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5 The IMF's Income Model

This chapter explains the sources of income for the IMF. It elaborates on how the IMF has adapted its financial structure to finance its administrative expenditures. The IMF's income is generated primarily through its lending and investing activities (Figure 5.1).

Since its inception, the IMF has relied primarily on lending activities to fund its administrative expenses. Lending income is derived from the fees and charges levied on the use of credit from the General Resources Account (interest on loans). In addition to the basic rate of charge, the use of IMF credit is subject to surcharges under certain circumstances, and IMF credit from the General Resources Account is also subject to service charges and commitment fees on credit lines. A small amount of income is also generated by receipts of interest on the IMF's holdings of Special Drawing Rights (SDRs).

A number of measures have been taken to allow the IMF to diversify its sources of income, but the most significant changes have occurred during the past 10 years. In 1978, the Second Amendment of the IMF's Articles of Agreement authorized the IMF to establish an Investment Account (IA), but this account was not activated until after a review of the IMF's financial structure that began in 2004. In 2006, largely because of a significant deterioration in the IMF's income position that reflected a steep decline in credit outstanding, the Executive Board agreed on a set of measures to address a near-term projected income shortfall. These measures included activation of the Investment Account,[1] a pause in the accumulation of reserves, and the use of the IMF's existing reserves to meet the remaining income shortfall. In addition, the Executive Board requested an assessment of the full range of available options to place the IMF's income position on a sustainable footing for the long term. In response, the IMF appointed the external Committee of Eminent Persons (CEP) to study the "sustainable long-term financing of the Fund." The committee's final report was submitted to the Executive Board on January 31, 2007.[2]

A proposal that reflected most of the committee's recommendations was endorsed by the Executive Board in April 2008. The reforms allowed the IMF to diversify its sources of income through the establishment of an endowment within the Investment Account, to be funded with the profits from a limited sale of the IMF's gold holdings and income generated under a broadened investment authority. At the same time, the Executive Board endorsed a resumption of the practice of reimbursing the IMF for the expenses incurred in administering concessional lending activities through the Poverty Reduction and Growth Trust (PRGT).[3]

Broadening the IMF's investment authority required an amendment to the Articles of Agreement, and in February 2011, that

[1] In June 2006, the Investment Account was activated with a transfer from the General Resources Account of about SDR 5.9 billion.

[2] "The Report to the Managing Director by the Committee of Eminent Persons on the Sustainable Long-Term Financing of the Fund" is available at www.imf.org/external/np/oth/2007/013107.pdf.

[3] The General Resources Account is reimbursed annually for expenses incurred in conducting the business of the SDR Department, administering the PRGT (unless waived), and administering Special Disbursement Account (SDA) resources in the Catastrophe Containment Relief (CCR) Trust. Reimbursements for the CCR Trust cover only expenses not attributable to other accounts or trusts administered by the IMF.

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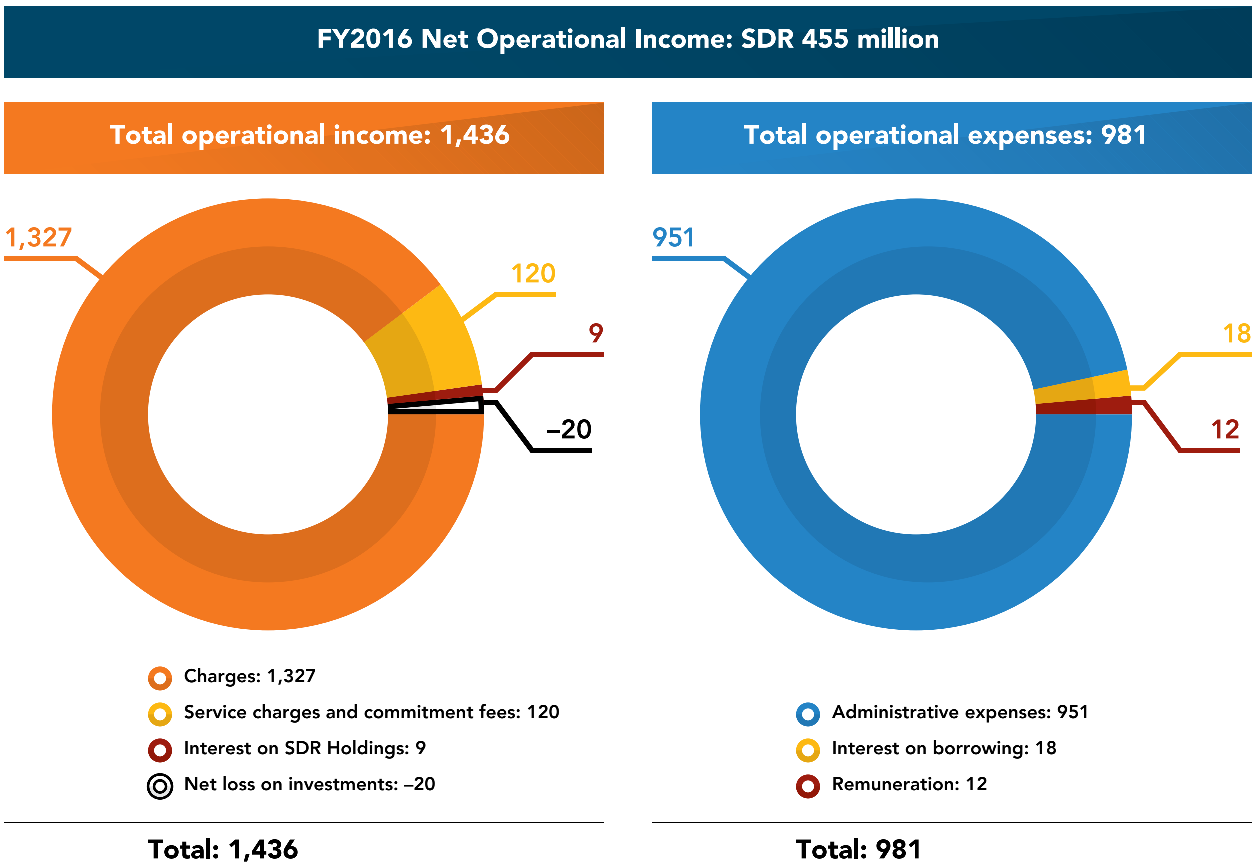
Figure 5.1 Snapshot of the IMF Income Statement
(Millions of SDRs; as of April 30, 2016)



Source: Finance Department, International Monetary Fund.

amendment (the Fifth Amendment) became effective, following ratification by the membership with the required majority of voting power. Currencies in an amount equivalent to the profits from the limited sale of IMF gold in the amount of SDR 6.85 billion were transferred from the General Resources Account to the Investment Account in March 2011.[4] The amendment gave the IMF authority to invest the gold endowment in a broader range of instruments. The new Rules and Regulations for the Investment Account reflecting the expanded investment authority went into effect in January 2013 and were amended in March 2014 and August 2015.[5]

The remainder of this chapter discusses the IMF's income position by elaborating on how income is generated from lending, explaining how the basic rate of charge is set, and describing various charges under the General Resources Account. The chapter then traces the development of the new income model including the creation of an endowment with the profits from the limited gold sale and the IMF's expanded investment authority. Next, it describes the subaccounts of the Investment Account and includes details on portfolio allocation, eligible instruments, and risk controls.

