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REVIEW OF CHARGES AND THE SURCHARGE POLICY— A POSSIBLE REFORM PACKAGE

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- The **Staff Report** prepared by IMF staff and completed on August 29, 2024

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EXECUTIVE SUMMARY

This paper provides additional analysis and a proposed reform package for further consideration by the Executive Board of charges and the surcharge policy. The Board met informally in early July to discuss the review of the margin for the basic rate of charge, fees, and the surcharge policy. Informed by a staff paper, Directors discussed changes in the Fund's lending and operating environment, the experience with the implementation of the surcharge policy since the previous review in 2016, possible approaches for surcharge policy reforms and adjustments to commitment fees, and considerations for the setting of the margin for the basic rate of charge for the remainder of FY2025 and FY2026.

The informal discussion provided pointers on the contours of the proposed reform package. The feedback from Directors indicated a broad consensus that surcharges remain relevant as a risk management tool, providing price-based incentives for prudent and temporary borrowing from the General Resources Account (GRA). At the same time, there was a shared sense that the sharp increase in the SDR interest rate (SDRi) over the last two years has been a problem for borrowers, whereas the Fund's financial position improved, including reaching the precautionary balances (PB) target of SDR 25 billion by end-FY2024. These developments warranted some adjustments to charges and the surcharge policy to lower the cost of credit for borrowers while maintaining the incentive structure, preserving the income and reserve accumulation functions of the policies, and adjusting for erosion. Directors' preliminary views suggested broad support for: (i) parametric modifications within the current surcharge framework, led by higher thresholds for level-based surcharges and commitment fees to address erosion; (ii) a meaningful reduction in the margin on the basic rate of charge; and (iii) establishment of a regular review cycle for the surcharge policy. Directors also supported consideration of lower surcharge rates, albeit views on the magnitude and scope varied.

Building on the feedback from the July informal session, this paper presents a targeted set of reform proposals, backed by additional analysis, to inform the deliberations of Directors. It is intended to build a consensus that would allow meeting the shared ambition of concluding the review ahead of the 2024 Annual Meetings. The merits of the proposed reform package continue to be assessed

in relation to the four guiding principles widely supported by Directors at the initial engagement: the reduction in the cost to borrowers; the impact on the price-based incentive structure; implications for income generation; and simplicity of the policy.

Additional analysis broadly confirms the findings in the July engagement paper regarding the experience with the surcharge policy and highlights the role of financing pressures in determining the effectiveness of incentives. The evidence shows that the cost of borrowing from the GRA has been consistently lower and more stable than market costs. Level-based surcharges are less effective in moderating borrowing from members when they face a high level of financial distress. Time-based surcharges have provided incentives for countries facing moderate financing pressure to make early repurchases or avoid high and prolonged credit exposures to the Fund, but not for members facing severe and sustained financial distress.

The proposed reform package consists of lowering the margin for the basic rate of charge, increasing the thresholds for level-based surcharges and commitment fees, and modestly reducing the time-based surcharge rate. Staff proposes: (i) setting the margin for the basic rate of charge at 70 basis points; (ii) increasing the level-based surcharge threshold to 300 percent of quota to address erosion; (iii) aligning the commitment fee thresholds to the overall annual and cumulative access limits under the GRA (currently 200 and 600 percent of quota); and (iv) reducing the time-based surcharge rate by 25 basis points. These changes could become effective promptly on November 1, 2024, which is the start of the third financial reporting quarter.

The proposed package would meaningfully reduce the cost of borrowing from the GRA and compensate for erosion in the thresholds while preserving robust incentives and net income generating capacity, which could allow for income distributions to the membership as well as some further accumulation of reserves. Staff estimates that the package would lower the annual margin, commitment fee, and surcharge payments by about SDR 796 million (FY2026 basis), a reduction for borrowers of about one-third compared to no change in the policy. Estimated net income of the GRA generated during FY2025–FY2026—the period of the margin proposed in this paper—would be SDR 4.1 billion. Assuming this margin and other policies are maintained for a longer period, for example through FY2029, estimated net income could reach SDR 9.1 billion. This would allow for possible distributions and further increase of PBs. Staff also proposes that reviews of the surcharge policy move to a regular five-year cycle.

Stress tests indicate that the medium-term income and PB projections under the proposed package are robust. The package would ensure a resilient income path and a level of PBs that is at or above the medium-term target of SDR 25 billion under various credit and interest scenarios, depending on any distributions.

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Glossary

ADB	Asian Development Bank
BOP	Balance of Payments
EA	Endowment Subaccount
EFF	Extended Arrangements under the Extended Fund Facility
EM	Emerging Market
EMBI	Emerging Market Bond Index
EMBIG	Emerging Market Bond Index Global
EMDE	Emerging Market and Developing Economy
ESM	European Stability Mechanism
FCL	Flexible Credit Line
FI	Fixed-Income Subaccount
GDP	Gross Domestic Product
GRA	General Resources Account
GRQ	General Review of Quotas
IBRD	International Bank for Reconstruction and Development
IA	Investment Account
IFL	Flexible Loans
IMF	International Monetary Fund
MDBs	Multilateral Development Banks
NAB	New Arrangements to Borrow
OCR	Ordinary Capacity Resources
PBs	Precautionary Balances
PLL	Precautionary and Liquidity Line
PRGT	Poverty Reduction and Growth Trusts
RST	Resilience and Sustainability Trust
SDR	Special Drawing Rights
SDRi	SDR Interest Rate
SLL	Short-Term Liquidity Line
SOFR	Secured Overnight Financing Rate
WEO	World Economic Outlook

INTRODUCTION

1. **The IMF's charges and surcharges provide price-based incentives for prudent and temporary borrowing, underpinning the revolving nature of Fund resources and the accumulation of precautionary balances (PBs) to help mitigate income and credit risks (Annex I).** The last review of the surcharge policy of the General Resources Account (GRA) took place in 2016, against the backdrop of the 14th General Review of Quotas (GRQ), which doubled members' quotas in the Fund. Since then, there have been notable changes to the global economic environment. Borrowing costs for IMF member countries increased significantly with the recent rise in global interest rates and the SDR interest rate (SDRi), while the Fund reached its medium-term target for PBs and enjoys a robust income outlook. These developments have created an opening to review the Fund's charges, fees, and the surcharge policy to lower the cost for borrowers while maintaining the goals of the policies.

