INTERNATIONAL MONETARY FUND

The Fund's Income Position for FY 2008—Midyear Review

Prepared by the Finance Department

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I. INTRODUCTION

1. **This paper provides the basis for the Executive Board's midyear review of the Fund's income position based on developments in the first half of FY 2008**. Under Rule I-6(4) of the Fund's Rules and Regulations, the Executive Board should consider whether the margin over the SDR interest rate used to calculate the rate of charge as determined at the beginning of the year should be changed in light of the actual income position for the first six months.

2. **In April this year, the Executive Board decided to leave the margin for calculating the rate of charge unchanged at 108 basis points**.[1] Directors agreed that FY 2008 should be treated as a transitional year with an unchanged stance on existing policy decisions while a new income model is being developed.

3. **The paper proposes that the Board leaves unchanged the margin for calculating the rate of charge**. The updated FY 2008 income outlook remains fundamentally unchanged and staff therefore proposes that the draft decision to leave the margin for the rate of charge at the current level be adopted. In the context of the ongoing work on the Fund's income and expenditure framework, this paper does not include any projections beyond FY 2008. It is expected that updated medium-term projections will be discussed in early 2008 as part of the ongoing work on a new model.

4. **The paper is structured as follows**: Section II reviews income-related Board decisions in effect for FY 2008; Section III provides an update on the FY 2008 income position based on developments in the first half of the financial year; and Section IV makes a proposal for the Board decision on the rate of charge and reviews the impact of the anticipated clearance of Liberia's arrears on burden sharing adjustments.

II. FY 2008 INCOME DECISIONS

5. **A number of income-related Board decisions were adopted in April 2007 for FY 2008**. Board decisions related to the FY 2008 income position are summarized in Box 1. These include an unchanged margin for calculating the rate of charge of 108 basis points over the SDR interest rate (same level as for FY 2007). Directors agreed in light of ongoing work on options for sustainable financing for the Fund that FY 2008 would be treated as a transitional year and, that in these exceptional circumstances, the margin would be maintained at the same level.

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[1] See *Review of the Fund's Income Position for FY 2007 and FY 2008* (4/9/07).

Box 1. Executive Board Decisions in Effect Related to the FY 2008 Income Position[1]

The Executive Board has taken the following decisions affecting the Fund's income position for FY 2008.

Rule I-6(4)
In *exceptional circumstances* the margin for calculating the rate of charge may 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 decide whether (i) "the exceptional circumstances" under which the margin has been determined have changed, and (ii) the margin over the SDR interest rate under Rule T-1 determined under Rule I-6(4)(a) shall be changed in light of the actual income position for the first six months of the financial year.

Rate of Charge
The margin for calculating the rate of charge in FY 2008 was set at the same level as for FY 2007—108 basis points above the SDR interest rate.

PRGF-ESF Administrative Expenses
The GRA will forgo the reimbursement from the Reserve Account of the PRGF-ESF Trust—via the Special Disbursement Account (SDA)—for the costs of administering the PRGF-ESF Trust.

Burden Sharing:

For Placement to the Special Contingent Account (SCA)-1
At the FY 2007 midyear review, the Executive Board decided to limit SCA-1 accumulations during FY 2007 to the amounts generated in the first half of FY 2007 (SDR 30 million). For FY 2008, no decision was adopted for SCA-1 accumulations.

For Deferred Charges
Income losses resulting from unpaid charges are shared equally between the 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 2007 and FY 2008* (4/9/07) and *The Fund's Income Position for FY 2007—Midyear Review* (12/7/06).

III. Updated Income Position

6. **The updated income shortfall** for FY 2008 is projected at about SDR 90 million compared with SDR 146 million at the start of the year (see Table 1). The improved outlook stems primarily from one-time gains associated with the prospective clearance of arrears by Liberia and lower expenditures. The variances from initial projections are discussed below.

