



IMF POLICY PAPER

REVIEW OF THE FUND'S INCOME POSITION FOR FY 2019 AND FY 2020

June 2019

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

- A **Press Release**.
- The **Staff Report** on the Review of the Fund's Income Position for FY 2019 and FY 2020 was prepared by IMF staff and completed on March 19, 2019 for the Executive Board's consideration on April 5, 2019.

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INTERNATIONAL MONETARY FUND



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IMF Executive Board Reviews the Fund's Income Position for Financial Years 2019–20

The Executive Board of the International Monetary Fund (IMF) completed its annual review of the Fund's income position for the financial years ending April 30, 2019 (FY 2019) and FY 2020, on April 5, 2019.

FY 2019 Income Position

Total FY 2019 net income, including income from surcharges applied to higher access borrowing from the IMF, was projected at SDR 0.5 billion (US\$0.7 billion). Net income excluding the retained earnings of the gold endowment, will be added to the IMF's precautionary balances which are projected to reach SDR 17.7 billion (US\$24.8 billion) at end-FY 2019. The net income position for FY 2019 is broadly in line with the April 2018 estimate and reflects the increase in lending and investment income; largely offset by the IAS (International Accounting Standard) 19 loss, relating to reporting of employee benefits.

FY 2020 Income Position and Lending Rate

Net income of SDR 1.7 billion (US\$2.4 billion) is projected for FY 2020. The projections are subject to a high degree of uncertainty and are sensitive to the timing and amounts of disbursements under approved arrangements included in the projections, possible new arrangements, and the performance of the Fund's investment portfolio. The projected net income will allow the IMF to continue to accumulate precautionary balances.

The IMF charges member countries a basic rate of charge on the use of IMF credit, which is determined as the SDR interest rate plus a margin expressed in basis points. In April 2018 the Executive Board set the margin for this rate of charge at 100 basis points for financial years FY 2019 and FY 2020. In the context of this year's comprehensive review of the Fund's income position at the midpoint of this two-year period, the Executive Board concluded that the margin should remain unchanged.

The Executive Board also adopted a number of other decisions that have a bearing on the Fund's finances. These included decisions to transfer income from the Fixed-Income Subaccount of the Fund's Investment Account (IA) to the General Resources Account

(GRA); to place FY 2019 General Resources Account net income in equal parts to the Fund's Special Reserve and the General Reserve; to transfer currencies from the GRA to the IA of amounts attributable to FY 2019 net operational income; and to reimburse costs to the GRA.

Special Charges Review

The annual review of the Fund's income position amended Section VI of the 1985 decision on special charges to shift the requirement for regular review from the annual review of the Fund's income position, to the five-yearly Review of the Fund's Strategy on Overdue Financial Obligations.



March 19, 2019

REVIEW OF THE FUND'S INCOME POSITION FOR FY 2019 AND FY 2020

EXECUTIVE SUMMARY

The Fund's overall net income for FY 2019, which includes income from the Endowment Subaccount (EA), is projected at about SDR 0.5 billion, broadly in line with the April 2018 estimate, but below the February 2019 estimate.

The Fund's operational income is projected to be significantly higher than the April 2018 estimate, reflecting increases in both lending and non-lending income. However, current estimates of the pension-related (IAS 19) position point to a downwards adjustment that could, if it persists through the end of the financial year, negate a substantial portion of the Fund's net operational income for FY 2019. Net operational income after taking into account the pension-related adjustment is now expected to reach about SDR 205 million, below the February 2019 and the April 2018 estimates.

Consistent with the EA payout policy endorsed by the Executive Board in April 2018, the paper proposes that EA investment income for FY 2019 be retained in the EA rather than transferred to the GRA to be used for administrative expenses.

The paper recommends that GRA net income for FY 2019 (excluding projected income of the EA) be placed equally to the special and general reserve. After the placement of GRA FY 2019 net income to reserves, precautionary balances are projected to reach SDR 17.7 billion at the end of FY 2019. The paper further proposes to transfer currencies equivalent to the increase in the Fund's reserves from the GRA, after taking into account the transfer of income from the Fixed-Income Subaccount for use in meeting FY 2019 administrative expenses, to the Investment Account.

In April 2018, the margin for the rate of charge was set at 100 basis points for the two years FY 2019 and FY 2020. The margin may be adjusted before the end of the first year of this two-year period (i.e., FY 2019) but only if warranted by fundamental changes in the underlying factors relevant for the establishment of the margin at the start of the two-year period. Staff does not propose any change in the margin.

The projections for FY 2020 point to a net income position of SDR 1.7 billion. These projections are subject to considerable uncertainty and are sensitive to a number of assumptions.

The paper discusses the special charges framework that is subject to annual review. Staff does not propose changes to special charges at this time but proposes that the next regular review of the framework take place as part of the wider review of the Fund's strategy on overdue obligations.

Approved By
Andrew Tweedie

Prepared by the Finance Department in consultation with the Legal Department and the Office of Budget and Planning.

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INTRODUCTION¹

- 1. This paper reviews the Fund's income position for FY 2019 and FY 2020.** The paper updates projections provided in April 2018 and proposes decisions for the current year. The paper includes a comprehensive review of the Fund's income position as required under Rule I-6(4). No change is proposed in the margin for the rate of charge that was established under this rule in April 2018 for the period FY 2019–20.²
- 2. The paper is structured as follows:** The first section reviews the FY 2019 income position and the main changes from the previous projections. The second section makes proposals on the disposition of FY 2019 net income and placement to reserves. The third section updates the income projections for FY 2020, discusses the margin for the rate of charge for that period, and reviews the projected burden sharing adjustments. The last section discusses the framework of special charges on overdue obligations and proposes that future reviews be combined with the broader review of the Fund's arrears strategy, which takes place on a five-year cycle.

REVIEW OF THE FY 2019 INCOME POSITION

- 3. Net operational income for FY 2019 is significantly higher than estimated in April 2018 but is largely offset by the projected pension-related (IAS 19) adjustment (see Table 1).**³ The projections for total lending income are sharply higher than previously projected, reflecting mainly the large new arrangements approved since April 2018; offset partly by advance repurchases. Investment income and net administrative expenditures are projected to be higher in SDR terms. However, current estimates of the pension-related (IAS 19) position point to a downwards adjustment that could, if it persists through the end of the financial year, negate a substantial portion of the Fund's net operational income for FY 2019. Further details are provided below.

Total operational lending income including surcharges is projected to be SDR 1.2 billion, about SDR 351 million higher than the April 2018 estimate. This reflects mainly the new arrangements approved since April:

- *Margin income* is expected to be SDR 92 million higher than initially projected, reflecting an increase in average credit outstanding of about SDR 9.2 billion. The higher average stock of credit is mainly attributable to disbursements under Argentina's new arrangement, offset partly

¹ Prepared by a team comprising Alexander Attie, Martin Gororo, Courage Gumbanjera, Joseph Hanna, Janne Akseli Hukka, Kenji Kitano, David Moore, Diviesh Nana (lead), Amadou Ndiaye, Enosa Okosodo Odibo, Breno Oliveira, Diana Parra, Vidhya Rustaman, Yan Sun-Wang, Charles Xie, Wei Zhang, and Vera Zolotarskaya, under the guidance of Maria Manno and Simon Bradbury (all FIN).

² [A New Rule for Setting the Margin for the Basic Rate of Charge](#) (11/23/11), was adopted by the Executive Board in December 2011 and was first applied in setting the margin for the rate of charge for FY 2013–2014.

³ See [Review of the Fund's Income Position for FY 2018 and FY 2019–2020](#) (04/05/18).

by Portugal's advance repurchases totaling SDR 3.9 billion, which fully settled its outstanding credit from the Fund;

- *Service charges* are projected at SDR 172 million, almost three times the initial estimate, reflecting an increase in disbursements mainly attributable to the large new GRA arrangements (including Argentina) approved since April 2018;
- *Commitment fees* are projected to be higher by about SDR 30 million as a result of the recognition of commitment fee income from Ukraine's cancellation of its extended arrangement in December 2018 (which was originally scheduled to expire in March 2019).⁴
- *Surcharge income* is projected to be SDR 119 million higher, with the bulk—over forty percent—attributable to Argentina's SBA; offset partly by the lower-than-expected surcharge income from Ukraine reflecting disbursements not drawn down as anticipated following the early cancellation of its previous arrangement.

Investment income is projected to be SDR 508 million, about SDR 187 million higher than in April 2018. This reflects mainly the impact of translation gains from restating the U.S. dollar value of the Endowment Subaccount into SDR, and higher than anticipated income from the Fixed-Income Subaccount:

- *The Fixed-Income Subaccount (FI)*: Full year investment income from the subaccount is now projected at SDR 249 million compared with SDR 190 million estimated a year ago. The difference reflects the positive impact on investment performance of a lower-than-expected rise in bond yields over the last year;
- *The Endowment Subaccount (EA)*: Investment income for FY 2019 is projected to be higher in SDR terms, almost double the previous estimate in April; mainly reflecting revaluation gains on the portfolio in SDR terms following the strengthening of the U.S. dollar against the SDR since the beginning of the year.⁵ EA income for the year is estimated at SDR 259 million, apportioned almost equally between: i) projected portfolio returns in U.S. dollar terms (1.31 percent through end-January), and ii) translation gains from restating the projected U.S. dollar value of the portfolio. In line with the EA payout policy agreed in April, staff proposes that EA investment income for FY 2019 be retained in the EA rather than transferred to the GRA to be used for administrative expenses (Box 1).

Interest free resources: Implicit earnings on the Fund's interest free resources are in line with previous estimates.

⁴ Commitment fee income is only recognized at the expiration or cancellation of an arrangement in accordance with accounting principles.

⁵ A translation gain (loss) arises if the U.S. dollar strengthens (weakens) against the SDR over the reporting period resulting in a higher (lower) reported value of the U.S. dollar-based EA in SDR equivalents.

Reimbursements to the General Resources Account (GRA): In accordance with the Articles of Agreement, the GRA has to be reimbursed in respect of (i) the expenses for conducting the business of the SDR Department; and (ii) the expenses of the Special Disbursement Account on the basis of reasonable estimates. Moreover, on the basis of an Executive Board decision, the PRGT has to reimburse the GRA for the expenses of administering the PRGT (all expenses not only those related to SDA resources).⁶ The methodology for estimating the costs incurred in administering concessional lending activities and the SDR Department was strengthened last year and reimbursements are now based on lagged actual data.⁷

- The expenses of conducting the business of the SDR Department in FY 2019 amount to SDR 3.19 million (proposed Decision 1), in line with the prior year estimate.⁸
- The estimated PRGT administrative expenses for FY 2019 are SDR 62.83 million (proposed Decision 2), slightly above earlier estimates in SDR terms.
- Similar to FY 2018, staff does not propose reimbursement related to SDA resources in the Catastrophe Containment and Relief (CCR) and PRG-HIPC trusts. In FY 2019, expenses incurred by the GRA for the CCR Trust and PRG-HIPC Trust were limited to staff's time relating to the investment and book-keeping of the CCR Trust's resources. In the view of staff, the administration of SDA resources in these trusts did not generate any incremental costs (i.e., costs beyond those that would have otherwise been incurred by the GRA in managing and investing donor resources in these trusts or PRGT or IA investments).⁹

Expenses are estimated to be about SDR 32 million higher than previously projected due mainly to a stronger annual average U.S. dollar/SDR exchange rate compared with the April projections. Net administrative expenditures in FY 2019 are expected to match earlier projections in U.S. dollar terms, reflecting a full utilization of the approved budget.¹⁰ However, based on the outcome for the first nine months of the year, these expenses are converted at a rate of US\$1.40 per SDR, compared with a rate of US\$1.46 per SDR assumed in the April projection, inflating the

⁶ Staff is undertaking further work regarding the methodology for SDA related reimbursements and will present these findings and any recommendations next year, in the FY 2021 review of the Fund's income position.

⁷ The process relies primarily on the Fund's Analytic Costing and Estimation System (ACES) and estimates now use lagged actual data as opposed to forecasting Q4 costs.

⁸ Consistent with paragraph 5(b) of Schedule M to the Articles of Agreement, the SDRs considered for calculating the assessment do not include SDR 20 million that, due to the overdue financial obligations of certain members, are being held in an escrow account pursuant to paragraph 5(a) of Schedule M.

⁹ Article V, Section 12(i) requires the GRA to be reimbursed from time to time in respect of the expenses of administration of the SDA paid from the GRA by transfers from the SDA on the basis of a reasonable estimate of such expenses. No reimbursement, however, would need to be made if the administration of SDA-related resources did not incur incremental costs, i.e., where the SDA-related expenses pertain to activities that are already being carried out and paid for by the Fund from the GRA or other account. On the basis of this rationale, no reimbursement has been made regarding SDA resources in the PRG-HIPC Trust. See [Multilateral Debt Relief Initiative and Exogenous Shocks Facility](#) (11/16/05).

¹⁰ See [FY2020–FY2022 Medium-Term Budget](#) (04/02/19).

expenses in SDR terms. Capital expenses and the depreciation charge are slightly lower than previously projected by about SDR 2 million.

Table 1. Projected Income and Expenditures—FY 2019

(in millions of SDRs)

	FY2019	
	Initial Projections ¹	Current Projections
A. Operational income including surcharges	1,153	1,564
Lending income	843	1,194
Margin for the rate of charge	419	511
Service charges	62	172
Commitment fees	53	83
Surcharges	309	428
Investment income	190	249
Fixed-Income Subaccount (reserves)	190	249
Endowment Subaccount payout ²	0	0
Interest free resources ³	56	55
SCA-1 and other	56	55
Reimbursements	64	66
SDR Department	3	3
PRG Trust	61	63
B. Expenses	841	873
Net administrative expenditures	777	811
Capital budget items expensed	24	22
Depreciation	40	40
C. Net operational income (A-B)	312	691
Net pension asset/(liability) (IAS 19) gains/(losses)	---	-486
D. Net operational income after pension-related (IAS 19) adjustment	312	205
Endowment Subaccount (gold profits) investment income	131	259
Net income position	443	464
<u>Memorandum Items:</u>		
Fund credit (average stock, SDR billions)	41.9	51.1
SDR interest rate (average, in percent)	1.1	1.0
US\$/SDR exchange rate (average)	1.46	1.40
Precautionary balances (end of period, SDR billions)	17.7	17.7

Source: Finance Department and Office of Budget and Planning

¹ [Review of the Fund's Income Position for FY 2018 and FY 2019-2020](#) (04/05/18).

