



## IMF POLICY PAPER

# RECENT FALL IN THE SDR INTEREST RATE— IMPLICATIONS AND PROPOSED AMENDMENTS TO RULE T-1

October 31, 2014

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- The **Staff Report** on Recent Fall in the SDR Interest Rate—Implications and Proposed Amendments to Rule T-1, prepared by IMF staff and completed on October 16, 2014 for the Executive Board's consideration on October 24, 2014.
- A **Press Release** summarizing the decision taken by the Executive Board on October 24, 2014.

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October 16, 2014

## RECENT FALL IN THE SDR INTEREST RATE—IMPLICATIONS AND PROPOSED AMENDMENTS TO RULE T-1

### EXECUTIVE SUMMARY

**The SDR interest rate is at historic lows.** Under the current Rule T-1, the SDR interest rate is calculated as the weighted average of interest rate instruments in the SDR basket, and stood at just 3 basis points for the week of October 13<sup>th</sup>. Market rates could decline further, which could reduce the SDR interest rate to zero or negative levels under the formula of the current Rule T-1.

**However, there is no authority under the Articles of Agreement for the Fund to establish a zero or negative SDR interest rate.** The wording of the relevant provisions in the Articles does not leave room for a zero or negative rate, and nothing in the legislative history of the First and Second Amendments suggests that zero or negative rates were ever contemplated. Negative SDR interest rates would also have adverse implications for the Fund's finances.

**Moreover, very low SDR interest rates affect the functioning of the burden sharing mechanism for deferred charges.** Under current Board decisions, the equal burden sharing, where creditors and debtors as a group generate equal amounts to cover deferred charges, requires a minimum positive SDR interest rate to operate. The SDR interest rate has now fallen below that minimum level.

**This paper proposes technical amendments to Rule T-1 and the burden sharing mechanism to address these issues.** In particular, the paper proposes setting a 5 basis point floor on the SDR interest rate, changing the rounding rules on the SDR interest rate and the burden sharing adjustment, and reducing the 1 basis point minimum of the burden sharing adjustment to 0.1 basis point. These measures would preserve a minimal capacity of equal burden sharing aimed at protecting the Fund's balance sheet, while limiting potential departures of the SDR interest rate from market interest rates.

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## INTRODUCTION

**1. The SDR interest rate has recently fallen to historic lows.** As of October 13, the SDR interest rate was only 0.03 percent. The rates on two of the four components of the SDR interest rate basket—the three month Eurorepo and three-month Japanese Treasury discount bills —were negative, and the rate on the three-month U.S. Treasury bill was only slightly above zero (Table 1).

**2. This decline raises two issues for the Fund:**

- i. *Consistency of a zero or negative SDR interest rate with the Articles of Agreement:* Under a strict application of the current formula in Rule T-1 for determining the SDR interest rate, there is nothing to prevent the SDR interest rate from turning negative.<sup>1</sup> However, a zero or negative SDR interest rate would not be consistent with the Fund’s Articles of Agreement, and would also create perverse incentives for the Fund’s financial operations.
- ii. *Burden sharing mechanism:* The burden sharing mechanism, which is a key element of the Fund’s strategy to protect its balance sheet against the impact of arrears, requires a minimum positive SDR interest rate to operate under current Board decisions. The SDR interest rate has now fallen below that minimum level.

**3. This paper proposes two changes in Rule T-1 to address these issues.** These changes involve setting a modest positive floor for the SDR interest rate and changing the current rounding convention for calculating the SDR interest rate. The paper also proposes corresponding changes in the rounding convention and the minimum adjustment in the burden sharing decision. These changes seek to limit the potential divergence of the SDR interest rate from underlying market rates while ensuring consistency with the Articles and preserving a minimal burden sharing capacity in an environment of very low interest rates.

**4. The paper is organized as follows.** The next section describes recent SDR interest rate developments and prospects, followed by a section that explores the legal and financial issues raised by low or negative SDR interest rates. A subsequent section discusses options and makes specific proposals for amendments to Rule T-1 and to the burden sharing decision to address these issues. The paper concludes with a draft proposed decision.

## RECENT INTEREST RATE DEVELOPMENTS AND OUTLOOK

**5. Under current rules, the SDR interest rate is set for weekly periods commencing each Monday based on market interest rates of the previous Friday.** Under Rule T-1, it is determined as the weighted average, rounded to the nearest basis point, of representative interest rates in the

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<sup>1</sup> See Annex.

money markets of the four SDR basket currencies. These are currently the rates on the 3-month U.S. T-bill, 3-month U.K. T-bill, 3-month Eurepo, and 3-month Japanese discount bill.<sup>2</sup>

**6. Since the global financial crisis, the SDR interest rate has fallen to historic lows**

(Figure 1). This reflects unprecedented monetary easing actions taken by the major central banks, including the use of unconventional monetary policies, to support economic activity and restore financial market stability. While the SDR interest rate has fluctuated around 10 basis points since early 2012, it has recently dropped to near zero. The short-term interest rates on two components of the SDR interest rate basket (the Eurepo and Japanese discount bill rates) are now negative, while the interest rates on the other two components of the basket are also very low, and near-zero in the case of the U.S. dollar.

**7. The short-term outlook for the SDR interest rate is uncertain.** While policy rate normalization is expected to begin in the U.K. and U.S. in 2015, the timing remains uncertain, and very accommodative monetary policies are expected to remain in place in the euro area and Japan. Although forward markets anticipate a gradual rise in the SDR interest rate from current levels, markets have consistently been wrong in recent months as the SDR interest rate has continued to fall to new lows (Figure 2). At current levels, it would take only a modest further decline in the market rates on one or more of the components of the SDR interest rate basket to push the SDR interest rate into negative territory.