5.1 Lending Income

The IMF's operational lending income is derived from the marginal return on the rate of charge (the interest rate assessed on IMF financing), services charges, and commitment fees. A multitiered system of charges compensates the IMF for the cost of its financing to members and is an important component of the institution's

[4] In December 2010, the IMF concluded the gold sales after total sales of 403.3 metric tons of gold (12.97 million ounces), as authorized by the Executive Board. The gold sales realized profits of SDR 6.85 billion, of which SDR 4.4 billion was used to establish an endowment as stipulated under the new income model. SDR 2.45 billion constituted the "windfall profit." (See Chapter 2 for additional details.)
[5] See Rules and Regulations for the Investment Account (2015): www.imf.org/external/np/pp/eng/2015/082815.pdf.

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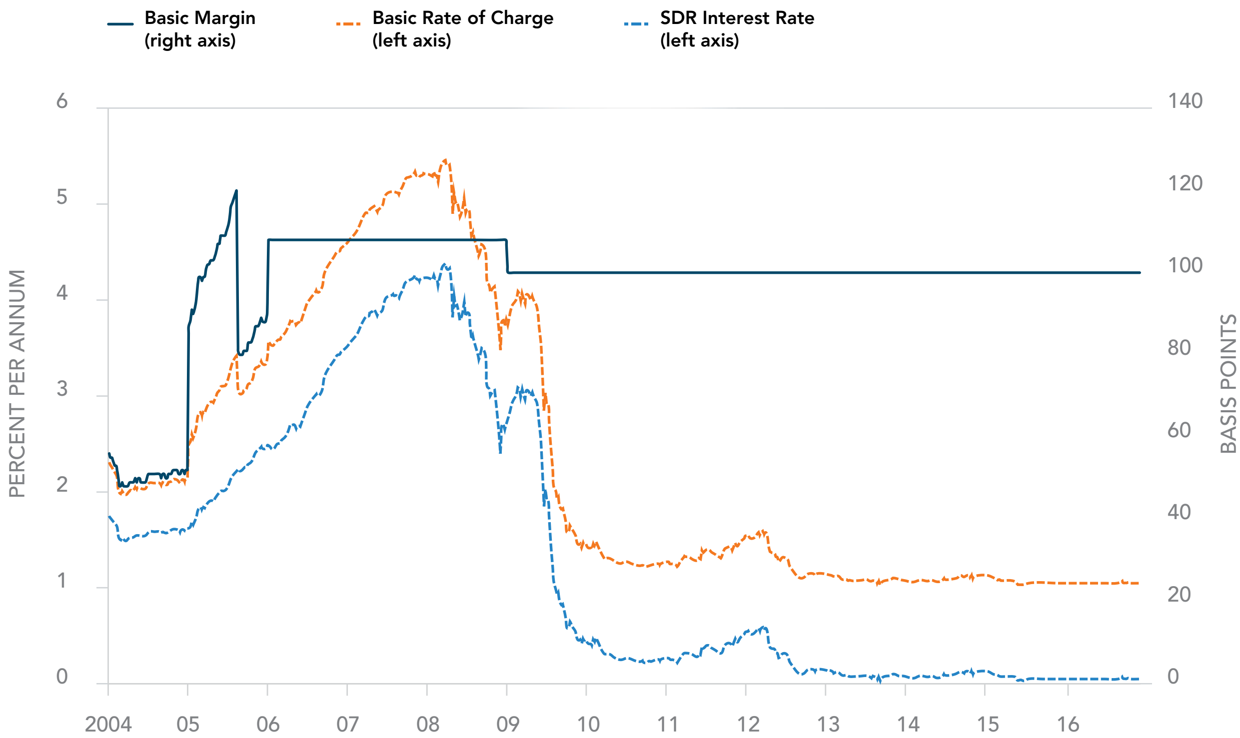
Figure 5.2 Weekly Interest Rates and Margins, 2004–16
(Percent and basis points)



Source: Finance Department, International Monetary Fund.

risk-mitigation framework.[6] The cost of financing includes remuneration to creditors and administrative costs associated with lending. The basic rate of charge comprises the SDR interest rate plus a fixed margin that is set by the Executive Board every 2 years (subject to a midterm review). The margin is expressed in basis points. The margin is established under a new rule for setting the basic rate of charge adopted by the Executive Board in December 2011 (Box 5.1). The rule, effective for FY2013, was an important step in full implementation of the new income model, under which the margin is set to cover the IMF's lending-related intermediation costs and allow for a buildup of reserves. In addition, the rule includes a cross-check to ensure that the rate of charge remains reasonably aligned with long-term credit market conditions.[7]

The rule was designed to move away from a reliance on lending income to finance the IMF's nonlending activities. However, investment income, which is now the main source of nonlending income, is currently constrained by much lower-than-normal global interest rates amid highly accommodative monetary policies aimed at supporting economic activity in the wake of the global financial crisis. As a result, nonlending income is unlikely to be sufficient to cover short- and medium-term nonlending expenses. Therefore, since FY2013/14, the margins have been adopted under a clause in the rule that, in exceptional circumstances, allows a margin for calculating the basic rate of charge to be set at a level other than is needed to cover the IMF's intermediation expenses and to generate an amount of net income for placement in reserves. Consistent with the Board-endorsed principle that the margin should be stable and predictable, the margin is set for a period of 2 financial years, subject to a comprehensive review before the end of the first year. For FY2015/16 and FY2017/18, the Executive Board agreed to keep the margin for the rate of charge unchanged at 100 basis points (Figure 5.2).

Surcharges are an important component of the IMF's risk-mitigation framework, and they contribute to net income and create incentives for member countries to avoid large and prolonged access to the IMF's lending resources. The system of surcharges is based on the level amount of credit (level-based surcharges) and

[6] The Articles of Agreement provide little guidance on setting charges except to indicate that rates of charge must be uniform for all members and should increase the longer credit is outstanding (Article V, Section 8).
[7] Burden-sharing adjustments are applied to the basic rate of charge (as well as the rate of remuneration) to compensate the IMF for lost income resulting from unpaid charges of members in arrears.

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the length of repayment (time-based surcharges). The policy on level- and time-based surcharges, introduced in 2009, replaced the previous Time-Based Repurchase Expectation Policy (TBRE) (Box 5.2). A core objective of the 2009 reforms was to simplify the complex system of surcharges that varied across facilities and provide stronger incentives for early repayment. Following the review of the surcharge policy in February 2016, the surcharge is set at 200 basis points on outstanding credit above 187.5 percent of quota, resulting from purchases in the credit tranches and under the Extended Fund Facility (EFF). An additional time-based surcharge of 100 basis points applies when that credit has been outstanding for more than 36 months in the case of purchases in the credit tranches, or more than 51 months in the case of purchases under the EFF. These level- and time-based surcharges are intended to help mitigate credit risk by providing members with incentives to limit their demand for IMF assistance and encourage timely repayments, while at the same time allowing the IMF to accumulate precautionary balances. Taken together, level- and time-based surcharges are calibrated to be broadly aligned with the market costs of borrowing for members emerging from balance of payments difficulties. Surcharge policies are reviewed by the Executive Board on an as-needed basis, and the last review took place in 2016.

In addition to periodic charges and surcharges, the IMF levies service charges, commitment fees, and special charges. A service charge of 0.5 percent is levied on each drawing from the General Resources Account (GRA). A commitment fee is also charged on amounts available under all GRA arrangements, such as Stand-By Arrangements, the Extended Fund Facility, Flexible Credit Line, and Precautionary and Liquidity Line. The fee is refundable if purchases are made under the arrangement during the period covered by the fee.