² Consistent with the EA payout policy framework endorsed by the Executive Board in April 2018, the initiation of payouts is assumed to be delayed (until at least FY 2021).

³ Interest free resources reduce the Fund's costs and therefore provide implicit returns. Since the Fund invests its reserves in the IA to earn a higher return, the interest free resources retained in the GRA are mainly attributable to the SCA-1, unremunerated reserve tranche positions not represented by gold holdings, and GRA income for the year not transferred to the IA. These resources reduce members' reserve tranche positions and the Fund's remuneration expense resulting in implicit income for the Fund.

Based on actual developments to end-January, the projected pension-related (IAS 19) adjustment is currently expected to reduce net income in FY 2019 by about SDR 486 million.

IAS 19 "Employee Benefits" is the International Financial Reporting Standard (IFRS) that deals with accounting for pension and other employee benefits. As discussed in Annex II, pension-related (IAS 19) gains and losses are volatile year-on-year but tend to offset over time.

- The FY 2019 expected pension-related (IAS 19) adjustment comprises two elements, remeasurement gains/(losses); and the net periodic pension cost, net of funding:
 - Remeasurement gains and losses result from changes in the actuarially-assessed estimated future benefit obligation; and changes in the fair value of plan assets.
 - The remeasurement projections for FY 2019 are based on actual data to end-January and current estimates for the remainder of the year. As such they remain subject to considerable uncertainty and may need to be revised based on developments over the next few months. For instance, at the end of the second quarter, there was a small remeasurement gain reflecting mainly the offsetting impact of the higher discount rate prevailing at the time (see Text Table). The discount rate began the year at 4.05 percent, and reached about 4.41 percent at end-October, before reversing to about 4.07 percent by end-February, mirroring the recent downturn in interest rates in the United States.¹¹
 - Current projections for the year point to net actuarial remeasurement

losses of SDR 364 million, compared with large gains recognized in the past two years (Text Table). Based on current projections, the fair value of plan assets is expected to decline in U.S. dollar terms by end-April 2019 reflecting a moderate loss (about negative 1.3 percent to end-January) on the portfolio driven by the performance of equities to end-January. After allowing for the expected interest income on plan assets the actuarially-determined

Text Table. Reconciliation of Pension-Related (IAS 19) Gains/(Losses)
(in millions of SDRs)

	FY 2017	FY 2018	FY 2019	
	Actual for year	Actual for year	Actual end- Oct 2018	Projected for year
Accrual vs. Funding	-247	-140	-63	-122
Pension cost accrual	-381	-274	-132	-263
Service cost	-354	-274	-137	-273
Interest expense on pension liability	-308	-340	-177	-355
Expected interest income on pension asset ¹	281	340	182	365
Pension funding	134	133	69	141
Remeasurement gains/(losses)	967	381	20	-364
Discount rate change	380	129	516	28
'Excess return' impact ¹	616	594	-512	-391
Exchange rate translation	-29	2	16	-1
Other ²	0	-344	0	0
Total IAS 19 gains/(losses)	720	241	-43	-486

Source: Willis Towers Watson and IMF Finance Department

¹ Total income from plan assets comprises two components for financial reporting purposes: i) the expected interest income on plan assets included in the pension cost and ii) a gain or loss included in remeasurement losses that is in 'excess' of this expected income.

² Relates to adoption of latest (2017) UN mortality table.

¹¹ A 100 basis point change in the discount rate can increase or decrease the value of the pension liability by 17 to 19 percent. The timely valuation of key inputs such as the valuation of plan assets is constrained by the diverse nature of the underlying asset classes, notably the non-marketable investments.

remeasurement of plan assets is about SDR 391 million (see Text Table). A small increase in the projected discount rate (as noted above) decreased the defined benefit obligation slightly, resulting in a gain of about SDR 28 million.¹²

- An additional adjustment of SDR 122 million is made, representing the difference between (i) the actuarially determined annual IAS 19 expense (the increase in obligations under the staff retirement plan stemming mainly from an additional year of staff service of SDR 263 million); and (ii) the funding (cash appropriation) for the year projected at SDR 141 million.
- Staff does not project the pension related (IAS 19) adjustment beyond the current year under review (i.e. FY 2019). Plan asset performance has been highly volatile historically making it more difficult to project with reasonable accuracy over the medium term (i.e. FY 2020 and beyond). On the liability side, the defined benefit obligation (DBO) is highly sensitive to the underlying actuarial assumptions, in particular the discount rate as noted above. The DBO is also susceptible to changes in other financial and demographic assumptions (e.g. inflation rate, salary increases, etc.).
- Going forward, the pension-related (IAS 19) adjustment is expected to remain unpredictable and any volatility in the underlying actuarial assumptions such as the discount rate would translate into volatility in the Fund's income and reserves.¹³ However, based on past experience, in the long run, gains and losses tend to offset each other over time (see Text Table).

DISPOSITION DECISIONS

4. As in previous years, the Executive Board needs to consider certain decisions on the disposition of income for FY 2019. These cover the use of IA investment income earned in FY 2019, which impacts the determination of GRA net operational income including surcharges in FY 2019; the placement of net income to reserves and the allocation between the special and general reserve; and the transfer of currencies from the GRA. These elements are discussed below, and presented in Figure 1, beginning with the disposition of IA investment income.

5. The use of IA income is guided by the Fund's Articles. Under Article XII, section 6 (f) (iv), investment income from the IA may be invested, held in the IA, or used for meeting the expenses of conducting the business of the Fund.¹⁴ Staff proposes that income in the subaccounts of the IA be used as follows:

- **Fixed-Income Subaccount:** Consistent with past practice, staff proposes that the estimated FY 2019 income be transferred to the GRA to be used towards meeting the expenses of the

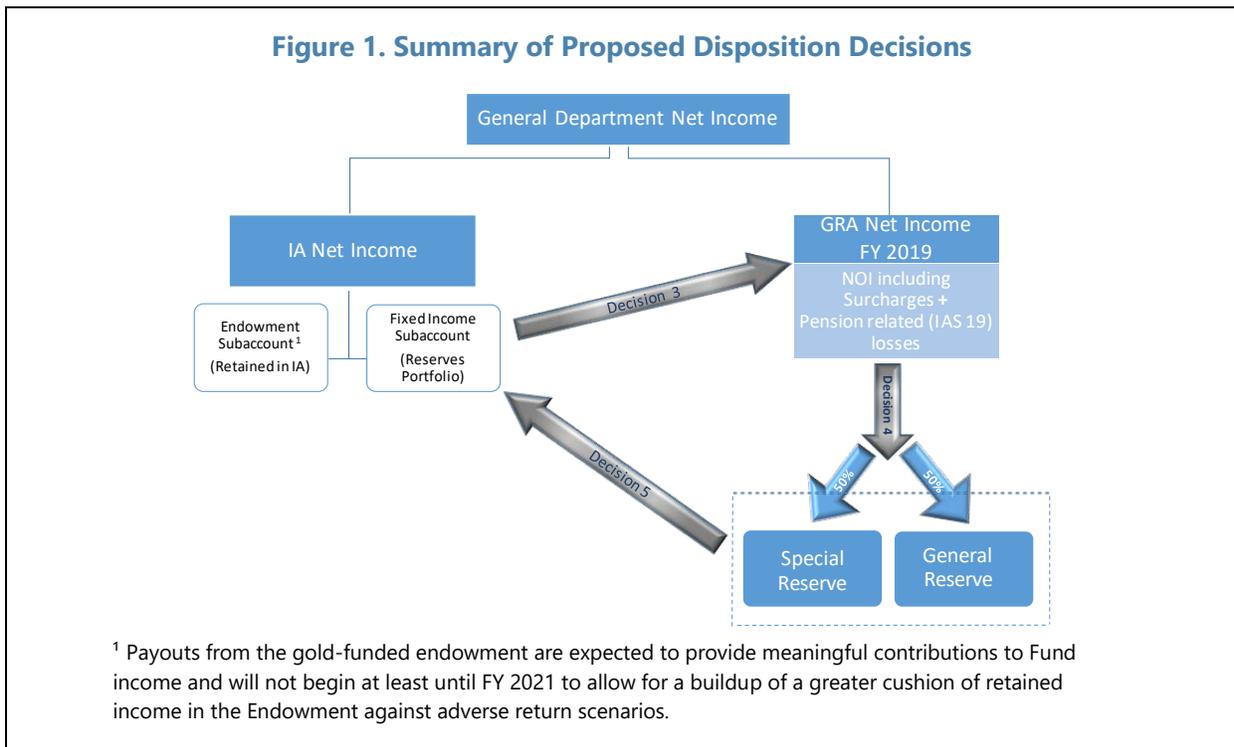
¹² The end-January rate is projected to year end.

¹³ The pension-related adjustment for FY 2019 will be finalized after year-end and the impact on net income will be reported in the Annual Financial Statements scheduled for release in June 2019, and the Actual Outcome paper, expected in August 2019.

¹⁴ Article XII, Section 6 (f)(iv). The Board could also, by a 70 percent majority of the total voting power, decide to reduce the amount of the investment in the IA (Article XII, Section 6 (f)(vi)).

Fund (proposed Decision 3). By so doing the IA income will contribute to the GRA net income, which will be placed to the Fund's reserves as indicated in Figure 1; and

- Endowment Subaccount:** In line with the EA payout policy framework endorsed by the Executive Board in April 2018, staff proposes that investment income earned in the EA in FY 2019 be fully retained in the endowment and not be transferred to the GRA to be used for administrative expenses (Box 1). Based on current projections for FY 2019, this would imply that EA projected income of SDR 259 million would be retained and reinvested according to the investment strategy for the Endowment Subaccount. An equivalent amount would be reflected in the special account for IA retained earnings, raising cumulative retained earnings of the IA (all attributed to the EA) to about SDR 917 million (proposed Decision 3).



Box 1. EA Payout Policy Framework

In April 2018, the Executive Board endorsed an EA payout policy framework with the following key features:

- Annual payout amounts in US dollars will be determined according to a constant real payout rule.
- Annual payouts will be decided at the time of the Fund's net income disposition decisions. The initial nominal US dollar value of the payout will be aligned with the prevailing return outlook.
- The deflator for annual inflation adjustments will be the Fund's annual GED.
- The payout will be subject to a NAV-based limit which would trigger a suspension of payouts. The initial value of the payout and NAV-based limit will be decided by the Board prior to the first payout.
- Payouts will be delayed for three years (until FY 2021) to build a cushion of retained investment income.
- The retained investment income would be reassessed at the end of the three-year period.

6. The Articles permit the Fund's net income of the GRA to be either distributed to members or placed to reserves in accordance with the annual decision on the disposition of the Fund's net income. At the last biennial review of the Fund's precautionary balances, Directors stressed the importance of maintaining an adequate level of precautionary balances and supported retaining the current indicative medium-term target of SDR 20 billion.¹⁵ Accordingly, staff proposes placing all FY 2019 GRA net income to reserves. This would increase precautionary balances by SDR 0.2 billion to SDR 17.7 billion at the end of FY 2019.

7. In April 2018, Directors broadly agreed with the principles proposed by staff to guide the framework for annual allocation decisions of net income between the special and general reserve (Box 2). On this basis, most Directors supported the proposal to continue the approach of allocating the net income of the General Resources Account (GRA) in equal parts to the two reserves. While willing to go along with the consensus, a few Directors would have favored a faster pace of accumulating special reserves, and a few saw limited value in distinguishing between the two reserves. Some other Directors preferred a lower allocation of net income to the special reserve. Directors stressed the need to monitor the framework closely and revisit the framework periodically, in line with the cycle for reviewing the adequacy of the Fund's precautionary balances and for setting the margin for the rate of charge, or sooner if needed.

8. Against this background, staff proposes that net income again be allocated equally to the general and special reserves in FY 2019 (proposed Decision 4). Based on current projections, maintaining an equal allocation of net income (including surcharge income) to the two reserves in FY 2019 would increase the special reserve by about SDR 103 million to SDR 5.7 billion,¹⁶ while the

¹⁵ See the [Review of the Adequacy of the Fund's Precautionary Balances](#) (12/27/17).

¹⁶ This does not include the part of the special reserve attributable to gold sales for the establishment of the endowment which is not considered to be part of the Fund's precautionary balances.

general reserve would also rise by SDR 103 million to SDR 10.8 billion.¹⁷ The Board will have an opportunity to review the framework in 2020.

Box 2. Principles to Guide Annual Reserve Allocation Decisions

Article XII, Section 6(a) requires the Fund's net income to be distributed to members or placed to the general or special reserve. The special reserve serves as the first line of defense against income losses under a 1957 Board Decision. Under the Fund's Articles, no distributions (dividends) can be made from the special reserve. It thereby provides fundamental strength to the Fund's balance sheet as these resources are assured to be available if needed to absorb future losses. The general reserve also provides important strength to the balance sheet and is available to absorb future losses. The Articles permit reserves accumulated in the general reserve to be distributed to members, in proportion to their quota, if the Board approves such decision by a 70 percent majority of the total voting power. The general reserve thereby preserves flexibility for the Board to consider alternative uses of the resources in the event that reserves are viewed as more than adequate to cover potential risks of financial losses.

