INTERNATIONAL MONETARY FUND

A New Rule for Setting the Margin for the Basic Rate of Charge

Prepared by the Finance Department

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I. INTRODUCTION[1]

1. **In April 2008, the Executive Board adopted a package of measures to reform the Fund's income model.**[2] This followed an intensive work program building on the recommendations of an independent committee appointed by the Managing Director to study options for sustainable long-term financing for the Fund.[3] The resulting new income model aims to broaden the Fund's income sources and reduce its reliance on lending income as the primary source of revenue. This new model includes: (i) creating an endowment funded with the profits from a limited sale of the Fund's gold holdings; (ii) expanding the Fund's investment authority to enhance the expected return on the Fund's investments; and (iii) resuming the practice of reimbursing the General Resources Account (GRA) for the cost of administering the PRG Trust.

2. **Significant progress has now been made in implementing the new income model**. The limited gold sales, which are a central component of the new model, were concluded in December last year, and the Executive Board has held two discussions on considerations for establishing the endowment to be funded by the gold profits. The amendment of the Articles of Agreement to broaden the Fund's investment authority became effective in February 2011.[4,5] Based on the current work program, the endowment is expected to become operational in calendar year 2012. Progress has also been made on developing a more transparent rules-based framework for assessing reserve adequacy and adjusting the target for precautionary balances within the context of the new income model.

3. **The new income model also envisages a change in the rule for setting the Fund's rate of charge.** Previously, the margin for the basic rate of charge on Fund lending operations was set to generate sufficient income for the Fund to cover all of its administrative

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[1] Prepared by D. Andrews, M. Kumar, S. Bassett, G. Kabwe, L. Kohler, J. Mburu, S. Rodriguez, D. Nana, A. Perez, and D. Tavlykaev (all FIN).

[2] *Developing a New Income Model for the Fund—Proposed Decisions* (4/2/08).

[3] *Report of the Managing Director to the International Monetary and Financial Committee on a New Income and Expenditure Framework for the International Monetary Fund* (4/9/08).

[4] *Fifth Amendment of the Articles of Agreement to Expand the Investment Authority of the International Monetary Fund—Entry Into Force*.

[5] The package of measures for the new income model included resuming the reimbursement of the General Resources Account (GRA) for the cost of administering the PRG Trust with the proviso that the Fund should temporarily suspend reimbursement if a determination is made that Trust resources are likely to be insufficient to support anticipated demand for PRGT loans and the Fund is unable to obtain additional subsidy resources. In view of the low subsidization capacity of the PRGT, the Executive Board decided in July 2009 that for financial years 2010 through 2012 no reimbursement shall be made to the GRA and instead the estimated cost shall be transferred to the PRG subsidy account at the end of each financial year.

expenses and to meet a specific net income target.[6] Under the new model, the margin should be set to cover only the Fund's intermediation (lending) costs and help build-up reserves.

4. **Since FY 2009, the margin on the rate of charge has been set in line with the principles endorsed by the Executive Board in 2008.** The margin has continued to be set under Rule I-6(4), because adoption of a new rule for setting the margin was considered premature pending implementation of other elements of the new income model. However, the margin was set under the exceptional circumstances clause of Rule I-6(4), guided by the new framework outlined in the April 2009 income paper that is consistent with the principles of the new income model.[7]

5. **This paper proposes adoption of a new rule for setting the margin for the rate of charge.** The paper is organized as follows: Section II provides background on the framework for setting the margin for the rate of charge and recent developments that take account of changes in the Fund's new income model. Section III proposes a framework to put into practice key principles that have been endorsed by the Executive Board for setting the margin. Section IV proposes adoption of a new Rule I-6(4) that provides for the margin to be set so as to cover the Fund's intermediation costs and allow for a build-up of reserves. It also includes a cross-check to ensure the resulting rate of charge maintains a reasonable alignment against long-term credit market conditions.

6. **Staff proposes that the new rule would be effective for FY 2013 onwards.** In April this year, the Executive Board set the margin on the rate of charge for FY 2012 at 100 basis points as part of its annual review of the Fund's income position. This paper does not propose to revisit that decision. The next steps on income-related issues are: (i) the issuance, in early December, of the midyear income review paper that updates the projections for FY 2012; (ii) the review, early next year, of the adequacy of precautionary balances which will update the medium-term projections, including the indicative target for precautionary balances based on the new projections for Fund credit; and (iii) the annual income paper, in April next year, that will review the Fund's income position for FY 2012 and FY 2013, including a proposal for the margin under the new Rule I-6(4).

II. BACKGROUND

A. The Basic Rate of Charge and Margin

7. **The basic rate of charge on Fund lending is a key element of the Fund's financial operations.** It is composed of the SDR interest rate, which is also the remuneration paid to

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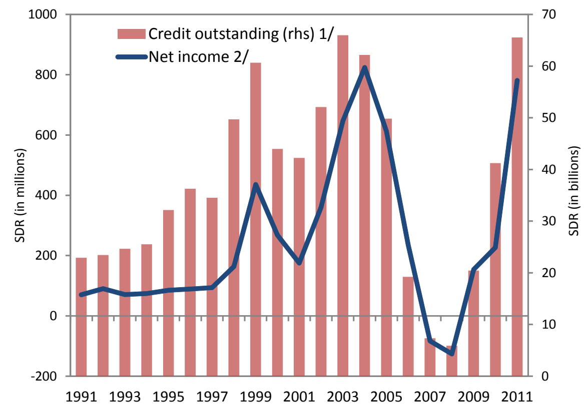
[6] The net income target under the existing rule was specified to generate a 5 percent increase in reserves. An exceptional circumstances clause, adopted in 2006, allows the margin for the rate of charge to be set on a basis other than the estimated income and expense of the Fund.

[7] *Review of the Fund's Income Position for FY 2009 and FY 2010* (4/14/09, Annex I).

creditors, and a margin (currently 100 basis points), which allows the Fund to cover the cost of its financing to members as well as to help accumulate reserves. In addition, it plays an important role, together with surcharges on lending, in providing incentives for timely repayment, thus helping to preserve the revolving nature of Fund resources. Since 2005, the margin has been a fixed interest rate spread over the floating three-month SDR interest rate and, under the current rule I-6(4), is set by the Executive Board at the start of every financial year. It is reviewed at least once during the year (at midyear) to determine whether it needs to be changed in light of developments during the first six months of the financial year.