2. **On July 8, 2024, the Executive Board held an informal engagement on the review of charges and surcharge policy and provided guidance to staff on the focus of possible reforms.** Overall, Directors' feedback pointed to a broad consensus that surcharges remain relevant as a risk management tool. At the same time, there was a widely shared sentiment that the implementation experience, the recent sharp rise in the SDRi, and improvements in the Fund's financial position, including reaching the PB target, warranted some adjustments to surcharges and the margin for the basic rate of charge to lower the cost to borrowers. Directors generally favored parametric adjustments within the current surcharges' framework, with broad support for an increase in the threshold for level-based surcharges and commitment fees to address erosion. There was also a broad consensus on a decrease of the margin on the rate of charge, to somewhere between 40 to 100 basis points, and the establishment of a regular review cycle for the surcharge policy. Consideration of a reduction in surcharge rates also received support, with some preference for lowering the time-based rate and differing views on the possible scope. Furthermore, Directors called for: (i) additional analysis, including on market cost comparisons, the incentive mechanism of time-based surcharges, and some further reform options; (ii) stress testing to assess the impact of reform options on the Fund's income and PBs; and (iii) a strong communication strategy to accompany reform implementation.

3. **Several considerations guided the search for a reform package.** The initial engagement paper proposed that, overall, policy changes should be guided by four principles: (i) lowering the cost of borrowing for members in a balanced manner, without excessively favoring large borrowers; (ii) sustaining effective incentive mechanisms; (iii) preserving adequate income generation capacity; and (iv) maintaining policy simplicity. The proposed reform package needs to be assessed holistically against its implications for the Fund's balance sheet and other upcoming policy reviews that may impact lending income and PBs, and for consistency with Fund rules and policies. Implementation issues also need to be considered, including the intervals for future surcharge policy reviews, adjustments at the time of implementation of the 16th GRQ, and effective communication.

Box 1. Other Reform Proposals Discussed at the July 8 Informal Board Session (to Engage)

Executive Directors expressed a range of views on reform options for charges and the surcharge policy in the July 8 Informal Board Session (to Engage). While there was a broad consensus to further explore the reform options discussed in this paper, the feedback on several other options suggested less broad-based support and limited prospects to meet the required 70 percent majority of the total voting power for changes to the policy. This box briefly summarizes these other options and key concerns raised regarding their merits.

- *Multiple thresholds and level-based surcharge rates*. This option was generally seen as deviating from the principle of maintaining policy simplicity and having a limited effectiveness in addressing concerns about the burden on large surcharge payers.

- *Time-varying surcharge rate inversely related to the basic rate of charges*. Concerns centered on the difficulty of setting the parameters, such as the "normal" range of SDRi, required to implement this option, the time needed to finalize the design and put such a mechanism in place, income implications, and the increased complexity of the surcharge policy.

- *Capping the total interest rate of Fund borrowing*. As with the time-varying rate, parametrization of the mechanism would be difficult, in particular the maximum interest rate, especially during periods of structural change. Income risks were also seen as very high.

- *Grace period for level-based surcharges*. A 12-month pause for level-based surcharges on net new credit was suggested for exploration. Staff analysis indicates that a net credit concept would be very difficult to operationalize given that effective net credit during the course of a program is sensitive to phasing of access, program duration, and timeliness of review completion, while a grace period on all new credit would create incentives for frequent negotiations of new programs. The objective of limiting surcharges at the onset of a program could be more easily pursued through a reduction in the level-based rate and an increase in the time-based rate (and fine tuning of the time-based threshold).

ADDITIONAL ANALYTICAL BACKGROUND

4. During the July informal meeting, Executive Directors requested additional analysis on several issues to help inform further discussions. These requests centered on the appropriate benchmarks to compare the cost of Fund borrowing, which is also relevant to setting the margin for the basic rate of charge, and clarifications on the empirical evidence of the effectiveness of surcharges, in particular time-based surcharges.