At the last review of the Fund's income position the Board broadly endorsed a set of principles to help guide future decisions on allocation of net income between the general and special reserves. In recognition of differing views among Directors on the appropriate allocation mechanism in past discussions, these principles aim to facilitate achieving the broadest consensus possible over future decisions:¹

- **Maintain a role for both the general and the special reserve.** This is consistent with the Fund's longstanding practice over the past six decades. As in the past, it does not preclude the possibility that in certain years, all net income would be allocated to the general reserve if balances in the special reserve were considered adequate, or to the special reserve, if for example there was a need to replenish balances following a period of losses.
- **Be consistent with the new income model and periodic Board assessments of the adequacy of precautionary balances.** This recognizes that the distinction between surcharge and other forms of lending income is no longer meaningful under the new income model. It also suggests that it would not be appropriate to accumulate special reserves above the agreed floor for precautionary balances.
- **Balance the goals of strengthening the Fund's balance sheet and preserving future Board flexibility in the use of reserves.** Both considerations have been stressed in previous Board discussions, and the allocation framework should allow scope for an appropriate balance to be struck between these two objectives. Where that balance is struck could be expected to vary over time.
- **Retain Board flexibility to decide on future income allocations.** Any framework should not be applied mechanistically, but rather would provide sufficient flexibility for future Board judgments in light of evolving circumstances.

¹ The Board has considered alternative allocation approaches on five occasions since FY 2015. See [Review of the Fund's Income Position for FY 2018 and FY 2019-2020](#) (04/05/18) for a detailed account of the history of the two reserves and past allocation practices, as well as the recent Board discussions.

9. The placement of FY 2019 GRA net income to reserves provides scope for further transfer of currencies to the Fixed-Income Subaccount. Article XII, Section 6(f)(ii) permits the transfer of additional GRA currencies to the IA if, at the time of the decision to make such transfer, the Fund's reserves are above the cumulative amount of previous transfers of currencies from the

¹⁷ Net operational income placed to reserves comprises net operational income together with the pension-related (IAS 19) losses.

GRA to the IA.¹⁸ After the above placement, the combined balance in reserves is projected to total SDR 20.9 billion. This would remain above the net cumulative amount of transfers made thus far to the IA from the GRA of SDR 20.7 billion.¹⁹

10. Accordingly, staff proposes to transfer currencies equivalent to the full amount of the increase in reserves from the GRA to the IA for investment in the Fixed-Income Subaccount (proposed Decision 5). This proposal is consistent with the assumption that the IA will over time achieve a higher return than the SDR interest rate (see Annex IV for IA performance scenarios).

11. The projection of GRA net income is sensitive to a number of assumptions and subject to considerable uncertainty. For FY 2019, net operational income reflects both actual as well as expected purchases and repurchases scheduled for the remainder of the year. The pension-related (IAS 19) adjustment projected for the year is sensitive to changes in market factors such as the discount rate and asset performance, and could still change significantly depending on developments in the last three months of the year (Annex II). Against this background, the projections remain susceptible to deviations in key underlying assumptions which can have a negative impact on the outcome of net income, and given the relatively small surplus currently projected, could even result in an actual GRA net income shortfall by end-April.

12. The Articles would permit an actual income shortfall for FY 2019 to be charged against either the special reserve or the general reserve. The special reserve was established in 1957, and the relevant Board decision provides that “any administrative deficit for any fiscal year of the Fund shall be written off first against this reserve”. Since the establishment of the special reserve, all operational deficits have been charged against the special reserve on the basis of the 1957 decision (with the most recent case being 2008) without the adoption of a specific Executive Board decision in any given financial year with a deficit. Further, in the event of a net income shortfall in the GRA, no transfer of currencies from the GRA to the IA would be made since the total amounts already transferred to the IA would exceed the total amount of the general reserve and the special reserve.

FY 2020 INCOME OUTLOOK

13. The income outlook for FY 2020 is still expected to be strong. Net income for FY 2020 is projected at about SDR 1.7 billion (Table 2). These projections assume the margin is maintained at 100 basis points (see below) and are sensitive to a number of factors including global interest rates; the timing of purchases and repurchases under existing arrangements; possible new arrangements; the US dollar/SDR exchange rate; and annual pension-related adjustment as determined under IAS 19.

¹⁸ The cumulative amount is derived net of transfers out of the IA. In the past, windfall gold sales profits of SDR 2.45 billion had been transferred to the IA but these were subsequently transferred out during FY13–14, following a distribution of the general reserve to the membership, as part of the strategy for the creation of a self-sustained PRGT.

¹⁹ These totals include special reserves attributed to profits from the 2009–2010 gold sales of SDR 4.4 billion, which are not treated as part of the Fund's precautionary balances, and corresponding transfers to establish the gold endowment.

Table 2. Projected Income Sources and Uses—FY 2019–2020

(in millions of SDRs)

	FY2019	FY2020
A. Operational income	1,564	2,418
Lending income	1,194	2,068
Margin for the rate of charge	511	735
Service charges	172	86
Commitment fees	83	357
Surcharges	428	890
Investment income	249	208
Fixed-Income Subaccount (Reserves)	249	208
Endowment Subaccount payout ¹	0	0
Interest free resources ²	55	74
SCA-1 and other	55	74
Reimbursements ³	66	68
SDR Department	3	3
PRG Trust	63	65
B. Expenses	873	888
Net administrative expenditures	811	821
Capital budget items expensed	22	21
Depreciation	40	46
C. Net operational income (A-B)	691	1,530
Net pension asset/(liability) (IAS 19) gains/(losses) ⁴	-486	
D. Net operational income after pension-related (IAS 19) adjustment	205	1,530
Endowment Subaccount investment income ¹	259	156
Net income position	464	1,686
<u>Memorandum Items:</u>		
Fund credit (average stock, SDR billions)	51.1	73.5
SDR interest rate (average, in percent)	1.0	1.2
US\$/SDR exchange rate (average)	1.40	1.41
Precautionary balances (end of period, SDR billions)	17.7	19.2

Source: Finance Department and Office of Budget and Planning

¹ Consistent with the EA payout policy framework endorsed by the Executive Board in April 2018, the initiation of payouts is assumed to be delayed (until at least FY 2021).

² Interest free resources reduce the Fund's costs and therefore provide implicit returns. Since the Fund invests its reserves in the IA to earn a higher return, the interest free resources retained in the GRA are mainly attributable to the SCA-1, unremunerated reserve tranche positions not represented by gold holdings, and GRA income for the year not transferred to the IA. These resources reduce members' reserve tranche positions and the Fund's remuneration expense resulting in implicit income for the Fund.

³ No incremental costs are projected in managing the SDA resources in the CCR Trust.

⁴ The pension-related (IAS 19) adjustment is actuarially determined and finalized shortly after the end of the financial year. An estimate is provided only for the current year under review (FY 2019).

A. Key FY 2020 Income Outlook Factors

14. Key factors that affect the FY 2020 income outlook are discussed below (see Table 2).

A sensitivity analysis on the income effects of changes in some of the assumptions is presented in Table 3.

- *Lending income.* Income from margin and surcharges is projected to be on an upward trend in FY 2020, at about SDR 735 million and SDR 890 million, respectively, reflecting the continued disbursements under the current arrangements. Income from commitment fees in FY 2020 of about SDR 360 million reflects the expected two-year commitment fees earned on Mexico's Flexible Credit Line (FCL) that is scheduled to expire in FY 2020.

IA Investment Income:

- *Fixed-Income Subaccount:*²⁰ Investment income is expected to be about SDR 208 million in FY2020, lower than previously estimated, and reflects an increase in interest rates as implied by market forwards. This is based on an estimated return of about 1.26 percent, and is lower than the April 2018 projection as a result of lower prevailing SDR interest rates. Annex IV provides further discussion on the sensitivity of the returns in this portfolio to changes in global interest rates.
- *Endowment Subaccount:*²¹ The projected average income from the endowment totals about SDR 156 million in FY 2020. This is based on projected average EA returns over the medium term of about 4.4 percent in nominal terms in U.S. dollars, compared with a 4 percent return projected in April 2018, and is consistent with the return outlook discussed with Directors at the last review of the IA (see Annex IV). Return projections are highly dependent on market assumptions and remain subject to considerable uncertainty given the high degree of volatility across asset classes in which the EA is invested, especially over short time periods. In line with the EA payout policy endorsed in April 2018, estimated income earned in the EA in FY 2020 is to be retained in the endowment for reinvestment, and is therefore not included in the Fund's operational income (Box 1).
- *Interest-free resources and reimbursements.* Income from interest-free resources is projected to grow steadily higher reflecting an expected rise in global interest rates and the increase in earnings projected for the year. Projected reimbursements are based on the FY 2019 estimates.
- *Expenditures.* Net administrative and capital expenditures are consistent with those estimated in the medium-term budget paper.²²

²⁰ The balance of the Fixed-Income Subaccount corresponds to the investment of the Fund's reserves except for the gold profits and any currencies retained in the GRA.

²¹ The implementation of the proposed investment strategy for the passively and actively managed portions of the endowment was completed during FY 2017 and FY 2019, respectively.

²² See [FY2020–FY2022 Medium-Term Budget](#) (04/02/19).

- *Impact of IFRS 9.* IFRS 9 “Financial Instruments” becomes effective for the Fund in FY 2019. Under the standard, entities are required to assess financial instruments for impairment using an “expected loss” methodology considering a broad range of relevant factors, including forward-looking information. As a result, in the event of significant expected arrears, IFRS 9 is likely to lead to an earlier recognition of an impairment loss than under the old standard, even though the underlying assessment of credit risk by the Fund has not changed. Accordingly, the implementation of IFRS 9 may heighten uncertainty around the volatility of income. While the adoption of the new standard by the Fund is not expected to significantly impact the FY 2019 annual financial statements, staff will only be able to finalize their assessments at the end of the year. Annex III contains a fuller discussion on the implementation of the new standard in the Fund.
- *Sensitivity.* Projected income and expenses remain susceptible to changes in the underlying assumptions. The effect of changes in key assumptions is summarized in Table 3.

**Table 3. Sensitivity Analysis—Effect of Changes
in Selected Assumptions on FY 2020 Projected Income**
(in millions of SDRs)

Increase/decrease in:	
SDR interest rate by 50 basis points	
Implicit returns ¹	33
Credit tranche purchases (non-FCL) by SDR 10 billion ²	275
US dollar vis-à-vis SDR by five percent - Administrative expenses	39
US dollar vis-à-vis SDR by 1 US cent - Endowment Subaccount	37
Investment income margin by 50 basis points	109

¹ Implicit returns on GRA interest-free resources.

² Assumes May 1 transaction with full drawing of SDR 10 billion and access of 500 percent of quotas.

Includes service charges, margin on the basic rate of charge and level based surcharges (commitment fees are excluded).

B. Review of the Margin for the Rate of Charge

15. Under Rule I-6(4), the Executive Board sets the margin over the SDR interest rate for a period of two financial years. The level of the margin should be adequate to cover the Fund’s intermediation costs, taking into account income from service charges, and help build up the Fund’s reserves, considering the existing level of precautionary balances and the expected contribution from surcharges and commitment fees. At the same time, the level of the margin should ensure that the Fund’s borrowing costs remain appropriately aligned with long-term credit market conditions. The rule also permits that, in exceptional circumstances, the margin may be set at a level other than that required to cover intermediation expenses and accumulate reserves.

16. In April 2018, Directors supported maintaining the margin for the basic rate of charge at 100 basis points for the period FY 2019–2020. At the time, Directors saw no compelling case for taking additional steps to affect the pace of the Fund’s reserve accumulation and considered the level of the margin to be broadly aligned with long-term credit market conditions. Directors also

acknowledged continued constraints to the Fund's non-lending income and that a portion of the Fund's non-lending activities will need to continue to be financed by income from the margin, thereby reducing its contribution to the Fund's reserve accumulation.²³

17. While the margin is set for a two-year period, Rule I-6(4) calls for a comprehensive review of the Fund's income position before the end of the first year. The Executive Board may adjust the margin in the context of such review but, to provide for stability and predictability, 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 two-year period.

18. Staff does not propose any change in the level of the margin in FY 2020. As discussed further below, staff is of the view that there has been no fundamental change in the underlying factors relevant for setting the margin since the last review, and therefore no change is proposed for FY 2020. Completion of the review is proposed in Decision 6.

Coverage of Intermediation Costs

19. Lending income is expected to remain substantially in excess of intermediation costs in FY 2020.^{24, 25} Income from service charges is projected at US\$121 million in FY 2020 (Table 4, row B). An unchanged margin of 100 basis points would provide further income of about US\$1,037 million. These amounts compare with estimated intermediation costs of about US\$94 million in FY 2020 (Table 4, Row A). Fund-wide intermediation costs related to generally available facilities (GAF) are derived using the Fund's Analytic Costing and Estimation System (ACES). They cover direct personnel, travel and other administrative expenses, as well as indirect support and governance costs. A proportion of capital spending is also added. Estimated FY 2020 costs are slightly higher than FY 2019, reflecting the expected increase in program engagement; budget-to-budget this is an addition of around 10 countries relative to what was expected during the FY 19 budget discussions.

20. Commitment fees for non-drawing arrangements and surcharges are also expected to make substantial further contributions to the Fund's lending income. Income from commitment fees and surcharges in FY 2020 are estimated at about US\$503 million and US\$1,255 million,

²³ The Executive Board has consistently set the margin under the exceptional circumstances clause since the amended Rule I-6(4) was first implemented as part of the Fund's New Income Model. The rule was designed to move away from reliance on lending income for financing the Fund's non-lending activities with the expectation that these would be covered by the Fund's non-lending income. However, investment income, the main source of the Fund's non-lending income, remains constrained by low global interest rates. Payouts from the gold-profits-funded endowment are also expected to provide a meaningful contribution to Fund income over the long term, but are not assumed to begin until FY 2021 to allow for a buildup of a greater cushion of retained income in the endowment against adverse return scenarios.

²⁴ Consistent with past practice, the projections only take account of arrangements approved through end-January 2019 and not possible new arrangements.

²⁵ Commitment fees are included in the analysis as a source of income that contributes to reserve accumulation. Under this approach, the analysis in setting the margin is insulated from the unpredictability of commitment fees. See paragraphs 19–20 in [A New Rule for Setting the Margin for the Basic Rate of Charge](#) (11/23/11).

respectively (Table 4, row E and F). Commitment fees are refundable in the event of drawings and thus income from these fees is recognized only at the expiration or cancelation of arrangements.

