

INTERNATIONAL MONETARY FUND

The Fund's Income Position for FY 2006—Midyear Review

Prepared by the Finance Department

In consultation with the Legal Department and the Office of Budget and Planning

Approved by Michael G. Kuhn

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EXECUTIVE SUMMARY

- **Under Rule I-6(4)(b), the Executive Board needs to review the Fund's income position at midyear.** If, at that review, the actual net income for the first six months of the financial year, on an annual basis, is below the target amount for the year by an amount equal to, or greater than, two percent of the Fund's reserves at the beginning of the year, the Executive Board must consider how to deal with the situation. This paper presents the Fund's actual outcome for the first half of FY 2006 together with updated income projections for the year as a whole.
- **Regular net income for the first half of FY 2006 amounted to SDR 99 million, or SDR 13 million lower than projected at the beginning of the financial year.** Projections for FY 2006 as a whole indicate that regular net income could fall short of the net income target (SDR 188 million) by SDR 18 million.
- **Other income**—consisting of surcharges minus certain costs that are excluded from the calculation of regular net income—amounted to SDR 104 million in the first half of the year and is projected at SDR 132 million for the year.
- **No action is required by the Executive Board at this time.** The currently projected shortfall in regular net income is below the threshold that would trigger Board consideration of the situation under the Fund's rules.

I. INTRODUCTION

1. **This paper provides the Fund's actual net income for the first half of FY 2006 together with updated income projections for FY 2006 as a whole.** Executive Directors will recall that a review of the Fund's finances is underway and that changes to the income mechanism may result from such a review. However, during the last discussion of the Fund's income position, there was broad agreement that FY 2006 would be a transition year.¹ Consequently, the present midyear review of the Fund's income position is based on the current Fund income mechanism as set out in Rule I-6(4) and the decisions taken at the beginning of the year (see Box 1).

2. **At the beginning of the financial year, the Executive Board set the rate of charge at 108 basis points over the SDR interest rate** in order to achieve the net income target for FY 2006. It was also decided that the practice of recovering shortfalls and refunding income in excess of target in the following year would apply in FY 2006.

¹ See *Review of the Fund's Income Position for FY 2005 and FY 2006*.

Box 1. Decisions Affecting the Fund's Income Position for FY 2006¹

- The net income target for FY 2006 was set at SDR 188 million, after taking into account the reduction by SDR 94 million to cover the estimated cost to the Fund of the off-market gold transactions completed in FY 2000.
- To achieve the net income target, the rate of charge levied on the use of Fund resources was set at the beginning of the year at 108 basis points over the SDR interest rate.
- Any shortfall in regular net income is to be recovered in FY 2007; regular net income in excess of the income target is to be refunded through a retroactive reduction in the rate of charge.
- As in prior years, the reimbursement to the GRA for the costs of administering the PRGF Trust was waived. To avoid a higher rate of charge to recover the foregone reimbursement, these costs were excluded from the target net income and are charged as an offset against income from surcharges.
- Income from surcharges net of the cost of administering the PRGF Trust and certain pension related expenses is to be excluded from the determination of the rate of charge and placed to the General Reserve after the end of the financial year.

¹ Decision No. 13483-(05/37), adopted on April 22, 2005.

II. NET INCOME FOR THE FIRST HALF OF FY 2006

3. **Regular net income for the first half of FY 2006 amounted to SDR 99 million, and was short of projections by SDR 13 million²** (see Table 1 and Attachment Tables 1 and 2).

² The paper refers to *regular net income* and *other income*. Regular net income, which consists of all income other than surcharges, enters into the calculation and achievement of the net income target and the determination of the rate of charge.