7. **Liberia's arrears clearance will give rise to a one-time income gain of about SDR 51 million from settlement of overdue charges that were not burden shared**. Of these overdue charges, about SDR 20 million arose before the adoption in 1986 of the system for burden-sharing of unpaid regular charges, and SDR 31 million arose from GRA special charges.[2] These charges when paid as part of the arrears clearance will accrue to Fund income. For income projection purposes, the assumed timing of arrears clearance is February 2008. The arrears clearance will have two other income-related effects. First, the anticipated SCA-1 partial distribution (SDR 525 million) associated with financing for Liberia's debt relief through bilateral contributions will reduce FY 2008 implicit returns on the Fund's interest-free resources by about SDR 4 million; going forward, the reduction of the SCA-1 balance will reduce annual income by some SDR 20 million at current SDR interest rates. Second, Liberia's enlarged access to Fund resources under a new extended arrangement will generate incremental income of some SDR 2 million.

8. **On the income side,** three other factors are expected to give rise to lower income than previously projected in FY 2008:

- **Changes in projected implicit returns**. The projected average SDR interest rate for FY 2008 is now estimated at 4.10 percent, a 14 basis point decrease from initial projections.[3] The SDR interest rate affects implicit returns from the Fund's interest-free resources. The GRA's interest-free resources broadly approximate the SCA-1 balances of SDR 1.7 billion.[4] The net benefit of holding interest-free resources is a reduction in the Fund's remuneration expense; the current rate of remuneration is the SDR interest rate. Implicit returns from the Fund's interest-free resources are therefore projected to be lower by some SDR 2 million.

- **Changes in Investment Account (IA) return assumptions**. Through end-October, the return of the IA has been higher than expected, as a result of a fall in yields that

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[2] The burden sharing mechanism makes up for the loss of income from unpaid regular charges. Special charges, which entered into effect in 1986, are additional charges levied on overdue obligations and are not subject to burden sharing.

[3] The SDR interest rate assumptions are based on updated World Economic Outlook (WEO) projections.

[4] See footnote 6 on "*Review of the Fund's Income Position for FY 2007 and FY 2008* for further background on the Fund's interest-free resources.

boosted the performance of the bond portfolio.[5] The IA has returned 2.56 percent or 49 basis points (unannualized) above the SDR interest rate (see para 11). Assuming no change in SDR yields and spreads for the rest of the financial year, the return in the second half of the year is expected to moderate such that the overall return for the year as a whole would be about 50 basis points above the SDR interest rate. On this basis, the IA is projected to generate income of about SDR 275 million in FY 2008, compared with an initial projection of SDR 283 million.

- **Rephasing of purchases projections**. A rephasing of projected purchases to dates later than originally scheduled is expected to result in lower charges and surcharges than initially projected by some SDR 11 million.

9. **On the expenditure side, operational costs are expected to be lower by about SDR 30 million**. First, the projected budget outturn is expected to be some SDR 17 million (US$27 million) below initial estimates. The underspend is mainly a reflection of a much higher staff vacancy rate than envisaged in the formulated budget. Second, in SDR terms, the Fund's administrative and capital expenses will be lower than budgeted owing to the increase in the US$/SDR exchange rate during FY 2008. The updated average US$/SDR exchange rate for FY 2008 is now projected at 1.53 compared with 1.50 at the beginning of the year.

[5] The investment objective of the IA is to exceed the return of the three-month SDR interest rate over time while limiting risk. The projected added value of 50 basis points is based on historical medium-term performance of a similar portfolio. Actual performance from year to year will vary with market conditions. Annex II of *Establishment of the Investment Account* provides a detailed analysis of the historical performance.

Table 1. Projected Income Shortfall—FY 2008
(In millions of SDRs)

Income shortfall projected in April 2007	**-146**
Income variances	**-21**
Changes due to:	
SDR interest rate assumptions	-10
Rephasing of purchases	-11
Advance repayments 1/	--
Expenditure variances	**30**
Changes due to:	
Projected budget outturn	17
US$/SDR exchange rate	13
Updated income shortfall	**-137**
Net effects of Liberia arrears clearance	49
Income shortfall now projected	**-88**

1/ Macedonia and Bolivia repaid outstanding Fund credit in full in May 2007 (SDR 24.2 million) and June 2007 (SDR 9.7 million), respectively. The FY 2008 income effect of these advance repayments is SDR 210,000 and SDR 70,000, respectively

10. **Table 2 outlines the projected income sources and uses for FY 2008** and the actual outturn at end-October 2007. The assumptions are based on a central scenario whereby projected FY 2008 purchases and repurchases take place as now scheduled, including the arrears clearance and a new extended arrangement for Liberia. Income from lending operations at the midyear point remains broadly on track with updated FY 2008 projections; service charge income is expected to be higher in the second half of FY 2008 when rephased purchases take place.