**Table 1. SDR Interest Rate Calculation**  
**For the week of October 13, 2014 to October 19, 2014**  
 (Data as of Friday, October 10<sup>th</sup>, 2014)

Currency	Currency amount under Rule O-1 (A)	Exchange rate against the SDR 1/ (B)	Interest rate 2/ (C)	Product (A) x (B) x (C)
Euro	0.423	0.850232	-0.0608	-0.0219
Japanese Yen	12.1	0.00623964	-0.01	-0.0008
U.K. Pound Sterling	0.111	1.08025	0.4	0.048
U.S. Dollar	0.66	0.672758	0.01	0.0044
			Total	0.0297
			<b>SDR Interest Rate</b>	<b>0.03</b>

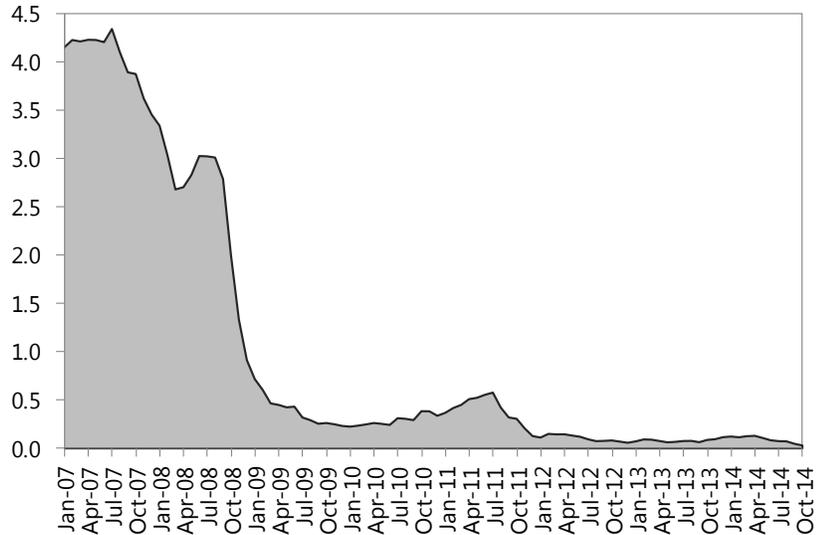
1/ SDR per currency rates are based on the representative exchange rates used in the SDR valuation basket.

2/ Interest rate expressed as an equivalent annual bond yield: three-month U.S. Treasury bills, three-month Eurepo; three-month Japanese Treasury Discount bills; and three-month UK Treasury bills.

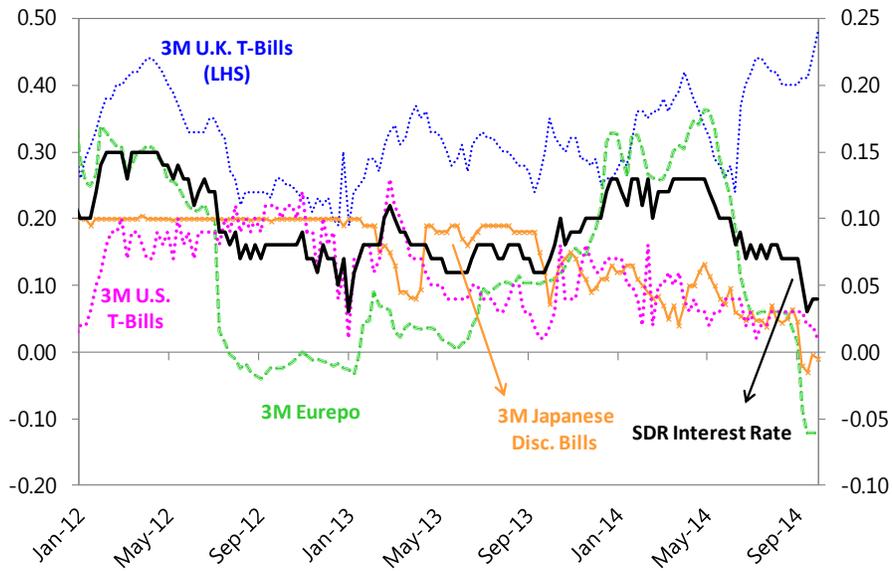
<sup>2</sup> The Eurepo rate is the rate at which, at 11.00 a.m. Brussels time, one bank offers, in the euro-zone and worldwide, funds in euro to another bank if in exchange the former receives from the latter the best collateral within the most actively traded European repo market. See <http://www.emmi-benchmarks.eu/eurepo-org/about-eurepo.html>. Given the small number of contributors to the Eurepo index, the European Money Market Institute (EMMI) that manages the compilation of Eurepo has announced that it can no longer guarantee the continuity of the Eurepo index. Staff is in discussion with the ECB staff to identify an alternative interest rate for the euro.

**Figure 1. Interest Rates on SDR and SDR-basket instruments**

SDR Interest Rate: January 2007 – October 2014  
(In percent)

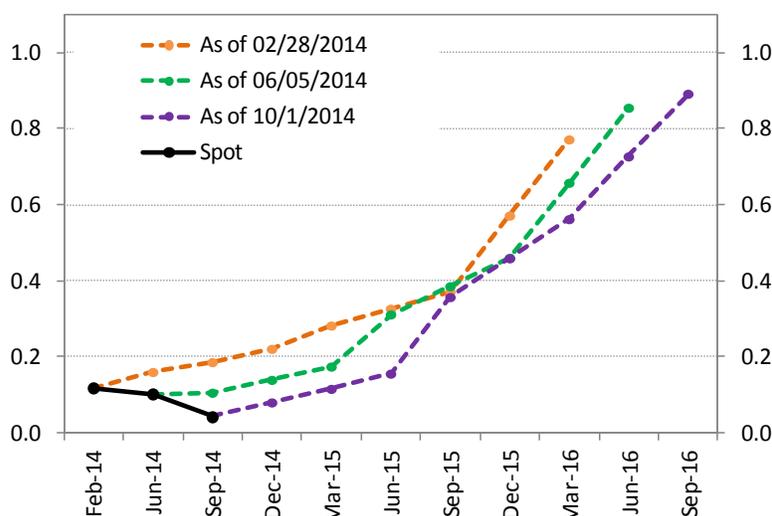


Interest Rates on the SDR and the SDR Basket Instruments: January 2012 – October 2014  
(In percent)



Source: Bloomberg; and Fund staff calculations.