Table 1. Midyear Regular Income—FY 2006
(In SDR millions)

Projected at beginning of the year	112
Variance due to:	
Lower use of Fund resources	-20
Higher SDR interest rate	+6
Higher other income (commitment fees)	+6
Higher SDR/U.S. dollar exchange rate	<u>-5</u>
Actual regular net income at midyear	99

- Lower-than-projected use of Fund resources resulted in lower income from service charges (SDR 10 million) and periodic charges (SDR 10 million). The average use of Fund resources outstanding for the first half of FY 2006 was SDR 45 billion, or SDR 2 billion less than projected. This decrease reflects (i) lower-than-projected purchases, mainly by Argentina and Turkey (due to delays in completing its first and second program reviews under its Stand-By Arrangement), and (ii) advance repurchases by Brazil and Uruguay.
- The SDR interest rate increased by 46 basis points, from 2.45 percent at the time of the April projections to 2.91 percent at end-October 2005. While the basic margin for determining the rate of charge was fixed for FY 2006 at 108 basis points over the SDR interest rate, a higher SDR interest rate increases the implicit earnings from the Fund's interest-free resources.
- The Fund levies a commitment fee on amounts committed under Stand-By Arrangements. The commitment fee is refundable as purchases are made, but accrues to the Fund's income only upon cancellation or expiration of an arrangement. During the first half of FY 2006, the Fund recognized commitment fees of SDR 6 million on arrangements that expired without being fully drawn.
- Total administrative expenses in SDR terms were higher than projected, reflecting largely the appreciation of the U.S. dollar vis-à-vis the SDR, offset by a somewhat slower execution of the administrative budget in line with its historical seasonal pattern. Since the beginning of FY 2006, the U.S. dollar has appreciated by 3 percent against the SDR.

4. **The annualized income shortfall is below the threshold that would trigger Executive Board consideration of how to address the shortfall** (Box 2). Under the safeguard clause, the income shortfall at midyear would need to exceed SDR 56 million to trigger Executive Board consideration of how to address the shortfall at midyear.

Box 2. The Safeguard Clause

- At the beginning of each financial year, the Executive Board sets the rate of charge to achieve an agreed target amount of net income, based on projected income and expenses for that year.
- The Executive Board reviews the Fund's income position at midyear and, if necessary, considers how to address any shortfall in income at midyear. Under Rule I-6(4)(b), referred to as the "safeguard clause", should actual regular net income at midyear indicate an annualized shortfall equal to or greater than two percent of the Fund's reserves at the beginning of the financial year (equal to SDR 112 million), the Executive Board will consider how to deal with the situation. If by December 15 no agreement has been reached as a result of this consideration, the rate of charge at the beginning of the year is increased as of November 1 to the level necessary to reach the target amount of net income for the year.

5. **Other income at midyear amounted to SDR 104 million.** Other income comprises income from surcharges, net of the cost of administering the PRGF Trust and the costs associated with post-retirement benefits under implementation of International Accounting Standard 19 (Attachment Table 1). Surcharge income was lower than anticipated by SDR 45 million primarily because of advance repurchases by Brazil of its outstanding use of Fund resources under the Supplemental Reserve Facility.

III. UPDATED PROJECTIONS FOR FY 2006

6. **Updated projections for FY 2006 as a whole indicate regular net income in the order of SDR 170 million, compared with the net income target of SDR 188 million.** The projected net income shortfall is due primarily to a higher SDR/U.S. dollar exchange rate that results in higher-than-projected administrative expenditures. Net operational income for the year, projected at SDR 682 million, remains broadly in line with projections made at the beginning of the year. This is the result of higher earnings resulting from a higher SDR interest rate, the effect of which, however, is almost entirely offset by lower income from charges.

7. **The final outcome for FY 2006 remains subject to uncertainties, especially with regard to developments in the SDR interest rate, the use of Fund resources, and the SDR/U.S. dollar exchange rate** (see Attachment Table 3).

- A continuation of a rising SDR interest rate would generate further earnings on the Fund's interest-free resources. If the SDR interest rate were to increase by 50 basis points on average for the remainder of FY 2006 (i.e., a rise of 100 basis points by end of April 2006), the projected shortfall of SDR 18 million would be eliminated.