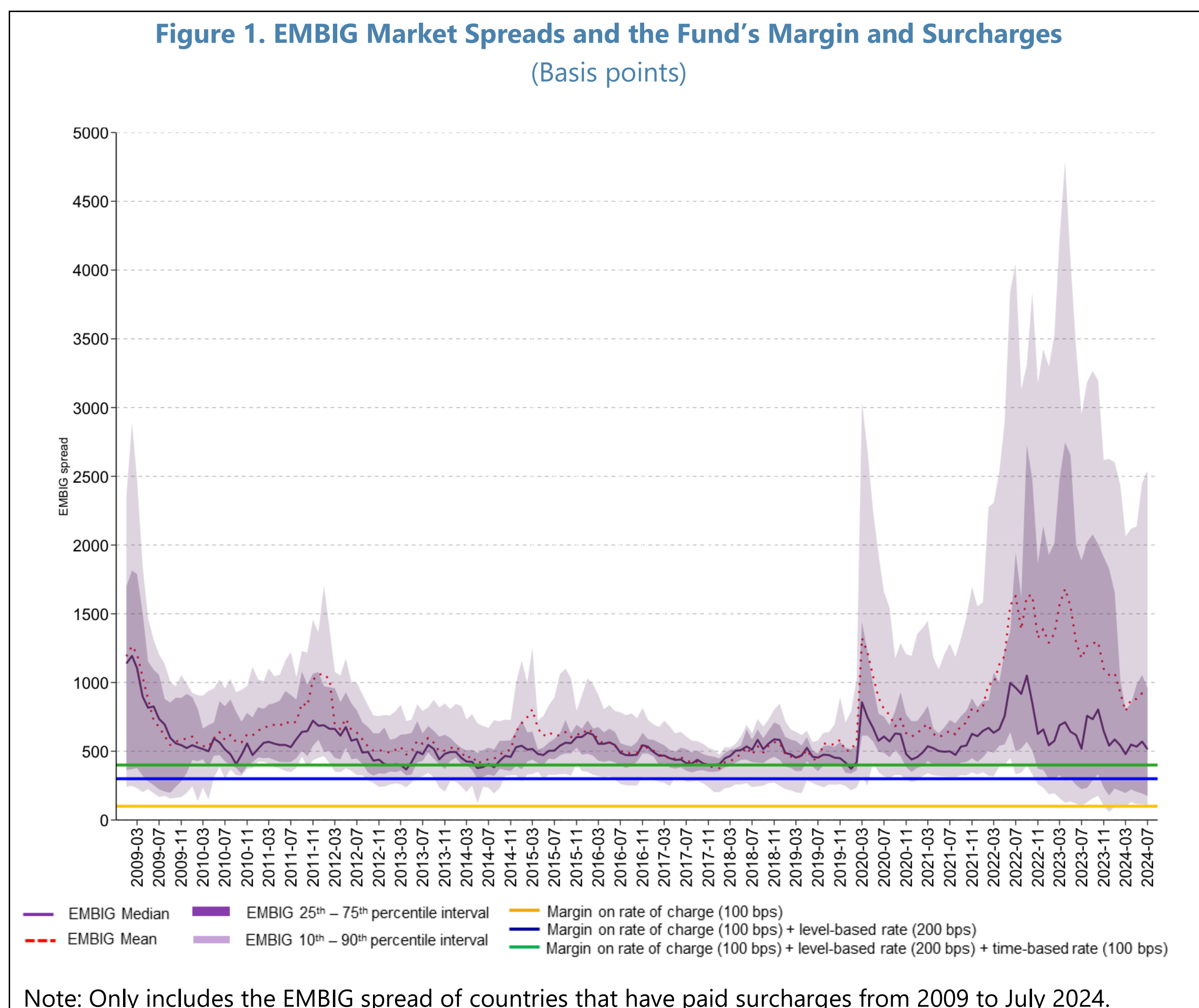
A. Cost of Fund Borrowing

5. While the market cost of borrowing by members is not a perfect benchmark for the Fund's GRA lending terms, it remains an appropriate and relevant comparator for policy purposes. Capital market participants fundamentally differ from the Fund in terms of their sources of financing, risk management practices and tolerance, objectives of lending, and profit orientation. As a result, market borrowing costs and the cost of borrowing from the Fund should, in principle, be expected to differ. Some considerations, however, justify the comparison of the borrowing cost from the Fund and the market. For instance, GRA lending provides balance of payments (BOP) support to countries that in principle have market access and can raise market financing with the same objectives and in similar volumes. In this context, the spread between the market cost and the cost of borrowing from the Fund is a relevant factor for members to consider when making financing decisions related to access and the timing of repayments from the Fund.

6. Likewise, the comparison between the dynamics of market spreads and IMF borrowing costs can be helpful to ascertain the cyclical nature of Fund lending relative to other sources of financing. For example, a significantly higher cost of market borrowing relative to the Fund can be interpreted as a sign of difficulties of a member in accessing financial markets, providing evidence that Fund lending is counter-cyclical in terms of volumes. Moreover, in times of financial stress, IMF borrowing costs tend to increase less than market costs, confirming that Fund lending is countercyclical in rates relative to capital market financing.

7. Additional analysis confirms that the cost of borrowing from the Fund has been consistently lower and more stable than market costs, as discussed in the paper for the July 8 informal Executive Board meeting (Annex II). A granular assessment of the data over time reveals that the marginal cost of borrowing from the IMF, including time-based surcharges, has been significantly lower for surcharge paying members than the cost of market financing (Figure 1). Likewise, while the cost of market financing was highly volatile in the aftermath of the global financial crisis and the pandemic, the marginal cost of borrowing from the Fund has remained stable over time.

Figure 1. EMBIG Market Spreads and the Fund's Margin and Surcharges
(Basis points)



Note: Only includes the EMBIG spread of countries that have paid surcharges from 2009 to July 2024.

8. The spread charged by the Fund (margin and surcharges) is broadly comparable to those applied by other international financial institutions (IFIs), even though comparisons are subject to limitations (Annex II). Countries generally have two major sources of financing other than the IMF—international capital markets and other official sources, such as other IFIs or bilateral creditors. For GRA countries, market financing is in most cases the main source of financing in normal times, although IFI and bilateral borrowing can also be significant. Benchmarking IMF borrowing with IFI costs indicates that the spreads over base rates are broadly comparable, while a comparison of total costs is less informative given the different currency composition of IFI lending instruments vis-à-vis SDRs denomination of Fund lending. Furthermore, some key differences must be kept in mind. First, Fund lending is intended to help close financing gaps in the BOP with shorter-term financing. By contrast, other IFIs and bilateral creditors mainly lend with the intention of supporting development and offering longer-term financing, mainly for projects. Characteristics of loans and pricing models therefore differ. Second, unlike other IFIs such as the World Bank, the Fund does not raise funding from the markets and employs a different approach to managing credit risk. In particular, the Fund cannot apply a portfolio approach with binding country or regional limits to

its lending, which by virtue of its mandate as an international crisis lender is much more concentrated and driven by a member's BOP financing needs. All these factors have implications for the relative pricing of borrowing.

