INTERNATIONAL MONETARY FUND

The Fund's Income Position for FY 2011—Midyear Review

Prepared by the Finance Department

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

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I. Introduction

1. **This paper updates the outlook for the Fund's income position for the financial year 2011 taking into account developments in the first half of the year**. The outlook has improved primarily reflecting additional lending activity, which raised the projected average credit outstanding in FY 2011 by about SDR 3 billion to SDR 54 billion. Net operational income for FY 2011 is projected at SDR 328 million, some SDR 126 million higher than the projection in April 2010.[1] The actual outcome is subject to considerable uncertainty related to the timing and amounts of disbursements under current and potential new arrangements and the performance of the Investment Account (IA).

2. **The paper also provides the basis for the midyear review of the Fund's income position.** In April, the Executive Board agreed that the FY 2011 margin for the basic rate of charge would be 100 basis points. The margin was established on the basis of principles endorsed by the Board in March 2008 and adopted on the basis of the exceptional circumstances clause of Rule I-6(4) (see Box 1).[2] Under this rule, a review of the Fund's income position at midyear is required.

3. **The paper is structured as follows**: Section II provides an update on the FY 2011 income position, based on the actual outturn for the first half of the financial year and projected developments in the second half of the year. Section III discusses the margin for the rate of charge and Section IV provides an update on the recent burden sharing adjustments. A draft decision for the midyear review then follows.

II. Updated FY 2011 Income Position

4. **Net operational income for FY 2011 is projected at about SDR 328 million, compared with SDR 202 million at the beginning of the financial year (see Table 1)**. Key factors that affect the updated projections are the following:

- **Lending income**. New arrangements approved after April 2010 have raised projected lending income by some SDR 102 million from the level projected at the beginning of the financial year.[3] This increase comprises about SDR 74 million in service charges and commitment fees, and SDR 28 million from the margin on the rate of charge.

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[1] See *Review of the Fund's Income Position for FY 2010 and FY 2011*.

[2] In the context of the agreement on the Fund's new income model in 2008, there was broad support for the principle that the margin for the basic rate of charge should be established to cover only the Fund's intermediation costs and the buildup of reserves. Rule I-6(4), however, has not yet been amended to reflect this new principle because the new income model is not yet fully implemented, i.e., certain sources of non-lending income have not been put in place yet. Therefore, as highlighted in the April paper, a new rule has not yet been proposed for establishing the margin for the basic rate of charge. Staff will come back to the Board on this issue in the context of the income discussions for FY 2012 in April next year.

[3] Commitments under new arrangements amounted to some SDR 36.6 billion, of which scheduled FY 2011 disbursements are about a third of the total and a number of arrangements expired or were cancelled with

(continued…)

- **Investment returns.** The Investment Account (IA) net returns in the six months through October 2010 amounted to SDR 60 million, about 80 percent of the initial full year projection of SDR 74 million. Overall, the IA returned 99 basis points (bps) to end-October (net of fees), exceeding the 3-month SDR interest rate by 84 bps (unannualized). The IA benefited from market concerns on the strength of the global economic recovery which pushed yields of high-rated government bonds lower. The updated IA income projection for FY 2011 is SDR 87 million, some SDR 13 million higher than the initial projection. Consistent with past practice, the updated projection takes account of actual performance in the first half of the financial year and assumes the IA earns 50 basis points over the SDR interest rate during the second half.[4]

Table 1. Projected Income Position—FY 2011
(In millions of SDRs)

Net operational income projected in April 2010	**202**
Income variances	**92**
Changes due to:	
New lending activity	102
Investment Account returns	13
Income from interest-free resources	-23
Expenditure variance	**34**
Updated net operational income	**328**

- **Implicit returns on interest-free resources**. The implicit income on interest-free resources is projected to be lower by some SDR 23 million mainly as a result of the current low interest rate environment. The average SDR interest rate for FY 2011 is now projected at 0.40 percent (previously 0.70 percent).[5] [6]

undrawn balances, thereby contributing commitment fee income. Rephasing of purchases under some existing arrangements has had a modest offsetting effect on FY 2011 income.

[4] The assumed added value of 50 basis points is based on historical performance and is intended to provide a relatively conservative indication of the additional returns from the IA over the medium term. Actual performance of the IA from year to year will vary with market conditions. Further discussion on the performance of the IA will be provided in the semi-annual review of the IA (to be issued shortly).

