INTERNATIONAL MONETARY FUND

The Fund's Income Position for FY2007—Midyear Review

Prepared by the Finance Department

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

Approved by Michael G. Kuhn

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I. Introduction

1. In March and April this year, Executive Directors had wide-ranging discussions on the Fund's income outlook, which has changed significantly following the recent sharp decline in credit outstanding.[1] Directors supported the proposal for a two-pronged strategy that would involve, first, immediate steps to address the projected income shortfall in FY2007 under current policies and within the framework of the FY2007 budget and, second, development of a broader work plan on the options to ensure a stable and sustainable income base.

2. **The Investment Account**. As an initial measure to help diversify the Fund's income sources, the Executive Board decided to establish and fund the Investment Account, which is authorized under the Articles. This decision involved investing an amount equivalent to the Fund's reserves with an objective of achieving investment returns that exceed the SDR interest rate.[2] The Investment Account became fully operational on June 20, 2006 through a transfer of SDR 6 billion in currencies from the GRA.

3. **A committee of eminent persons** was appointed by the Managing Director in May this year to identify and assess the full range of income-generating options available and to make specific recommendations for one or more models that would generate sustainable long-term financing of the Fund's running costs. The committee is expected to present its report in early 2007.

4. **This paper reviews the Fund's net income position based on experience in the first half of FY2007.** In line with Rule I-6(4), the paper considers whether any change in the margin used to calculate the rate of charge is warranted in light of the income outturn in the first half of the financial year. The paper also examines the impact on the burden sharing mechanism of the lower-than-expected level of credit outstanding, and extends and updates the medium-term income projections.

II. FY2007 Income Decisions

5. **A number of income-related decisions were adopted in April 2006 for FY2007**. These included a change in Rule I-6(4) to allow, in exceptional circumstances, for flexibility in setting the margin for calculating the rate of charge in an environment of projected income shortfalls (Box 1).[3] If such flexibility is exercised, the Board must review any change in the exceptional circumstances, and decide by December 15 whether the margin over the SDR

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[1] See *The Fund's Medium-Term Income—Outlook and Options (*2/17/06) and *The Chairman's Summing Up* (3/14/06); and *Review of the Fund's Income Position for FY2006 and FY2007* (4/12/06).

[2] See *Establishment of the Investment Account* (4/17/06), *Establishment and Operation of the Investment Account* (8/15/05) and *The Acting Chair's Summing Up* (9/9/05).

[3] Prior to the change, the rate of charge had to be determined on the basis of the estimated income and expenses of the Fund during the year and a net income target for the year (normally five percent of reserves).

interest rate should be changed as of November 1 in light of the actual income position in the first six months.

6. **Unchanged rate of charge and different use of surcharge income**. Based on the income outlook at the start of FY2007, Directors agreed that a pause in the strategy of accumulating reserves would be appropriate and that further increases in the margin for calculating the rate of charge could be counter-productive, particularly in light of the relatively low cost of alternative financing available to members from private market sources. Accordingly, the margin for calculating the rate of charge was left unchanged at 108 basis points over the SDR interest rate. Directors also agreed, as a temporary measure, on the use of surcharge income—after paying for the expenses of administering the PRGF-ESF Trust—to help defray GRA administrative expenses.[4]

7. **Income shortfall for FY2007**. Notwithstanding these measures, the Fund was projected to face an income shortfall of some SDR 60 million in FY2007. A number of options were considered for closing the income gap, including a package proposal that involved substitution of further SCA-1 accumulations with offsetting reductions in the rate of remuneration and increases in the rate of charge. Reduction in the rate of remuneration was not favored by the requisite majority however and the Executive Board agreed to offset the projected loss in reserves (from the income shortfall) by the accumulation in the SCA-1 of an equivalent amount; i.e., SDR 60 million. At the time of the decision, it was noted that an accumulation of SDR 60 million was expected to increase average burden sharing adjustments for the SCA-1 by around two basis points; i.e., from 15 basis points in FY 2006 to an anticipated 17 basis points in FY2007. This relatively moderate increase was an important consideration in light of the Board's view that significant increases in the effective rate of charge could be counter-productive. Another important consideration was that the decision to accumulate SDR 60 million in the SCA-1 would keep the overall level of precautionary balances broadly unchanged.[5]

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[4] In previous years, income from surcharges after meeting the cost of administering the PRGF-ESF Trust was directly placed to the General Reserve.