8. **Until FY 2007, decisions on the margin were driven primarily by the need to cover the Fund's total administrative expenses and accumulate reserves.** Under Rule I-6(4), the margin had been set based on the level of income needed to cover projected expenses and meet a net income target (specified as 5 percent of the Fund's reserves at the beginning of the financial year from FY 1985 to FY 2006).[8] However, due to the sharp decline in credit outstanding (Figure 1), this approach would have implied a margin of over 350 basis points for FY 2007—a level that was not viewed as desirable and would have made the cost of borrowing from the Fund relatively expensive. In response, a new exceptional circumstances clause was added to Rule I-6(4) in April 2006 to allow the margin for the rate of charge to be set on a basis other than the estimated income and expense of the Fund.[9] In addition, the Executive Board began to take steps to broaden the Fund's income sources with the establishment of the Investment Account (IA) in April 2006.[10] In April 2008, the Executive Board adopted decisions to reform the Fund's income model.[11]

Figure 1. Fund's Credit Outstanding and Net Income
(SDR Millions)



Source: IMF Finance Department

1/ General Resources Account; end of financial year.

2/ Includes net operational income and surcharges, but not gold profits.

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[8] This approach was adopted in FY 1981, when the Fund reformed a fairly complex schedule of charges. From FY 1981 to FY 1984, the net income target was set at 3 percent of the Fund's reserves.

[9] For FY 2007–08, the Executive Board kept the margin unchanged from the FY 2006 level of 108 basis points under the exceptional circumstances clause of Rule I-6(4). The Fund suffered net income shortfalls of SDR 83 million and SDR 127 million in FY 2007 and FY 2008, respectively.

[10] *Establishment of the Investment Account* (4/17/06). In June 2006, currencies in the amount of SDR 6 billion, equivalent to the Fund's total reserves at end-FY 2006, were transferred from the GRA to the IA with the objective of achieving average investment returns that exceeded the SDR interest rate.

[11] *Developing a New Income Model for the Fund—Proposed Decisions* (4/2/08).

B. Principles for Setting the Margin in the New Income Model

9. **In the 2008 discussions, the Executive Board endorsed several principles for setting the margin for the rate of charge in the new income model:**

- The margin on the rate of charge should be set in a stable and predictable manner;
- The margin on the rate of charge should no longer cover the full range of the Fund's activities but rather be set as a margin over the SDR interest rate to cover the Fund's *intermediation costs* and allow for a *build-up of reserves*; and
- A mechanism should be developed for checking that the margin is in reasonable alignment with *long-term credit market conditions*, including ensuring that the cost of borrowing from the Fund does not become too expensive or too low relative to the cost of borrowing from the market.

10. **The margin for the rate of charge has, since FY 2009, been set consistent with these principles,** albeit under the exceptional circumstances clause of Rule I-6(4). A framework to operationalize these principles was set out in the income paper for FY 2009 and has been applied since then. In this manner, the margin over the SDR rate has been set at a level sufficient to cover estimated intermediation costs and allow for reserve accumulation. The pace of reserve accumulation has not been pre-defined; rather at the time of each review, the Executive Board has assessed whether the pace is adequate in light of the level of precautionary balances relative to their target level, and the expected contribution from surcharge income to reserve accumulation. The framework has included a cross-check of the alignment of the margin with long-term credit market conditions. Finally, it should be noted that the framework employed since 2009 has sought to avoid an overly mechanistic approach. Judgment has been required in several areas, including the pace of reserve accumulation, the comparison with private market borrowing costs, and the outlook for intermediation costs, particularly when significant change in demand for Fund credit is in prospect.

III. PROPOSED FRAMEWORK FOR THE NEW RULE

11. **This section discusses the main elements of the new framework for setting the margin for the rate of the charge in the context of the new income model**. Key considerations for the framework are (i) the Fund's intermediation costs, (ii) operational lending income[12] to cover the intermediation costs and contribute to reserve accumulation, and (iii) a cross-check for alignment of the rate of charge with long-term credit market conditions. Each of these elements is discussed below.

A. Intermediation Costs

12. **Under the new rule, the margin should no longer cover all costs of the Fund, but rather it should be set so as to cover intermediation costs and contribute to reserve**

[12] Operational lending income comprises the margin, service charges, and commitment fees.

accumulation. In the 2008 discussions, Directors supported the establishment of a comprehensive cost accounting framework for the Fund that would allow proper identification of intermediation costs. However, a few Directors noted that an attempt to fully disentangle different Fund tasks and allocate specific income sources to each of them was unlikely to be feasible, and that a certain degree of cross-subsidization will have to be accepted.

13. **The Fund's intermediation costs comprise all costs related to the generally available facilities (GAF).** These costs include direct personnel expenses, direct travel costs, support and other administrative expenses, governance costs and capital and depreciation expenses. Box 1 provides further details on the methodology used for estimating the Fund's intermediation costs and discusses on-going improvements to the costing processes.

14. **Intermediation costs are projected at about US$117 million for FY 2012**. Intermediation costs have averaged about US$110 million over the past three years (Figure 2, Table 1). The increase in the number of GRA arrangements since the onset of the global financial crisis during FY 2009 has resulted in higher intermediation costs and these are expected to remain at elevated levels in FY 2012. However, estimated intermediation costs have increased more modestly than the number of GRA arrangements (of the current 23 GRA arrangements, eleven were approved in the current or last financial year and have an average term of 30 months).[13] This outcome mainly reflects refinements to the costing methodology over this period, which have resulted in a decline in support costs attributable to GAF. In addition, the Fund's 2009 restructuring program also resulted in savings in support costs that would have been attributed to the GRA, and the recent changes in the Fund's travel policy have also generated savings in average mission costs. While the staff is of the view that these recent estimates more accurately capture intermediation costs, staff will continue efforts to refine the methodology drawing on the Analytical Costing and Estimation System (ACES), which is expected to become fully operational during FY 2012. ACES-based estimates will also improve the comparability of intermediation costs over time.

[13] Excludes the three Flexible Credit Line arrangements for Colombia, Mexico, and Poland. These arrangements do not have ex-post conditionality and as such do not entail significant staff monitoring costs.

Box 1. Estimating Intermediation Costs

The costs related to Generally Available Facilities (GAF) in FY 2011 were estimated as follows:

- ***Direct personnel expenses***. Data on work-time allocation obtained from the Time Reporting System (TRS) and its successor, the Time Reporting for Analytical Costing and Estimation System (TRACES) together with standard personnel costs were used to derive an estimate for personnel expenses.
- ***Direct costs of mission travel***. Travel expenses for activities related to the GAF were obtained from the Travel Information and Management System (TIMS).
- ***Support and other administrative expenses***. Support costs were allocated to GAF activities based on their share of the Fund's total service delivery, excluding support and governance, while the remaining other administrative expenses were allocated to GAF-related outputs based on their share of total staff time.
- ***Governance costs***. Governance costs were estimated as the GAF-related portion of OED's, OMD's, SEC's and IEO's combined estimated outturn for the financial year, using the percentage of Executive Board meeting hours spent on GAF business as a proxy for the share of GAF-related governance costs.
- ***Capital and depreciation expenses***. The GAF portion of these expenses, which include depreciation and capital projects that are not capitalized (facilities and IT), was derived based on GAF's estimated share of the Fund's estimated outturn for the internally financed portion of the administrative budget.