B. Incentive Function of Surcharges

9. Staff undertook some further analysis regarding the effectiveness of level- and time-based surcharges (Annex III):

- **Level-based surcharges:** The previous paper assessed the effectiveness of level-based price incentives by analyzing whether the threshold has influenced members' borrowing decisions over time and by examining the relationship between borrowing patterns and the intensity of financial pressures experienced during the sample period. This paper provides complementary evidence by examining members' peak credit outstanding relative to the surcharge threshold, and the financing pressures experienced around the peak. The data shows that, for a considerable number of countries, borrowing peaked near the level-based threshold, suggesting that the incentive mechanism has played a role in keeping credit outstanding close to the threshold. At the same time, there are countries with peak credit outstanding far above the threshold, suggesting that price incentives have been less effective or ineffective for them. Crucially, countries with peak borrowing closer to the threshold were generally less financially distressed. These findings add to the earlier evidence that the incentive mechanism of level-based surcharges appears to play a role in moderating borrowing for countries facing moderate financial stress but are less effective, or outright ineffective, when members face severe financial distress.[1]

- **Time-based surcharges:** The previous paper found that time-based surcharges have provided incentives to make early repurchases for borrowers with access to alternative financing on favorable terms, but also that their effectiveness was not clear or evident in more recent cases and where financing pressures are protracted. In this paper, staff expands the exercise to investigate whether time-based surcharges have helped prevent high credit outstanding for prolonged periods even in cases when early repurchases were not made and assesses the role of financial distress in determining the effectiveness of time-based surcharge incentives. The new evidence shows that, for countries facing moderate financing pressures, time-based surcharges provided incentives for making early repurchases to reduce or avoid surcharge payments. Time-based surcharges were found to also provide price incentives for countries to reduce credit outstanding over time even when they did not appear to induce early repurchases. In contrast, for countries that have faced protracted and severe financial stress, including the current top

[1] As mentioned in the paper for the Informal Board discussion in July, conclusively assessing the effectiveness of the incentive mechanism of surcharges is methodologically challenging because counterfactuals cannot be observed. Moreover, borrowing and repayment decisions not only respond to financial incentives but may also reflect other considerations, including possible reputational and confidence effects.

surcharge payers and recurring Fund borrowers, time-based surcharges have not provided incentives for early repurchases or for reducing credit outstanding.

A POSSIBLE REFORM PACKAGE

10. The feedback received from the informal discussion at the Executive Board and the application of the four guiding principles of reform provide the contours of a possible reform package. Staff proposes consideration of a package that would include lowering the margin on the rate of charge, increasing the thresholds for level-based surcharges and commitment fees to broadly compensate for erosion, and moderately reducing surcharge rates. This section assesses the incidence of this package across Fund borrowers, as well as its impact on incentives, the Fund's income, and policy simplicity.

A. Margin on the Rate of Charges

11. The setting of the margin is governed by Rule I-6(4) (Annex I). Under this rule, the margin should be set at a level that is adequate to: (i) cover the Fund's estimated intermediation costs; and (ii) generate an amount of net income for placement to reserves, with the appropriate amount to be assessed taking into account, in particular, the current level of PBs and any floor or target, the expected contribution from surcharges and commitment fees to PBs.[2] At the same time, the margin should not be set at a level at which the basic rate of charge would result in the cost of Fund credit becoming too high or too low in relation to long-term credit market conditions (the "market test"). Application of these criteria requires judgment by the Executive Board, including regarding the desirable levels of net income and reserve accumulation and the application of the market test.

Income Loss Compared with the Current Level of Margin (100 basis points), FY2026
(Millions of SDR)

Margin level (basis points)	Lending income loss (SDR million)
40	515
50	430
60	344
70	258
80	172
90	86

Source: IMF staff calculations.

12. While the July informal Board paper illustrated possible margins within 40–100 basis points under Rule I-6(4) for the remainder of FY2025 and FY2026, staff now proposes to set the margin at 70 basis points, in the middle of this range. A margin of 70 basis points would cover estimated intermediation costs (about SDR 126 million in FY2024) and would allow for the generation of net income of about SDR 2.6 billion and SDR 2.2 billion in FY2025 and FY2026,

[2] Rule I-6(4) also provides for an exceptional circumstances clause under which the margin may be set at a level other than that which is adequate to cover estimated intermediation expenses and to generate an amount of net income to be placed to reserves. This clause has been relied upon since the adoption of the rule in 2011 as income from

(continued)

respectively, at current policies on surcharges. Relative to the current margin, the proposal would lower annual income by SDR 258 million (FY2026 basis), reducing payments by GRA borrowers in proportion to their credit outstanding. Although the PB target has been reached, generating net income at this level for potential placement to reserves provides an additional buffer in the event that risks from high outstanding GRA credit were to materialize (for example, in the event of large-scale arrears). Net income could also be distributed to members, for example, if such distribution could be justified in light of the financial position of the Fund at the time the annual income dispositions are taken. Importantly, setting the margin at 70 basis points would ensure that the cost of Fund credit is not too low or too high relative to long-term credit market conditions.[3] Setting the margin at either the lower or higher end of the 40–100 basis points range would be more difficult to justify from the perspective of the market test:

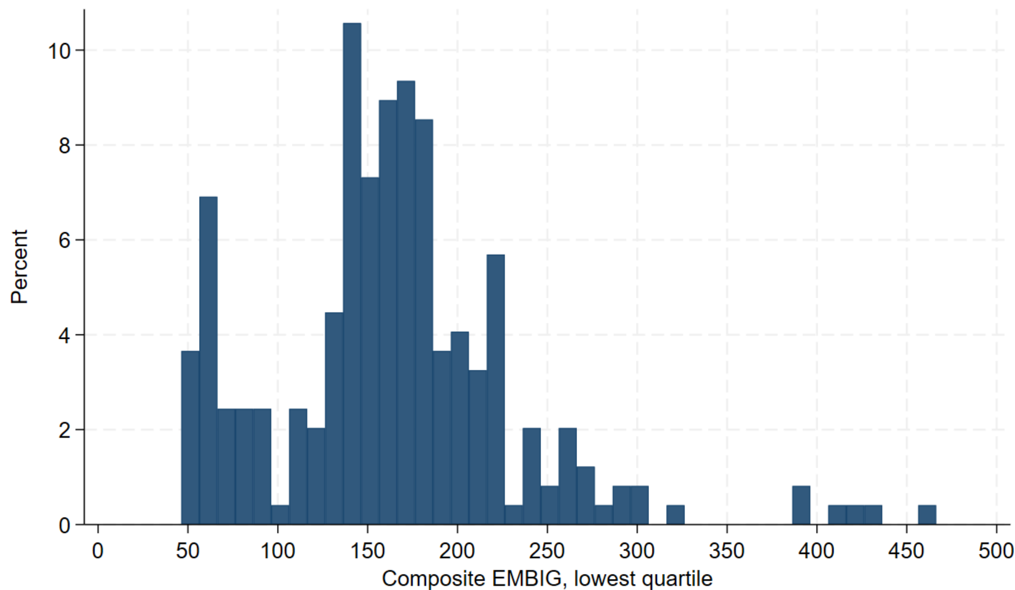
- **A margin close to the lower end of 40 basis points would make the cost of Fund credit very low compared to market costs.** Over the past 20 years, the probability of the lowest quartile EMBIG (Emerging Market Bond Index Global) spreads falling below the level of 50 basis points has been less than 1 percent (Figure 2).[4] Over the past five years, only two of the countries in the lowest quartile of EMBIG spreads had five-year median spreads around 40 basis points, while the mean spread of the five-year medians across these countries was 130 basis points and the median for all countries was 366 basis points (Figure 3). In a historical context, a margin of 40 basis points would be significantly below the historical mean and median of the lowest quartile and far from the historical relative position of the margin (Figure 4).

other sources was not sufficient to cover the non-lending related administrative expenses. However, in the current environment of high investment income in the Investment Account, the margin is no longer needed to cover non-lending related administrative expenses.

[3] See "Initial Considerations for the Review of Charges and the Surcharge Policy" for details.

[4] The lowest quartile EMBIG spreads were in the range of 40 to 50 basis points in a brief period of time in 2005, when market conditions were unusually benign.

Figure 2. Probability Distribution of Composite EMBIG, January 2004–June 2024[1]

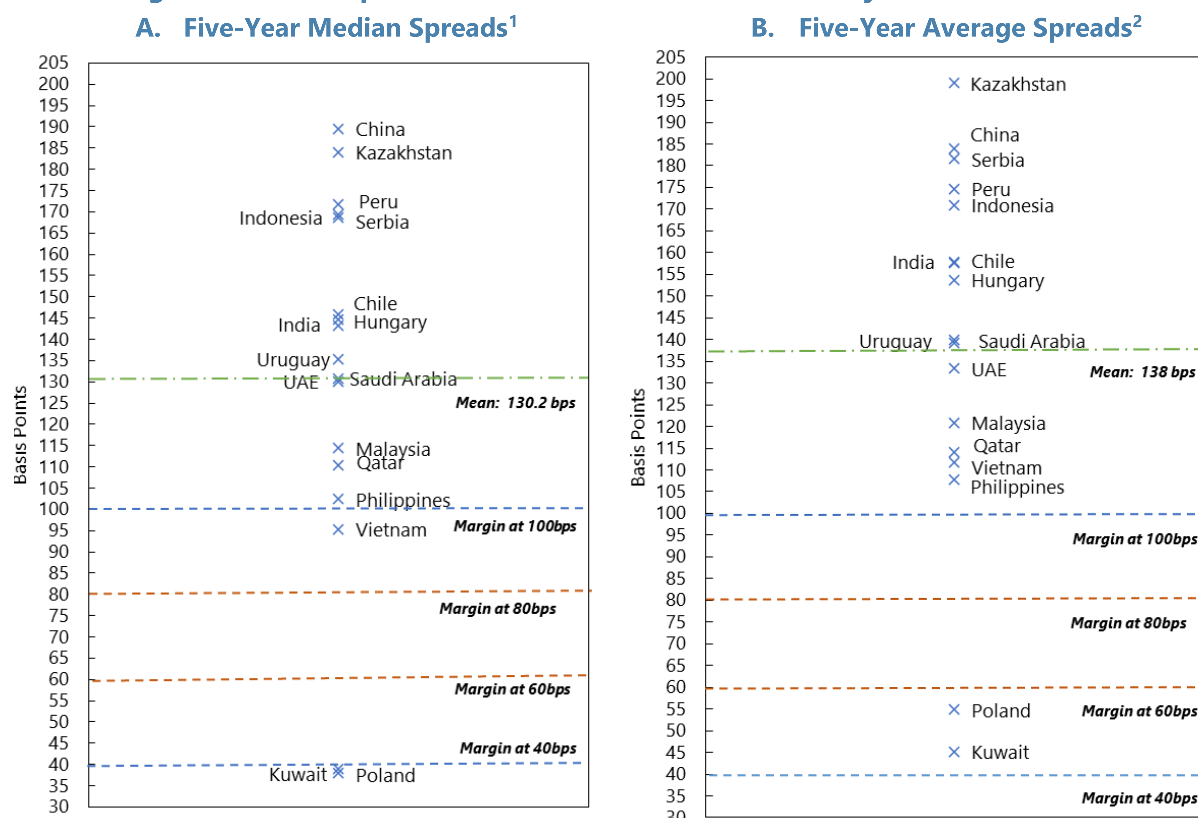


Source: JP Morgan Markets and IMF staff calculations

[1] Weighted average of the lowest quartile of country-specific U.S. dollar EMBIG spreads and the lowest quartile of country-specific euro EMBIG spreads, using US dollar and euro weights in the SDR basket.