Reserve Accumulation

21. Precautionary balances at end-FY 2020 are now projected to be somewhat higher than the April 2018 estimate but would still remain short of the medium-term target. Table 4 first illustrates the potential reserve accumulation that would result if lending income were required solely to cover intermediation costs and provide for additional reserves (Rows G and H). In this hypothetical scenario, potential reserve accumulation with a margin of 100 basis points would rise to 11.3 percent in FY 2020. Projected actual reserve accumulation (after taking into account the need to cover non-lending expenditures while investment income is constrained by low interest rates) would be 8.7 percent of reserves in FY 2020 (Rows I and J). Precautionary balances are now projected to reach SDR 19.2 billion by end-FY 2020, compared with SDR 18.6 billion estimated in April 2018. Table 4 further simulates reserve accumulation at alternative margins of 80 and 120 basis points, respectively.

22. The medium-term outlook for Fund income and reserve accumulation is also significantly higher than projected in April 2018 (Figure 2 and Annex VI).²⁶ This reflects mainly the medium-term contribution to the Fund's income of the arrangements approved by the Executive Board since the last review. The higher projected path for lending income is only partially offset by a reduction in projected income from other sources, reflecting mainly the impact of lower SDR interest rates over the medium term. The updated projections suggest that precautionary balances would remain below the indicative medium-term target of SDR 20 billion in FY 2020, but could reach it in FY 2021, three years earlier than previously projected, should purchases from approved arrangements take place as scheduled, and in the absence of significant new advance repurchases.²⁷ The Board will have an opportunity to review the appropriate medium-term target for precautionary balances again in early 2020 in light of developments in credit and other financial risks.

²⁶ The income projections for the baseline scenario only include arrangements approved through end-January 2019, and exclude any projections for pension-related (IAS 19) adjustments over the medium term.

²⁷ See [Review of the Fund's Income Position for FY 2018 and FY 2019-2020](#) (04/05/18).

Table 4. Income from the Margin and Reserve Accumulation¹
(in millions of US Dollars, unless otherwise indicated)

	Actual			Projected	
	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
A. Intermediation costs ²	97	92	90	92	94
<i>Less</i>					
B. Service charges	32	42	30	241	121
C. Costs to be covered by income from margin (A-B)	65	50	60	-149	-27
D. Income from margin ³					
80 basis points	...	...	...	572	829
100 basis points	716	671	617	715	1,037
120 basis points	...	...	...	858	1,244
E. Commitment fees ⁴	133	459	459	116	503
E.1 FCL/PLL	25	459	459	69	503
E.2 Other	108	0	0	48	0
F. Surcharges ⁵	1,094	805	527	599	1,255
G. Potential reserve accumulation ⁶ (D+E+F-C)					
80 basis points	...	...	...	1,436	2,615
100 basis points	1,878	1,885	1,542	1,579	2,823
120 basis points	...	...	...	1,722	3,030
H. Potential reserve accumulation (as a percent) ⁷					
80 basis points	...	...	...	5.9%	10.5%
100 basis points	9.5%	9.0%	6.5%	6.5%	11.3%
120 basis points	...	...	...	7.0%	12.2%
I. Actual reserve accumulation ⁸					
80 basis points	...	...	...	144	1,949
100 basis points	1,440	2,055	1,074	287	2,157
120 basis points	...	...	...	430	2,364
J. Actual reserve accumulation (as a percent) ⁸					
80 basis points	...	...	...	0.6%	7.8%
100 basis points	7.3%	9.8%	4.5%	1.2%	8.7%
120 basis points	...	...	...	1.8%	9.5%
K. Precautionary balances at the end of FY (in SDR billions) ⁹					
80 basis points	...	...	...	17.6	19.1
100 basis points	15.2	16.7	17.5	17.7	19.2
120 basis points	...	...	...	17.8	19.4
<u>Memorandum items</u>					
Average Fund credit outstanding (in SDR billions)	51.5	48.6	43.4	51.1	73.5
Number of active arrangements (average) ¹⁰	15	17	16	...	...
Average exchange rate US\$/SDR	1.39	1.38	1.42	1.40	1.41

Source: Finance Department and Office of Budget and Planning

¹ For analytical purposes, surcharges and commitments fees are considered for reserve accumulation only.

² Costs related to the Fund's "generally available facilities."

³ Derived by applying the margin against average Fund credit outstanding at the average US\$/SDR exchange rate.

⁴ Includes commitment fees for expired or cancelled arrangements.

⁵ Surcharges are projected on the basis of current quotas and surcharge thresholds.

⁶ Potential reserve accumulation is derived by assuming other sources of income are sufficient to cover non-intermediation costs.

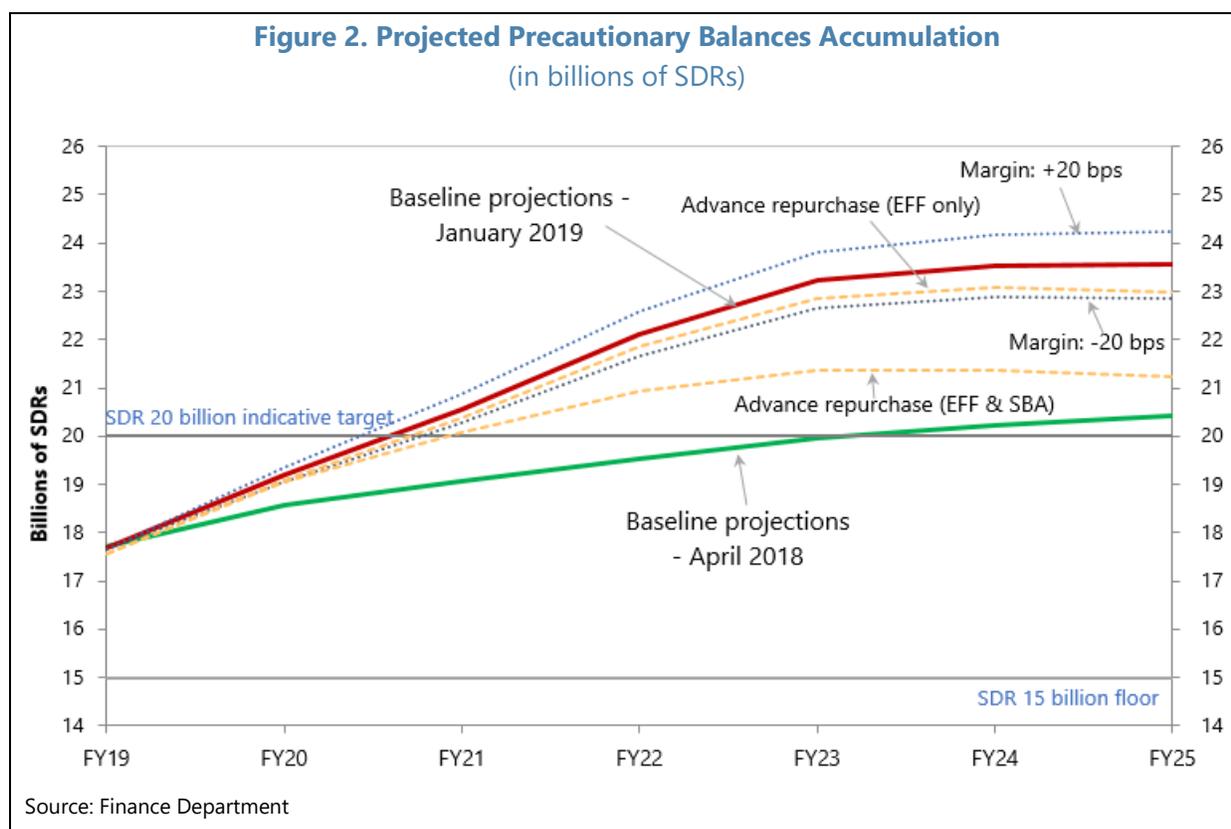
⁷ Potential reserve accumulation as a percent of precautionary balances at the beginning of the financial year.

⁸ Additions to reserves based on net income for the year (including actual and projected IAS 19 gains/(losses) up to FY 2019, and excludes retained Endowment Subaccount investment income).

⁹ Precautionary balances include the Fund's reserves and SCA-1 balance less the gold endowment of SDR 4.4 billion.

¹⁰ Excludes FCL and PLL arrangements.

23. The pace of accumulation of precautionary balances would be lower in the event of further advance repurchases. As an illustrative example, if all members with GRA credit outstanding subject to surcharges settle 50 percent of their scheduled repurchases two years in advance, average GRA credit outstanding would be lower by SDR 9.7 billion through FY 2025; and precautionary balances would accumulate at a slower pace reaching about SDR 21.2 billion by FY 2025 (rising to SDR 23 million if advance repurchases are limited to extended arrangements under the EFF only).



Alignment of Fund Borrowing Costs with Market Conditions

24. Rule I-6(4) requires a cross-check of the margin's alignment with long-term credit market conditions.²⁸ This aims to ensure that the cost of borrowing from the Fund is not too high or low relative to the cost of long-term market funding. Staff benchmarks based on EMBI spreads provide a useful guide for this purpose, but should not be applied mechanistically without judgment on the global financial context and future developments.²⁹ As in the past, the comparisons take account of two specific considerations:

²⁸ See [A New Rule for Setting the Margin for the Basic Rate of Charge](#) (11/23/11).

²⁹ The index for EMBI spreads includes 66 countries, which are mostly emerging markets. While the index does not include advanced economies that currently have outstanding credit from the Fund, their share of overall outstanding credit has fallen to 15 percent from 35 percent in April 2018. Moreover, based on currently available measures, staff continues to view the EMBI-based measure as the most appropriate metric of long-term market conditions. See Annex II, [Review of the Fund's Income Position for FY 2014 and FY 2015–2016](#) (04/07/14).

- *Proxy for risk premium:* The level of the margin is compared to the lowest quartile of EMBI spreads (reflecting the spreads for the more creditworthy borrowers within the sample) as a proxy measure to account for the lower credit risk the Fund faces as a cooperative public policy institution. Market borrowing spreads reflect a country-specific, time-varying credit risk premium. While the Fund also bears credit risk when it lends to member countries, such risk is reduced by its lending policies and its de facto preferred creditor status.
- *Proxy for term premium:* The comparator spreads are adjusted to account for the maturity difference between the SDR interest rate (based on a floating rate composed of three-month instruments) and the EMBI measures (based on medium-term fixed interest rate instruments).

25. The cost of Fund credit at the current margin remains broadly in line with the staff benchmarks for long-term credit market conditions. Since the last review in April 2018, the EMBI spreads have increased, partially offsetting the previously observed decline since late-2015. Accordingly, the five-year rolling average of the spreads remains broadly unchanged since the last review (Figure 3). The median for the lowest quartile EMBI spread adjusted for the term premium stands at 52 basis points above the current margin (relative to 57 basis points at the time of the April 2018 income review, Table 5). Staff therefore does not see any fundamental change in the alignment of the margin with long-term credit market conditions.

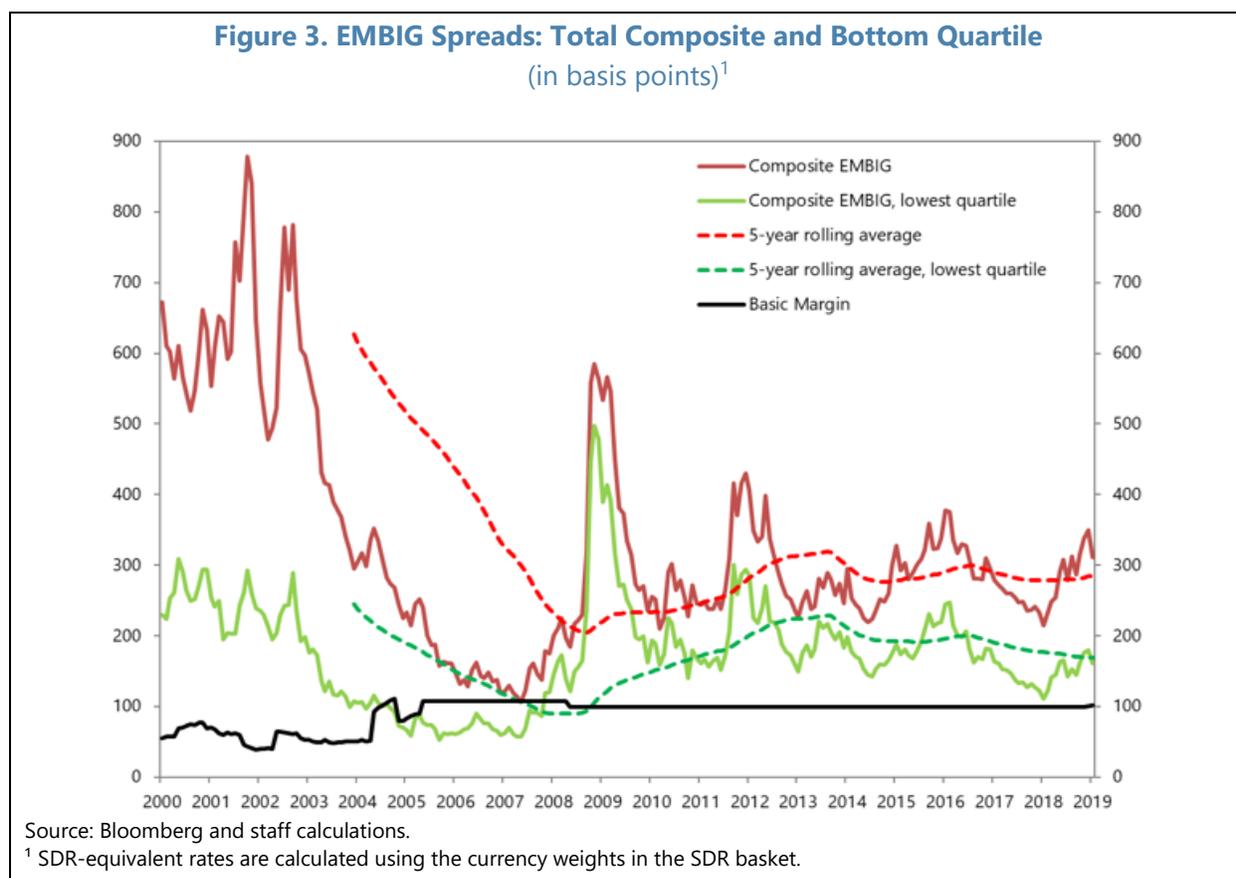


Table 5. Long-Term Credit Market and Comparator Spreads¹
(median spread unless otherwise noted, in SDR-equivalent basis points)

	2006 - 2010	2011 - 2015	Feb 2014 - Jan 2019	Change since April 2018 Review
<i>(Median spread unless otherwise noted, in SDR-equivalent basis points) 1/</i>				
Country risk spread-EMBI-based measures				
Composite EMBI 2/	219	277	281	+5
Lowest quartile 3/	157	182	166	-7
Term premium 4/	-12	4	14	-2
Term-premium adjusted country risk spread				
Composite EMBI	231	273	268	+8
Lowest quartile	169	179	152	-5
<i>Memorandum item</i>				
Past Borrowers 5/	237	300	274	-11
Margin on the basic rate of charge 6/	104	100	100	-

Sources: Bloomberg, JP Morgan and Fund staff calculations.