**Figure 2. Spot and 2-Year Forward SDR Curves: February 2014 – September 2016** <sup>1/</sup>  
(In percent)



Source: Bloomberg; and Fund staff calculations.

<sup>1/</sup> The SDR forward curve is the weighted average of the components per rule T-1.

## LOW OR NEGATIVE SDR INTEREST RATES: LEGAL AND FINANCIAL CONSIDERATIONS

**8. While the interest rate formula in Rule T-1 could indicate a zero or negative SDR interest rate, there is no authority under the Articles of Agreement for the Fund to establish such a rate.** The Articles establish a number of basic debtor and creditor relationships in the GRA and the SDR Department and provide for the payment of remuneration/interest and charges on these positions. A key element of this framework is the authority of the Fund to set the SDR interest rate. An analysis of the plain wording of the relevant provisions, the manner in which they are designed to apply, and their legislative history all point to the conclusion that a zero or negative SDR interest rate is not permitted under the Articles. Specifically, Article XX, Sections 1 and 2 require the Fund to *pay* interest on SDR holdings and SDR Department participants to *pay* charges at the SDR interest rate on their net cumulative SDR allocation.<sup>3</sup> Application of a zero rate to these transactions would not allow for the “payments” to be made, and a negative rate would reverse the payer-payee relationship established under the Articles. Moreover, the provisions of the Articles

<sup>3</sup> Article XX reads: “1. Interest at the same rate for all holders shall be *paid by the Fund* to each holder on the amount of its holdings of special drawing rights. The Fund shall pay the amount due to each holder whether or not sufficient charges are received to meet the payment of interest. 2. Charges at the same rate for all participants shall be *paid to the Fund* by each participant on the amount of its net cumulative allocation of special drawing rights plus any negative balance of the participant or unpaid charges.” (emphasis added)

regarding the ceiling and floor for the rate of remuneration of reserve tranche positions could not be effectively applied with a zero or negative SDR interest rate.<sup>4</sup> Finally, there is nothing in the legislative history of the First and Second Amendments to the Articles of Agreement to suggest that a zero or negative SDR interest rate was ever contemplated when the relevant provisions were adopted. If Rule T-1 were to remain in place in its present form and were to indicate a zero or negative rate, considerable uncertainty would arise as to what the Fund would do to address this situation.

**9. Moreover, a negative SDR interest rate could also have adverse implications for the Fund's finances.** In particular, it could undermine members' willingness to contribute quota and loan resources to the Fund if they are effectively charged by the Fund on their creditor positions. It could also undermine the functioning of the SDR Department as participants might not be willing to exchange freely usable currency for SDRs if they are effectively charged interest on their SDR holdings.

**10. Even if the SDR interest rate remains positive, the current very low rate has important implications for the burden sharing mechanism.** This mechanism was established in 1986 to compensate the Fund for any overdue charges by members in arrears ("deferred charges"), and in so doing, to offset the impact of unpaid charges on Fund income (Box 1, Table 2). Under burden sharing, the creditor and debtor members as a group each shall contribute equal amounts to cover for unpaid charges through reductions in the rate of remuneration paid to the former, and increases in the rate of charge paid by the latter ("burden sharing adjustments"), with limitations on the maximum adjustment to the rate of remuneration.<sup>5</sup> The burden sharing mechanism has proven essential to protect the Fund's income position and to comply with International Financial Reporting Standards (IFRS) with respect to the valuation of credit in arrears on the Fund's financial statements.

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<sup>4</sup> Article V, Section 9(a) reads: "(a) The Fund shall *pay remuneration* on the amount by which the percentage of quota prescribed under (b) or (c) below exceeds the Fund's average daily balances of a member's currency held in the General Resources Account other than balances acquired under a policy that has been the subject of an exclusion under Article XXX(c). The rate of remuneration, which shall be determined by the Fund by a seventy percent majority of the total voting power, *shall be the same for all members and shall be not more than, nor less than four-fifths of, the interest rate under Article XX, Section 3.* In establishing the rate of remuneration, the Fund shall take into account the rates of charge under Article V, Section 8(b)." (emphasis added). Consequently, if the SDR interest rate were negative, there would be no remuneration rate that satisfies the provision under Article V, Section 9(a) of being "not more than, nor less than four-fifths of," the SDR interest rate, since in negative territory, numbers that are "not more than" the SDR interest rate cannot at the same time be "not less than four-fifths" of the rate.

<sup>5</sup> These adjustments are currently set to cover unpaid charges. Burden sharing adjustments could also be made to generate amounts for placement to the Special Contingent Account (SCA) 1, which forms part of the Fund's precautionary balances. Contributions to the SCA-1 were suspended in 2006.

### Box 1. The Burden Sharing Mechanism and the Fund's Finances

**Background:** The burden sharing mechanism was established in 1986 to address the consequences from the existence of overdue financial obligations to the GRA. The burden sharing mechanism for overdue (“deferred”) charges is designed to generate an amount equal to the lost income due to unpaid charges, thereby enabling the Fund to demonstrate that on a net present value basis, there is no impairment of credit outstanding. It generates additional income by distributing the financial consequences of unpaid charges equally between creditor and debtor members by reducing the rate of remuneration and increasing the rate of charge.<sup>1</sup> As such, it seeks to ensure that the Fund’s cash flow is not negatively impacted by unpaid charges. The burden sharing mechanism has also been used to accumulate additional precautionary balances against possible credit default on overdue repurchases in a special contingent account (the SCA-1) but accumulations were suspended in 2006.<sup>2</sup> As of April 30, 2014, the balances in the SCA-1 (SDR 1.2 billion) exceeded the current stock of overdue repurchase obligations by SDR 0.9 billion.