Changes in costing methodologies complicate comparisons with previous years. The Fund's FY 2011-2013 medium-term budget introduced a new output structure—the Responsibility Areas (RAs), and related to this, the new time reporting system, TRACES, was rolled out during FY 2011 in the context of introducing the Analytic Costing and Estimation System (ACES) in the Fund. These changes, together with concurrent improvements in the allocation of support to the production of the Fund's outputs and definitional changes to certain activities, affected the overall process for allocating the Fund's administrative expenditures to outputs, including the derivation of the GAF cost estimates. Notably, in the transition from TRS to TRACES/ACES, the Fund's definition of support and the method for allocating it were changed, and this resulted in lower GAF-related support costs in FY 2011 compared with the earlier periods.

Using ACES, staff will continue efforts to refine the methodology for estimating the cost of GAF related activities. TRACES-based data will be available for FY 2012 and ACES will become fully operational during the current financial year. Against this backdrop, staff intends to use to the full extent possible ACES in estimating administrative expenses related to the GAF. (Such estimates will still need to be complemented with estimated capital and depreciation expenses.) ACES-based estimates will improve the comparability of credit intermediation costs over time and will also allow monitoring of these costs within financial years.

Table 1: Income from Margin and Reserve Accumulation
(millions of dollars unless otherwise indicated)

	Actual FY 2009	Actual FY 2010	Actual FY 2011	Projected FY 2012	Steady State 1/
A. Intermediation costs 2/	104	119	111	117	100
Less					
B. Service charges	126	164	205	268	16
C. Costs to be covered by income from margin (A-B)	-22	-45	-94	-151	84
D. Income from margin 3/	191	534	827	1265	155
E. Commitment fees 4/	5	127	254	20	37
E.1 FCL	0	125	222	8	37
E.2 Other	5	2	32	12	0
F. Surcharges	122	406	779	1,435	0
G. Potential reserve accumulation 5/ (D+E+F-C)	340	1,112	1,954	2,871	108
H. Potential reserve accumulation (as a percent) 6/	3.2%	10.0%	17.4%	22.9%	0.7%
I. Actual reserve accumulation 7/	240	354	1,203	2,210	110
J. Actual reserve accumulation (as a percent) 7/	2.3%	3.2%	10.7%	17.6%	0.7%
Memorandum items					
Precautionary balances at the beginning of FY (in SDR billions) 8/	6.9	7.1	7.3	8.1	10.0
Average Fund credit outstanding (in SDR billions)	12.4	34.2	53.7	81.6	10.0
Number of active arrangements (average) 9/	10	19	24	23	
Average exchange rate U.S dollar/SDR	1.54	1.56	1.54	1.55	1.55

Source: OBP, Finance Department, and staff estimates.

1/ The steady state illustrates how the framework would operate in a low-credit environment, when crises lending is assumed to have dissipated. The steady state assumed to be reached in FY2021 when full drawings under current arrangements have been reached, and assumes Fund credit of SDR 10 billion and FCL arrangements of SDR 10 billion.

2/ Costs under "generally available facilities" item of the Fund's outputs for country programs and financial support.

3/ Derived by applying the margin against average Fund credit outstanding at the average $/SDR exchange rate.

4/ Actuals for FY 2009–11 and income projections for FY 2012. Includes commitment fees for expired or cancelled precautionary arrangements in FY 2009–11.

5/ Potential reserve accumulation assumes other sources of income are sufficient to cover non-intermediation costs.

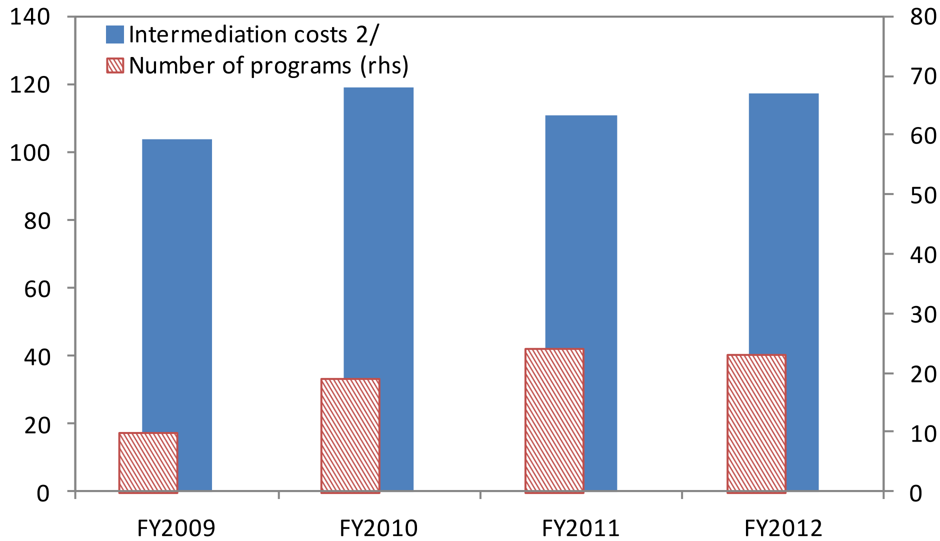
6/ Potential reserve accumulation as a percent of precautionary balances at the beginning of the financial year.

7/ Additions to reserves based on excess of net income (excluding gold profits) over total Fund expenses (including restructuring costs and IAS 19 adjustments). FY 2009-11 are based on actual outcome, while FY 2012 is a projection.

8/ Precautionary balances include the Fund's reserves and SCA-1 balance less profits from the sale of gold in FY 2010-11.

9/ Excludes FCL arrangements.

Figure 2. Intermediation Costs and Number of Programs
FY 2009-12 1/

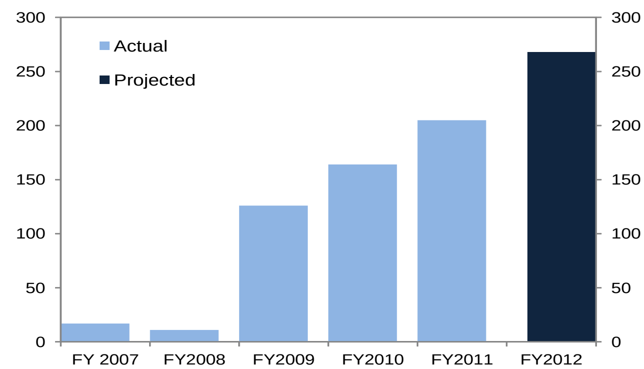


Source: IMF Office of Budget and Planning and Finance Department
1/ For FY 2012, the projected number of programs is based on the current stock of arrangements only, while the intermediation costs are derived from departmental estimates on GAF-related costs that implicitly include potential new arrangements.
2/ Intermediation costs in US$ million.