¹ SDR-equivalent rates are calculated using the currency weights in the SDR basket.

² A linear combination of spreads from the JPMorgan Emerging Market Bond Index Global Sovereign Spread (US dollar) and the JPMorgan Euro EMBI Global Government Spread, rebased using US dollar and euro weights in the SDR basket.

³ The lowest quartiles for all dollar and euro denominated spreads (consisting of 66 and 17 countries included in EMBI indices), weighted by the rebased SDR basket weights.

⁴ Difference in yields between a medium-term fixed-rate SDR bond and the medium-term average 3-month SDR interest rate as implied in futures market contracts, adjusted for the higher risk premium of instruments in future markets. Starting October 2016, these calculations account for the Chinese renminbi inclusion in the SDR basket.

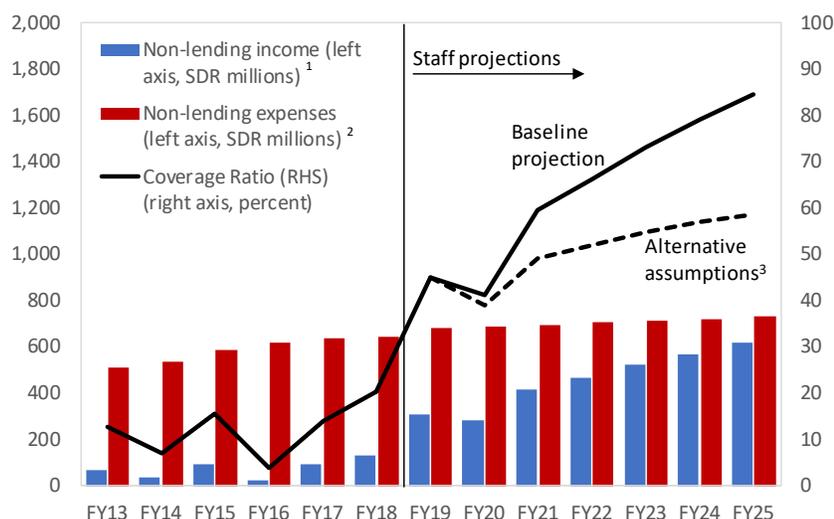
⁵ Median level of the SDR weighted US dollar and euro EMBI spreads for the members with Fund GRA arrangements between 2000 and 2018.

⁶ Margin reduced to 100 bps from 108 bps in May 2008. The margin is defined in absolute basis points over the SDR interest rate.

Exceptional Circumstances Clause

26. The Fund will need to continue to rely on its lending income to cover a portion of its non-lending operational costs. The Fund's non-lending operational income, consisting of investment income and implicit income from its interest free resources, is projected to cover on average about 64 percent of the Fund's projected non-lending operational expenses over the medium-term. This coverage ratio is expected to improve significantly toward the end of the projection period, although remaining highly sensitive to the projected path of interest rates. The projected coverage ratio also assumes the commencement of payouts from the Endowment Subaccount in FY 2021 in line with the framework endorsed by the Board (Figure 4). The need to cover the residual non-lending expenses by income from the margin reduces its expected contribution to the Fund's reserve accumulation.

Figure 4. Projected Non-Lending Operational Income and Non-Lending Expenses
(in millions of SDR, percent)



Source: Finance Department and Office of Budget and Planning

¹ Investment income and implicit income from interest free resources. Baseline projection from FY 2019 assuming a 2 percent payout from the Endowment Subaccount commencing in FY 2021.

² Net administrative expenditures less intermediation costs related to generally available facilities, PRGT and SDR Department. Projections beyond FY 2020 assume non-lending expenses remain constant in real terms.

³ Assumes SDR interest rates remain unchanged at the projected FY 2019 level and a reduced payout of 1 percent from the Endowment Subaccount to the GRA in a low investment return environment.

27. Burden sharing adjustments remain at low levels reflecting the current levels of overdue obligations and lending, and the moderate rise in interest rates. The burden sharing rate stands at 0.1 basis point and together with the 5 basis point floor on the SDR interest rate aims to preserve a minimal capacity of equal burden sharing for protecting the Fund’s balance sheet, while limiting potential departures of the SDR interest rate from market interest rates.³⁰ The burden sharing decision allows for a “carry-forward” of excess amounts generated from a minimum adjustment to the rate of charge and the rate of remuneration.³¹ If the amounts brought forward are sufficient to offset deferred charges in subsequent quarter(s), no adjustments are necessary for such quarters (see Table 6). For a report on the cumulative burden sharing adjustments (by member) at end-January 2019 refer to www.imf.org/external/np/fin/tad/query.aspx.

³⁰ Under the burden sharing mechanism, where creditors and debtors together generate equal amounts to cover deferred charges, a minimum positive SDR interest rate is required for the mechanism to operate.

³¹ See [The Fund’s Income Position for FY 2010—Midyear Review](#) (12/08/09), paragraphs 8–10.

Table 6. Recent Burden Sharing Adjustment Rates
(in basis points, unless otherwise stated)

	FY12	FY13	FY14	FY15 ³	FY16	FY17	FY18	FY19
								Projected
Rate of Remuneration ¹								
Deferred charges	– ²	– ²	– ²	0.300	0.575	0.375	0.500	0.500
Rate of Charge ¹								
Deferred charges	– ²	– ²	– ²	–	–	0.150	0.500	0.500
Average SDR interest rate (in percent)	0.30	0.09	0.09	0.061	0.051	0.187	0.678	1.037
Average basic rate of charge (in percent)	1.30	1.09	1.09	1.061	1.051	1.187	1.678	2.037

¹ The average rates have been calculated using the quarterly burden sharing rates and SDR interest rates. No adjustments to the rate of charge in FY 2015, FY 2016, and the first two quarters in FY 2017.

² Annual average rate calculated is less than 0.5 basis points. (prior to October 2014, the minimum burden sharing adjustment rate was set at 1 basis point).

³ In October 2014, the minimum for the quarterly burden sharing rate adjustment of 1 basis point was reduced to 0.1 basis point.

REVIEW OF SPECIAL CHARGES

28. The decision on special charges sets out a framework for charges on overdue repurchases and overdue charges in the GRA.³² The decision calls for an annual review in the context of the reviews of the Fund's income position.³³ Staff proposes to amend Section VI of the 1985 decision on special charges to shift the requirement for regular review from the annual review of the Fund's income position, to the five-yearly Review of the Fund's Strategy on Overdue Financial Obligations.

29. Special charges apply to financial obligations in the GRA that are overdue by more than 10 days and less than six months. The decision sets special charges as follows:

- *Overdue repurchases*: at a rate equal to the excess, if any, of the SDR interest rate over the basic rate of charge. This rate has been zero since 1993 (see below).
- *Overdue charges*: at the SDR interest rate.

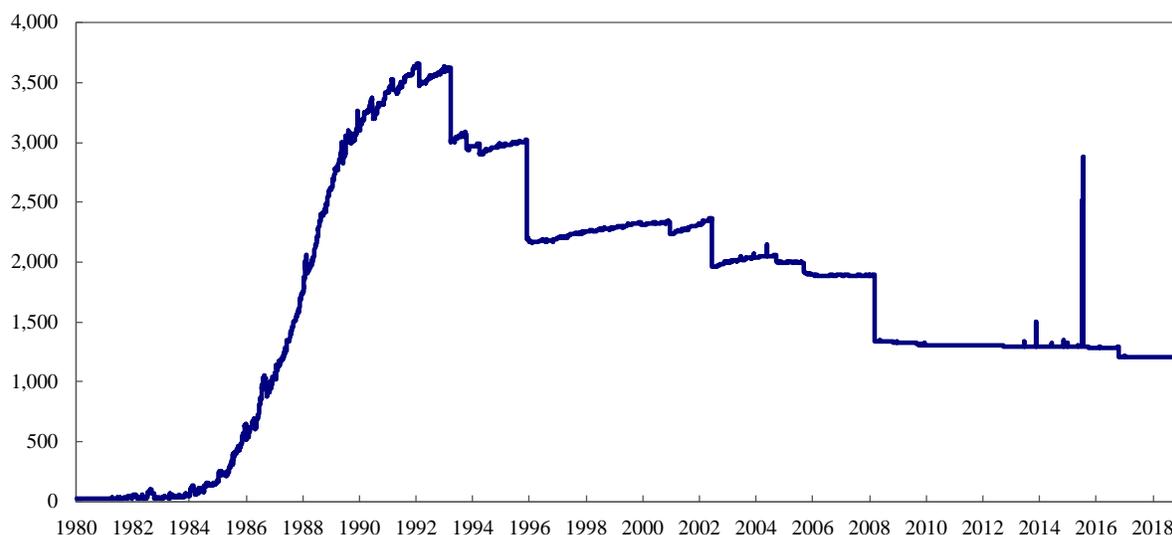
Charges on overdue obligations to the PRGT are specified in the PRG Trust Instrument and so are outside the scope of the decision on special charges.

³² [Decision No. 8165-\(85/189\)](#), adopted December 30, 1985, effective February 1, 1986 as amended. The Decision also applies to Trust Fund obligations preceding establishment of the PRGT. However, since all remaining Trust Fund obligations are more than six months overdue, these do not incur special charges.

³³ During Board consideration of the FY 2018 income review, staff was asked for a more detailed review of the special charges framework in the FY 2019 income review.

30. The framework for special charges was introduced in 1985 primarily to recover costs to the Fund of then-rising overdue obligations. It was motivated by concerns that overdue financial obligations to the Fund were rising rapidly and, if unchecked, could erode the Fund's income position and financial integrity (Figure 5).³⁴ The framework was accordingly designed with the principal objective of cost recovery. It was also hoped that special charges would strengthen incentives for members remain current with their financial obligations to the Fund, though some Board members were skeptical that special charges would materially affect members' payment behavior (except for very short-term arrears cases).

Figure 5. Evolution of Overdue Financial Obligations, 1980–2019
(in millions of SDRs, as of end-February 2019)^{1,2}



Source: Finance Department

¹ All overdue obligations (GRA, PRGT and SDR Department) irrespective of duration.

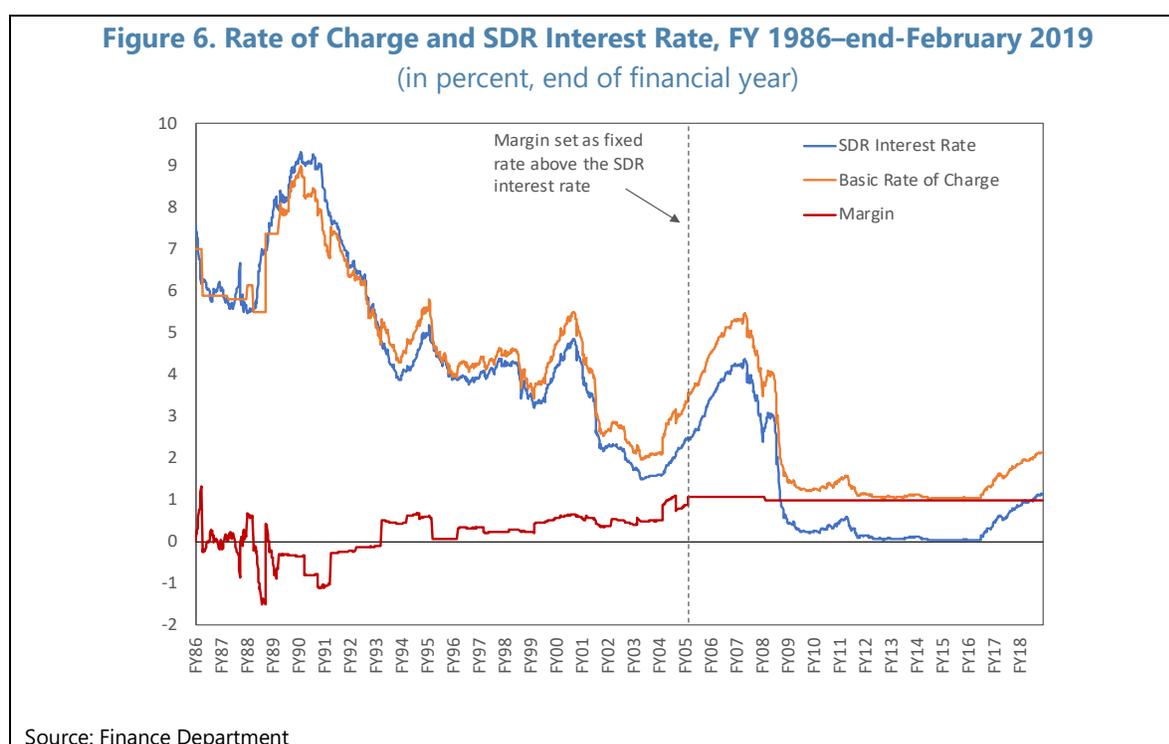
² The sharp drops in arrears in 1993, 1995, 2002 and 2008, were largely attributable to arrears clearance by Peru, Zambia, the Democratic Republic of the Congo, and Liberia respectively. The sharp temporary increase at end-June 2015 corresponds to Greece's short-term arrears, which have since been cleared.