11. **Over the six months to end-October, the IA returned 2.56 percent (unannualized), 49 basis points above the return on the 3-month SDR interest rate**. The bond portfolio, which benefited from investor flight-to-quality in the wake of the credit market turmoil, performed strongly (2.65 percent), while the return on medium-term instruments was somewhat lower (2.48 percent), as a result of a widening in swap spreads.

Table 2. Projected Income Sources and Uses—FY 2008
(In millions of SDRs, except where indicated)

	Actual to end-Oct 2007	FY 2008 Initial Projections	FY 2008 Updated Projections
A. Income sources 1/	**257**	**511**	**539**
Margin for the rate of charge (108 basis points)	39	82	79
Surcharges	23	56	48
Service charge (50 basis points on disbursements) 2/	4	16	18
Settlement of overdue charges	--	--	51
Investment income	153	283	275
Implicit returns on interest-free resources 3/	38	74	68
B. Administrative and capital expenses 4/	**273**	**657**	**627**
Administrative budget	258	615	585
Capital budget not capitalized	5	19	19
Depreciation expense	10	23	23
C. Income shortfall (A - B)	**-16**	**-146**	**-88**
Memorandum Items:			
Average Fund credit outstanding (in SDR billions)	7.2	7.6	7.3
Average SDR interest rate (in percent)	4.12	4.24	4.10
US$/SDR exchange rate	1.53	1.50	1.53

1/ Annex II details the assumptions underlying these projections.
2/ Includes commitment fees, which are refundable (when disbursements take place) so income arises only if planned disbursements are not made.
3/ The Fund's GRA interest-free resources currently broadly approximate the level of resources in the SCA-1 (since resources equivalent to the Fund's reserves have been transferred to the IA).
4/ The updated administrative and capital expenditure figures assume a US$/SDR exchange rate of 1.53.

IV. FY 2008 Midyear Review

12. **The Executive Board needs to take a decision on the margin for calculating the rate of charge based on the updated income outlook for FY 2008**. In particular, the Board must decide whether a change in the margin is necessary.

13. **Staff proposes that the margin for calculating the rate of charge remain unchanged**. This would be in line with the agreed transitional nature of FY 2008 at the April 2007 income discussion and consistent with the fundamentally unchanged income outlook after taking into account developments during the first half of FY 2008.

14. **Burden sharing**. A concern at last year's midyear review was the projected increase in burden sharing adjustments to the rate of charge due to the decline in overall Fund credit.

In particular, burden sharing adjustments were projected to reach as high as 34 basis points in the fourth quarter of FY 2007, primarily as result of the advance repayments.[6] At the midyear review of the Fund's Income Position for FY 2007, the Board agreed to limit accumulations in the SCA-1 during FY 2007 to the amount generated in the first half of the year. For FY 2008, no decision was adopted for SCA-1 accumulations.

15. **The FY 2008 burden sharing adjustments have remained steady and lower than in FY 2007**, which included adjustments for SCA-1 contributions in the first half of the year (see Annex III). Adjustments to the rates of charge and remuneration were 21 and 19 basis points, respectively, in the first and second quarters of FY 2008, compared with an average adjustment of 23 basis points in FY 2007 for both charges and remuneration.

16. **Following the anticipated Liberia arrears clearance, burden sharing adjustments are projected to fall to about 10–11 basis points** (see Table 3). The arrears clearance will reduce the number of countries with overdue GRA obligations to two (Somalia and Sudan). Annual unpaid charges would decrease by about SDR 10 million to some SDR 20 million at current SDR interest rates, with Sudan accounting for over 70 percent. The rephasing of purchases accounts for a modest part of the decrease in the projected adjustments.