**Constraining factors:** The Articles of Agreement require that the rate of remuneration be no less than 80 percent of the SDR interest rate, but under existing Board decisions on burden sharing the adjusted rate of remuneration cannot fall below 85 percent of the SDR interest rate. This constrains the equal burden sharing capacity, particularly in a low interest rate environment. Further, burden sharing adjustments are not applied to interest paid on outstanding borrowing; hence the financing mix in the FTP has ramifications for total burden sharing capacity.

**Importance to Fund finances:** The Fund’s ability to assert that credit outstanding in arrears is not impaired, despite unpaid charges, depends on the capacity of the burden sharing mechanism to recover the lost income. Should the income loss exceed the burden sharing capacity, the reduction in future cash flows could undermine the Fund’s ability to demonstrate that the carrying value of credit outstanding has not been impaired. This would have implications for the accounting treatment of credit outstanding on the Fund’s balance sheet, including the possibility of an impairment loss if the carrying value exceeds the present value of expected future cash flows. Under International Financial Reporting Standards (IFRS), should an impairment loss be recognized, the carrying value of the credit outstanding in arrears is reduced either directly or through the use of an allowance account.<sup>3</sup> A variety of factors would need to be considered in addressing this question, including the unique nature of the Fund’s financing mechanism and the associated provisions in the Fund’s Articles.<sup>4</sup>

Should equal burden sharing be unable to fully offset charges in arrears, either debtors would have to bear any difference through asymmetrical burden sharing adjustments to the rate of charge, or the Executive Board would need to take a decision by 70% majority that the resulting shortfall in income would be added to the amounts to be generated by the adjustments to the rates of charge and remuneration for the subsequent quarter, or lower the remuneration coefficient. “Carry forward” of a shortfall has been done on three occasions in the late 1980s when the adjustment to the rate of remuneration under burden sharing was limited by the 85 percent floor. This option could be considered if necessary in the future, although such measure by itself would not assure the full and timely recovery of the income shortfall given the current low level of the SDR interest rate.

<sup>1/</sup> See Decision No. 11945-(99/49). <http://www.imf.org/external/pubs/ft/sd/2012/123111.pdf>

**Box 1. The Burden Sharing Mechanism and the Fund's Finances (concluded)**

<sup>2/</sup> See *The Fund's Income Position for FY 2007 – Midyear Review* (December 7, 2006 and Supplement 1, December 19, 2006) and Executive Board Decision No. 13858-(07/1), adopted January 3, 2007. <http://www.imf.org/external/np/pp/eng/2006/120706.pdf>

<sup>3/</sup> The recognition of an impairment loss is not equivalent to writing off the outstanding claims against the member in arrears. The recognition of an impairment loss does not relieve the member of its obligations to the Fund.

<sup>4/</sup> For example, the estimated reduction in the net present value of future cash flows associated with the credit outstanding in arrears would need to be weighed against the protection provided by balances in the SCA-1, in considering whether an impairment adjustment is needed to properly comply with IFRS. The Fund's unique circumstances on loss recognition limitations would also need to be taken into account. For a discussion on the accounting and audit implications of a breakdown in the burden sharing mechanism for deferred charges, see Boxes 2 & 3 in *Review of the Adequacy of Precautionary Balances* (1/14/14). <http://www.imf.org/external/np/pp/eng/2014/011414.pdf>

**Table 2. The Fund's Financial Operations Under the Articles of Agreement and Implementing Rules**

<i>Operation</i>	<i>Authority</i>	<i>Description</i>
SDR interest rate	Article XX, sec. 3	The Fund shall determine the rate of interest on SDR holdings by a 70% majority of the total voting power. The rate of charges on net cumulative allocations of SDRs (and negative balances) shall be equal to the rate of interest.
	Rule T-1	Defines the methodology for calculating the SDR interest rate.
Remuneration	Article V, sec. 9(a)	The Fund shall determine the rate of remuneration of the remunerated reserve tranche position by a 70% majority; it shall be the same for all members and shall be not more than, nor less than four-fifths (80%) of, the rate of interest under Art. XX, sec. 3.
	Rule I-10	Sets the rate of remuneration at 100% of the rate of interest on SDR holdings under Rule T-1.
Charges	Article V, sec. 8	The Fund shall levy charges on its average daily balances of a member's currency held in the GRA. The basic rate of charge shall be determined by a 70% majority of the total voting power and shall be uniform for all members.
	Rule I-6(4)	Sets the basic rate of charge as equal to the SDR interest rate under Rule T-1 plus a margin.
Burden Sharing	Executive Board Decision No. 12189-(00/45)	The loss of income due to unpaid charges is to be recovered by adjustments to the rate of charge and remuneration, subject to the current limitation that the adjustment to the rate of remuneration cannot exceed 15 percent of the SDR interest rate.

**11. Under current rules, it is very unlikely that a symmetric burden sharing adjustment could be made for the financial quarter ending in October.** This is because of a combination of two policy decisions that constrain equal burden sharing adjustments at the current very low interest rates. First, under the current burden sharing decision, the average rate of remuneration for a financial quarter cannot be reduced to below 85 percent of the SDR interest rate (“remuneration coefficient”); this is slightly higher than the 80 percent floor established for the remuneration coefficient under the Articles.<sup>6</sup> In other words, the maximum burden sharing adjustment that can be made to the rate of remuneration is 15 percent of the average SDR interest rate over the quarter.<sup>7</sup> This constrains the amount that can be generated from creditors at very low SDR interest rates. Second, both the SDR interest rate and the burden sharing adjustment are rounded to 2 decimal places, and the minimum burden sharing adjustment is currently set at 1 basis point.<sup>8</sup> This means that, for equal burden sharing adjustments to take place from the rates of remuneration and charge in any given financial quarter, the average SDR interest rate for that quarter must be at least 7 basis points.<sup>9</sup> However, for the current financial quarter ending in October, the average SDR interest rate so far has been only 6 basis points, making it highly unlikely that equal burden sharing adjustments can be made under current rules.