The rationale for charging a commitment fee for contingent credit is to compensate the IMF for the cost of establishing and processing potential lending arrangements (which may not be actually drawn upon), including the monitoring of precautionary arrangements as well as for the cost of setting aside resources to be used when a purchase is made. Commitment fees are levied at the beginning of each 12-month period on the amounts available for purchase during that period. The fees are refunded when credit is used, in proportion to the drawings made. The current upward-sloping fee structure was introduced as part of the broader 2009 GRA lending toolkit reform, with the aim of discouraging unnecessarily high precautionary access (Box 5.3), and the thresholds were reviewed and revised by the Executive Board in 2016. The current commitment fee structure has three tiers that rise along with amounts available for purchase as a percent of the member country's quota. Commitment fees are levied at 15 basis points on amounts available up to 115 percent of a member's quota, 30 basis points on amounts in excess of 115 percent and up to 575 percent of quota, and 60 basis points on amounts in excess of 575 percent of quota.

5.2 The New Income Model

Historically, the IMF has relied almost entirely on income from lending to meet the expenses incurred in conducting its business, including expenses for its nonlending activities. This meant that the IMF's net income was largely dependent on interest and charges on lending to members, along with surcharge income and other charges. The activities supported by this income, many of which carry significant costs, include multilateral and bilateral surveillance, crisis prevention, research, gathering and reporting statistics, capacity building (including technical assistance and training), and concessional lending to low-income countries. Relying primarily on lending income to support these critical activities was not sustainable when credit outstanding declined, nor was it equitable for the cost of these activities to be borne primarily by those members receiving IMF financing from the General Resources Account.

In March 2006, the IMF's Executive Board agreed on a two-pronged strategy to adapt the IMF's financing model to changing circumstances and future needs. The first prong addressed a looming shortfall in income for FY2007. The Board agreed on a package of measures that included the establishment and activation of the Investment Account, a pause in the accumulation of reserves, and the use of the IMF's existing reserves to meet any remaining income shortfalls. No changes in these income policies were made for FY2008, which was considered a transitional year during which a new income model would be developed.

The second prong of the strategy was to ensure a lasting framework for meeting the institution's income needs over the long term. The IMF appointed an external Committee of Eminent Persons to study the issue (Box 5.4). The committee's final report on "Sustainable Long-Term Financing of the IMF" was submitted to the Managing Director on January 31, 2007.

5.2.1 Features of the New Income Model[8]

Taking into consideration the report by the Committee on Eminent Persons, in April 2008 the Executive Board endorsed a new income model based on more robust and diverse sources of revenue that reflected the IMF's multiple functions (Figure 5.3). This marked the first major change in the way the IMF generates income since its establishment. The package contained the following income-generating initiatives:

- Create an endowment with the profits from the sale of 403.3 metric tons of the IMF's gold holdings to help diversify the sources of income. This amounted to one eighth of the IMF's total holdings of gold (see Section 2.3.3.3 IMF Gold Sales).
- Amend the Articles of Agreement to broaden the IMF's investment authority to enhance the average expected return

[8] The IMF's New Income and Expenditure Framework—Frequently Asked Questions: www.imf.org/external/np/exr/faq/incfaqs.htm.

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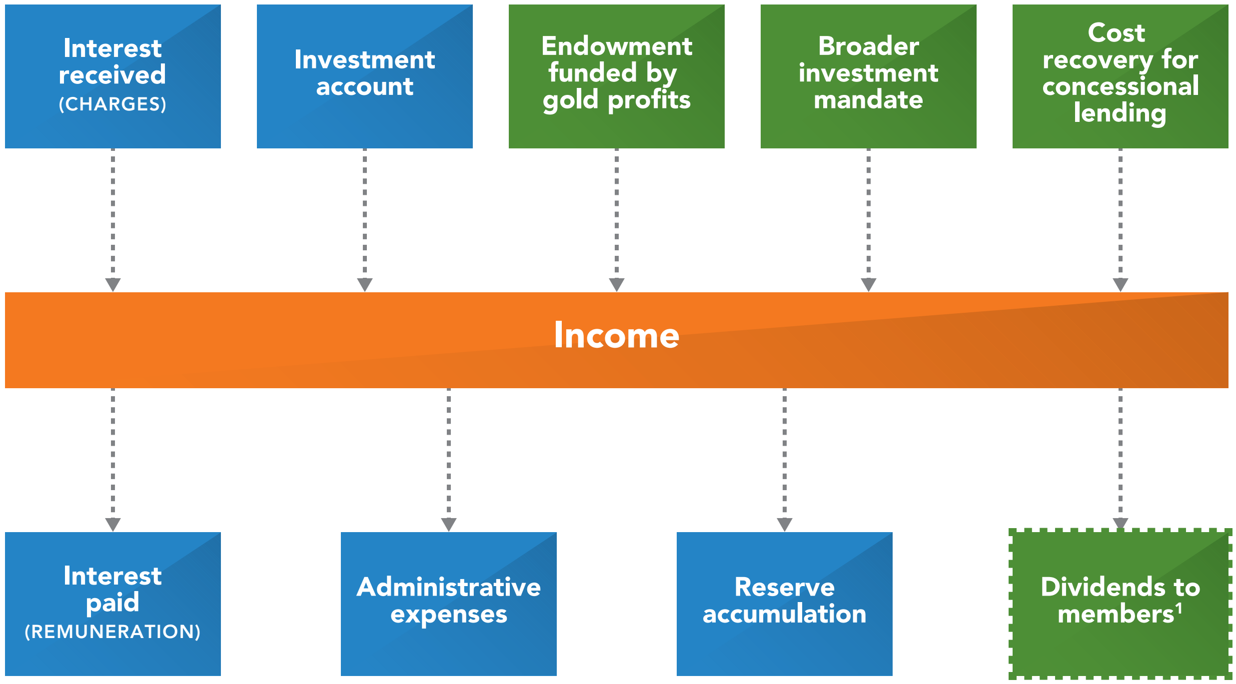
Figure 5.3 The IMF's New Income Model

The IMF implemented a plan to draw on additional revenue sources to better align the IMF's income model with its activities.



Source: Finance Department, International Monetary Fund.
Note: Green boxes represent new elements.
[1] As of April 30, 2016, the Dividend policy had not been adopted by the membership.

on investments and enable the IMF to adapt its investment strategy over time.

- Resume the long-standing practice of reimbursing the IMF's budget for the cost of administering the trust fund for concessional lending to low-income countries from the Poverty Reduction and Growth Trust, while retaining the IMF's capacity to provide concessional lending to low-income countries.

One element of the new income model is expansion of the IMF's investment authority, which allows it to generate higher returns. The Fifth Amendment to the Articles of Agreement of the International Monetary Fund to Expand the Fund's Investment Authority entered into force in February 2011.[9] The Board of Governors approved that the Fund's Articles of Agreement be amended to broaden the range of instruments in which the Fund may invest. Such an expansion of the Fund's investment authority would enable the Fund to adapt its investment strategy over time without the need of further amendments to the Articles. Given the public nature of the funds to be invested, the implementation of a broader investment authority would be conducted pursuant to investment policies that take into account, among other things, a careful assessment of acceptable levels of risks. It would also include safeguards aiming to minimize actual or perceived conflicts of interest. Finally, it was recognized that the evolution of the Fund's investment policies would need to proceed gradually. To this end, on January 23, 2013, the Executive Board adopted the new Rules and Regulations for the IMF's Investment Account that provided the legal framework for implementation of the expanded investment authority, focusing first on the Endowment Subaccount. The Rules and Regulations were amended in March 2014 to include a technical amendment refining the portfolio rebalancing rule and were further amended in August 2015 to reflect the expanded investment strategy approved by the Executive Board for the assets in the Fixed-Income Subaccount.[10]

[9] IMF's Broader Investment Mandate Takes Effect: www.imf.org/external/np/sec/pr/2011/pr1152.htm.