[5] The SDR interest rate projection is based on market forward rates for the underlying three-month financial instruments in the SDR interest rate basket.

[6] To the extent gold proceeds are retained in the GRA, the Fund's interest-free resources increase since these currency holdings reduce members' reserve tranche positions and thus the Fund's remuneration expense.

- **Expenditures.** Expenditures are projected to be about SDR 34 million below the initial projection, principally reflecting lower-than-planned staffing levels.

Box 1. Decisions in Effect Related to the FY 2011 Income Position[1]

The Executive Board has taken the following decisions affecting the Fund's income position for FY 2011:

Rate of Charge
The margin for calculating the basic rate of charge in FY 2011 was set at 100 basis points. This decision was adopted under the *exceptional circumstances* clause of Rule I-6(4), which, in exceptional circumstances, allows the margin for calculating the basic rate of charge to be set on a basis other than the estimated income and expense of the Fund and a target amount of net income for the year. A midyear review of the income position shall be held to review any change in the exceptional circumstances and to decide by December 15 whether the margin over the SDR interest rate determined at the beginning of the financial year should be changed as of November 1 in light of the actual income position for the first six months of the financial year.

Limited Gold Sales
Limited sales of 12,965,649 fine troy ounces of gold that was acquired by the Fund after the second amendment of the Articles of Agreement may take place on the basis of prices in the market. A key element of the new income model is the creation of an endowment with the profits from gold sales.

Disposition of Surcharges
After meeting the administrative costs of running the Fund, any remaining net operational income generated from surcharges on purchases in the credit tranches and under Extended Fund Facility shall be transferred, after the end of the financial year, to the General Reserve.

Poverty Reduction and Growth Trust (PRGT) Administrative Expenses
For financial years 2010 through 2012, no reimbursement shall be made to the General Resources Account (GRA) from the Reserve Account of the PRGT for the cost of administering the PRGT. The estimated cost of administering the PRGT shall be transferred after the end of each such financial year from the PRGT Reserve Account (through the Special Disbursement Account) to the General Subsidy Account of the PRGT.

Burden Sharing for Deferred Charges
Income losses resulting from unpaid charges are shared equally between debtor and creditor members under the burden sharing mechanism largely pursuant to a decision taken in 2000. Unless amended by the Board, this mechanism will continue for as long as overdue obligations to the Fund persist.

[1] See *Review of the Fund's Income Position for FY 2010 and FY 2011*.

5. **Table 2 provides updated projections for FY 2011 and the outturn for the first half of the year**.[7] The projections do not include any provision for potential purchases under (i) arrangements not yet approved since the timing and amounts involved for these are uncertain or (ii) existing or potential precautionary arrangements.[8] Repurchases of outstanding Fund credit, and disbursements under arrangements already approved, are assumed to take place as scheduled (see Annex 2).

Table 2. Projected Income and Expenditures
(In millions of SDRs)

		FY 2011	
	Actual to end-Oct 2010	Initial Projections 1/	Updated Projections 2/
A. Operational income	**454**	**872**	**964**
Lending income	**378**	**734**	**836**
Margin for the rate of charge	244	515	543
Service charges 3/	134	219	293
Investment income	**60**	**74**	**87**
Interest free resources	**14**	**60**	**37**
SCA-1 and other	11	45	27
Gold book value	3	15	10
Reimbursements	**2**	**4**	**4**
MDRI-I Trust and SDR Department	2	4	4
PRGT	0	0	0
B. Expenses	**333**	**670**	**636**
Net administrative expenditures	317	631	597
Capital budget items expensed	2	7	7
Depreciation	14	32	32
C. Net operational income position (A-B)	**121**	**202**	**328**
<u>Memorandum Items:</u>			
Fund credit (average stock, SDR billions)	48.3	51.5	54.3
Surcharges	219	499	528
SDR interest rate (in percent)	0.3	0.7	0.4
US$/SDR exchange rate	1.5	1.5	1.5

1/ See *Review of the Fund's Income Position for FY 2010 and FY 2011*.
2/ The updated projections take account of arrangements approved through end-November 2010.
3/ Includes commitment fees, which are refundable (when disbursements take place) so income arises only if planned disbursements are not made.