- **A margin closer to 100 basis points, on the other hand, would appear high relative to recent market developments and against the background of strong projected Fund income and PBs at or above the current medium-term target.** Over the last 20 years, the probability of the lowest quartile of EMBIG spreads falling below 100 basis points has been about 17 percent, but this has not happened since late 2007 (Figure 2). Among the countries in the lowest quartile of EMBIG spreads, only three (two) countries' median (average) spreads were below 100 basis points (Figure 3). For the last five years, the average difference between the Fund's margin and the median EMBIG spread of the bottom quartile has been about 30 basis points. However, over the past 18 months, the Fund margin on the rate of charge has been broadly in line with the mean and average EMBIG spread of the bottom quartile, indicating that a margin at 70 basis points (which would reflect the historical 30 basis point difference) would be more consistent with past experience (Figure 4). Moreover, maintaining a margin closer to the upper end of 100 basis points would generate significant Fund net income against the backdrop of the PB target having been reached.

Figure 3. EMBIG Spreads: Bottom Quartile Countries, July 2019–June 2024

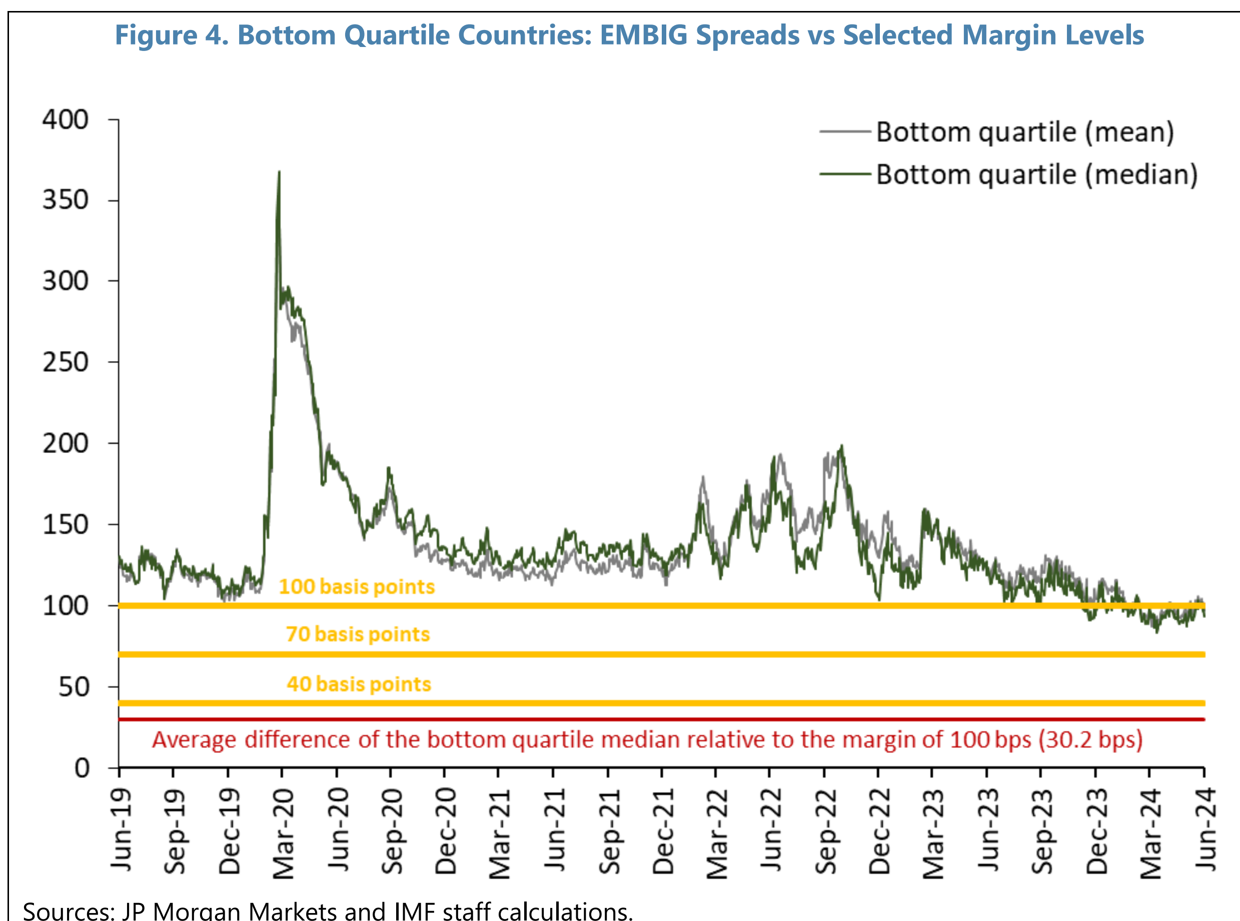


Sources: JP Morgan Markets and IMF staff calculations.

[1] Overall five-years median EMBIG spreads for all borrowers is 366 bps.

[2] Overall five-year average EMBIG spreads for all borrowers is 400 bps.

Figure 4. Bottom Quartile Countries: EMBIG Spreads vs Selected Margin Levels



Sources: JP Morgan Markets and IMF staff calculations.

B. Threshold for Level-Based Surcharges

13. Staff also considered the appropriate level of the threshold for level-based surcharges in light of the strong support by Executive Directors for its adjustment. Since the 2016 review, the median erosion across metrics was around 33 percent of quota for both the world and EMDEs, suggesting an increase in the threshold for level-based surcharges by about 50 percent to 280–285 percent of quota (Table 1). However, as some Directors noted at the previous informal engagement, the adjustment of the threshold in the 2016 review did not fully restore erosion since the previous 2009 review. This would require an increase in the threshold by about 75 percent to 325–330 percent of quota.

Table 1. Level-Based Surcharge Thresholds Offsetting Erosion Since 2016

	Using **Median** erosion		Using **Aggregate** erosion	
	2016-2024 erosion (Percent)[1]	Threshold offsetting erosion	2016-2024 erosion (Percent)[1]	Threshold offsetting erosion
World				
GDP	34	283	32	277
Current Payments	38	302	37	296
Capital Inflows	32	275	23	245
External Financing Needs	31	271	32	277
Median across metrics	*33*	*279*	*32*	*277*
EMDEs				
GDP	34	284	37	295
Current Payments	39	307	40	315
Capital Inflows	32	275	35	286
External Financing Needs	29	265	30	266
Median across metrics	*33*	*279*	*36*	*291*
EMDEs excl. India and China[2]				
GDP	35	289	33	281
Current Payments	42	322	43	330
Capital Inflows	32	275	40	313
External Financing Needs	33	278	25	250
Median across metrics	*34*	*283*	*37*	*297*

Source: IMF staff calculations.