[10] The Rules and Regulations for the Investment Account—adopted January 2013, and amended March 2014 and August 2015: www.imf.org/external/pp/longres.aspx?id=4734.

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5.3 Investment Income

The Second Amendment to the IMF's Articles of Agreement in 1978 authorized the IMF to establish an Investment Account in order to generate income from other sources.

The Investment Account was established by the Executive Board in 2006 in order to broaden the IMF's income base. It was originally funded through the transfer of currencies from the General Resources Account in an amount equivalent to the total amount of the IMF's General and Special Reserves at the time of the decision authorizing the transfer (SDR 5.9 billion).[11] This was the maximum transfer allowed by the Articles of Agreement.

While establishing the Investment Account was an important step toward reducing the IMF's medium-term financing gaps and diversifying its income, achieving a sustainable income position for the long-term required additional measures. As discussed in Section 5.2, to address this need, and following the proposals of the Committee of Eminent Persons, the Executive Board endorsed the new income model that included, among other things, the broadening of the investment authority and establishment of an endowment funded by limited gold sales (see Section 2.3) with new Rules and Regulations for the Investment Account.

Prior to the effectiveness of the Fifth Amendment in 2011, the Articles of Agreement were the main reference for the investment framework by specifying a list of eligible instruments and issuers into which the IMF could invest its own resources, and when the CEP prepared its report, it noted that the list was more restrictive than practices found within other international financial institutions.[12]

With the Fifth Amendment authorizing the broadened investment authority of the Investment Account, the Executive Board adopted new Rules and Regulations for the Investment Account in January 2013. The rules initially focused on the Endowment Subaccount and were amended in August 2015 to apply the broadened investment authority to the Fixed-Income Subaccount. The new Rules and Regulations for the Investment Account specify the objective of the Investment Account and the broad principles governing its operations. They establish two portfolios (subaccounts), define the investment objective of each portfolio, outline potential uses of investment income, and provide guidelines for investing the assets. They also further define the governance framework, including delegating the implementation of the investment policies set out in the Rules and Regulations to the Managing Director, while ensuring that the Executive Board is provided with regular and ad hoc reports on the operations and investment activities of the Investment Account and consulted on key topics, including conflict of interest policies. Finally, the Rules and Regulations also set out key principles to mitigate the risks of perceived or actual conflicts of interest.

5.3.1 Subaccounts

The Investment Account has two subaccounts, each with its own investment objectives: the Fixed-Income Subaccount, and the Endowment Subaccount. As noted, the Investment Account was originally funded through the transfer from the GRA in an amount equivalent to the total amount of the Fund's General and Special Reserves at the time (SDR 5.9 billion). The Fixed-Income Subaccount was created in 2013 when the new Rules and Regulations were adopted. All Investment Account assets not attributed to profits from gold sales were placed in this Subaccount and continued to be invested under the mandate originally established in 2006. The Endowment Subaccount was funded in January 2013 with SDR 4.4 billion in profits from gold sales.[13] As of April 2016, the IMF's investment portfolios in the Investment Account totaled SDR 15.0 billion, which are divided between the Fixed-Income Subaccount (SDR 10.4 billion) and the Endowment Subaccount (SDR 4.6 billion).

5.3.1.1 INVESTMENT OBJECTIVES

As outlined in Table 5.1, each Subaccount in the Investment Account has different objectives and pursues different investment strategies. With a view to generating income while protecting the Fund's balance sheet, the investment objective of the Fixed-Income Subaccount is to achieve investment returns in SDR terms that exceed the 3-month SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of three to four years. The investment objective of the Endowment Subaccount is to achieve a long-term real return target of 3 percent in U.S. dollar terms. This is consistent with the overall objective for the Investment Account of generating investment returns to provide a meaningful contribution to the IMF's income while preserving the long-term real value of these resources.

[11] Under the Articles of Agreement, the Investment Account may be funded with transfers of a part of proceeds from the sale of the IMF's gold and of currencies held in the General Resources Account, provided that the amount of these transfers may not exceed the total amount of the IMF's General and Special Reserves at the time of the transfer decision.

[12] Section 6(f) (iii) of the former Article XII (amended later in 2011) prescribed that "The Fund may invest a member's currency held in the Investment Account in marketable obligations of that member or in marketable obligations of international financial organizations. No investment shall be made without the concurrence of the member whose currency is used to make the investment. The Fund shall invest only in obligations denominated in special drawing rights or in the currency used for investment."

[13] In 2011, SDR 6.85 billion from the profit of sale of IMF gold was transferred to the Investment Account. Of that, SDR 4.4 billion was used to fund the Endowment Subaccount and the remainder was placed in the Temporary Windfall Profits Subaccount. In February and September 2012, the Executive Board approved the distribution of SDR 0.7 billion and SDR 1.75 billion, respectively, from the General Reserve to IMF members, to become effective once members provided satisfactory assurances of new subsidy contributions in an amount equivalent to at least 90 percent of the distribution to the PRGT, including through transfers of their share in the distributions directly to the PRGT. Assurances were obtained during 2012 and 2013, and the Temporary Windfall Profits Subaccount was wound down in October 2013. This followed the re-transfer of resources from the Temporary Windfall Profits Subaccount to the General Reserve and two reserve distributions in October 2012 and October 2013, respectively.

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Table 5.1 Investment Account Subaccounts

Fixed-Income Subaccount	Endowment Subaccount
Funded in June 2006 with SDR 5.9 billion.	Funded in January 2013 with SDR 4.4 billion.
Assets under management as of April 30, 2016, totaling SDR 10.4 billion.	Assets under management as of April 30, 2016, including cash to be invested, totaling SDR 4.6 billion.
Funded by transfers of currencies from the General Resources Account (GRA) in amounts equivalent to the IMF's total reserves as of June 2006, plus subsequent transfers of GRA net income not associated with gold profits.	Funded with gold profits (other than windfall profits), as part of the new income model aimed at diversifying the IMF's income sources.
Investment Objective: to achieve returns in SDR terms that exceed the 3-month SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of 3 to 4 years.	Investment Objective: to achieve a long-term real return target of 3 percent in U.S. dollar terms. This is consistent with the objective of generating investment returns to contribute to the IMF's income while preserving the long-term real value of these resources.
Assets are gradually transitioned from the previous strategy anchored to an SDR-weighted 1- to 3-year government bond benchmark, to a high-quality fixed-income portfolio with two tranches, a short-duration and prudently diversified tranche and a longer-duration buy-and-hold tranche mainly composed of highly rated government bonds.	Once fully funded, assets will be managed against a conservative diversified benchmark with a 65 percent share of global fixed-income instruments and 35 percent share for global equities (including real estate investment trusts).
5-year phased-in implementation for the longer-duration buy-and-hold tranche to minimize market timing and interest rate risk and with a view to mitigating any risks of perceptions of conflicts of interest.	3-year phased-in implementation for the passively managed portion, ending December 2016 to minimize market risk and with a view to mitigating any risks of perceptions of conflicts of interest. It is expected that the cash holdings for the actively managed portion will be invested in FY2017.

Source: Finance Department, International Monetary Fund.