[5] Precautionary balances comprise reserves plus the SCA-1.

Box 1. Executive Board Decisions in Effect Related to the FY2007 Income Position[1]

The Executive Board has taken the following decisions affecting the Fund's income position for FY2007.

Changes in Rule I-6(4)
Clause (a) was amended to introduce the possibility that 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.

Clause (b) was amended to provide for a mid-term review of any change in "the exceptional circumstances" and decide whether 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 FY2007 was set at the same level as for FY2006—108 basis points above the SDR interest rate.

PRGF-ESF Administrative Expenses
The GRA will forgo the reimbursements from the reserve account of the PRGF-ESF Trust for the costs of administering the PRGF-ESF Trust.

Burden Sharing:

For Placement to the SCA-1
An amount of SDR 60 million will be generated during FY2007 by equal contributions by debtor and creditor members under burden sharing.

For Deferred Charges
Income losses resulting from unpaid charges are shared equally between the debtor and creditor members under the burden sharing mechanism by 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 FY2006 and FY2007* (4/12/06).

III. Updated Income Position

8. **On the income side**, the shortfall for FY2007 before budget and exchange rate variances is now projected at around SDR 95 million, compared with about SDR 60 million at the start of the year (Table 1).[6] The main reasons for the worsened outlook are as follows:

- **Advance repayments increase the projected income shortfall for FY2007 by over SDR 45 million.** Advance repurchases during the first half of FY2007 by Indonesia (SDR 4.7 billion), Serbia (SDR 0.3 billion) and Uruguay (SDR 0.6 billion) have sharply reduced credit outstanding and therefore income generated from the rate of

[6] Table 1 provides a precise breakdown of the impact of the changes in the underlying variables.

charge.[7] In addition, changes (delays) in purchases under current arrangements result in less income than had been projected. Overall, the estimated average use of Fund credit in FY2007 has decreased from an initial projection of SDR 17.3 billion to about SDR 12.7 billion.

- **However, the impact of the advance repayments and delayed purchases is partly offset by higher interest rates, which provide more income in the Investment Account than projected.** The SDR interest rate used in the initial projections was 3.5 percent. The actual average SDR interest rate for the year is now projected at about 3.9 percent, or close to 40 basis points higher than originally projected. The higher SDR interest rate boosts earnings in the Investment Account and also increases the implicit earnings from the Fund's interest-free resources.

- **The increase in Turkey's quota reduces surcharge income**. The recent ad-hoc quota increase brought Turkey's quota to SDR 1,191 million (effective November 1, 2006) compared to SDR 964 million prior to the increase. The quota increase reduces the amount of credit outstanding that is subject to surcharges, resulting in a decrease in surcharge income compared to initial projections.[8]

[7] Uruguay made a second advance repayment at end-November of all its credit outstanding (SDR 0.7 billion).

[8] Surcharges apply on credit outstanding in the credit tranches and the Extended Fund Facility (EFF) above 200 and 300 percent of quota. The Supplemental Reserve Facility (SRF) carries a different schedule of surcharges, but there is currently no SRF credit outstanding.

Table 1. Projected Income Shortfall—FY2007
(In millions of SDRs)

Income shortfall projected in April 2006	**-59**
Income variance due to:	
Advance repayments 1/	-47
Delayed purchases	-15
Higher SDR interest rates	33
Turkey's quota increase (lower surcharge income)	-6
Updated income shortfall	**-94**
Expenditure variance due to:	
Projected budget outturn	8
Changes in the U.S. dollar/SDR exchange rate	17
Income shortfall now projected	**-69**

1/ Includes the effect of Uruguay's advance repayment of the full outstanding credit (SDR 0.7 billion) that took place at end-November 2006.