**12. In the event the burden sharing mechanism cannot operate in a symmetrical way, a review of the burden sharing decision would be triggered under the terms of the burden sharing decision.** Specifically, the burden sharing decision needs to be reviewed if the required adjustment to the rate of remuneration were to result in a remuneration coefficient below the 85 percent floor.<sup>10</sup> Absent any Executive Board decisions at the time of the review, debtor members would be required to cover any remaining amounts of unpaid charges through further (uncapped) adjustments to the rate of charge.<sup>11</sup> Burden sharing would become asymmetric. In earlier instances in 1987-88, when the amounts generated under equal burden sharing without breaching the

<sup>6</sup> Rule I-10(b) states: “The relationship of the rate of remuneration to the SDR interest rate will be referred to as the “remuneration coefficient.”

<sup>7</sup> While the existing burden sharing decision requires the remuneration coefficient to be at least 85 percent in any given financial quarter, it allows the remuneration coefficient during any given week to fall below 80 percent, as long as it is above 85 percent over the quarterly period. The Articles provide that remuneration is paid on average daily balances, which allows the remuneration coefficient to be applied on a quarterly basis while remuneration accrues daily.

<sup>8</sup> The minimum adjustment of 1 basis point was adopted in 2009. At the same time, it was also agreed to allow any excess or shortfalls in adjustments in one quarter resulting from the 1 basis point minimum to be carried over to subsequent quarters, such that adjustments are not necessarily made every quarter (see *IMF's Income Position for FY 2010 Midyear Review*, 12/8/09). <http://www.imf.org/external/np/pp/eng/2009/120709.pdf>.

<sup>9</sup> The 7 basis point threshold follows from the following computation: the adjusted rate of remuneration (RR) is the SDR interest rate (SDRi) minus the burden sharing adjustment (BSA). Under current Board decisions, the minimum RR allowed is 85 percent of SDRi; i.e., the maximum BSA possible is 15 percent of the SDRi. Also, under the burden sharing decision, the minimum BSA allowed is 1 bp, or 0.01 percent. Therefore, the minimum possible SDRi that generates a 1 bp BSA equals  $0.01/(0.15)$ , rounded to 2 decimal places, which is 0.07 percent or 7 basis points.

<sup>10</sup> See Section V of Decision No. 12189-(00/45), April 28, 2000, as amended.

<sup>11</sup> This is because, unlike the limit on the adjustments to the rate of remuneration under the Articles and Decision No. 12189-(00/45), there are no limits on burden sharing adjustments to the rate of charge.

85 percent threshold were insufficient to cover unpaid charges, the Executive Board decided to uphold the principle of equal burden sharing between debtors and creditors, as well as to maintain the 85 percent threshold, and decided to carry forward the amounts of unpaid charges that could not be covered by equal burden sharing contributions. While a similar approach of carrying the amounts of unpaid charges that cannot be covered by equal burden sharing forward could be considered in the current context, it could have implications for the carrying value of credit outstanding. As long as the amounts generated under the burden sharing mechanism cover fully the unpaid charges in a timely manner, the net present value of the expected cash flows on credit outstanding in arrears remains intact and supports the assertion that credit outstanding has not been impaired in accordance with International Financial Reporting Standards (IFRS). However, a prolonged period of very low interest rates could severely hamper the ability of the burden sharing mechanism to absorb the full impact of unpaid charges carried over from previous quarters, and would raise the question of whether the credit outstanding has been impaired. (see also Box 1).

## PROPOSED RULE CHANGES

**13. A change in Rule T-1 is required to ensure that the SDR interest rate will remain positive under all market conditions.**<sup>12</sup> This can be achieved by modifying the current rule to introduce a minimum positive floor. Under current rounding rules, the lowest level at which this minimum could be set is 1 basis point. However, such a change would only address one of the two issues discussed in the previous section and would not be sufficient to allow equal burden sharing in a low SDR interest rate environment going forward. Accordingly, staff has explored options for setting a modestly higher floor while limiting the extent of any potential departures from a market-based rate.<sup>13</sup>

**14. In this context, staff considered 3 approaches to setting the floor:**<sup>14</sup>

- 1) **Set the floor at the minimum level required to allow equal burden sharing to operate under current rules.** As discussed in ¶11, this would imply setting the floor at 7 basis points, which would preserve the ability to implement symmetric burden sharing adjustments at the current minimum level of 1 basis point. Under this approach, the SDR interest rate would rise from its current level of 0.03 percent to 0.07 percent and allow for the minimum 1 basis point burden sharing adjustment to be made to the rates of remuneration and charge going forward. However, for the current financial quarter, it will most likely not be possible to make a burden sharing adjustment to the rate of remuneration, as discussed in ¶11. To maintain the

<sup>12</sup> Under the Articles, the Board has broad discretion in setting the SDR interest rate. Amending Rule T-1 requires a decision by the Executive Board with a 70 percent majority of the total voting power (Article XX, Section 3). As any amendment to the Rules and Regulations, it would be submitted to the Board of Governors for review at the next regular meeting (Section 16 of By-Laws).

<sup>13</sup> The link between the SDR interest rate and market rates dates back to the 1970s, and the current arrangements have been in place since 1981 (see Box 2).

<sup>14</sup> Staff does not consider fundamental changes in the burden sharing mechanism at this point, such as departing from the practice of equal burden sharing between creditors and debtors.

symmetrical adjustments of the rates of charge and remuneration, a decision by the Executive Board would be necessary to carry forward any unpaid charges not covered by burden sharing to the next financial quarter.