5.3.1.2 ELIGIBLE INSTRUMENTS, ASSET ALLOCATION, AND INVESTMENT STRATEGY

In August 2015, the Executive Board approved an amendment to the Rules and Regulations for the Investment Account to implement a modification of the investment strategy for the Fixed-Income Subaccount.[14] With the 2015 amendment, the Fixed-Income Subaccount will gradually transition to a more diversified portfolio. The amendment created two tranches of the of the Fixed-Income Subaccount of roughly equal sizes. The shorter duration Tranche 1 will be managed actively against a 0- to 3-year government bond benchmark index, weighted to reflect the currency composition of the SDR basket. The longer duration Tranche 2 will be managed according to a buy-and-hold approach against a 0- to 5-year government bond benchmark index, weighted to reflect the currency composition of the SDR basket. To minimize market timing and interest rate risk and with a view to mitigating any risks of perceptions of conflicts of interest, investments in Tranche 2 will be phased in over 5 years.

Both tranches may be invested in sovereign bonds, securities of members' national agencies and other international financial institutions, and obligations of the BIS—all of which must be denominated in SDR or a SDR basket currency. Tranche 1 may also be invested, up to 35 percent of the total value of the Fixed-Income Subaccount assets, in sovereign bonds denominated in non-SDR currencies (subject to the requirement to hedge back to SDR currencies) and in other fixed-income securities denominated in SDR or a SDR basket currency, including subnational government bonds, mortgage-backed securities, asset-backed securities, covered bonds, corporate bonds, and cash instruments.

Securities in the Fixed-Income Subaccount must have a minimum credit rating equivalent to A (based on Standard & Poor's long-term rating scale), with higher minimum credit ratings expected for certain asset classes. Hedging with derivative instruments is strictly monitored and required for managing the currency risk in the case of allocations to non-SDR basket currencies. Short selling, or any form of financial leverage is prohibited. Pending the gradual implementation of this new strategy, assets in the Fixed-Income Subaccount will remain invested in medium-term instruments issued by the BIS and managed by IMF staff, and in externally managed sovereign bond portfolios.

With respect to the Endowment Subaccount, by the end of the 3-year phase-in period in December 2016, at least 90 percent of assets will be managed passively under mandates that require the external managers to closely track benchmark indices, pursuant to a strategic asset allocation benchmark that includes 20 percent in developed market sovereign bonds, 20 percent in developed market inflation-linked bonds, 15 percent in developed market corporate bonds, 10 percent in emerging market bonds, 25 percent in developed market equities, 5 percent in emerging market equities, and 5 percent in real estate investment trusts (REITs).

[14] Prior to the amendment, eligible assets in the Fixed-Income Subaccount were limited to marketable obligations of members, their official agencies, and international financial organizations. The latter includes deposits and Medium-Term Instruments with the Bank for International Settlements (BIS). The investment strategy was anchored to a customized 1- to 3-year government bond benchmark index comprising bonds denominated in dollars, euros, pounds sterling, and Japanese yen, weighted to reflect the composition of the SDR basket.

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Initially, 5 percent of the Endowment Subaccount assets will be managed actively, and this portion of the Endowment Subaccount is limited to a maximum of 10 percent of its total assets. The actively managed portion may be invested only in the same asset classes as the strategic asset allocation benchmark for the passively managed portion, with a 65 percent share of fixed-income instruments and a 35 percent share for equities including REITs, but with no specific allocation requirements for each asset class within these two categories.

Short selling and any form of financial leverage as well as direct investment in gold are prohibited in the Investment Account. Derivative instruments, including options, forwards, futures, and swaps, are allowed for the passively managed portion of the Endowment Subaccount only for operations authorized under the Rules and Regulations and to minimize transaction costs in the context of subaccount rebalancing and for benchmark replication. For the actively managed portion of the Endowment Subaccount, broader use of derivatives is permitted subject to adequate risk control parameters.

5.3.1.3 RISK CONTROLS

The investment mandates for the Investment Account's asset managers explicitly set limits based on a range of acceptable risk exposures, including for risks related to interest rates, foreign exchange, liquidity, credit, and the operation of the Investment Account itself. Mechanisms are in place to monitor compliance. The following portfolio-specific risk controls apply.

FIXED-INCOME SUBACCOUNT

Interest rate risk in this portfolio, which is the risk of fluctuations in a portfolio's market value due to changes in market interest rates, is controlled by the short-duration portfolio that will gradually move to a 0- to 3-year benchmark index for Tranche 1 while a 0- to 5-year benchmark index will apply for Tranche 2. It is expected that this level of interest rate exposure along with some diversification, tranching, and phasing will provide an efficient tradeoff between risk and return, resulting in returns that exceed the SDR interest rate under most market conditions. Going forward, cautious diversification is intended to strengthen the resilience of the portfolio across varying market conditions and minimize the risk of permanent impairment of capital.

There is some, albeit very limited, foreign exchange risk in the Fixed-Income Subaccount portfolio because the investments are not made in SDRs but in securities denominated in the currencies comprising the SDR basket. Going forward, foreign exchange risks will also remain limited when the new strategy is fully implemented in 2016, as any sovereign bonds denominated in a currency outside of the SDR basket will be hedged back to a currency in the SDR basket. More specifically, exchange rate risk is limited to the portfolio deviations from the SDR basket that occur due to different investment performance in each of the constituent currencies' investments—in other words, interest rates moving differently in each region, leading to relative over- or underperformance of, for example, the euro-denominated bonds compared with dollar-denominated bonds. Any such over- or underperformance carries a residual out-of-alignment risk from the relative weight of the investment in a particular currency compared with the currency's weight in the SDR basket. To control such currency risk, the weight of each currency in the portfolio is adjusted to reflect its weight in the SDR basket through a regular rebalancing of the portfolio.

Liquidity risk is small given the low likelihood of a call on the Fixed-Income Subaccount assets and the high credit quality and liquid nature of the investments.

Pending the gradual transition to the new investment strategy, credit risk is similarly limited in a portfolio that currently features BIS deposits and Medium-Term Instruments, the securities of highly rated international financial organizations, and the domestic government bonds of countries whose currencies are included in the SDR basket. Under the expanded investment strategy, credit risk will be tightly monitored, notably through stringent rating requirements and concentration limits.

ENDOWMENT SUBACCOUNT

Although the Endowment Subaccount assets are exposed to a wide variety of market risks, these are controlled by the diversification by geography and asset classes. To control asset class exposure in the larger, passively managed portion, the portfolio must be rebalanced to the strategic asset allocation benchmark at least annually or when the weights of any of the asset classes move beyond a certain threshold. In the smaller, actively managed portion, the portfolio may only deviate from its 65/35 global fixed-income/equity split within specified parameters. The impact of foreign exchange volatility in the passively managed portion is also controlled through mandatory hedging of part of the assets back to the base currency, the U.S. dollar. Furthermore, the Rules and Regulations set a prohibition on short selling and financial leverage activities and set minimum credit-rating thresholds of BBB– for corporate bonds and BBB+ for sovereign bonds.

OPERATIONAL RISKS IN THE INVESTMENT ACCOUNT

Operational risk is controlled by carefully structured due diligence reviews of external investment managers and custodians, the checks and balances inherent in the reconciliation of portfolio valuation by managers and the custodian, and stringent performance measurement and reporting requirements.

5.3.2 The Use of Investment Income

The Executive Board normally decides every financial year how the Investment Account income will be used, including whether it may be invested, retained in the Investment Account, or transferred to the General Resources Account to meet the expenses involved in conducting the business of the IMF.