Table 3. FY 2008 Burden Sharing Adjustments
(In basis points)

	Actual		Projected	
	Q1	Q2	Q3	Q4
Adjustment to:				
Rate of charge	21	21	17	11
Rate of remuneration	19	19	16	10

1/ Figures for the third and fourth quarters are based on an assumed SDR interest rate of 3.9 percent.

17. **The sustainability of the burden sharing mechanism needs to be kept under review**. In the past, Directors have highlighted that the current mechanism may not be sustainable in a low credit environment. In this context, staff recently explored the possibility of members in protracted arrears attributing payments to current GRA charges in order to alleviate the financial burden on the Fund's debtor and creditor members, but no changes in current practices resulted from these contacts. Staff proposes to keep these issues under close review in light of developments in Fund credit outstanding.

[6] See paragraphs 14–18 in *The Fund's Income Position for FY 2007—Midyear Review* (12/7/06).

Annex I. Projected Income and Expense—FY 2008

	Actual end-Oct 2007	FY2008 Initial Projections	FY2008 Updated Projections
1. Income Sources			
Periodic charges, including burden sharing	182	406	378
Interest on SDR holdings	52	133	93
Surcharges	23	56	48
Investment income	153	283	275
Settlement of overdue charges	--	--	51
Service charges	4	16	18
Total income	**414**	**894**	**863**
2. Expenses			
Remuneration, including burden sharing	157	383	324
Administrative expenses	273	657	627
Total expenses	**430**	**1,040**	**951**
3. Net income shortfall	**(16)**	**(146)**	**(88)**
4. Other: IAS 19 timing difference (FY 2008 effect) 1/	--	--	45
5. Total net income shortfall	**(16)**	**(146)**	**(43)**

1/ See Annex II in *Review of the Fund's Income Position for FY 2006 and FY 2007* (4/12/06) for a detailed explanation of IAS 19 accounting and timing differences. IAS 19 is the accounting standard that prescribes the accounting treatment of pension and employee benefits expenses, and involves actuarial valuations.

Annex II. Assumptions Underlying the FY 2008 Projections

	Actual through end-Oct 2007	FY 2008 Initial Projections	FY 2008 Updated Projections
	(In billions of SDRs)		
Regular Facilities:			
1. Purchases (excl. reserve tranche purchases)	1.0	3.2	3.5
2. Repurchases	1.5	2.4	2.6
3. Average balances subject to charges	7.2	7.6	7.3
4. Average SDR holdings	2.5	3.1	2.3
5. Average remunerated positions	7.9	9.0	7.9
6. Average investment account assets	6.0	6.0	6.0
	(In percent)		
Average interest rates:			
1. SDR interest rate and basic rate of remuneration	4.12	4.24	4.10
2. Basic rate of charge	5.20	5.32	5.18
3. Margin for the rate of charge	1.08	1.08	1.08
4. Return on investments 1/	5.19	4.74	4.60

1/ The actual end-October figure is annualized.

Annex III. Recent Average Burden Sharing Rates and FY 2008 Quarterly Rates

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008			
							Q1	Q2	Q3	Q4
							--- (actual) ---		--- (projected) ---	
Rate of Remuneration 1/										
Total average adjustment	14	10	9	12	23	23	19	19	17	11
Deferred charges	4	2	1	2	5	13	19	19	17	11
SCA-1	10	8	8	10	18	10	–	–	–	–
Rate of Charge 1/										
Total average adjustment	13	10	8	11	19	23	21	21	16	10
Deferred charges	3	2	1	2	4	13	21	21	16	10
SCA-1	10	8	7	9	15	10	–	–	–	–
Average basic rate of charge (in percent)	3.26	2.54	2.09	3.01	4.00	5.04	5.34	5.06	4.95	4.95
Average SDR interest rate (in percent)	2.80	2.06	1.58	2.09	2.93	3.96	4.26	3.98	3.87	3.87

1/ The average rates have been calculated using the quarterly burden sharing rates.