9. **On the expenditure side**, the projected budget outturn is expected to be a little below the approved FY2007 budget, as noted in the forthcoming budget paper.[9] Thus, assuming that capital expenses, which comprise both depreciation and expenditures in the capital budget that are not capitalized for accounting purposes, will be broadly in line with initial estimates, administrative and capital expenses will be some US$12 million below initial estimates.[10] In SDR terms, the Fund's administrative and capital expenses will be even lower because of the increase in the U.S. dollar/SDR exchange rate since the start of the financial year. The actual rate in the first six months has been around U.S. dollar 1.48 to the SDR compared with U.S. dollar 1.44 that was projected at the start of the year. The overall impact for the year is estimated at SDR 17 million. See Annex I for the estimated IAS 19 year-end accounting adjustment.

10. **Staff has also updated its projections for the Fund's medium-term income position (Table 2).** The updated projections assume an unchanged medium-term budgetary outlook, i.e., a path for administrative expenses of minus one percent in real terms in each year of the FY 2008 to FY 2010 period. The projections further assume that the margin for calculating the rate of charge will be unchanged at 108 basis points, that purchases will take place as phased under already existing arrangements, an SDR interest rate path in line with WEO-based projections for global interest rates and that the Investment Account will

[9] See *The FY2007 Administrative Budget—Six Month Outturn.*

[10] See *The FY2007–FY 2009 Medium-Term Administrative and Capital Budgets* (3/31/06).

generate returns on average about 50 basis points above the SDR interest rate,[11] and the repeat of existing policy decisions with respect to PRGF-ESF administrative expenses, which are currently not reimbursed to the GRA by the PRGF-ESF Trust.

11. **The advance repayments worsen the income picture in the short run, but do not fundamentally alter the medium-term outlook**, as they just bring forward some of the income shortfall that was already built into the previous medium-term projections. Annex II provides a variance analysis between prior projections and the current outlook. The FY 2008 income shortfall is now projected at about SDR 125 million compared to SDR 104 million previously, while the shortfall in FY 2009 is projected at some SDR 165 million (about SDR 190 million previously). However, there are downside risks, notably further advance repayments, a possible partial refund of SCA-1 balances and a lower interest rate path. On the upside, new crisis financing remains the main source of potential income, pending implementation of proposals for new income sources in follow-up to the recommendations by the Committee of Eminent Persons.

[11] See *Semi-Annual Review of Investment Account Assets* for further discussion on the performance of the portfolio.

Table 2. Projected Income Sources and Uses (FY2007–10)
(In millions of SDRs, except where indicated)

	Actual end-Oct 2006	FY07	FY08	FY09	FY10
A. Income sources 1/	**302**	**590**	**535**	**510**	**451**
Margin for the rate of charge (108 basis points)	83	137	93	82	60
Surcharges	58	98	64	56	27
Service charge (50 basis points on purchases) 2/	9	21	10	--	--
Investment income 3/	84	256	289	296	301
SCA-1 and other 4/	68	78	79	76	63
B. Administrative and capital expenses 5/	**334**	**659**	**659**	**674**	**696**
Administrative budget	319	608	619	635	655
Capital budget not capitalized	5	30	17	15	15
Depreciation expense	10	21	23	24	26
C. Income surplus/shortfall (A-B) 6/	**-32**	**-69**	**-124**	**-164**	**-245**
<u>Memorandum Items:</u>					
Fund credit outstanding (average in SDR billions)	15.4	12.7	8.7	7.6	5.5
SDR interest rate path (in percent)	3.8	3.9	4.4	4.5	4.6

1/ Annex III details the assumptions underlying these projections.
2/ Includes commitment fees, which are refundable (if purchases are made) such that income is only generated if phased purchases are not made.
3/ For ease of comparison, FY07 Investment Account income is imputed from May 1, 2006.
4/ Comprises the implicit return on the Fund's interest-free resources (primarily the SCA-1).
5/ Assumes the FY08-09 administrative and capital expenditures remain consistent with the medium-term budget, and assumes a U.S. dollar/SDR exchange rate of 1.50 for FY08–FY10.
6/ Annex V outlines the effect of changes in selected assumptions on the FY2007 income shortfall.