[1] Refers to percent of quotas per the 14th General Review of Quotas.

[2] For comparability with the 2016 Review.

14. **On balance, staff would pragmatically propose to raise the threshold to 300 percent of quota, which broadly offsets erosion while, importantly, enhancing the simplicity of the framework.** Such a threshold would be slightly above the level required to offset erosion since 2016, going some way toward addressing concerns related to the limited adjustment for erosion made at the 2016 review while helping to keep the framework simple, as setting the threshold at 300 percent of quota would translate into 200 percent of "new" quota to maintain the nominal SDR value of the threshold once the 16th GRQ increase becomes effective. Consistent with the principles guiding this review, therefore, this change would provide a tangible reduction in the borrowing

costs of members, a change made all the more pertinent by the increased frequency and magnitude of shocks faced by the membership. By keeping the broader surcharge framework in place, it would preserve incentives to limit borrowing from the Fund and address underlying imbalances, while providing *simplicity* and allowing for easy translation into the current and new quota structure. The proposed higher threshold alone would reduce the surcharge income by SDR 430 million in FY2026, with seven surcharge payers no longer subject to surcharges. This reduction would benefit the smaller surcharge payers relatively more than the larger ones, with the top three surcharge payers' share in total surcharge reduction being about 46 percent (compared to a share in credit outstanding subject to surcharges of about 74 percent). As noted in the July informal Board paper, there is a trade-off in benefitting small and large borrowers through threshold increases and surcharge rate reductions: threshold increases reduce the surcharge burdens of small borrowers relatively more, while large borrowers benefit more in relative terms from rate reductions.

C. Thresholds for Commitment Fees

15. Offsetting the erosion of commitment fee thresholds since 2016 enjoys broad support. Fully offsetting median erosion since 2016 would require an increase in the thresholds by about 50 percent. This could be achieved, for instance, by raising the lower threshold to 172.5 percent of quota (from 115 percent of quota currently) and the higher threshold to 862.5 percent of quota (from 575 percent of quota currently). While mechanically adjusting the commitment fee thresholds to these values has the advantage of being straightforward, it also implies greater complexity of the overall lending framework by having multiple thresholds for commitment fees and access limits. While conceptually the set of factors informing the calibration of access limit thresholds and commitment fees are not identical, they are related. On balance, the latter approach is preferable—broadly offsetting erosion while enhancing simplicity.

16. Staff therefore proposes to use the opportunity to align the thresholds for commitment fees with the GRA access limits, currently 200 and 600 percent of quota, respectively. This approach would also align the trigger for producing the assessment of the impact on the Fund's finances and liquidity position with the related requirement under the exceptional access policy to produce an assessment of financial risks to the Fund. The effects of the change in threshold would be limited to the users of precautionary facilities, estimated to amount to SDR 16 million in FY2026.

Commitment Fee Thresholds
(Percent of quota)

	Current	Proposed
15 basis points	up to 115	up to 200
30 basis points	between 115 and 575	between 200 and 600
60 basis points	above 575	above 600

D. Surcharge Rate Reductions

17. At the informal meeting in July, **Directors supported consideration of lower surcharge rates, albeit views on the scope and composition varied, with relatively more support for lowering the time-based surcharge rate.** Rate reductions would reduce borrowing costs, particularly for large surcharge payers whose interest burden has increased significantly driven by the SDRi. Surcharge rate reductions can be broadly consistent with the four guiding principles depending on their magnitude and when considered in conjunction with the other elements of a possible reform package:

- **Lowering the borrowing cost of members:** Rate reductions help lower the borrowing costs of surcharge payers. While the reduction in borrowing costs under both level-based and time-based surcharge rate reductions would be concentrated among the largest borrowers, this feature could help balance the incidence of the other elements of the possible reform package which tend to favor members with smaller exposures, such as surcharge threshold increases.

- **Sustaining effective price-based incentives:** While rate reductions would in principle weaken price-based incentives for the group of countries for which they have shown to be effective, the impact could be mitigated by limiting the size of the rate reductions.

- **Preserving adequate income generation capacity:** The loss of lending income can be limited through the size of the rate reduction.

- **Maintaining policy simplicity:** Surcharge rate reductions would generally preserve the simplicity of the current surcharge policy framework.

18. Conceptually, level- and time-based surcharge rate reductions differ in terms of incidence on borrowers but in the near term they would have similar implications given the characteristics of the current stock of credit outstanding:

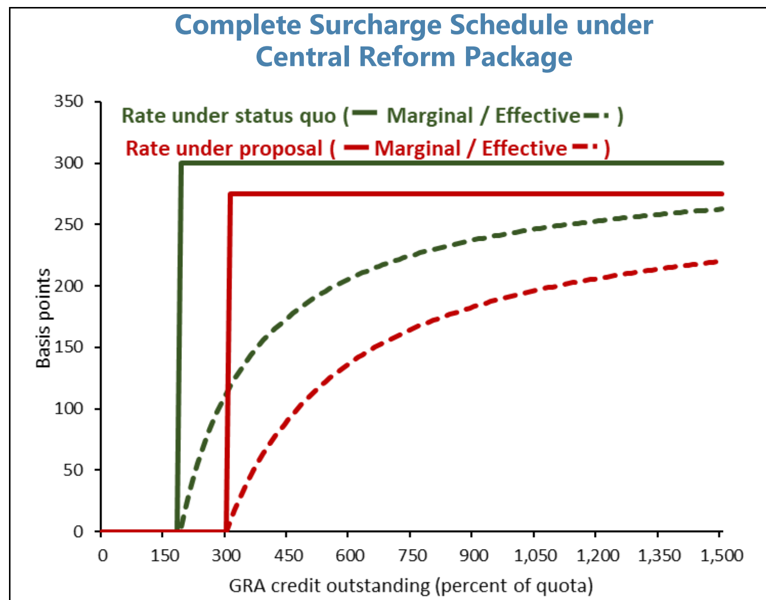
- Level-based surcharge rate reductions lower the burden on borrowers at the inception of a program, when financing needs are highest, which would partially address procyclicality concerns by helping the country at the time of maximum financing need and least margins for maneuver.