31. In the early 1990s the framework was limited to short-term arrears (Box 3). A 1992 modification to the framework limited the coverage of special charges to obligations overdue by no more than 6 months to avoid exacerbating repayment difficulties of members in protracted arrears.³⁵ Following a comprehensive review in 1995–96, staff proposed to abolish special charges for short-term arrears as well, but the Board at the time preferred to retain the system owing to concerns that abolition could misleadingly signal a relaxation of the Fund's concern and vigilance regarding overdue financial obligations.

³⁴ Overdue obligations surged from SDR 178 million at end-1984 to a peak of SDR 3.6 billion at end-1991. Most but not all payment delays were temporary, with the increase in protracted arrears (overdue six months or more) raising serious concerns.

³⁵ [Decision No. 10000-\(92/58\)](#), adopted April 17, 1992.

32. With arrears to the Fund now sharply lower and against a backdrop of changes in other Fund policies, special charges have played a diminishing role in the Fund's risk management framework. The framework has continued to be reviewed annually without further substantive changes to the decision.³⁶ The Strengthened Cooperative Strategy on Overdue Financial Obligations has been in place since the early 1990s and is reviewed regularly.³⁷ Since then, protracted GRA arrears have fallen sharply and are now limited to Somalia and Sudan, while new instances of non-technical short-term arrears (exceeding 10 days) have also become rare (notwithstanding overdue repurchases by Greece in 2015 that were cleared after 20 days). Furthermore, the basic rate of charge has exceeded the SDR interest rate since May 1993 (Figure 6) and, since 2005, the margin on the basic rate of charge has been set as a fixed rate over the SDR interest rate. This has implied zero special charges on overdue repurchases since 1993, since a non-zero rate applies under the current framework only if the basic rate of charge is less than the SDR interest rate. Special charges equivalent to the SDR interest rate remain applicable to overdue charges, but have not been triggered since the early 2000s.



³⁶ A 2003 modification amended the value date for payment of special charges alongside other Fund charges ([Decision No. 13001-\(03/39\)](#), adopted April 25, 2003).

³⁷ The Strengthened Cooperative Strategy established procedures to deal systematically with arrears and consists of three elements: (1) preventive measures to avoid new arrears from emerging; (2) intensified collaboration with members in arrears; and (3) remedial measures of increasing intensity to encourage members to cooperate with the Fund in seeking a solution to their arrears. The Strategy includes neither special charges nor any other form of penalty charges on overdue obligations. The Strategy was reviewed most recently in 2017 (see [Review of the Fund's Strategy on Overdue Financial Obligations](#), 7/20/17).

33. The current special charges framework nonetheless would continue to fulfill its cost-recovery function if new arrears emerge. The special charge on overdue charges compensates Fund income for the lost time-value of money until this can be recovered through the burden-sharing mechanism, which applies after 6 months. Although the Decision effectively no longer applies a special charge on overdue repurchases, the Fund does not incur a shortfall in income because overdue principal continues to incur a regular charge equal to at least the SDR interest rate, which covers the rate of remuneration and avoids a net present value loss on the associated amounts.

34. Staff proposes to retain the current special charges framework at this time. The policy would continue, despite its diminished role, to serve its original purpose of cost recovery if new arrears emerge. Moreover, arrears to the GRA are low and not currently a pressing issue. Steps to redesign the framework at this time could send unintended signals that the Fund considers prospective arrears a problem and/or its existing policies would be inadequate for dealing with such arrears. Accordingly, staff does not propose changes to special charges in the context of this review, as it considers that any benefits would be small and outweighed by the risk of unintended signals on the outlook for arrears or the Fund's approach to addressing them.

35. However, staff proposes to amend the 1985 decision to conduct the next review of the framework in the context of the wider review of the Fund's strategy on overdue obligations (proposed Decision 7). While annual reviews of the framework were relevant in the 1980s and 1990s in a context of rising and/or high arrears, annual reviews in the context of the income discussions no longer serve a practical purpose in a context where short-term arrears cases have become rare. Accordingly, staff proposes to amend Section VI of the 1985 decision on special charges to shift the requirement for regular review from the annual review of the Fund's income position to the five-yearly Review of the Fund's Strategy on Overdue Financial Obligations. This would imply the next review of the special charges framework would be due by 2022, but could take place sooner if circumstances warrant.

Box 3. Evolution of the Special Charges Framework

1986–92: introduction of special charges. In the context of increasing member arrears to the GRA, the Fund adopted special charges in December 1985, effective from February 1986. Special charges were intended to cover the cost to the Fund of borrowing members' overdue obligations to the GRA. At the same time, it was hoped that special charges would strengthen incentives for members to settle obligations to the Fund on time.

1992–93: modifications. The system of special charges was deemed unproductive in the context of protracted arrears that typically arose from insufficient repayment capacity. In 1992–93, to avoid charges that would worsen repayment problems, special charges were limited to short-term arrears, for which they were seen to retain deterrent value.

1995–96: discussions on potential abolition. In the context of the 1995–96 annual reviews, staff proposed to eliminate the system of special charges as not meaningfully meeting its objectives. The proposal did not acquire sufficient Board support out of concern for an adverse signal of the Fund relaxing its attitude toward arrears. While the possibility of abolishing the system was raised in subsequent income reviews through 1999, no further changes to the system have since been made.

Since the 1990s: falling arrears. The number of new arrears cases has since been limited and the stock of arrears was significantly reduced. This has been partly attributed to the success of the strengthened cooperative strategy on overdue obligations introduced in 1990, setting out steps to collaboratively resolve protracted arrears and strengthening measures for preventing and deterring new arrears, without introducing financial penalties on overdue borrowers. The special charges were not part of this framework.

Proposed Decisions

Decisions Pertaining to FY 2019

- Decision 1 provides for the assessment on SDR Department participants for the reimbursement of the General Department for the expenses of conducting the business of the SDR Department in FY 2019.
- Decision 2 provides for the reimbursement to the General Resources Account for a total amount of the cost of administering the PRGT in FY 2019.
- Decision 3 provides for the transfer of income from the Fixed-Income Subaccount of the Investment Account to the General Resources Account for use in meeting FY 2019 administrative expenses. The income of the Endowment Subaccount for FY 2019 shall be retained.
- Decision 4 provides for the placement of FY 2019 General Resources Account net income to the Fund's Special Reserve and the General Reserve.
- Decision 5 provides for the transfer of currencies from the GRA to the Investment Account equivalent to the increase of the special and general reserves following the placement of FY 2019 net income.

Decisions Pertaining to FY 2020

- Decision 6 completes the review of the Fund's income position and concludes that there are no fundamental changes that warrant adjustment to the current rate of charge at 100 basis points over the SDR interest rate for FY 2020.
- Decision 7 reviews the system of special charges.

Decisions 1, 2, 3, 4, 6, and 7 may be adopted by a majority of the votes cast. Decision 5 may be adopted by a 70 percent majority of the total voting power.

Decision 1. Assessment under Article XX, Section 4 for FY 2019

Pursuant to Article XVI, Section 2 and Article XX, Section 4 of the Articles of Agreement and Rule T-2 of the Fund's Rules and Regulations, it is decided that:

- (i) The General Department shall be reimbursed for the expenses of conducting the business of the SDR Department for the period of May 1, 2018 through April 30, 2019; and
- (ii) An assessment shall be levied on all participants in the SDR Department. The special drawing right holdings accounts of participants shall be debited on April 30, 2019 with an amount equal to 0.00156151 percent of their net cumulative allocations of special drawing rights. The total assessment shall be paid into the General Department.

Decision 2. PRG Trust Reimbursement for FY 2019

In accordance with paragraph 3 of Decision No. 8760-(87/176), adopted on December 18, 1987, an amount equivalent to SDR 62.83 million, representing the cost of administering the Poverty Reduction and Growth Trust (PRGT) for FY 2019, shall be transferred from the Reserve Account of the PRGT (through the Special Disbursement Account) to the General Resources Account.

Decision 3. Transfer of Investment Income for FY 2019 to General Resources Account

The income of the Fixed-Income Subaccount of the Investment Account for FY 2019 shall be transferred to the General Resources Account for use in meeting the expenses of conducting the business of the Fund during FY 2019. The income of the Endowment Subaccount for FY 2019 shall be retained in the Endowment Subaccount and invested according to the Rules and Regulations for the Investment Account.

Decision 4. Placement of FY 2019 Net Income of the General Resources Account to the Special Reserve and General Reserve

The net income of the General Resources Account for FY 2019 shall be placed in equal parts to the Fund's Special Reserve and General Reserve.

Decision 5. Transfer of Currencies to the Investment Account for FY 2019

Pursuant to Article XII, Section 6(f)(ii) of the Articles of Agreement, the Fund shall transfer from the General Resources Account to the Investment Account currencies in an amount equivalent to the difference between the Fund's general and special reserves as of April 30, 2019 and the cumulative amount of previous transfers of currencies from the General Resources Account to the Investment Account. This transfer of currencies to the Investment Account shall be effected in the context of the Financial Transactions Plan covering the period May – October 2019. The currencies transferred to the Investment Account pursuant to this decision shall be used for immediate investment in the Fixed-Income Subaccount in accordance with the Rules and Regulations for the Investment Account.

Decision 6. The Rate of Charge on the Use of Fund Resources for FY 2020

Pursuant to Rule I-6(4)(a), the Fund has completed the review of the Fund's income position and concluded that for FY 2020 there are no fundamental changes to warrant any adjustment to the margin for the basic the rate of charge as determined by Decision No. 16363-(18/36), adopted April 25, 2018.

Decision 7. Review of the System of Special Charges

1. The Fund has conducted the annual review required under Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, effective February 1, 1986, as amended, on Special Charges on Overdue Financial Obligations to the Fund.
2. Section VI of the above-referenced Decision is hereby deleted.
3. It is expected that the review of the above-referenced Decision will take place in conjunction with each Review of the Fund's Strategy on Overdue Financial Obligations.

Annex I. Decisions in Effect Related to the FY 2019 Income Position

Decisions in Effect

The Executive Board has taken the following decisions affecting the Fund's income position for FY 2019:

Rate of Charge

The margin for calculating the basic rate of charge in FY 2019 was set in 2018 at 100 basis points for a period of two years (FY 2019–20). This decision was adopted under the *exceptional circumstances* clause of Rule I-6(4), which allows the margin for calculating the basic rate of charge to be set at a level other than that which is adequate to cover the estimated intermediation expenses of the Fund and to generate an amount of net income for placement to reserves.

*Burden Sharing for Deferred Charges*¹

Income losses resulting from unpaid charges are shared equally between debtor and creditor members under the burden sharing mechanism largely pursuant to decisions taken in 2000 and 2009. Unless amended by the Board, this mechanism will continue for as long as overdue obligations to the Fund persist.²

Special Charges

For overdue repurchases, the special rate of charge is set to equal the excess, if any, of the SDR interest rate over the basic rate of charge (Paragraph 3 of Decision No. 8165-(85/189), as amended). Pursuant to Rule I-6(4), the basic rate of charge "shall be determined at the beginning of each financial year as the SDR interest rate under Rule T-1 plus a margin expressed in basis points". Since under the current system for setting the basic rate of charge, that rate is always in excess of the SDR interest rate, members are not subject to special charges on their overdue repurchases.

¹ [Decision No. 12189-\(00/45\)](#), adopted on April 28, 2000, as amended.

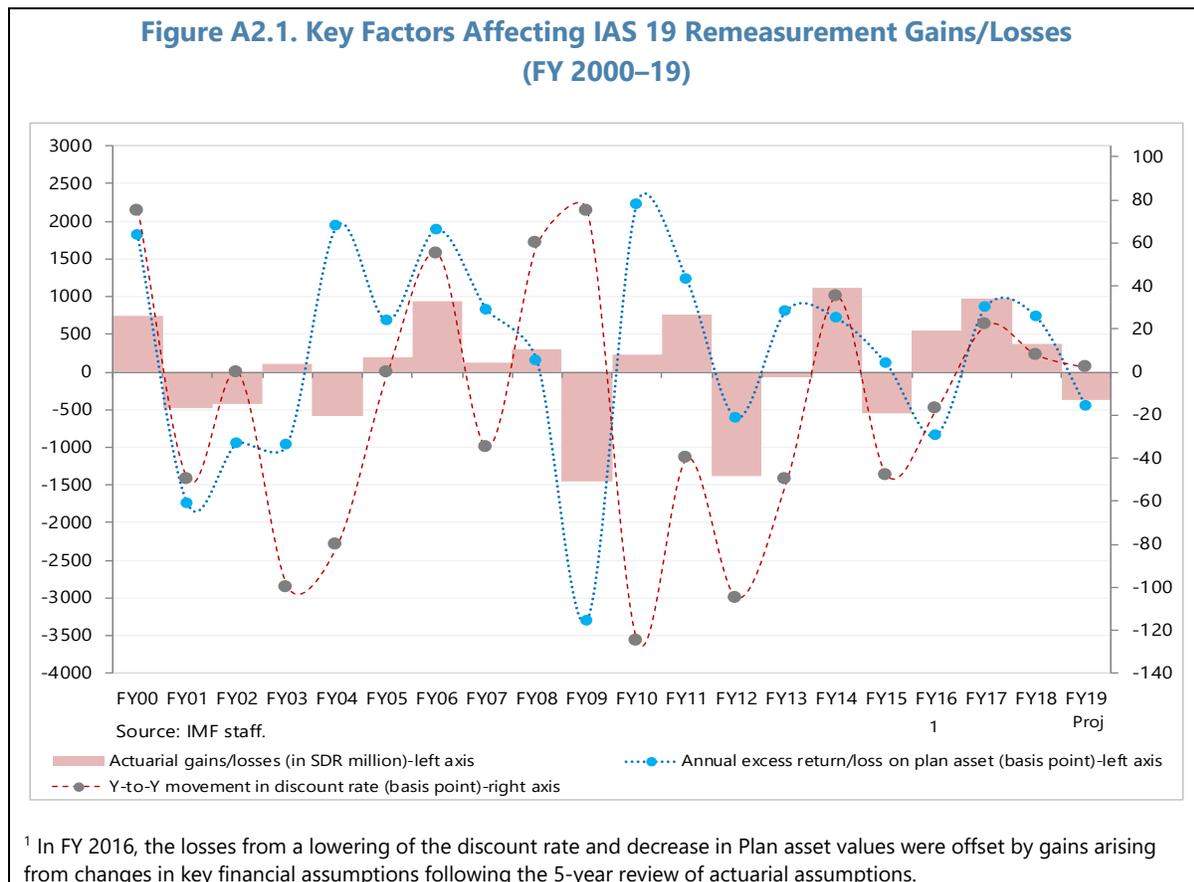
² See [Recent fall in the SDR Interest Rate – Implications and Proposed Amendments to Rule T-1](#) (10/16/14).