IV. FY2007 Midyear Review

12. **It is for consideration by the Executive Board whether any decisions need to be taken for the remainder of FY2007, in light of the updated income outlook**. In particular, one issue is whether a change in the margin for calculating the rate of charge is necessary. Another issue that needs to be examined is whether the decision to accumulate SDR 60 million in the SCA-1 remains appropriate in light of the changed circumstances in credit levels since April 2006.

13. **Margin for the rate of charge**. As noted during the March discussions, the current margin at 108 basis points over the SDR interest rate reflects steady increases in recent years and is a record high. Since 2002 when Fund credit peaked at SDR 70 billion, the margin has more than doubled. At the beginning of the financial year, there was agreement that there

should be no further increase in the rate of charge. Factors that weighed against increasing the margin in response to the projected income shortfall continue to hold and the changes to the FY2007 income projections are not large enough to warrant a departure from this position. Further, the exceptional circumstances prevailing at the beginning of the financial year continue to exist and the medium-term outlook remains fundamentally unchanged. Staff therefore does not propose any changes to the margin for the rate of charge.

14. **Accumulations in the SCA-1.** As aforementioned, the decision to place SDR 60 million in the SCA-1 during FY2007 reflected a desire to keep the overall level of precautionary balances unchanged. The increase in the projected income shortfall to around SDR 70 million might suggest that an increase in targeted SCA-1 accumulations by SDR 10 million is warranted. However, such an approach would be contrary to understandings reached at the start of the year, when burden sharing adjustments for the SCA-1 were expected to remain broadly unchanged.[12] Moreover, looking forward, the floor on the rate of remuneration under the Articles (80 percent of the SDR interest rate) would make it unfeasible to offset, through further SCA-1 accumulations, the projected impact on precautionary balances of the medium-term income shortfalls.

15. **Further consideration is that the recent decline in the number of large users of Fund resources (i.e., debtors) has increased the burden on the few remaining debtors.** As noted at the time of the decision of April 28, 2006, the adjustments were anticipated to average 17 basis points for FY2007. Actual adjustments to the rate of charge were 18 basis points in the first quarter of the financial year and could reach as high as 34 basis points in the fourth quarter (see Annex IV), primarily as a result of the early repayments.[13] The advance repayments have meant that remaining debtor countries are shouldering an increasingly large burden since the contribution is based on relative credit levels. The impact on individual debtors as a result of the shrinking pool of debtor members is significant. For example, it is now projected that Turkey would have to contribute SDR 18 million to the SCA-1 in FY2007, compared with the SDR 12 million projected at the start of the year.[14]

16. **The decline in the number of debtors is not an issue for burden sharing by creditor members**. The number of creditors participating in the Financial Transaction Plan (FTP) has remained largely unchanged in contrast to the decline in the number of debtors. Moreover, the relative contributions of creditors are quota-based and therefore not affected by changes in credit outstanding.

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[12] See paragraphs 15 and 16 in *Review of the Fund's Income Position for FY 2006 and FY2007* (4/12/06).

[13] The burden-sharing for deferred charges shows a similar pattern to that of SCA-1, though at a lower level. It is important to note that burden-sharing for deferred charges provides direct income to the Fund by protecting the Fund from the losses that would arise from unpaid charges. This direct protection is a central element of the Fund's financial structure and essential from an accounting and auditing perspective.