The earnings of the Investment Account and its potential contribution to the IMF's operating expenses depend on the size of

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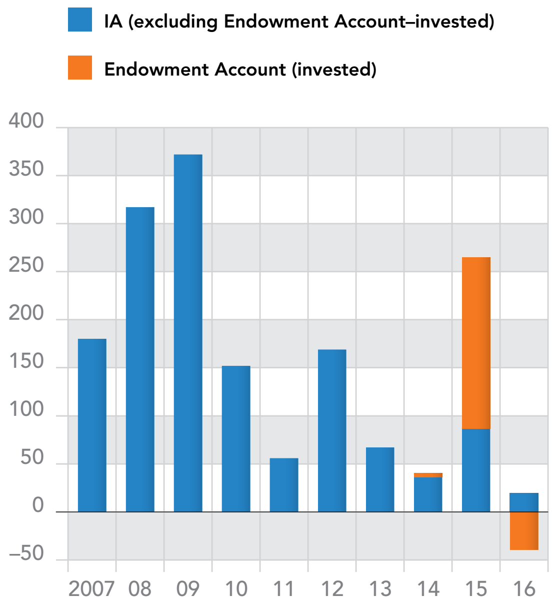
Figure 5.4 Earnings of the Investment Account
(Millions of SDRs)



Source: Finance Department, International Monetary Fund.

the portfolio and the performance of its investments. Since its inception, the returns have made a visible and positive contribution (Figure 5.4).

5.4 Reimbursements to the General Resources Account

The General Resources Account is reimbursed annually for the expenses incurred in conducting the business of the SDR Department and administering Special Disbursement Account resources in the Catastrophe Containment and Relief (CCR) Trust. Reimbursement to the GRA from the CCR Trust is for expenses not already attributable to other accounts or trusts administered by the IMF or to the GRA. The framework for the Poverty Reduction and Growth Trust (PRGT) also provides for the reimbursement of the GRA for the expenses of conducting the business of the PRGT, though there have been suspensions in previous years. In FY2013, the practice of reimbursing the GRA for the expenses of conducting the business of the PGRT resumed (see Chapter 3). This reimbursement is an important element of the IMF's new income model, and its resumption was part of the financing strategy for the PRGT that was approved in September 2012, which was directed toward putting concessional lending on a self-sustaining basis over the long term.

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Box 5.1 Setting the Margin for the Basic Rate of Charge

The basic rate of charge on lending is a key element of the IMF's financial operations. It is composed of the SDR interest rate, which is also the remuneration paid to creditors, and a margin, to cover the cost of IMF financing to members as well as to help accumulate reserves. In addition, the rate of charge plays an important role, together with surcharges on lending, in creating incentives for timely repayment, thus helping to preserve the revolving nature of IMF resources.

Until FY2007, decisions on the margin were driven primarily by the need to cover the Fund's administrative expenses and accumulate reserves. The margin was set based on the level of income needed to cover projected expenses and meet a net income target (specified as 5 percent of IMF reserves at the beginning of the financial year from FY1985 to FY2006).[1] However, due to the sharp decline in credit outstanding by the mid-2000s, this approach would have implied a margin of over 350 basis points for FY2007—a level that would have made the cost of borrowing from the IMF relatively expensive. In response, an 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 estimated income and expenses.[2] In addition, the Executive Board began to take steps to broaden the IMF's income sources with the establishment of the Investment Account in April 2006.[3]

In April 2008, the Executive Board adopted decisions to reform the IMF's income model. 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 IMF's activities but should instead be set as a margin over the SDR interest rate to cover the IMF's intermediation costs and allow for a buildup of reserves.
- 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 IMF does not become too expensive or too low relative to the cost of borrowing from the market.

In line with these principles, in December 2011 the Executive Board adopted a new framework for setting the basic rate of charge.[4] It became effective on May 1, 2012, and includes the following elements:

1) The rate of charge shall be determined as the SDR interest rate plus a margin expressed in basis points. The margin shall be set at a level that is adequate (a) to cover the estimated intermediation expense of the IMF for the period under (2) below, taking into account income from service charges, and (b) to generate an amount of net income for placement to reserves. The appropriate amount for reserve contribution is assessed by 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.

2) 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 incurred by the IMF and to generate an amount of net income for placement to reserves. This new exceptional circumstances clause is to provide a safeguard that would allow the Executive Board to set the margin on a basis other than that required to cover intermediation costs and allow for a buildup of reserves, should income from other sources be insufficient to cover the administrative expenses for the nonlending activities of the Fund.

3) The margin shall be set for a period of 2 financial years. A comprehensive review of the income position shall be held before the end of the first year of each 2-year period and the margin may be adjusted in the

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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 2-year period.

[1] This approach was adopted in FY1981 when the IMF reformed a fairly complex schedule of charges. From FY1981 to FY1984, the net income target was set at 3 percent of the Fund's reserves.

[2] For 2007 and 2008, the Executive Board kept the margin unchanged from the FY2006 level of 108 basis points under the exceptional circumstances clause of Rule I-6(4). The IMF suffered net income shortfalls of SDR 83 million and SDR 127 million in FY2007 and FY2008, respectively.

[3] Establishment of the Investment Account (4/17/06). In June 2006, currencies in the amount of SDR 5.9 billion, equivalent to the IMF's total reserves at the end of FY2006, were transferred from the General Resources Account to the Investment Account.

[4] "A New Rule for Setting the Margin for the Basic Rate of Charge," IMF Policy Paper, November 2011. www.imf.org/external/pp/longres.aspx?id=4622.

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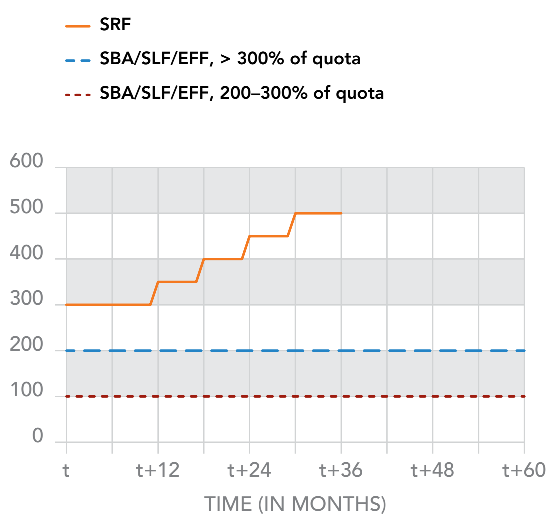
Box 5.2 Evolution of Surcharges

Surcharges were introduced in 1997 with the establishment of the Supplemental Reserve Facility (SRF).[1, 2] Applying only to the SRF, a time-based structure of surcharges and short-term maturities was designed to incentivize early repayment by members with exceptional access that were experiencing capital account crises. In 2000, level-based surcharges were introduced on purchases in the credit tranches and under extended arrangements starting at 200 percent of quota to discourage unduly high access. Considerations were given to thresholds of 300 percent (consistent with the upper limit of "normal" access), and 100 percent, to capture more prolonged users of IMF resources and allow for a more graduated charge. In the end, the Executive Board adopted a threshold in between starting at 200 percent of quota and with a two-step increase in the rate. A schedule of time-based repurchase expectations was introduced at the same time, from which a member could request an extension to the maximum allowed under the repurchase obligation schedule. This resulted in a complicated system of surcharges and maturities, as illustrated in the figure and table.

In 2009, surcharges were streamlined and aligned across facilities to simplify the structure of charges and to eliminate sources of misalignment of terms across facilities.[3] At the same time, the time-based repurchase expectations policy was eliminated and replaced by applying time-based surcharges on credit outstanding for more than 36 months under all General Resources Account facilities, which was deemed more effective and transparent. In conjunction with the new time-based surcharge, the new single level-based threshold was set at the previous upper step of 300 percent of quota. The reform also eliminated the Supplemental Reserve Facility, which had been the only facility on which time-based surcharges had been levied.