Annex II. IAS 19 Accounting for Employee Benefits

IAS 19 is the International Financial Reporting Standard (IFRS) that deals with accounting for pension and other employee benefits in the financial statements of the Employer. Reporting requirements under the standard introduce an additional source of volatility to Fund income as the full impact of remeasurement gains and losses incurred during the year is reflected in the annual pension-related (IAS 19) adjustment.

Figure A2.1 illustrates the Fund's remeasurement gains and losses for FY 2000–19 (restated retrospectively under amended IAS 19 for FY 2000–13). Historically, variances in the discount rate used to derive the net present value of pension obligations and movements in the fair value of pension assets have had the largest impact on changes in the funded status of the defined benefit pension plan. Any volatility in the underlying actuarial assumptions can translate into volatility in the Fund's reserves and income. As a result, on an annual basis, remeasurement gains and losses can be substantial; however, these tend to offset each other over time, as evidenced recently over the last few years where pension-related gains more than offset the loss being projected for FY 2019.

Going forward, pension-related gains and losses are expected to remain unpredictable and any volatility in the underlying actuarial assumptions would translate into volatility in the Fund's income and reserves.



Box A2.1. IAS 19—Background to the Standard and Accounting in the Fund

Since the adoption of IFRS in FY 2000, the Fund has followed IAS 19 in accounting for employee benefits. The objective of IAS 19 is to ensure that the liability associated with services provided by employees in exchange for benefits to be paid in the future and the related annual expense is properly recognized by the employer in its financial statements. IAS 19 prescribes the accounting by employers for (i) short-term employee benefits (e.g., salaries and wages); and (ii) post-employment benefits (e.g., pension, post-retirement health benefits, and termination grants). The employer recognizes an expense for short-term employee benefits in the period in which an employee has rendered services. Cash outflows associated with long-term benefits are subject to a high degree of uncertainty and are actuarially determined.

To meet the benefit obligations associated with post-employment and long-term benefits, the Fund has sponsored a defined benefit plan (Staff Retirement Plan) and a separate Retired Staff Benefits Investment Account. The Fund reports on the balance sheet a net asset or liability equal to the difference between the fair value of plan assets and the net present value of the defined benefit obligation. To determine the present value of the defined benefit obligation, the Fund discounts projected future cash outflows by applying demographic assumptions (e.g., mortality and employee turnover), and financial assumptions (e.g., the discount rate, salary increases, inflation rate, and future medical costs). Changes in underlying assumptions from year to year give rise to actuarial gains or losses (e.g., a reduction in the discount rate, and all else being equal, would result in a higher defined benefit obligation that contributes to a remeasurement loss).¹ The change in the net asset (or liability), after taking into account annual pension costs, the employer's contributions to the plans, and remeasurement gains and losses, determines the IAS 19 gain or loss for the year.

In FY 2014, IAS 19 was amended eliminating the "corridor method." As a result, all gains and losses arising from changes in actuarial assumptions are recognized in the year incurred. The amendment was implemented retrospectively such that a one-time adjustment for the cumulative unrealized actuarial losses was charged against the reserves on May 1, 2013 (start of the financial year), bringing the Fund's net asset (or liability) and reserves to the same level as if the Fund had never chosen to apply the "corridor method."

Accounting vs. Funding

The actuarial methods under IAS 19 to measure the IAS 19 expense in the Fund's financial statements are different from the actuarial method used to determine the Fund's annual contribution for the pension plans (i.e., the funding requirement). Therefore, the accounting for employee benefits differs between the Fund's financial statements (accrual basis) and the administrative budget (cash basis for employer's contributions). The resulting differences can be substantial but should net to zero over the life of the pension and benefit plans, as from an accounting perspective the net IAS 19 pension expenses necessarily equal the employer's funding over time.

¹ Under IAS 19, the discount rate should be determined by reference to market yields at the end of the reporting period, on "high quality corporate bonds".

Annex III. Implementation of IFRS 9—Financial Instruments in the Fund

A new accounting standard IFRS 9, “Financial Instruments” becomes effective for the Fund in FY 2019. The new standard establishes principles for the classification and measurement of financial instruments, including the recognition of impairment losses on financial assets.

Historically, the Fund has never recognized any loan loss provisions due to the impairment of its assets. In the 1980s, provisioning in the Fund was discussed against the background of an increased incidence and lengthened duration of overdue financial obligations. The Board last discussed this concept in 1987 and rejected provisioning at the time. Instead, a number of other measures to mitigate the risk of overdue obligations were adopted by the Fund, including the burden sharing mechanism and the establishment of the Special Contingent Account (SCA-1), which have since strengthened the Fund's financial safeguards and supported the arguments for non-recognition of loan loss provisions. At the time, the Fund did not adhere to any national or international accounting standards, and provisioning for loan losses was not mandatory for the Fund from a financial reporting perspective.¹

In 2000, the Fund began preparing its annual financial statements under International Financial Reporting Standards that included specific requirements for accounting and reporting of impairment losses under IAS 39.² Under IAS 39, an impairment loss was recognized when, and only if, there was objective evidence that a credit event had occurred (which in the Fund's context would mean a case of protracted arrears). In contrast, under IFRS 9, it is no longer necessary for a credit event to occur before a credit loss is recognized. Instead, an entity is required to estimate an expected loss considering all relevant information, including forward looking information. As a result, in the event of significant expected arrears, IFRS 9 is likely to lead to an earlier recognition of an impairment loss than under IAS 39, even though the underlying assessment of credit risk by the Fund has not changed.

The Fund's implementation of IFRS 9 takes into account the institution's unique mandate and its multilayered risk management framework. The Fund's mandate is to stand ready to provide financial assistance to countries that experience actual or potential balance of payments difficulties, and when other sources of financing are constrained. The burden sharing mechanism and the establishment of the SCA-1, the Fund's unique relationship with its members, its de facto preferred creditor status, its lending policies, as well as the Fund's strategy for dealing with arrears, significantly reduce the likelihood of incurring credit losses.³ This has also been proven in practice –

¹ The Fund's financial statements were prepared in accordance with “generally accepted accounting principles”, which meant that accounting policies were adopted based on benchmarking against selected national or international accounting frameworks, while considering the Fund's unique financial and operational structure.

² At the time, the set of standards was called International Accounting Standards (IAS). It was renamed to International Financial Reporting Standards (IFRS) in 2001.

³ See [Statement by the Managing Director on the Strengthened Cooperative Strategy on Overdue Financial Obligations to the Fund](#) (3/15/90).

defaults to the Fund have been rare since the adoption of the current strategy of arrears prevention (early 1990s).

Staff has completed the development of a framework to assess loan credit deterioration, which is the first step of measuring expected credit losses (ECLs). The framework is a result of inter-departmental collaboration and consultations with the external auditor (PwC) and the External Audit Committee (EAC). It draws upon the Fund's unique institutional characteristics and nature of its lending. The framework does not employ the use of statistical methods or rely on external credit risk ratings typically used by financial institutions in the private sector. Instead, it encompasses a holistic approach, which is conducted on a member-by-member basis. The framework considers qualitative and quantitative factors, including the status of the economic programs underlying the Fund's lending, the member's cooperation on policy implementation and timely settlement of financial obligations to the Fund, and projections of the member's capacity to repay.

In assessing the credit quality of loans in the portfolio, the standard requires an entity to determine if the loan's credit risk has increased significantly since inception. When a loan is disbursed, credit risk is assessed for its quality (low or credit-impaired) and subsequently reassessed at the end of each financial reporting date.⁴ The criteria used to identify significant increases in credit risk are monitored and reviewed for appropriateness at least annually under the Fund's framework. Staff's pilot analysis of the Fund's end-April 2017 and 2018 GRA and PRGT loan portfolios, which was reviewed by the external audit firm, categorized all outstanding loans with a low credit risk rating other than the two cases of protracted arrears, which were credit-impaired.⁵

After assessing the credit quality of loans, IFRS 9 requires an entity to calculate the ECLs. IFRS 9 does not prescribe a standard method to calculate ECLs. However, the calculation must consider probability-weighted cash shortfalls (difference between contractual cash flows and the cash flows expected under different probability-weighted scenarios, discounted over the life of the loan) on loans whose credit risk has significantly increased or that are credit-impaired. For loans classified with a low credit risk rating, the calculations are similar, but are limited to assessing the probability-weighted cash shortfalls within twelve months from the reporting date. Under the current circumstances and given the existing financial safeguards, such as burden sharing and SCA-1, the estimate of ECLs for the FY 2019 loan portfolio is not expected to produce results that are material for financial statement purposes, as confirmed by the ECLs calculated for the end-April

⁴ Under IFRS 9, credit risk related to the Fund's exposure to a member country is considered low if: (i) it has a low risk of default; (ii) the member country has a strong capacity to meet its contractual cash flow obligations in the near term; and (iii) adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the member country to fulfill its contractual cash flow obligations. A loan is considered credit-impaired when a member has defaulted on its obligation, i.e., an obligation is in protracted arrears (obligation has not been settled in more than six months).

⁵ The loans extended to Somalia and Sudan will be classified as being in default and disclosures for these loans will broadly be similar to those under the previous accounting standard (IAS 39). Under IFRS 9, the face value of these loans would also continue to be preserved through the burden sharing mechanism and the balance in the SCA-1, which respectively, (i) compensate the Fund for loss of income and (ii) protect the Fund's financial position against ultimate failure by members to settle protracted arrears.

2017, and 2018 loan portfolios.⁶ However, the possibility of ECLs in the future cannot be ruled out, particularly in cases where either the GRA or the PRGT is faced with a relatively higher credit exposure and lower probabilities of recoverability.

Staff is currently in the process of drafting the FY 2019 annual financial statement disclosures and work is underway to assess the credit quality of the GRA and PRGT loan portfolios.

In accordance with the requirements of the standard, the FY 2018 financial statements contained extensive disclosures on IFRS 9 and its expected impact. In general, the disclosures are expected to be broadly similar to those that were included last year. They will include a high-level description of the Fund's impairment analysis framework and highlight the unique features and safeguards of the Fund's lending. The disclosures will also describe the criteria for determining whether the credit risk on loans has increased significantly, including considerations for determining how loans could have low credit risk, and an overview of the process for measuring ECLs.⁷

The adoption of IFRS 9 by the Fund is not expected to significantly impact the FY 2019 annual financial statements.

However, the Board would have to revisit its stance on the issue of loss recognition and provisioning in the event that the credit risk assessment would result in ECLs that require recognition in the financial statements. No impairment losses would be recognized without prior endorsement of provisioning by the Board. Consistent with past practice, the draft FY 2019 annual financial statements, with a complete set of IFRS disclosures, will be circulated to the Board for review before they are finalized.

⁶ Materiality from a financial statement perspective is entity-specific and takes into account the size and magnitude of items to which financial information relates. As such, it is based on both qualitative and quantitative characteristics. IFRS does not prescribe a uniform quantitative threshold for materiality, or predetermine what could be material in a situation, because of the entity-specific nature of materiality.

⁷ The IFRS 9 financial statement disclosures will be reviewed by PwC and the EAC to ensure proper adherence to the accounting standards.

Annex IV. Investment Account (IA) Performance Scenarios

The two IA subaccounts have distinct investment objectives and pursue different strategies accordingly. Investment return projections are sensitive to underlying assumptions and highly uncertain. This annex illustrates a probable range of investment returns for each, based on two different market scenarios.¹

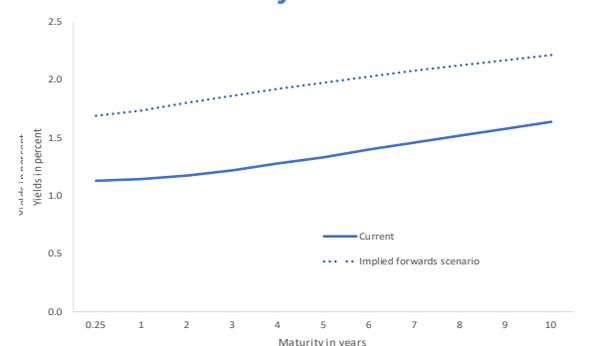
Fixed-Income Subaccount (FI)

The FI investment strategy aims to achieve returns in excess of the 3-month SDR interest rate over a three- to four-year horizon. The portfolio is invested in highly-rated liquid fixed-income instruments across two tranches: a short duration actively-managed tranche and a longer duration passively managed tranche. The current portfolio duration is approximately 1 year.

Staff analysis illustrates that average FI returns are expected to remain positive over a short and medium-term horizon. Higher levels of government bond yields compared to previous years is expected to translate into higher coupon income over time and improved protection for the FI against rising yields. However, compared to last year 3-month SDR rates have increased by about 30 bps while longer maturity bond yields are at similar or lower levels. Staff's analysis uses two yield curve scenarios: (i) yields remain unchanged from current levels; and (ii) yields increase in line with market implied forward rates (Figure A4.1).