[14] The increase reflects Turkey's higher relative proportion of outstanding Fund credit and the higher projected average burden sharing adjustments to the rate of charge of 32 basis points for the second half of FY2007 compared to actual average adjustments of 20 basis points in the first half.

17. **The increase in burden sharing adjustments raises the question of whether the April 2006 decision on the SCA-1 should be revisited.** The increase in the projected income shortfall, together with the fact that burden sharing adjustments are fully refundable, could argue for maintaining the existing burden-sharing arrangements for the remainder of FY2007. However, this approach could prove counterproductive in terms of increasing the incentives for further advance repayments, and also runs contrary to the original expectation that the burden sharing adjustment would be broadly unchanged. Staff favors, therefore, options that mitigate the impact of the decline in credit on the burden sharing adjustments. This approach would remain within the spirit of the FY2007 package of income decisions. There are two broad options that could be considered:

- **Suspend debtor contributions to the SCA-1 in the second half of the year**. This approach would alleviate the impact of the decline in outstanding Fund credit on burden sharing by debtors and would reduce the planned accumulation to SCA-1 by SDR 15 million. However, this would also introduce a fundamental change to the burden-sharing mechanism which has traditionally involved a 50:50 split between debtors and creditors. Such a change would seem to warrant a more detailed and comprehensive discussion. Staff would propose to take up such a more general review of burden sharing in conjunction with the ongoing review of Fund finances.

- **Suspend SCA-1 contributions in the second half of FY2007**. This option would reduce the Fund's targeted precautionary balances by around SDR 30 million.[15] The total burden sharing adjustments to the rate of charge (for SCA-1 and deferred charges) for the entire year would be an average of 23 basis points, broadly similar to the total adjustment initially expected of 26 basis points.

18. **On balance, staff favors suspension of SCA-1 contributions in the second half of FY2007.** This approach would align total contributions by debtors with original expectations and would mitigate the impact of the advance repayments. Adoption of this proposal would require a decision by a 70 percent majority of the total voting power.

[15] Total precautionary balances are SDR 7.6 billion.

Annex I: Projected Income and Expense (FY2007-10)
(In millions of SDRs)

	FY2007	FY2007	FY2008	FY2009	FY2010
	Midyear Actuals	Updated Projections			
Regular Income					
1. Operational Income					
a. Periodic charges, including burden sharing	368	633	470	422	312
b. Interest on SDR holdings	66	127	137	140	140
c. Service and stand-by charges	9	21	10	--	--
Total operational income	443	781	617	562	452
2. Operational Expense					
Remuneration, including burden sharing	283	521	435	404	329
3. Net operational income	160	260	182	158	123
4. Administrative expense	334	659	659	674	696
Less: estimated cost of administering the PRGF-ESF Trust	(29)	(58)	(58)	(58)	(58)
	305	601	601	616	638
5. Net regular income shortfall **(A)**	(145)	(341)	(419)	(458)	(515)
Other Income					
6. Investment Income	84	232	289	296	301
7. Surcharges	58	98	64	56	27
Less: estimated cost of administering the PRGF-ESF Trust	(29)	(58)	(58)	(58)	(58)
8. Total other income **(B)**	113	272	295	294	270
9. Net income shortfall **(A + B)**	(32)	(69)	(124)	(164)	(245)
10. Other: IAS 19 timing difference (FY2007 effect) 1/		33			
11. Total FY2007 net income shortfall		(36)			

1/ See Annex II in *Review of the Fund's Income Position for FY 2006 and FY2007* (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: Medium-Term Income Position: Variance Analysis (FY2007–09)
(In millions of SDRs)

			FY2007	FY2008	FY2009
A.	**Income shortfall (April 2006 projections)** 1/		**-59**	**-104**	**-189**
	Changes due to:				
	Higher interest rates 2/		33	26	27
	Advance repayments 3/		-47	-61	-18
	Rephased purchases		-15	--	--
	Turkey's quota increase (lower surcharge income) 3/		-6	-11	-11
	Projected budget outturn variance		8	--	--
	Higher US$/SDR exchange rate 4/		17	26	27
B.	**Income shortfall (revised baseline projection)**		**-69**	**-124**	**-164**
	Memorandum Items:				
	Fund credit outstanding (average)	– April projections	17,300	13,500	10,700
		– revised projections	12,700	8,700	7,600
	SDR interest path (in percent)	– April projections	3.5	4.1	4.2
		– revised projections	3.9	4.4	4.5