B. Other Lending Income to Cover Intermediation Costs

15. **In addition to the margin, service charges on disbursements and commitment fees contribute to the Fund's operational lending income.**[14] Table 1 shows lending income in relation to intermediation costs and its contribution to reserve accumulation. Income associated with the higher lending levels has been well in excess of intermediation costs (see row D), and this trend is expected to continue in the near-term.

Figure 3. Service Charges FY 2007-2012
(Millions of U.S. dollars)



Source: IMF Finance Department

Service Charges

16. **Income from service charges has increased sharply in the current lending environment**. Service charges, which are levied at 50 basis points for each

[14] At the 2008 discussion on the adequacy of precautionary balances, Directors noted that the practice of placing surcharges directly to reserves should resume once the Fund's income position had returned to a sufficiently positive outturn. This practice was resumed beginning with FY 2011, and consequently surcharges are no longer considered part of operational income.

disbursement under a GRA arrangement, have increased from around SDR 7 million (US$11 million) in FY 2008 (before the financial crisis) to about SDR 133 million (US$205 million) in FY 2011. Service charges generally move in tandem with increases in the level of Fund credit outstanding and current levels reflect the high levels of new lending in recent years (see Figure 3) which brought Fund credit outstanding to a historic high of SDR 80 billion at end-September 2011. In practice, service charges are paid in full at the time of each disbursement and could therefore be considered to be the first source of income to meet intermediation costs.

Commitment Fees

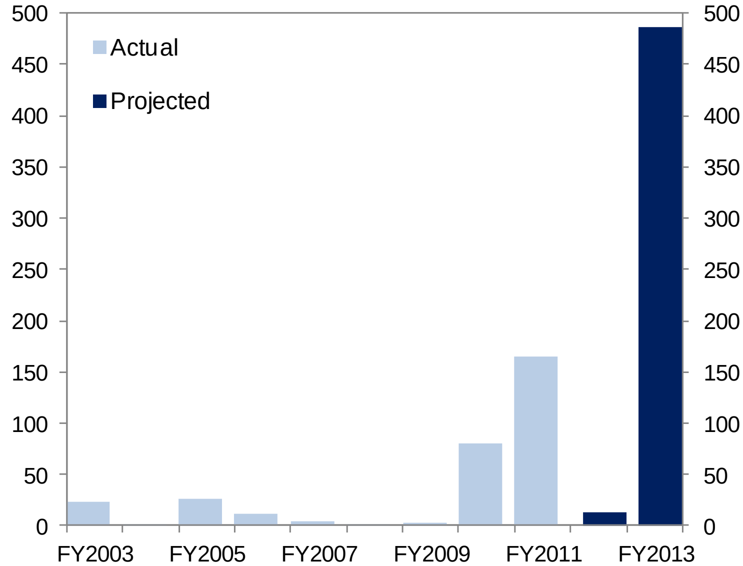
17. **Commitment fee income is also now much larger but, in addition, more variable than before** (see row E in Table 1, and Figure 4). Commitment fees are refundable if drawings are made under an arrangement and therefore income from the fees is only recognized at the cancellation or expiration of the arrangement.[15] These fees have, until recently, been relatively small and fairly stable. However, following the introduction of Flexible Credit Line arrangements (FCLs) in 2009, commitment fees have become more significant and subject to wide annual variation.[16] This variability reflects the absence of a cap on access to Fund resources under the FCL and the extension of the maximum FCL term to two years (since commitment fee income is only recognized at the expiration or cancellation of an arrangement, the fees for two-year arrangements would only be included in income at the end of the two-year period).[17]

[15] This practice accords with requirements under the Fund's accounting framework, International Financial Reporting Standards (IFRS).

[16] If a member were to draw on an FCL arrangement, commitment fees would be refunded to the extent disbursements are made, and instead service charges (at 50 basis points) would apply on the disbursement(s).

[17] Projected fees in FY 2012 and FY 2013 are some SDR 5 million and SDR 475 million, respectively. The latter results from the recognition in income of the commitments fees associated with two large two-year FCL arrangements, approved during FY 2011, only at the expiration of the arrangements in FY 2013.

Figure 4. Commitment Fees (SDR millions)



Source: IMF Finance Department

18. **The current commitment fee structure reflects policy considerations at the introduction of FCLs and high access precautionary arrangements such as the Precautionary Credit Line (PCL).** The current upward-sloping commitment fee schedule was considered necessary to discourage unduly large precautionary access and to contain related liquidity risks to the Fund. It sets commitment fees at 15 basis points (bps) for annual access of up to 200 percent of quota; 30 bps for access between 200 and 1,000 percent of quota; and 60 bps for access beyond 1,000 percent of quota.[18] The new structure sought to strike a balance between the above policy considerations and the goals of simplicity and cost recovery, since the Fund's finances are finite and the institution faces an opportunity cost from committing part of its liquidity.[19] The FCL arrangements approved to date have involved significantly larger access compared with stand-by precautionary arrangements prior to the lending toolkit reforms in 2009, thereby introducing a structural change from the past for income from commitment fees.

19. **Different options could be considered for the appropriate treatment of commitment fees in the framework for setting the margin.**[20] One option would be to

[18] The commitment fee structure prior to the 2009 reforms was a downward-sloping schedule as follows: 25 bps for annual access up to 100 percent of quota and 10 bps for amounts over 100 percent of quota. See *GRA Lending Toolkit and Conditionality—Reform Proposals* (3/13/09).

[19] The opportunity cost arises from tying up finite resources that could be otherwise be available for lending and the operational costs of maintaining additional liquidity against possible large purchases.

[20] Paragraph 18 in *Review of the Fund's Income Position for FY 2011 and FY 2012* (4/7/11).

continue to include commitment fees as a source of income to cover intermediation costs. This approach, however, could give rise to large swings in the analysis for income to cover intermediation costs and thereby detract from the principle of a desirable stable and predictable margin in the new income model. An alternative option would be to continue to include commitment fees as a source of income that contributes to the accumulation of reserves but not to include it in the analysis of the margin needed to cover intermediation costs. This would facilitate analysis of the underlying impact on lending income of these fees without them serving as a revenue stream to cover intermediation (lending) costs. Under this approach, the analysis in setting the margin would be somewhat insulated from the volatility of commitment fees.