Surcharge Structure before 2009

Basis points



Source: Finance Department, International Monetary Fund.
Note: EFF = Extended Fund Facility; SBA = Stand-By Arrangement; SLF = Short-Term Liquidity Facility; SRF = Supplemental Reserve Facility.

Repurchase Expectations Policy before 2009

	Repayment period (in years)	
Facility	Expectations basis	Obligation basis[1,2]
Credit tranches	2¼–4	3¼–5
EFF	4½–7	4½–10
SRF	2–2½	2½–3
SLF	n.a.	3,6, or 9 months

Source: Finance Department, International Monetary Fund.

Note: EFF = Extended Fund Facility; SRF = Supplemental Reserve Facility: SLF = Short-Term Liquid Facility.

[1] For the credit tranches and the EFF, a member whose external position has not improved sufficiently to meet the expectations schedule without undue hardship or risk could request an extension.

[2] For the SRF, extensions provided if: (1) the member is unable to meet the repurchase expectation without undue hardship, and (2) the member is taking actions to strengthen its balance of payments.

The current surcharge policy adopted in February 2016 sets a surcharge of 200 basis points on credit outstanding more than 187.5 percent of quota resulting from purchases in the credit tranches and under the Extended Fund Facility (EFF). An additional time-based surcharge of 100 basis points applies to credit outstanding for more than 36 months in

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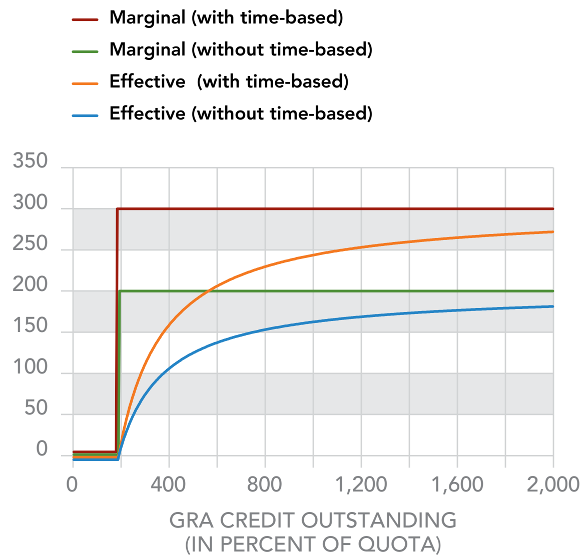
the case of purchases in the credit tranches, or 51 months in the case of purchases under the EFF. The difference in the starting point of time-based surcharges between purchases under the credit tranches and those under the EFF aims to achieve alignment of the surcharges with the start of repurchases (54 months under extended arrangements) and the nature of the balance of payments needs specific to the EFF.[4]

Current Surcharge Schedule

Basis points



Source: Finance Department, International Monetary Fund.
Note: GRA = General Resources Account.

[1]See Annex I of the Review of Charges and Maturities—Policies Supporting the Revolving Nature of Fund Resources (5/24/05).

[2]Prior to 1981, when a flat rate of charge was introduced for all IMF credit financed with ordinary resources, the Fund operated a graduated structure of charges based on the level and duration of credit outstanding. Different rates of charge continued to apply on financing from borrowed resources until 1993.

[3]See GRA Lending Toolkit and Conditionality—Reform Proposals (3/13/09) and Charges and Maturities—Proposals for Reform, (12/12/08).

[4]See Review of Access Limits and Surcharge Policies, (01/20/2016).

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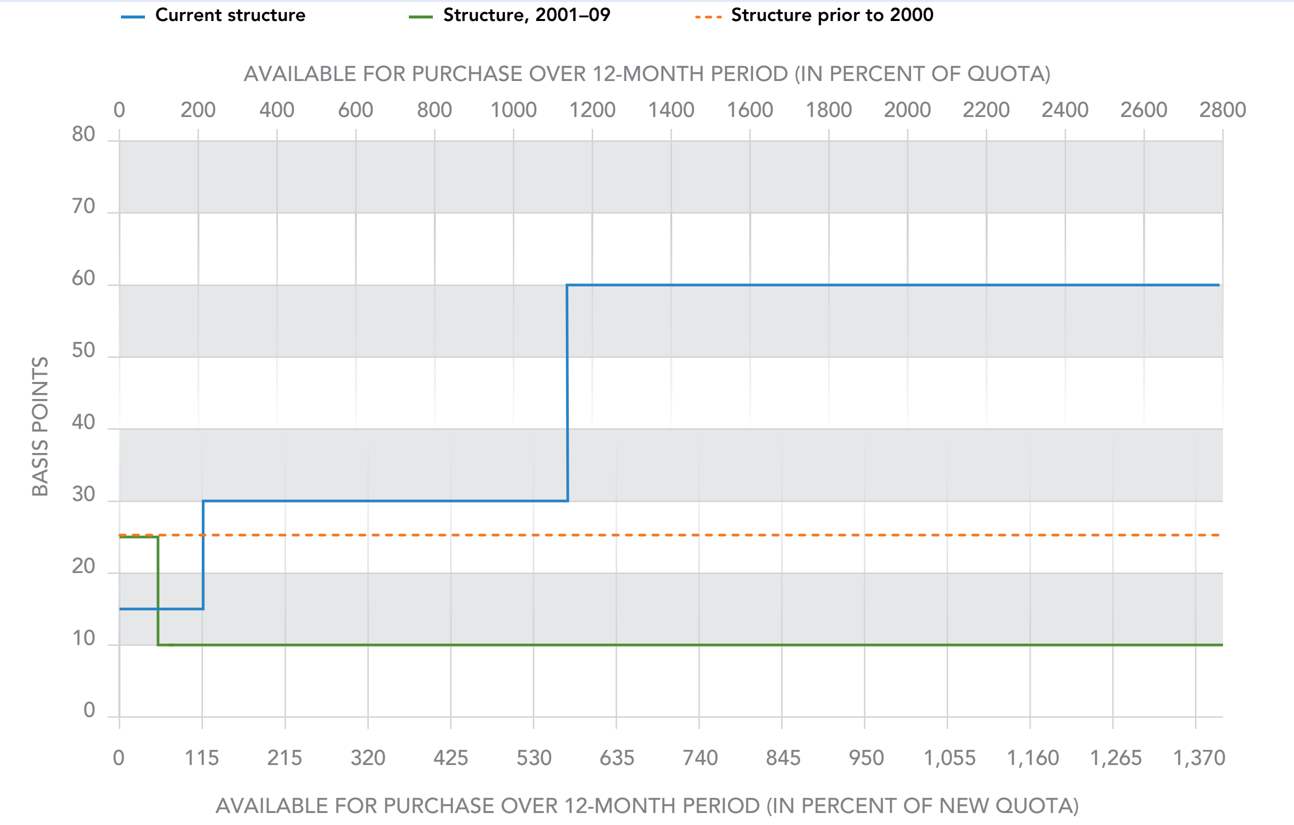
Box 5.3 Commitment Fees

Commitment fees were originally put in place to help manage incentives and compensate the IMF for cases in which commitments were not drawn. They were first introduced in conjunction with the establishment of the Stand-By Arrangement (SBA) in 1952.