- 2) **Lower the floor on the remuneration coefficient to the minimum level possible under the Articles and establish the SDR interest rate floor at the lowest level consistent with this coefficient (5 basis points).** As noted, under the current burden sharing decision, the minimum remuneration coefficient has been set at 85 percent of the SDR interest rate.<sup>15</sup> This threshold is higher than the minimum of 80 percent allowed under the Articles (Article V, Section 9(a)). The Board could decide to lower the floor on the remuneration coefficient to the minimum allowed under the Articles; i.e., allow for a maximum burden sharing adjustment of 20 percent of the SDR interest rate. This would allow the burden sharing adjustment to operate at the current minimum level of 1 basis point with an SDR interest rate at 0.05 percent. Setting the floor at this level would result in a smaller adjustment in the SDR interest rate from its current level, relative to the option above. It would also be expected to allow for a burden sharing adjustment to be made to the rate of remuneration in the current financial quarter, avoiding the need for a review of the burden sharing decision to carry forward unpaid charges. However, as discussed above, in the earlier instances when the Executive Board considered lowering the remuneration coefficient, it decided to uphold the 85 percent floor to avoid fundamental changes to rules.<sup>16</sup>
- 3) **Change the rounding rules for the calculation of the SDR interest rate and the burden sharing adjustment to 3 decimal places and set the SDR interest rate floor to preserve burden sharing.** As discussed above, the SDR interest rate is currently rounded to 2 decimal places and the minimum burden sharing adjustment is set at 1 basis point. While the current rounding rule for the SDR interest rate has been in place since 1981 and the one for the burden sharing adjustment was taken in 2002, there is no clear market convention for rounding on financial instrument yields, and rounding to 3 or even 4 decimal places is quite common, particularly in the current low interest rate environment. If both the SDR interest rate and the burden sharing adjustment were rounded to 3 rather than 2 decimal places, it would be possible to operate the burden sharing mechanism at lower SDR interest rates.<sup>17</sup> It would also allow finer adjustments to be made to the rate of remuneration to more accurately generate the burden sharing amounts needed to cover unpaid charges. There would be a corresponding change to the required minimum adjustment from 1 basis point to 0.1 basis point. With 3 decimal places, the SDR interest rate floor could be set as low as 0.025 percent to cover the current level of unpaid charges, but such an approach would not be robust to changes in key parameters underlying the calculation of the burden sharing adjustment going forward (such as an increase

<sup>15</sup> Decision No. 12189-(00/45), April 28, 2000, effective May 2, 2000, as amended.

<sup>16</sup> At that time, the Directors judged that the deferred income not covered by the burden sharing adjustments was small enough to not warrant an extensive review.

<sup>17</sup> Staff's sensitivity analysis of the burden sharing capacity suggests there is no compelling reason at this stage to go beyond 3 decimal places. The additional burden sharing capacity generated by going from 3 to 4 decimal places averages about SDR 0.33 million per year (a 6 percent increase in capacity, keeping all else constant) between SDR interest rates of 5 and 7 basis points. Moving beyond 4 decimal places has almost no impact on capacity.

in the level of unpaid charges or a decline in the overall level of credit outstanding). Accordingly, it would be preferable to set a slightly higher floor of 0.050 percent (5 basis points) to provide a modest buffer.<sup>18</sup> Like the second option, this proposal would allow for symmetrical burden sharing adjustments to be made in the current financial quarter, and thereby not necessitating a review of the burden sharing decision.

**15. On balance, staff proposes adopting the third approach.** This would combine a change in the rounding conventions for the SDR interest rate and the burden sharing adjustment to 3 decimal places with the introduction of a floor on the SDR interest rate of 0.050 percent (5 basis points). It would ensure that the SDR interest rate is set in line with the prohibition in the Articles on a zero or negative SDR interest rate while preserving a limited capacity of equal burden sharing aimed at protecting the Fund's balance sheet. It could be implemented by an amendment of Rule T-1 and corresponding changes to the rounding rules for calculating the burden sharing adjustments and the amount of the minimum adjustment (from 1 basis point to 0.1 basis point). These changes can be adopted by a 70 percent majority of total voting power.

**16. The overall impact of such a change is expected to be modest.** It could, in current circumstances, imply a small departure from the principle of a market-determined SDR interest rate. However, as the floor would be binding only when the market-implied SDR interest rate falls below it, any such departure is expected to be only temporary and modest in scale. Informal staff consultations with key official sector users of the SDR suggest that the proposed change would not have any material impact on their operations. The change would also not affect Fund income (the Board will review the Fund's income position again in April 2015). When the floor is triggered under the revised Rule T-1, the marginal impact of each basis point difference between the SDR interest rate floor and the calculated rate based on market rates in terms of increased charges paid by borrowers and of increased remuneration and interest paid to creditors would be about SDR 8 million on an annual basis (against total expected charges in FY2015 of SDR 2.7 billion).<sup>19</sup>

<sup>18</sup> Assuming current remunerated reserve tranche positions and principal in arrears, the proposed 5 basis point floor for the SDR interest rate would imply an annual burden sharing capacity of about SDR 5.2 million. This would provide a very modest buffer over the amount currently required to offset unpaid charges (about SDR 2.8 million annually). This buffer would be exhausted by a modest increase in principal in arrears corresponding to about 0.3 percent of current credit outstanding, or, alternatively, by a decline in credit outstanding of about 50 percent (to around SDR 41 billion), with an unchanged remunerated reserve tranche position (RRTP) to total borrowing ratio.