20. **On balance, staff proposes to include commitment fees as a source of income that contributes to reserve accumulation rather than covers intermediation costs.** This approach would essentially recognize the above policy considerations for the fee structure, under which FCL and PCL commitment fees primarily serve to cover the cost of setting aside financial resources for a period of time. Furthermore, this approach would be more consistent with the Board-endorsed principle that the margin be set in a stable and predictable manner as it would avoid any perceived need to offset swings in commitment fee income by adjusting the margin. Under this approach, there could be some income from non-FCL or PCL precautionary arrangement commitment fees that would not be included in the calculation of the amount available to help cover intermediation costs.[21] However, on balance, staff considers this option to be appropriate as these proportionate costs have generally been relatively small and the associated commitment fees would nonetheless continue to contribute to reserve accumulation.

C. Reserve Accumulation

21. **The contribution of the margin to reserve accumulation varies with the lending cycle.** During high lending cycles (the situation we are currently in and which is likely to continue for some time), income from the margin and service charges is likely to be well in excess of the intermediation costs, providing a needed build up of precautionary balances to mitigate elevated credit risks in such periods. During low credit cycles, the margin will tend to be the main source of income available to cover intermediation costs and reserve accumulation would likely be lower, as would credit risks. Table 1, last column, illustrates how the framework would operate during such periods.

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[21] The impact on commitment fees under the proposed reforms to the Fund's toolkit is difficult to gauge—there could be a positive effect if there are more arrangements on a precautionary basis, but the reforms may result in more lending income if there is significant use of the new PLL (which replaces the PCL) by members with a BOP need. (See *The Fund's Financing Role: Proposals on Liquidity and Emergency Assistance* (10/28/11)).

22. **Actual reserve accumulation is less than it would be when the new income model is fully implemented.** As noted, the implementation of the new income model has progressed significantly but is not yet fully in place. The gold endowment is not yet operational, reimbursement of the General Resources Account for PRG Trust expenses has not yet resumed, and precautionary balances remain below the target.[22] In addition, non-lending income is also reduced by the current very low level of interest rates. Consequently, lending income continues to cover a significant proportion of the Fund's operating costs, i.e., beyond the intermediation costs. Accordingly, the potential reserve accumulation shown in Table 1, row G is hypothetical and actual reserve accumulation is significantly lower (Table 1, row I and Table 2).[23] However, once the income model is fully in place the results should converge (see last column for the above two rows). The steady state illustrates the Fund's income position in the long-term when lending income has declined and investment income provides a sustainable revenue source.

23. **The margin will tend to contribute more to reserve accumulation during high lending cycles given the nature of the Fund's cost structure.** Although the share of the Fund's total costs related to lending activities increases with the level of lending, the increase is not proportional particularly given the typically high concentration in the Fund's lending portfolio. Furthermore, factors such as staff time and travel for an active arrangement tend to generate broadly similar costs regardless of the level of access involved, whereas the margin, service charges and commitment fees increase with the level of access. Consequently, all things being equal, the build-up of precautionary balances should normally be at a faster pace during high lending cycles.

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[22] The Executive Board decided in July 2009 that for FY 2010–12, no reimbursement would be made to the GRA for the cost of administering the PRGT. Work on establishing the gold endowment continues to progress and implementation is expected to begin in calendar year 2012.

[23] For example, in FY 2012 projections the calculated potential reserve accumulation, after taking account of commitment fees and surcharges, is US$2.9 billion whereas the actual reserve accumulation is US$2.2 billion.

24. **The new framework shifts from an explicit annual target of reserve accumulation to a medium-term outlook where judgment is required**.[24] Unlike the explicit target of annual net income of 5 percent of reserves under Rule I-6(4), no pre-determined pace of reserve accumulation is proposed under the new framework. Rather, the amount for reserve accumulation to be generated through the margin would be based on a judgment of the Executive Board, taking account of relevant factors including the level of precautionary balances in relation to the target or floor, and the expected contribution from other sources including surcharges, which traditionally have been the main source of reserve accumulation. This is indeed the case in the current high lending environment.

Table 2: Income Sources and Uses (FY 2011-12)
(millions of SDRs and U.S. dollars)

		FY 2011 (Actual)		FY 2012 (Projected)	
		SDRs	US$ 1/	SDRs	US$ 1/
A.	**Operational income 2/**	**928**	**1,429**	**1,168**	**1,810**
	of which: Lending income	835	1,286	1,002	1,553
B.	**Expenses**	**631**	**972**	**668**	**1,035**
C.	**Net operational income position (A-B)**	**297**	**457**	**500**	**775**
	Gold profits	3,100	4,774	--	--
	Surcharges 3/	506	779	926	1,435
	Other 4/	-22	-34	--	--
D.	**Net income position**	**3,881**	**5,976**	**1,426**	**2,210**

1/The average exchange rate U.S. dollar/SDR for FY 2011 and FY 2012 is 1.54 and 1.55, respectively.
2/ Operational income includes income from lending, investments, the Fund's interest free resources, and reimbursements to the GRA from the SDR Department, the MDRI-1 Trust and the PCDR Trust.
3/Surcharges are assumed to be placed directly to reserves.
4/ Includes restructuring costs and IAS 19 timing adjustments, which are deducted to arrive at the net income position on the basis presented in the Fund's IFRS annual financial statements.

25. **The framework would continue to provide a modest reserve accumulation in a low credit environment.** Staff has previously provided long-term steady state income estimates of an environment in which lending income declines from current elevated levels. In the steady state, Fund credit is assumed to stabilize at about SDR 10 billion, while commitments under precautionary lending instruments are assumed to fall back from their current high levels and make a modest contribution to income from commitment fees.[25] In the

[24] Regular updates on the projected accumulation of precautionary balances over the medium-term have been provided to the Board in the context of the consolidated medium-term income and expenditure outlook papers issued twice a year. See *Consolidated Medium-Term Income and Expenditure Framework* (4/14/11). A Board discussion on the adequacy of precautionary balances is planned for early 2012.

[25] The impact on the demand for Fund resources of the proposed changes in the toolkit is expected to have a relatively limited impact on the overall need for Fund resources, mainly due to the confidence effects which would offset part of the upfront call for resources. See *The Fund's Financing Role: Proposals on Liquidity and Emergency Assistance* (10/28/11), pages 16-17.

steady state, reserve accumulation would be about US$110 million annually, assuming a margin of 100 basis points (see Table 1, last column). In the absence of commitment fees, reserve accumulation would be of the order of US$70 million.