Directors emphasized that while the charge should not discourage countries with need, it would serve as a deterrent to those who had no real reason to request IMF assistance. It was decided that a commitment charge of 25 basis points a year would be levied and that, if a member draws under the SBA, this charge would be credited against the service charge on a pro rata basis. In the context of the review of Fund facilities in 2000, a two-tier commitment fee schedule was adopted under which the fee remained at 25 basis points a year for commitments up to 100 percent of quota; a lower 10 basis point fee was levied on amounts in excess of 100 percent of quota that could be purchased over the same period.[1] The lower 10 basis point fee for access above 100 percent of quota was adopted mainly to encourage the use of the Contingent Credit Line (CCL) (since discontinued), and the declining schedule was motivated by the lower probability of drawing under the CCL which made refunds less likely. The argument is consistent with the prevailing view at the time that the basic rationale for charging commitment fees for contingent credits was to cover the cost to the IMF of establishing and monitoring such arrangements.

The current commitment fee schedule stems from the 2009 GRA lending toolkit reform—and the applicable thresholds were revisited in February 2016—and reflects an expanded focus on managing liquidity risks.[2] Reforms to the GRA lending toolkit included improvements in the design and availability of precautionary SBAs, including High Access Precautionary Arrangements (HAPA). The reforms also included establishment of the Flexible Credit Line and the Precautionary Credit Line (which was replaced in 2011 by the Precautionary and Liquidity Line), allowing the IMF



Source: Finance Department, International Monetary Fund.

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to provide up-front contingent financing for countries that had very strong or sound fundamentals and policies but could nevertheless potentially be affected by a crisis originating elsewhere. Recognizing that large commitments have costs associated with the finite availability of IMF resources and that such costs are likely to increase at the margin as resources available for other lending decline, the schedule introduced in 2009 increased fees progressively with access. The structure is designed to generally increase incentives against unnecessarily high precautionary access and also to provide income to the IMF to help offset the cost of setting aside substantial financial resources. At the same time, commitment fees would not be set so high as to discourage members from seeking precautionary arrangements.

The current commitment fee structure was adopted in February 2016. Commitment fees are levied at 15 basis points a year on amounts up to 115 percent of quota; 30 basis points a year for amounts in excess of 115 percent and up to 575 percent of quota; and a 60 basis point fee is levied on amounts in excess of 575 percent of quota.[3]

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[1] Review of Fund Facilities—Proposed Decisions and Implementation Guidelines, (11/02/2000).

[2] GRA Lending Toolkit and Conditionality—Reform Proposals, (03/13/2009.

[3] See Review of Access Limits and Surcharge Policies, (01/20/2016).

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Box 5.4 Committee of Eminent Persons' Proposal for Increasing IMF Income

Conceptually, the Committee of Eminent Persons organized its proposals for ensuring the IMF's income over the long term by linking the sources and uses of the funds.[1] To this end, the committee identified three broad categories of IMF activities: credit intermediation, the provision of public goods, and bilateral services.

Credit intermediation: As a general principle, the committee believed that the margin for the basic rate of charge on Fund lending should be stable and should not be linked to credit outstanding or to the IMF's income needs (that is, the rate of charge should not increase as lending activities decline and vice versa). The committee also took the view that lending should yield enough to cover intermediation costs and build up reserves but should not have the objective of funding the full range of IMF activities.

Provision of public goods: The committee saw a need for the IMF's income sources to be diversified to reduce the reliance on lending. The committee considered several measures, some of which required amendments to the Articles of Agreement:

- Levies on members: Despite their use by other public international institutions and their various benefits, levies on member countries were considered inconsistent with independent surveillance and were not favored by the committee.

- Investment operations: The committee recommended that the IMF liberalize its investment policies to enhance the benefits of creating additional sources of funds for investment. In particular, it recommended a broadening of the investment mandate for the IMF's existing reserves. This would include more duration risk, given the absence of refinancing risks on its reserves, and an expansion of the instruments in which the IMF may invest in line with the policy followed by AAA-rated multilateral development banks. To generate income over time, the committee also proposed that the IMF use a part of the quota resources subscribed by members to invest in higher-yielding market securities. These securities would be highly liquid to reflect the potential need to use these resources for lending.

- Creation of an endowment: The committee favored creating an endowment and managing it so as to preserve its long-term real value while generating a sustainable income flow. One of the options proposed for funding such an endowment was through a limited sale of the IMF's gold holdings. The committee proposed to conduct any such sale in a way that would ensure the continued strength of gold in the IMF's balance sheet and would avoid disturbance to the functioning of the gold market. The committee cautioned that spending from a gold-financed endowment should not materially weaken the IMF's financial position, and so the endowment should have a prescribed payout ratio that preserves its real value over time.

Bilateral services: The committee recommended charging member countries for some of the bilateral services provided by the IMF, including most notably technical assistance. It recognized that some of these services incorporate a measure of public good but felt that charging users would help ensure a disciplined approach to the costs and benefits associated with the services and enhance the IMF's transparency and accountability. The committee raised the possibility of subsidizing such fees for low-income countries. The committee also recommended that the General Resources Account no longer absorb the administrative costs of providing concessional assistance to low-income countries and should end the recent practice of waiving reimbursement of these costs.

[1] The Report to the Managing Director by the Committee of Eminent Persons on the Sustainable Long-Term Financing of the Fund (January 2007). The Committee was chaired by Andrew Crockett.

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Additional Reading

Annex I of Review of Charges and Maturities—Policies Supporting the Revolving Nature of Fund Resources, IMF Policy Paper, May 23, 2005: www.imf.org/external/np/pp/eng/2005/052305.pdf

Charges and Maturities—Proposals for Reform, IMF Policy Paper, December 12, 2008: www.imf.org/external/np/pp/eng/2008/121208a.pdf

GRA Lending Toolkit and Conditionality—Reform Proposals, IMF Policy Paper, March 13, 2009: http://www.imf.org/external/np/pp/eng/2009/031309a.pdf

IMF Articles of Agreement—Article XII, Section 6(f) (ii): www.imf.org/external/pubs/ft/aa/#a12s6

IMF's Broader Investment Mandate Takes Effect, Press Release No. 11/52, February 18, 2011: www.imf.org/external/np/sec/pr/2011/pr1152.htm

IMF Executive Board Reviews Access Limits, Surcharge Policies, and Other Quota-Related Policies, Press Release No. 16/166, April 11, 2016: www.imf.org/external/np/sec/pr/2016/pr16166.htm

IMF Executive Board Reviews the Fund's Income Position for Financial Years 2016 and 2017-2018, Press Release No. 16/219, May 13, 2016: www.imf.org/external/np/sec/pr/2016/pr16219.htm

IMF Executive Board Reviews Fund's Income Position, Sets Rate of Charge for FY 2007 and Approves Establishment of an Investment Account, Press Release No. 06/90, May 4, 2006: www.imf.org/external/np/sec/pr/2006/pr0690.htm

The Report to the Managing Director by the Committee of Eminent Persons on the Sustainable Long-Term Financing of the Fund, January 2007: www.imf.org/external/np/oth/2007/013107.pdf

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Review of the Fund's Income Position for FY 2016 and FY 2017–2018, IMF Policy Paper, May 13, 2016: www.imf.org/external/np/pp/eng/2016/040816.pdf

Rules and Regulations for the Investment Account, IMF Policy Paper, August 15, 2014: www.imf.org/external/np/pp/eng/2012/122812.pdf

Rules and Regulations for the Investment Account, IMF Policy Paper, September 10, 2015: www.imf.org/external/np/pp/eng/2015/082815.pdf

SDR Interest Rate, Rate of Remuneration, Rate of Charge and Burden Sharing Adjustments, 2013: www.imf.org/cgi-shl/create_x.pl?bur

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