<sup>19</sup> See *Review of the Fund's Income Position for FY 2014 and FY 2015–2016*, Table 4 <http://www.imf.org/external/np/pp/eng/2014/040714b.pdf> for details on total expected charges in FY2015. Under the current burden sharing decision, if the floor were established at a lower level (for example 2.5 basis points or as low as 1 basis point), any amounts for deferred charges that could not be met by symmetrical burden sharing would be borne asymmetrically by the debtors unless the Executive Board were to decide otherwise. While, in a given quarter, the amount required from debtor members as a group under such asymmetrical burden sharing could be less than the incremental increase in the cost of borrowing that results from the establishment of the floor on the SDR interest rate at 5 basis points, setting the floor at such a low level would set a precedent for asymmetrical burden sharing adjustments, and staff is of the view that the relatively very small amounts involved do not justify departing from the principle of symmetric burden sharing.

### Box 2. SDR Interest Rate Determination: A Brief History

The Executive Board reviews the appropriate instruments and SDR interest rate determination as part of its regular reviews of the SDR valuation basket, with the last review concluded in late 2010.<sup>1</sup> The setting of the SDR interest rate has evolved over time, with important implications for the interest rate level.

Under the First Amendment, the rate of interest on holdings of SDRs (set initially at 1.5 percent per annum) was controlled by the rate of remuneration, as the Articles provided that the SDR interest rate could be no greater than 2 percent or the rate of remuneration, whichever was higher, and could also be no smaller than 1 percent or the rate of remuneration, whichever was lower (Article XXVI, Section 3, First Amendment). In turn, the rate of remuneration, also introduced in the Articles by the First Amendment (with an initial rate also set at 1.5 percent per annum), could be modified within a range of 1–2 percent per annum by an Executive Board decision adopted with a majority of the votes cast. The Articles allowed the rate of remuneration to be set beyond these limits if so decided by a special majority of 75 percent of the total voting power. As stated in the Executive Board report to the Board of Governors on the proposed First Amendment, however, a rate of remuneration of 2 percent above the SDR interest rate or 1 percent below the SDR interest rate per annum was not expected “*unless it were necessary in light of developments in international money markets.*”

Following the Second Amendment, the SDR interest rate was progressively aligned to market determined rates to support the SDR’s attractiveness as a reserve asset. In 1974, the SDR interest rate was raised at first from 1.5 percent to 5 percent, and subsequently adjusted every six months by a fixed portion of the average change of the combined market interest rate. In 1976, the interest rate calculation was simplified and quarterly interest rate resets were introduced. The SDR interest rate was progressively increased from 60 percent to 100 percent of the combined market interest rate between 1976 and 1981, and the official SDR interest rate has been reset on a weekly basis since July 1983.

The Second Amendment changed the relationship between the SDR interest rate and the rate of remuneration by making the former control the latter. In accordance with Article V, Section 9(a) the rate of remuneration cannot exceed the rate of interest on the SDR and cannot be lower than 80 percent of that rate. Considerations underlying the Second Amendment discussions that informed the current link between the SDR interest rate and the rate of remuneration on reserve tranche positions included, on the one hand, the objective of having the same or a very similar rate of interest apply to holdings of SDRs and remuneration, because of the similarity between the rights attached to the SDR and the rights of a member in a remunerated position in the General Resources Account. On the other hand, there was also a desire to enhance to attractiveness of the SDR as a reserve asset by paying an adequate rate of interest.

As the Articles specify no criteria for setting the SDR interest rate, the Fund can determine the rate on the basis of considerations it deems appropriate, taking into account, *inter alia*, the purposes of the Fund and the role of the SDR in the international monetary system. While the Fund has thus broad discretion to determine the SDR interest rate and the rate of charge on outstanding credit in the GRA, it has less flexibility to set the rate of remuneration.

<sup>1/</sup> See *The Acting Chair’s Summing Up Review of the Method of Valuation of the SDR* (11/17/10).

<http://www.imf.org/external/np/sec/pn/2010/pn10149.htm>.

## Proposed Decision

Accordingly, the following decision, which may be adopted with a 70 percent majority of the total voting power, is proposed for adoption of the Executive Board (see Annex for the full text of Rule T-1 and Decision No. 12189-(00/45), as amended, showing in red-line the proposed changes):

1. Rule T-1(b) and (c) shall be amended to read as follows:

“(b) the rate of interest on holdings of SDRs for each weekly period commencing each Monday shall be equal to the combined market interest rate as determined by the Fund at the beginning of the period in the manner described in (c) below, provided that, if the combined market rate is below 0.050 percent, the rate shall be established at 0.050 percent.

(c) The combined market interest rate shall be the sum, rounded to the three nearest decimal places, of the products that result from multiplying each yield or rate listed below, expressed as an equivalent annual bond yield, for the preceding Friday by the value in terms of the SDR on that Friday of the amount of the corresponding currency specified in Rule O-1, as determined pursuant to Rule O-2(b). If a yield or rate is not available for a particular Friday, the calculation shall be made on the basis of the latest available yield or rate.

U.S. dollar	Market yield for three-month U.S. Treasury bills
Euro	Three-month Eurepo Rate
Japanese yen	Three-Month Japanese Treasury Discount Bills
Pound sterling	Market yield for three-month U.K. Treasury bills”

2. Section IV, Paragraph 2 (d) of Decision No. 12189-(00/45), adopted April 28, 2000 (as amended) shall be revised to read as follows:

“(d) Notwithstanding Paragraph 1 (a) above, the rate of charge and the rate of remuneration determined under this section shall be rounded to three decimal places, provided that an adjustment of at least 0.1 basis point shall be made to both the rate of charge and the rate of remuneration, subject to subparagraph (e) below.”

## Annex. Redlined Revisions

### 1. Revised Rule T-1

“(a) Interest and charges in respect of SDRs shall accrue daily at the rate referred to in (b) below. The amount that has accrued during each quarter of the financial year of the Fund shall be paid promptly as of the beginning of the following quarter. The accounts of participants shall be credited with the excess of interest due over charges or debited with the excess of charges over the interest due. The accounts of holders that are not participants shall be credited with the interest due.