D. Alignment with Market Conditions

26. **The new framework includes a mechanism for cross-checking the alignment of the margin with long-term credit conditions.** It aims to ensure that the cost of borrowing from the Fund is not too high or too low compared to market costs faced by members that borrow from the Fund. Costs that are too high could prevent members from seeking early assistance from the Fund thereby raising the ultimate costs of crisis resolution; such cost would also, more generally, be inconsistent with the Fund's mandate and cooperative character. Costs that are too low, on the other hand, could act as a disincentive to members from seeking market funding as their primary recourse, thereby reducing the Fund's available lending resources. Appropriately priced lending incentives would also be expected to encourage timely repayment, supporting the revolving nature of Fund resources. Comparing Fund lending costs to long-term credit conditions better captures underlying market conditions particularly given the short-term volatility of financial markets.[26]

27. **In the 2008 discussion, most Directors supported the general approach proposed by staff to make the mechanism operational.** A number of Directors cautioned that comparing the rate of charge with market interest rates is difficult given the Fund's mandate, its use of conditionality, and its preferred creditor status. The approach therefore relies significantly on judgment. In 2008, staff also explored a mechanical rule that produced a band for comparing the basic margin to market conditions, which, however, was not embraced by the Executive Board.

28. **The analysis below clarifies the main elements of the mechanism:** it discusses the comparator rate for *long-term average market conditions* and adjustments that are made for *risk* and *term premia*.

Long-term average market conditions

29. **An appropriate market comparator rate for long term average market conditions needs to take into account the characteristics of Fund lending** (maturities, potential borrowers) as well as the available market indices. Since the Fund's lending characteristics may change (e.g., increased use of EFFs) and/or new market indexes may be developed, there needs to be sufficient flexibility in the mechanism to modify the market

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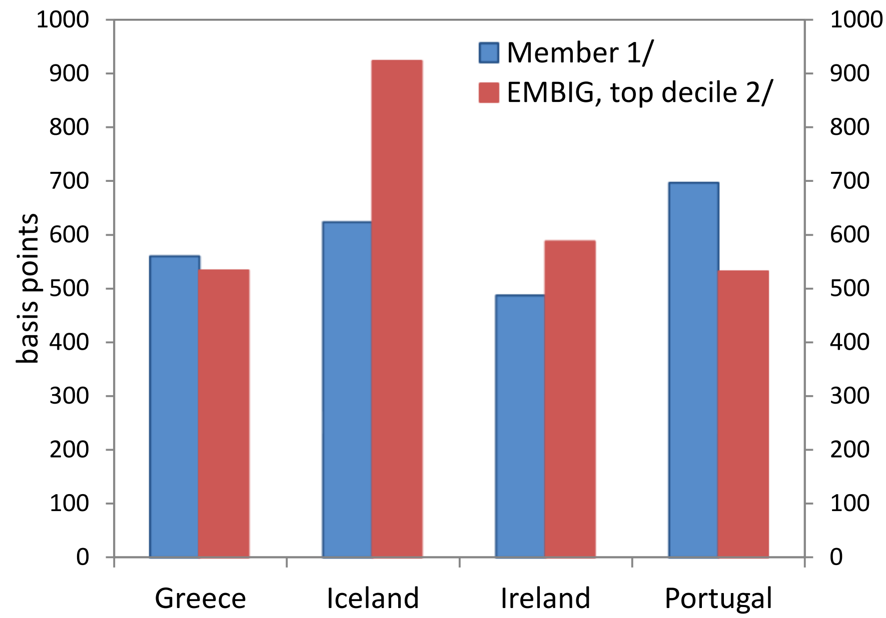
[26] Surcharges are not included in this analysis since the framework postulates a cross check of the margin with long-term market conditions, when market access is "normal". Surcharges typically occur when market access is limited and are meant to address large and long use of Fund credit, and to reinforce timely repayment of Fund resources once market conditions improve by narrowing the differentials between Fund and market borrowing costs.

comparator at the time of each review if needed. In the past, staff has used five-year JP Morgan EMBI yields and spreads to reflect emerging market members' market borrowing costs.[27] While it does not include advanced countries, which now represent a large portion of the Fund's portfolio, recent spread data suggest that it provides a sufficiently good proxy for these borrowers (Figure 5). The five-year maturity corresponds to the maximum maturity of the Stand-by Arrangement, and this maturity also has the most liquid market. Five-year average periods would bridge volatility associated with the business cycle and reflect *long-term average* market conditions (Table 3 and Figure 6).[28]

Figure 5. Advanced Countries' and EMBI Spreads at Time of Fund Arrangement



Source: Bloomberg, Staff calculations.
1/ 5 year government bonds versus euro area 5 year benchmark; three-month average preceding program.
2/ Three-month average spread preceding program adoption; rebased for SDR euro and US dollar weights. Average is calculated over the spreads that correspond to the 90th percentile of the sample.

Adjustment for Risk Premium

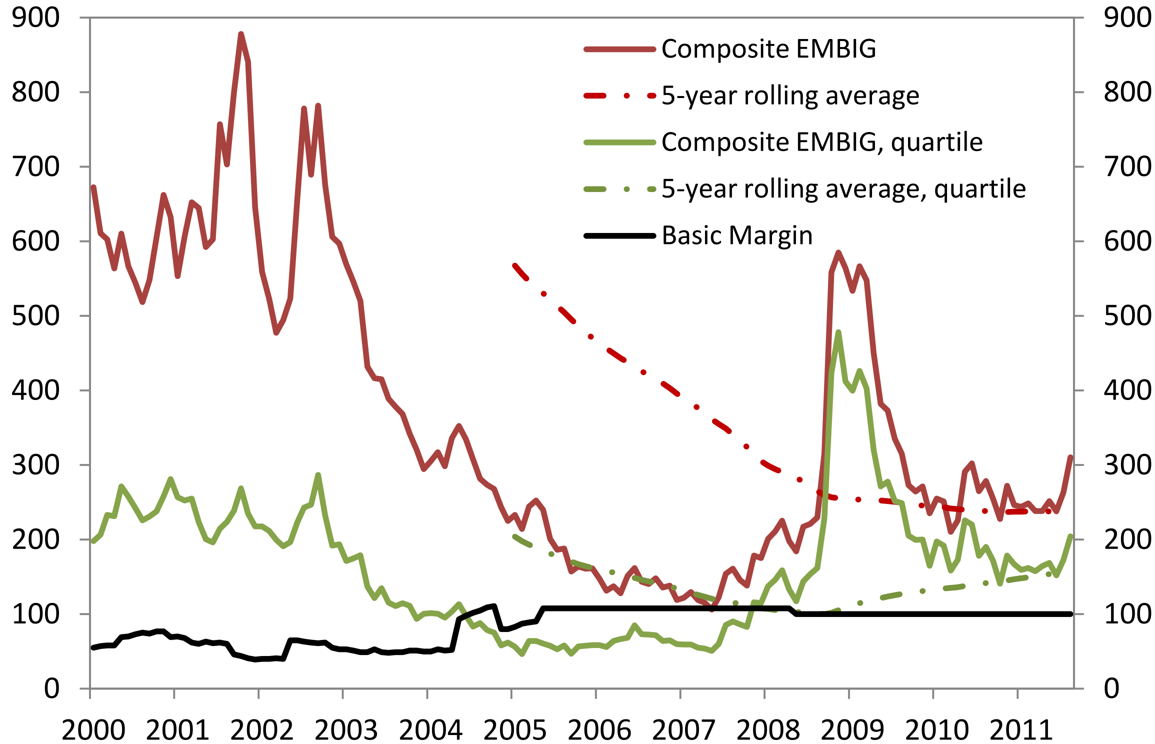
30. **For comparison, an adjustment is proposed to take account of the lower risks the Fund faces as a cooperative public policy institution.** As noted above, the Fund should

[27] *Review of the Fund's Income Position for FY 2011 and FY 2012* (4/7/11). A comparable broad market index based on ten year instruments is not available.