1/ Medium-term projections presented in April 2006.
2/ Based on revised WEO-based projections, except for the first half of FY2007 which is based on actual.
3/ Reflects Turkey's quota increase from SDR 964 million to SDR 1,191 million effective November 1, 2006.
4/ The U.S. dollar has strengthened to an expected average US$/SDR exchange rate of 1.48 for FY2007 compared to initial projections of 1.44.

Annex III: Assumptions Underlying the Projections (FY2007–10)

	Actual Midyear Result	FY2007 Initial Projections	FY2007 Revised Projections	FY2008 Revised Projections	FY2009 Revised Projections	FY2010 Revised Projections
			(In billions of SDRs)			
Regular Facilities:						
1. Purchases (excl. reserve tranche purchases)	1.4	3.8	3.6	1.9	0.0	0.0
2. Repurchases	9.3	8.0	13.5	2.7	2.0	2.2
3. Average balances subject to charges	15.4	17.3	12.7	8.7	7.6	5.5
4. Average SDR holdings	3.4	2.7	3.2	3.1	3.1	3.1
5. Average remunerated positions	15.3	18.1	13.4	10.0	9.0	7.2
6. Average investment account assets	4.5	5.9	5.2	6.0	6.0	6.0
			(In percent)			
Average interest rates:						
1. SDR interest rate and basic rate of remuneration	3.78	3.46	3.89	4.35	4.47	4.55
2. Basic rate of charge	4.86	4.54	4.97	5.43	5.55	5.63
3. Margin of the rate of charge	1.08	1.08	1.08	1.08	1.08	1.08
4. Return on investments	4.34	3.96	4.46	4.85	4.97	5.05

Annex IV. Recent Average Burden Sharing Rates and FY2007 Quarterly Rates

(In percent)

	FY2002	FY2003	FY2004	FY2005	FY2006	-------------- FY2007 --------------			
						1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
						---- (actual) ----		---- (projected) ----	
Rate of Remuneration 1/									
Average adjustment for deferred charges	0.04	0.02	0.01	0.02	0.05	0.09	0.10	0.13	0.14
Average adjustment for SCA-1	0.10	0.08	0.08	0.10	0.18	0.19	0.20	0.26	0.29
Rate of Charge 1/									
Average adjustment for deferred charges	0.03	0.02	0.01	0.02	0.04	0.08	0.11	0.15	0.17
Average adjustment for SCA-1	0.10	0.08	0.07	0.09	0.15	0.18	0.22	0.29	0.34
Average basic rate of charge	3.26	2.54	2.09	3.01	4.00	4.75	4.98	5.08	5.08
Average SDR interest rate	2.80	2.06	1.58	2.09	2.93	3.67	3.90	4.00	4.00

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

Annex V. Effect on Projected Net Income Shortfall for FY2007 of Changes in Selected Assumptions
(In SDR millions)

	Average SDR Interest Rate in Second Half (in percent)					
	3.94	4.04[1/]	4.14	4.24	4.34	4.44
1. Net income shortfall with a fixed margin of 108 basis points	-72.6	-68.5	-64.4	-60.3	-56.0	-51.4
2. Increase in income due to purchases in the credit tranches higher by SDR 1 billion	7.7	7.7	7.7	7.7	7.7	7.7
3. Decrease in income due to a 5 percent appreciation in the U.S. dollar vis-à-vis the SDR	17.0	17.0	17.0	17.0	17.0	17.0

[1/] The projections for the remainder of the financial year assumed an average SDR interest rate of 4.04 percent.