(b) the rate of interest on holdings of SDRs for each weekly period commencing each Monday shall be equal to the combined market interest rate as determined by the Fund at the beginning of the period in the manner described in (c) below, provided that, if the combined market rate is below 0.050 percent, the rate shall be established at 0.050 percent.”

(c) The combined market interest rate shall be the sum, rounded to the ~~two~~ three nearest decimal places, of the products that result from multiplying each yield or rate listed below, expressed as an equivalent annual bond yield, for the preceding Friday by the value in terms of the SDR on that Friday of the amount of the corresponding currency specified in Rule O-1, as determined pursuant

to Rule O-2(b). If a yield or rate is not available for a particular Friday, the calculation shall be made on the basis of the latest available yield or rate.

U.S. dollar                      Market yield for three-month U.S. Treasury bills

Euro                              Three-month Eurepo rate

Japanese yen                  Three-Month Japanese Treasury Discount Bills

Pound sterling                Market yield for three-month U.K. Treasury bills

(d) Deleted.

**2. Amended Decision No. 12189-(00/45), adopted April 28, 2000 (as amended)**

Section I.        *Principles of Burden Sharing*

1. The financial consequences for the Fund, which stem from the existence of overdue financial obligations shall be shared between debtor and creditor member countries.

2. The sharing shall be applied in a simultaneous and symmetrical fashion.

Section II.        *Determination of the Rate of Charge*

The rate of charge referred to in Rule I-6(4) shall be adjusted in accordance with the provisions of Sections III and IV.

...

Section IV. *Adjustment for Deferred Charges*

1. (a) If income from charges becomes deferred during an adjustment period as defined in (c), notwithstanding Rule I-6(4)(a) and (b) and Rule I-10, the rate of charge referred to in Rule I-6(4), and, subject to the limitation in (b), the rate of remuneration prescribed in Rule I-10, shall be adjusted in accordance with the provisions of this paragraph, so as to generate, in equal amounts, an additional amount of income equal to the amount of deferred charges. For the purposes of this provision, special charges on overdue financial obligations under Decision No. 8165-(85/189)G/TR, adopted December 30, 1985, shall not be taken into account.

(b) No adjustment in the rate of remuneration under this paragraph shall be carried to the point where the average remuneration coefficient would be reduced below 85 percent for an adjustment period.

(c) The adjustments under this paragraph shall be made as of the first day after each financial quarter beginning May 1, August 1, November 1 and February 1:

shortly after July 31 for the period May 1 to July 31;

shortly after October 31 for the period August 1 to October 31;

shortly after January 31 for the period from November 1 to January 31;

shortly after April 30 for the period from February 1 to April 30.

2. (a) An amount equal to the proceeds of any adjustment for deferred charges shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration, when, and to the extent that, charges, the deferral of which had given rise to the same adjustment, are paid to the Fund. Distribution under this provision shall be made quarterly.

(b) Distribution under (a) shall be made in proportion to the amounts that have been paid or have not been received by each member as a result of the respective adjustments.

(c) If a member that is entitled to a payment under this paragraph has any overdue obligation to the Fund in the General Department at the time of payment, the member's claim under

this paragraph shall be set off against the Fund's claim in accordance with Decision No. 8271-(86/74), adopted April 30, 1986, or any subsequent decision of the Fund.

(d) Notwithstanding paragraph 1(a) above, the rate of charge and the rate of remuneration determined under this section shall be rounded to ~~two~~ **three** decimals ~~places~~, provided that an adjustment of at least ~~one~~ **0.1** basis point shall be made to both the rate of charge and the rate of remuneration, subject to subparagraph (e) below.

(e) If the amounts generated as a result of paragraph 2(d) above exceed or fall short of the amounts to be generated from adjustments to the rate of charge or the rate of remuneration under paragraph 1(a) above for the relevant quarterly period, then any excess or shortfall from adjustments to the rate of charge <sup>11</sup> or the rate of remuneration shall be applied, respectively, to the amount to be generated from the adjustment to the same rate for the following quarterly period. No adjustment shall be made if any excess amount generated from the previous quarterly period is equal to or exceeds the amount needed in the following quarterly period.

Section V. *Review*

The operation of this decision shall be reviewed when the adjustment in the rate of remuneration reduces the remuneration coefficient to the limit set forth in paragraphs 2(b) of Section III and 1(b) of Section IV.



INTERNATIONAL MONETARY FUND



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### **IMF Executive Board Modifies Rule for Setting SDR Interest Rate**

On October 24, 2014, the Executive Board of the International Monetary Fund (IMF) amended the rule for setting the Special Drawing Right (SDR) interest rate by introducing a floor of 0.050 percent (5 basis points) and changing the rounding convention for calculating the SDR interest rate from two to three decimal places.

The Executive Board also made a corresponding change in the rounding convention for the burden sharing mechanism and reduced the minimum burden sharing adjustment from 1 basis point to 0.1 basis point.

In view of the prevailing interest rates today, the SDR interest rate for the next weekly period starting Monday, October 27, will be established at the floor of 0.050 percent.

#### **Background information:**

The SDR interest rate provides the basis for calculating the interest charged to members on nonconcessional IMF loans from the IMF's general resources, the interest paid to IMF members on their remunerated creditor positions in the IMF (reserve tranche positions and claims under borrowing agreements), and the interest paid to members on their SDR holdings and charged on their SDR allocation.

The SDR interest rate is determined weekly and is based on a weighted average of representative interest rates on short-term financial debt instruments in the money markets of the SDR basket currencies, except if the weighted average falls below the floor for the SDR interest rate of 0.050 percent (5 basis points).

Under the burden sharing mechanism, debtor and creditor members as a group share equally the cost of unpaid charges on outstanding IMF credit through adjustments to the rates of charge and remuneration.

For further information on the IMF's financial operations visit:  
<http://www.imf.org/external/pubs/ft/finop/2014/index.htm>