- The Fund's income position is very sensitive to the use of Fund resources by members, including the timing of purchases under Fund arrangements. An increase of SDR 1 billion in purchases in the second half of FY 2006 would increase the Fund's net income by around SDR 8 million.
- There is also considerable uncertainty related to the projection of administrative expenses in terms of the SDR. The revised projections assume that the approved Administrative Budget, denominated in U.S. dollars, would be fully utilized and that the current SDR/U.S. dollar exchange rate would remain constant. At this stage, it is uncertain to what extent the budget will be utilized and further changes in the SDR/U.S. dollar exchange rate will also affect the outcome.³

³ In FY 2005, total administrative expenses in SDR terms were lower than projected, reflecting primarily the depreciation of the U.S. dollar vis-à-vis the SDR and also a small budget underrun.

Table 1. Projected Income and Expense
Financial Year 2006

(In millions of SDRs)

	First half		FY 2006	
	Actual result	Projections at beginning of year 1/	Revised Projections	Initial Projections 1/
Regular Income				
1. Operational Income				
a. Periodic charges, including burden sharing	822	832	1,596	1,558
b. Interest on SDR holdings	12	11	20	22
c. Service and stand-by charges:	10	14	20	23
Total operational income	<u>844</u>	<u>857</u>	<u>1,636</u>	<u>1,603</u>
2. Operational Expense				
Remuneration, including burden sharing	492	498	954	920
3. Net operational income	352	359	682	683
4. Administrative expense	281	275	570	551
Less: estimated cost of administering the PRGF Trust	(29)	(28)	(58)	(56)
	<u>252</u>	<u>247</u>	<u>512</u>	<u>495</u>
5. Regular net income	<u>99</u>	<u>112</u>	<u>170</u>	<u>188</u>
Other Income				
6. Surcharges	201	246	326	402
Less: estimated cost of administering the PRGF Trust	(29)	(28)	(58)	(56)
	172	218	268	346
7. Other - IAS 19 2/	68	--	136	--
8. Total other income	<u>104</u>	<u>--</u>	<u>132</u>	<u>--</u>
9. Total net income	<u>203</u>	<u>--</u>	<u>302</u>	<u>--</u>

1/ Projections made at the beginning of FY 2006 are based on assumptions set out in *Review of the Fund's Income Position for FY 2005 and FY 2006*.

2/ The IAS 19 expense for FY 2006 was not available when the income projections for FY 2006 were prepared.

Table 2. Assumptions Underlying the Projections
for Financial Year 2006

	First Half		FY 2006	
	Actual	Projections	Revised	Projections
	Result	at beginning	Projections	at beginning
		of year 1/ ^{1/}	of year	of year
	(In billions of SDRs)			
Regular Facilities:				
1. Purchases (excl. reserve tranche purchases)	0.9	2.9	3.0	4.5
2. Repurchases	10.0	8.2	15.7	15.5
3. Average balances subject to charges	44.5	46.9	41.6	44.2
4. Average SDR holdings	0.8	0.9	0.7	0.9
5. Average remunerated positions	37.8	40.4	34.7	37.6
	(In percent)			
Average interest rates:				
1. SDR interest rate and basic rate of remuneration	2.61	2.45	2.77	2.45
2. Basic rate of charge	3.69	3.53	3.85	3.53
3. Margin of the rate of charge	1.08	1.08	1.08	1.08

^{1/} Projections made at the beginning of FY 2006 are based on assumptions set out in *Review of the Fund's Income Position for FY 2005 and FY 2006*.

Table 3. Effect on Projected Regular Net Income for FY 2006 of Changes in Selected Assumptions

	Average SDR Interest Rate in Second Half (in percent)					
	2.86	2.96 ^{1/}	3.06	3.16	3.26	3.36
1. Regular net income with a fixed margin of 108 basis points	165.6	169.5	173.3	177.1	181.0	184.8
2. Increase in regular net income due to purchases in the credit tranches higher by SDR 1 billion	7.7	7.7	7.7	7.7	7.7	7.7
3. Decrease in regular net income due to a 5 percent appreciation in the U.S. dollar vis-à-vis the SDR	13.6	13.6	13.6	13.6	13.6	13.6

1/ The projections for the remainder of the financial year assumed an average SDR interest rate of 2.96 percent.