[28] As noted, during high lending cycles (the situation we are currently in and which is likely to continue for some time), income from commitment fees and service charges are likely to be well in excess of the intermediation costs, providing a needed build up of precautionary balances to mitigate elevated credit risks in such periods.

provide credit to its members at a cost that is consistent with its mandate to provide balance of payments support to vulnerable members. Policy conditionality and the preferred creditor status of the Fund are key factors in reducing the credit risk faced by the Fund, while not eliminating this risk.[29] This suggests that the cost of borrowing from the Fund should be below that reflected in the overall EMBI spread. The EMBI spread of countries in the lowest quartile could be regarded as providing a useful indicator of conditions facing the more creditworthy emerging markets. This measure has been used in the past, and staff considers that it can provide a proxy of market conditions to serve as a cross check when setting the rate of charge.[30]

Figure 6. EMBIG Spreads: Total Composite and Lowest Quartile (Basis Points)



Source: IMF Finance Department, JP Morgan, and Bloomberg.

[29] Risks remain because successful balance of payment adjustment depends ultimately on borrowers' ownership and effective implementation of appropriate policies, and because the risk of further shocks cannot be eliminated and access to other sources of financing is not guaranteed.

[30] While assessments of longer term market conditions using a measure such as the EMBI are inevitably backward-looking, the EMBI provides the best proxy for the credit risk premium faced by the Fund's membership given its market coverage, link with GRA borrowers, and the liquidity of the underlying market instruments.

Adjustment for Term Premium

31. **An additional adjustment is needed to take into consideration the *term premium*.** Standard GRA financing carries a maturity of up to five years, yet members are charged based on the floating SDR interest rate, which is composed of three month instruments of the basket currencies designated by the Executive Board.[31,32] Generally, a premium is charged to borrowers for locking in financing for longer periods at fixed interest rates. Thus, a comparison of the basic margin with spreads in the market—which are proxied by indexes of five-year, fixed interest rate instruments—requires a downward adjustment to account for this maturity difference. As in past discussions, the term premium is estimated as the difference between the weighted average of the yields on the five-year synthetic SDR bonds and the three-month synthetic SDR rate implicit in future market contracts over a five year period (the maturity of most Fund lending).[33] The term premium averaged about 15 basis points over the period 2006-11(see Table 3).

32. **In sum, the approach outlined above provides a useful cross-check against long-term credit market conditions.** For potential Fund borrowers in 2006-2011, the average margin was 103 basis points (Table 3). At this level, the margin has in recent years been modestly lower than the EMBI spread for the lowest quartile of borrowers, adjusted for the term premia, of 143 basis points.

[31] More specifically, maturity on Stand-by Arrangements (SBA) is 3 ¼ – 5 years and is applied to each disbursement independently. The Extended Fund Facility (EFF) carries a longer maturity of 4 ½ – 10 years.

[32] See Rule-T, adopted September 18, 1969 and amended November 23, 2005. Currently the interest rates on the 3 month Eurepo, Japanese Treasury Discount bills, and UK and US Treasury bills.

[33]Another proxy for the term premium was examined in previous papers based on the simple spread between the yield on a five-year fixed rate (synthetic) SDR bond and the three-month interest rate, however it overstates the term premium that should be applied to Fund credit given that the Fund lends for fixed maturities but at a floating rate, with the borrower bearing the interest rate risk associated with changes in global monetary conditions. See *Review of the Fund's Income Position for FY 2009 and FY 2010* (4/14/09).

Table 3. Long Term Credit Market and Comparator Spreads (in basis points)

	1996 - 2000	2001 - 2005	2006-2011
	(Median spread, in SDR-equivalent basis points) 1/		
Country risk--EMBI-based measures 2/			
Composite EMBI	667	402	235
Countries in the lowest quartile	260	118	159
Term premium 3/	n/a	0.3	15
Term premium adjusted country risk spread			
Composite EMBI	**n/a**	**402**	**220**
Countries in the lowest quartile	**n/a**	**118**	**143**
Memorandum item			
Past users of Fund resources 4/	507	316	233
Basic margin	68	69	103

Source: Bloomberg, JP Morgan and Fund staff calculations.

1/ SDR-equivalent rates are calculated using the currency w eights in the SDR basket.

2/ Table reports linear combination of spreads in EMBIG-U.S. dollar and EMBIG-Euro composites. Series w ere combined using the w eights of the U.S. dollar and Euro in the SDR basket (normalized to 100). During the sample period, the combined EMBIG indices contained spreads for a total of 40 countries.

3/ Difference in yields betw een a five-year fixed-rate bond, and the five-year average 3-month interest rate as implied in futures market contracts, adjusted for the higher risk premium of instruments in future markets.

4/ Members w ith arrangements during the periods in heading. Median level of the SDR w eighted U.S. dollar and euro EMBIG spreads for the members w ith Fund arrangements betw een 1996 and 2011.

IV. PROPOSED NEW RULE I-6(4)

33. **As noted earlier, adoption of a new rule for setting the margin is an important step in implementing the new income model**. During FY 2011, the limited gold sales were successfully concluded and the amendment of the Articles of Agreement to broaden the Fund's investment authority came into force. Work on establishing the gold endowment is in train and based on the current work program the endowment should become operational in 2012.[34] In light of these key elements of the new income model coming in place in the near-term, it is now timely for the Executive Board to consider a new rule to replace the existing Rule I-6(4).