[7] The updated projections do not include the gold sales. . Rather, the projections focus on the net operational income of the Fund, comprising net income from lending operations, the Investment Account and the Fund's interest free resources.

[8] The projections, however, include income from the commitment fees for the precautionary Flexible Credit Lines (FCLs) at their expiration.

6. **At the April income discussion, the Board decided to resume the practice of placing surcharges to reserves in FY 2011**.[9] The projections in April showed a positive net operational income position, excluding surcharges, thus allowing a resumption of this practice. The updated net operational income projection remains positive and therefore, on this basis, at the end of FY 2011 surcharges would be placed in the General Reserve allowing for additional buildup of the Fund's precautionary balances. The projected surcharges of SDR 528 million for FY 2011 are some SDR 30 million higher than previously estimated owing to the new approved arrangements since April (see paragraph 4).

7. **Restructuring costs amounting to about SDR 11 million in the first half of FY 2011 were charged against the restructuring provision (see Annex 1)**. The provision was established in FY 2008, in the amount of SDR 68 million charged against income for that year, for costs for which no rendered services were expected (e.g., the modified SBF payments under the voluntary separation plan).[10] Other restructuring costs incurred in the first half of the year, e.g., salaries during the delay period, were less than SDR 1 million.

8. **Overall, on the basis of the updated projections, precautionary balances are expected to increase to about SDR 8.2 billion at the end of FY 2011**. At the end of FY 2010, precautionary balances stood at SDR 7.3 billion. The updated projections point to an increase of some SDR 0.9 billion, primarily reflecting the net operational income and the surcharges (Table 2).[11] At the recent review of the Fund's precautionary balances, Directors supported setting a minimum floor (a proposed initial floor of SDR 10 billion) for precautionary balances to protect against an unexpected rise in credit risks and to ensure a sustainable income position. Most Directors considered it prudent to raise the indicative target for precautionary balances to SDR 15 billion over the medium-term. The projected net income from lending in FY 2011 will help build precautionary balances toward these levels. The forthcoming paper on the consolidated income and expenditure framework, scheduled for discussion in January 2011, will provide a more detailed discussion of the medium-term projection, including the projected buildup of precautionary balances.

III. FY 2011 Midyear Review

9. **As discussed above, the Board adopted a margin for calculating the basic rate of charge for FY 2011 of 100 basis points under the exceptional circumstances clause of Rule I-6(4)**. Under this rule, the Board is to review at midyear any change in the exceptional

[9] In the December 2008 discussion on precautionary balances, Directors noted that once the Fund returns to a positive net income position, surcharges should again be placed directly to reserves to help accelerate the pace of reserve accumulation.

[10] Eligible restructuring costs since then have been charged against the provision and the balance at the end of FY 2010 was SDR 27 million. Annex 1 provides further details on restructuring costs.

[11] As highlighted in the April 2010 paper (, paragraph 15), net income placed to reserves that is attributable to gold profits is excluded from the computation of precautionary balances as the amounts to be transferred to the endowment are distinct from the traditional role of precautionary balances to provide a buffer against financial risks.

circumstances and decide whether the margin over the SDR interest rate determined at the beginning of the year shall be changed in light of the actual income position for the first six months of the financial year. Staff considers that the exceptional circumstances under which the margin may be set on a basis other than the estimated income and expenses for the year still exist. Accordingly, no change in the margin is proposed.

IV. Burden Sharing Mechanism

10. **Burden sharing adjustments in FY 2011 have remained low (see Table 3 below)**. At the mid-year review last year, the burden sharing decision was amended to take account of the low burden sharing adjustments in the prevailing high lending, and low interest rate, environment and allow for no adjustments in quarters where the minimum adjustment of 1 basis point to the rate of charge and the rate of remuneration in the previous quarter(s) had generated sufficient excess amounts to offset deferred charges in the subsequent quarter(s).[12] For example, in the last quarter of FY 2010 and the first quarter of FY 2011, the amounts generated in previous quarters were sufficient to fully cover the deferred charges in those quarters, while the adjustments in the second quarter of FY 2011 amounted to one basis point. Projections for the second half of FY 2011 indicate similar levels of burden sharing adjustments.

