs in the context of subaccount rebalancing and benchmark replication.