34. **Reflecting the above discussion, the proposed new Rule I-6(4) builds on the principles endorsed by the Board in 2008**. It also takes account of the elements of the framework outlined in the 2009 income paper that has guided the setting of the margin for

[34] As discussed in footnote 5 above, the package of measures for the new income model also included resuming the reimbursement of the General Resources Account (GRA) for the cost of administering the PRG Trust. The current financial year would be the last under the July 2009 Executive Board decision for which no reimbursement is made to the GRA and instead the estimated cost is transferred to the PRG subsidy account.

rate of charge in FY 2010 through to FY 2012. The key features of the new rule are as follows:

- ***The overarching principle is that the margin on the rate of charge should be set as a margin over the SDR interest rate to cover the Fund's intermediation costs and allow for a buildup of reserves***. Thus, in contrast to the previous regime, the margin would no longer be required to cover the full range of the Fund's activities. Rather, it would be set so that projected lending income, i.e., service charges and income from the margin are at least sufficient to cover estimated intermediation costs.

- ***While the margin should also provide for a build-up in reserves, no pre-determined pace of reserve accumulation is proposed***. Rather, the amount for reserve accumulation to be generated through the margin would be based on a judgment of the Executive Board, taking account of relevant factors including the level of precautionary balances in relation to the target, and the expected contribution from other sources including surcharges, which traditionally have been the main source of reserve accumulation, and commitment fees.

    - The analysis for setting the margin on the rate of charge will be undertaken in the context of the review of the Fund's income position for each financial year and an update of the medium-term outlook for precautionary balances.[35] These papers will provide the Executive Board with information on the long-term pace of reserve accumulation.

    - The annual April income paper will include updates of Table 1 with analysis on the projected reserve accumulation, and sensitivity analysis for different levels of the margin (e.g., 50, 100, and 150 basis points in recent years).

- ***Stability and predictability of the margin would be a key principle under the new rule for setting the margin***. This also contrasts with the previous regime, where frequent adjustments were necessary, adding to the uncertainty over borrowing costs faced by members borrowing from the Fund.

    - ***The margin would be set for a period of two financial years starting with FY 2013***. In the March 2008 discussion on the new framework, many Directors had indicated support for the staff's proposal of setting the margin for a longer period in the absence of a strong rationale for an earlier adjustment, and with an interim update of the analysis prepared by the staff. In

[35] The annual April income paper now has a companion paper that provides a longer term outlook of the Fund's income and expenditure framework and at the request of Directors now includes a section on the projected accumulation of precautionary balances over the medium-term. See *The Consolidated Medium-Term Income and Expenditure Framework* (4/14/11).

the *off-cycle* year, the review would include a full staff analysis under the framework, but would not propose a change to the margin unless the analysis were to indicate that there were compelling reasons to change the margin in light of fundamental changes in the underlying factors relevant for the establishment of the margin.

- ***The new rule includes a cross-check to ensure that the resulting rate of charge maintains a reasonable alignment against credit market conditions***. This is needed to ensure that the cost of borrowing from the Fund resulting from the above considerations does not become too high or too low relative to the cost of borrowing from the market. The new rule does not prescribe a precise formula for assessing when the rate of charge would be considered to be misaligned in relation to market conditions, nor does it prescribe the relevant benchmarks for assessing the market alignment. Rather, under the new rule, the selection of the relevant benchmarks for comparison of the Fund's lending rate with market borrowing costs will require judgment that the benchmarks adequately reflect the profile of recent Fund borrowers. More concretely, the analysis on long-term credit market conditions based on the relevant benchmark, currently the average EMBI spread adjusted for the credit and risk premiums (Table 3) will yield a result for comparison to the proposed margin.

- ***Staff proposes that the rule include an exceptional circumstances clause***. This is to provide a safeguard that would allow the Board to set the margin on a basis other than that required to cover intermediation costs and allow for a buildup of reserves, should the framework encounter extreme stress conditions as observed in FY 2007–08 notwithstanding the shift to no longer cover all costs of the Fund.

35. **The next steps in the context of near-term income-related Board decisions or considerations are outlined below.**

- ***Midyear income paper***. Staff will shortly issue a paper on the midyear review of the Fund's income position for FY 2012. Under the current Rule I-6(4), a review of the Fund's income position at midyear is required to provide an update of the income projections for the financial year and to consider whether there has been any change in the exceptional circumstances under which the margin was set at the beginning of the year.[36] This paper is issued on a lapse-of-time basis.

- ***Review of precautionary balances paper***. Under the current work program, the Executive Board is scheduled to review the adequacy of precautionary balances early next year. The staff paper will update the medium-term income projections, including the pace of accumulation of precautionary balances, and will provide an updated

[36] This would no longer be necessary under the new rule, although a midyear income paper would continue to be prepared for the Executive Board's information only.

medium-term indicative target for precautionary balances based on the new projections for Fund credit.

- ***Annual income paper***. In April 2012, the Executive Board will review the Fund's income position for FY 2012 and FY 2013.[37] At that time, the Board would set a margin for calculating the basic rate of charge for FY 2013-2014 based on the proposed new rule. Staff will prepare a full analysis under the framework and propose a margin for the two-year period. In the *off-cycle* year, e.g., April 2013, the staff paper would still include a full analysis under the proposed framework for setting the margin, except a change in the margin would only be considered by the Board if the analysis were to indicate compelling underlying factors that are misaligned with the Board-endorsed principles for setting the margin.

[37] Staff will also issue a companion paper on the integrated income and expenditure framework, which will provide the medium-term projections of the Fund's income and expenses outlook.

PROPOSED DECISION

Accordingly, the following draft decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

"Effective May 1, 2012, Rule I-6(4) shall be amended to read as follows:

"(4) The rate of charge on holdings (i) acquired as a result of a purchase under a policy that has been the subject of an exclusion under Article XXX(c), or (ii) that exceed the amount of the member's quota after excluding any balances referred to in (i), shall be determined in accordance with (a) and (b) below.

"(a) The rate of charge shall be determined as the SDR interest rate under Rule T-1 plus a margin expressed in basis points. The margin shall be set at a level that is adequate (i) to cover the estimated intermediation expense of the Fund for the period under (b) below, taking into account income from service charges, and (ii) to generate an amount of net income for placement to reserves. The appropriate amount for reserve contribution shall be assessed taking into account, in particular, the current level of precautionary balances, any floor or target for precautionary balances, and the expected contribution from surcharges and commitment fees to precautionary balances; provided, however, that the margin shall not be set at a level at which the basic rate of charge would result in the cost of Fund credit becoming too high or too low in relation to long-term credit market conditions as measured by appropriate benchmarks. Notwithstanding the above, in exceptional circumstances, the margin may be set at a level other than that which is adequate to cover estimated intermediation expenses of the Fund and to generate an amount of net income for placement to reserves.

(b) The margin shall be set for a period of two financial years. A comprehensive review of the Fund's income position shall be held before the end of the first year of each such two-year period and the margin may be adjusted in the context of such a review, but only if this is warranted in view of fundamental changes in the underlying factors relevant for the establishment of the margin at the start of the two-year period.”