- **Under both the unchanged yields and forward scenarios, the FI returns are projected to be higher than the 3-month SDR interest rate over a 5-year horizon (Figure A4.2).** While excess returns are expected to remain positive, a flatter yield curve results in relatively limited estimated excess returns relative to the 3-month SDR rate of 21 bps under the scenario that yields remain unchanged from current levels. If rates rise in line with forwards, excess returns over the SDR rate would be around 13 bps although the absolute level of returns would be higher.
- **Risk return scenarios over a one-year horizon suggest the downside risks remain moderate (Figure A4.3).** Annual investment income from the FI is expected to fall within the range of SDR 116 million to SDR 300 million based on a portfolio size of SDR 16.5 billion and one standard deviation around the average projected return under the unchanged yields and forwards scenario. Under the adverse scenario that yields rise sharply by 210 bps from the current levels,

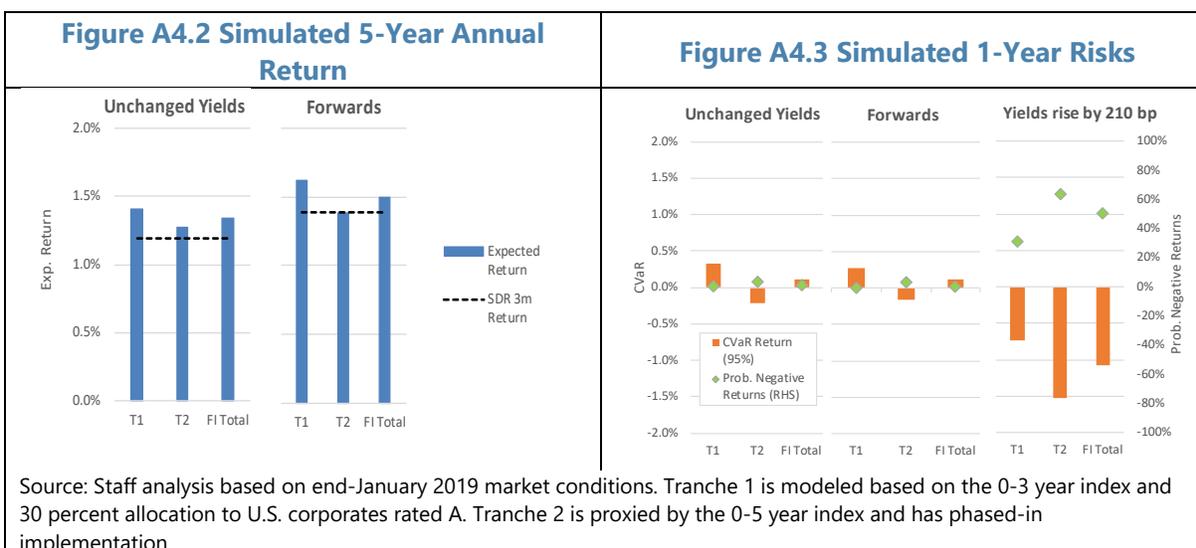
Figure A4.1 Illustrative Yield Curve Scenarios over a 5-year Horizon



Source: Staff calculations based on market conditions at end-January 2019.

¹ A stochastic simulation model is used to derive a distribution of expected return projections from which the ex-ante risk statistics are measured. The range of possible risk and return outcomes for the IA will vary depending on the assumptions made regarding capital market returns and the future evolution of yields over the projection horizon.

the 1-year return would be close to zero. If yields rise beyond that level the FI is likely to record a negative return. The estimated worst-case loss would be about -1 percent (proxied by the 95 percent conditional value at risk (CVaR)), equivalent to a SDR 164 million loss.



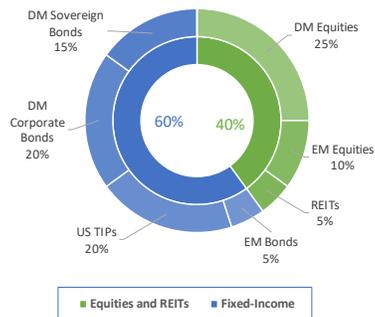
Endowment Subaccount (EA)

The investment objective of the EA is to generate a long-term real rate of return of 3 percent in US dollar terms. At least 90 percent of the EA is invested passively following a diversified Strategic Asset Allocation (SAA) with a 60/40 percent split between global fixed-income and equity (Figure A4.4).² The broad range of assets in the SAA increases the probability of meeting the EA's return target over the long run at the expense of higher volatility of short-term returns, especially compared to the FI. The EA carries higher interest rate and currency risks as its fixed-income assets have a duration of around 6 years and approximately 25 percent of assets are unhedged to the U.S. dollar base currency. In addition, the allocations to global equities, Real Estate Investment Trusts, emerging market and corporate bonds carry additional market and credit risks.

The 3 percent real return target is likely to remain challenging to achieve in the medium term (Figure A4.5). Staff's forward looking simulations based on the central market scenario indicate a high probability for the EA to underperform its 3 percent real return target as real yields remain at very low levels and equity valuations are elevated. Average expected returns are between 4.4 percent and 5.2 percent in nominal terms in U.S. dollars (approximately 2 and 3 percent in real terms) over a 5- and 15-year horizon respectively. In addition, the estimated worst case annual loss (based on CVaR) is around 12 percent, equivalent to 877 million in U.S. dollar terms or 633 million in SDR terms.

² The actively managed portion is initially only 5 percent and managed in the same asset classes as of the passive but with wide deviation bands.

Figure A4.4 - EA Strategic Asset Allocation (SAA)



Source: Staff calculations based on market conditions as of end-December 2018.

Figure A4.5 - Simulated Annual Return and Risk for the EA (in U.S. dollar terms)

Horizon	Medium-term (5-year)	Long-term (15-year)
Avg. Expected Nominal Return	4.4%	5.2%
Standard Deviation	8.5%	8.4%
Reward-to-risk Ratio	0.52	0.62
VaR Return (95%)	-8.9%	-8.0%
CVaR Return (95%)	-11.9%	-10.9%
Probability of Underperforming Real Return Target	3% Real	59.8%
	2% Real	50.6%
	0% Real	31.2%
Memo. Item	US Inflation	2.1%
		58.2%
		36.6%
		8.6%
		2.1%

Annex V. Assumptions Underlying the Income Projections

Assumptions Underlying the Income Projections			
(in billions of SDRs, unless otherwise stated)			
	Actual		
	through	FY	FY
	Jan. 2019	2019	2020
Regular Facilities:			
1. Purchases (excl. reserve tranche purchases)	24.3	34.4	17.1
2. Repurchases	7.5	8.2	4.9
3. Average balances subject to charges	48.3	51.1	73.5
4. Average SDR holdings	24.7	24.5	24.8
5. Average remunerated positions	49.6	53.2	80.3
6. Average Fixed-Income subaccount balance	16.1	16.2	16.5
7. Average Endowment subaccount balance	5.2	5.2	5.5
8. Average borrowings and issued notes	18.1	17.1	11.7
		(In percent)	
Return on investments-Fixed-Income subaccount ¹	1.18	1.50	1.26
Return on investments-Endowment subaccount ^{1,2}	3.91	5.12	2.93
Average interest rates:			
SDR interest rate and basic rate of remuneration	1.00	1.00	1.20
Basic rate of charge	2.00	2.00	2.20
Margin on the rate of charge	1.00	1.00	1.00
¹ End-January figure is unannualized.			
² The projected returns for the Endowment Subaccount is shown in SDR terms.			

Annex VI. Consolidated Medium-Term Income and Expenses

Consolidated Income and Expenses, FY 2019–29 Baseline Scenario¹

	FY19	FY20	FY21	FY22	FY23	FY24	FY25	Low-lending environment	
								Scenario A	Scenario B
								SDRi 2.5%	SDRi 3%
								FY29	FY29
	(in SDR millions)								
A. Operational income including surcharges	1,564	2,418	2,239	2,460	2,021	1,244	938	913	1,069
Lending income	1,194	2,068	1,754	1,921	1,426	606	250	247	247
Margin for the rate of charge	511	735	760	723	553	314	166	200	200
Service charge	172	86	18	8	0	0	0	23	23
Commitment fees	83	357	47	0	0	0	0	24	24
Surcharges	428	890	929	1,190	873	292	84	0	0
Investment income	249	208	343	389	441	484	530	473	604
Fixed-Income Subaccount 1/	249	208	234	279	329	372	417	414	484
Gold endowment pay-out 2/	0	0	109	110	112	112	113	59	120
Interest free resources 3/	55	74	73	80	83	83	86	124	149
SCA-1 and other	55	74	73	80	83	83	86	124	149
Reimbursements	66	68	69	70	71	71	72	69	69
SDR Department	3	3	3	3	3	3	3	4	4
PRG Trust	63	65	66	67	68	68	69	65	65
B. Expenses	873	888	887	906	918	928	939	974	974
Net administrative budget	811	821	832	846	854	861	873	917	917
Capital budget items expensed	22	21	6	5	3	3	3	3	3
Depreciation	40	46	49	55	61	64	63	54	54
C. Net operational income including surcharges (A-B)	691	1,530	1,352	1,554	1,103	316	-1	-61	95
D. Net pension asset/(liability) (IAS 19) loss	-486	0	0	0	0	0	0	0	0
Net operational income after pension-related (IAS 19) adjustment (C-D)	205	1,530	1,352	1,554	1,103	316	-1	-61	95
Endowment (Gold Profits) Subaccount	259	156	54	94	57	103	147	77	168
Net income	464	1,686	1,406	1,648	1,160	419	146	17	263
	(in US\$ millions)								
E. Operational income including surcharges	2,190	3,410	3,202	3,566	2,951	1,845	1,407	1,415	1,655
Lending income (including Surcharges)	1,672	2,917	2,508	2,785	2,083	898	375	382	382
Investment income	349	293	491	564	642	718	795	735	936
Interest free resources	76	104	104	116	122	123	129	192	231
Reimbursements	93	96	99	101	104	106	108	106	106
F. Expenses	1,221	1,252	1,270	1,313	1,339	1,373	1,409	1,508	1,508
Net administrative budget	1,135	1,158	1,190	1,227	1,247	1,275	1,310	1,421	1,421
Capital budget items expensed	30	30	9	7	4	4	4	4	4
Depreciation	56	64	71	79	88	94	95	83	83
G. Net operational income including surcharges (E-F)	969	2,158	1,932	2,253	1,612	472	-2	-93	147
Memorandum Items:									
Fund credit (average stock, SDR billions)	51.1	73.5	76.0	72.3	55.3	31.4	16.6	20.0	20.0
SDR interest rate (in percent)	1.0	1.2	1.2	1.3	1.4	1.5	1.6	2.5	3.0
US\$/SDR exchange rate	1.40	1.41	1.43	1.45	1.46	1.48	1.50	1.55	1.55
Surcharges (US\$ millions)	600	1,256	1,329	1,726	1,275	432	126	-	-
Precautionary balances (end of period, SDR billions)	17.7	19.2	20.6	22.1	23.2	23.5	23.5	15.0	15.0

¹ The current medium-term projections are conservative and assume that a premium of 50 basis points over the SDR rate is attained in the longer run.

² The baseline projections assume a 2 percent payout from the Endowment Subaccount commencing in FY 2021. The illustrative scenarios for FY 2029 show a reduced payout of 1 percent in a low investment return environment (Scenario A); and a continued payout of 2 percent (Scenario B).

³ Interest free resources reduce the Fund's costs and therefore provide implicit returns. Since the Fund invests its reserves in the IA to earn a higher return, the interest free resources retained in the GRA are mainly attributable to the SCA-1, unremunerated reserve tranche positions not represented by gold holdings, and GRA income for the year not transferred to the IA. These resources reduce members' reserve tranche positions and the Fund's remuneration expense resulting in implicit income for the Fund.

Annex VII. Projected Income and Expenses—FY 2019

Linking the Analytical Presentation with the Fund's Income Statement

The purpose of this Annex is to prepare a reconciliation between the analytical framework presented in Table A7.1 of this paper and the traditional format used to prepare the Fund's income statement under IFRS.¹ The formulation of the Fund's income and expense flow results in the same projected net income position. However, the analytical framework is preferred in discussing the income position as it succinctly captures the main variables that drive the Fund's income position. To this end, the presentation focuses on the net contribution made by the Fund's income-earning assets.

The starting point to move from the traditional format in the Fund's financial statements to the analytical framework in the paper is to net the financing costs (remuneration and interest on borrowings) against the income generated from Fund credit and the GRA's SDR holdings. This provides the income from the margin and interest free resources by eliminating the flows from the SDR interest rate between the debtor and creditor members of the Fund. Thereafter, the main adjustments involve re-arranging the various line items on the Fund's IFRS financial statements to the analytical framework. This includes:

- Reallocation of surcharges from interest and charges;
- Reallocation of income from the Endowment Subaccount from total investment income since this amount is retained in the investment account; and
- Separation of the reimbursements and the pension related (IAS 19) gains/(losses) from administrative expenses.

Table A7.1 below highlights this reconciliation process.

¹ The Annex is prepared in response to requests to simplify and explain the process of reconciling various aspects of the Fund's financial structure.

Table A7.1. Reconciliation of the Accounting and Analytical Presentations of Projected Income and Expense—FY 2019

	Actual to end-Jan 2019	FY 2019 Projections	Adjustments		Analytical presentation
			Financing costs	Surcharges and endowment income		IAS 19 expense re- allocation
(In millions of SDRs)					
A. Operational income					
Interest and charges	1,009	1,469	-530	-428	511
Interest on SDR holdings	187	253	-253		0
Net income from investments	387	508		-259	249
Service charges and commitment fees	204	255			255
Total income	1,787	2,485			
B. Operational expenses					
Remuneration ¹	377	551	-606		-55
Interest expense on borrowings	137	177	-177		0
Administrative expenses ²	712	929		66	-122
Total expenses	1,226	1,657			
<i>Other reconciling items:</i>					
Surcharges				428	428
Reimbursements				66	66
Pension-related (IAS 19) gains/(losses)		-364			-122
Endowment Subaccount investment income				259	259
C. Net income ³	561	464			464

¹ Interest free resources lower the Fund's costs by reducing members' reserve tranche positions and the Fund's remuneration expense resulting in implicit income for the Fund. At the present time, the interest free resources retained in the GRA comprises the SCA-1, unremunerated reserve tranche positions not represented by gold holdings, and GRA income for the year not transferred to the IA.

² Administrative expenses presented on an IFRS basis include net administrative expenditures, capital budget items expensed, and depreciation. This is partially offset by reimbursements to the GRA. Pension related (IAS 19) remeasurement gains/(losses) at end-January 2019 are excluded.

³ Income statement on the basis presented in the Fund's annual IFRS financial statements.