Table 3. Recent Average Burden Sharing Rates and FY 2011 Quarterly Rates
(In basis points unless otherwise stated)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11			
								Q1	Q2	Q3	Q4
										(projected)	
Rate of Remuneration 1/											
Total average adjustment	9	12	23	23	14	3	1	–	1	–	1
Deferred charges	1	2	5	13	14	3	1	–	1	–	1
SCA-1	8	10	18	10	–	–	–	–	–	–	–
Rate of Charge 1/											
Total average adjustment	8	11	19	23	16	3	1	–	1	–	1
Deferred charges	1	2	4	13	16	3	1	–	1	–	1
SCA-1	7	9	15	10	–	–	–	–	–	–	–
Average SDR interest rate (in percent) 2/	1.58	2.09	2.93	3.96	3.64	1.79	0.29	0.27	0.33	0.40	0.51
Average basic rate of charge (in percent)	2.09	3.01	4.00	5.04	4.72	2.79	1.29	1.27	1.33	1.40	1.51

1/ The average rates have been calculated using the quarterly burden sharing rates and SDR interest rates.
2/ The SDR interest rates are projected to average 0.4 percent in FY 2011.

[12] See *The Fund's Income Position for FY 2010—Midyear Review*, paragraphs 8-10.

PROPOSED DECISION

The following decision is proposed for adoption by the Executive Board and may be adopted with a majority of the votes cast.

Decision

Pursuant to Rule I-6(4)(b)(ii) of the Fund’s Rules and Regulations, the Fund has conducted the midyear review of its income position for FY 2011 and decides to leave unchanged the rate of charge established by Decision No. 14604-(10/41)—adopted April 28, 2010.

Annex 1. Restructuring Costs

In accordance with International Financial Reporting Standards (IFRS), the Fund established a restructuring provision (SDR 68 million) in FY 2008 for costs for which no rendered services are expected (e.g., the modified SBF payments) and outplacement and retraining of separating staff. Costs related to services from which the Fund will benefit, such as salaries during the staff delay period of up to 12 months under the separation plan were not included in the provision; these costs have been recognized as expenditures are incurred.

The provision had a balance of SDR 27 million at April 30, 2010. At end-October 2010, the restructuring provision amounted to SDR 15 million, reflecting costs of SDR 11 million charged against the provision during the current financial year, and the effects of the movement in the SDR/U.S. dollar exchange rate in the six months to end-October 2010, which decreased the provision by about SDR 1 million. A summary of the movements in the provision is shown below.

Restructuring Provision as at end-October 2010
(In millions of SDRs)

Restructuring provision at April 30, 2010	27
Amounts utilized	-11
Effects of movement in exchange rate and discount rate	-1
Restructuring provision at end-October 2010	15

In addition, at end-October 2010, FY 2011 costs incurred toward the staff delay period were less than SDR 1 million. SRP contributions for separating staff amounted to about SDR 2 million. Thus, total restructuring costs in the first half of FY 2011, including the above SBF costs, were about SDR 13 million (about US$19 million).

Annex 2. Assumptions Underlying the FY 2011 Projections

	Actual through end-October 2010	FY 2011 Initial Projections	FY 2011 Updated Projections
		(In billions of SDRs)	
Regular Facilities:			
1. Purchases (excl. reserve tranche purchases)	12.7	16.2	27.3
2. Repurchases	1.2	1.9	2.3
3. Average balances subject to charges	48.3	51.5	54.3
4. Average SDR holdings	3.2	2.4	3.3
5. Average remunerated positions	32.3	33.2	34.4
6. Average investment account assets 1/	6.1	6.0	6.1
7. Average borrowings and issued notes 2/	10.2	11.9	13.5
		(In percent)	
Return on investments 3/	0.99	1.20	1.42
Average interest rates:			
SDR interest rate and basic rate of remuneration	0.30	0.70	0.40
Basic rate of charge	1.30	1.70	1.40
Margin on the rate of charge	1.00	1.00	1.00

1/ The figures are based on a general assumption that investment income is transferred annually to the GRA.
2/ In the first half of FY 2011, the Fund made drawings under bilateral loan and note purchase agreements to finance lending activity. The figures in the table are period averages. Since the interest costs on the borrowed resources are the same as those on use of quota resources, i.e., the SDR interest rate, projections are not affected by the use of borrowed resources.
3/ End-October figure is unannualized.