- Time-based surcharge rate reductions would defer the reduction in borrowing costs giving borrowers extra time to make the policy changes needed for external adjustment, including for members experiencing persistent BOP pressures originating from structural problems or suffering from repeated exogenous shocks.

- While the time-based surcharge rate reduction by itself would reduce the surcharge burden for large borrowers with prolonged financing needs more than the level-based rate reduction, in practice there would be very little difference between the near-term impact of lowering either the time or the level-based surcharge rates because of the current structure of credit

outstanding and the other elements of reform being considered. With the proposed increase in the surcharge threshold, almost all credit outstanding would be subject to both the level- and time-based surcharges and, therefore, the impact on incentives, GRA income, and the incidence of the reduction in costs on borrowing members would be broadly the same.

19. To balance all these considerations, staff proposes a modest reduction of the time-based surcharge rate. Considering the shock-prone environment, which increases the likelihood of members being subjected to sequential shocks, and the relative preference expressed by Directors in the informal meeting, staff proposes reducing the time-based rate by 25 basis points to 75 basis points. For illustration, the Text Figure shows the surcharge schedule for borrowers subject to time-based surcharges under the proposed reform package. The reduction of time-based surcharge rate by itself would lower the surcharge burden more for large borrowers, providing some balance for the package in terms of incidence as the proposed increases in threshold would reduce the surcharge burden more for small borrowers. The proposed reduction would lower annual lending income by about SDR 120 million (FY2026 basis) compared to current policies and by about SDR 520 million in total if implemented together with an increase in the level-based threshold to 300 percent of quota. The alternative option of reducing the level-based surcharge rate by 25 basis points would have broadly similar income implications. Finally, an additional 25 basis point reduction in the time- or level-based surcharge rate would reduce net income by an additional SDR 90 million, if implemented together with a threshold increase to 300 percent of quota.



E. Overall Implications of the Proposed Reform Package

20. The income implications for the GRA of the proposed reform package can be illustrated in comparison with a no policy change scenario. Table 2 shows the combined effect of: (i) a reduction in the margin for the basic rate of charge to 70 basis points; (ii) an increase in the level-based surcharge threshold to 300 percent of quota; (iii) alignment of commitment fee thresholds with the GRA access limits; and (iv) a reduction of the time-based surcharge rate to 75 basis points. In this analysis, responding to Directors' feedback, the projection of the demand for GRA financing is based on an improved baseline (Box 2). In the baseline, lending projections for the period end-June 2024 to end of FY 2026 stem from the Fund's desk survey, which assesses the

likelihood and access of Fund program requests, considering countries' economic outlook, financing needs, and political landscape.[5] For FY2027-29, the lending projections assume that, in aggregate, new arrangements will cover about 60 percent of the repurchases during the period. This assumption reflects the expectation that some members will likely continue to require financial support in a shock-prone global environment albeit at a lower scale, consistent with a gradual easing of the total demand for Fund financing. Under this baseline, the proposed reform package would reduce annual lending income by about SDR 800 million in FY2026, with the largest three surcharge payers accounting for 54 percent of the total (Table 2). The total cumulative income loss over FY2025-29 (assuming no changes in the margin and other relevant policies over this period) is estimated at about SDR 3.6 billion. The reform package would imply a meaningful reduction in the borrowing costs of GRA borrowers, with an average reduction of about 33 percent in combined margin and surcharge payments in FY2026 relative to a no policy change scenario (Table 3). Moreover, the number of surcharge-paying members would decline substantially from 20 to 13 in FY2026.[6]

Table 2. Lending Income and Incidence Under the Proposed Reform Package, FY2025–29[1]

	FY25	FY26	FY27	FY28	FY29	Total during FY25-29
A. No policy changes						
Margin income (SDR million)	903	859	873	866	823	4,324
Commitment fee income (SDR million)	143	159	126	159	0	587
Surcharge income (SDR million)	1,502	1,537	1,582	1,585	1,495	7,701
Total lending income (SDR million)	2,627	2,600	2,625	2,641	2,347	12,840
Number of surcharge payers	23	20	21	21	20	
B. Proposed Package						
Margin income (SDR million)	767	601	611	606	576	3,161
Commitment fee income (SDR million)	142	144	116	131	0	533
Surcharge income (SDR million)	1,248	1,015	1,043	1,043	946	5,295
Total lending income (SDR million)	2,236	1,805	1,814	1,811	1,551	9,217
Lending income loss compared with A. (SDR million)	391	796	810	829	796	3,623
Number of surcharge payers	23	13	15	16	15	
Share of lending income loss attribuitable to top three surcharge payers (percent)	60.9	53.8	53.0	51.7	52.4	

Source: IMF staff calculations.

[1] Includes projected level of credit outstanding based on staff desk survey conducted in June 2024.

[5] In all scenarios, policy changes are assumed to take effect on November 1, 2024.

[6] The following countries would not pay any surcharges during FY2026 under the proposed reform package while they would pay surcharges under no policy change scenario: Benin; Côte d'Ivoire; El Salvador; Gabon; Georgia; Moldova; and Senegal.

Table 3. Country-by-Country Incidence Under the Proposed Reform Package, FY2026[1]

Members	Surcharges and margin payment reduction (SDR million)	Share in total reduction (percent)	Reduction of margin and surcharge payments in percentage of those payments under no policy change (percent)	Ratio of share in total reduction to share in credit outstanding	Surcharge payments under proposed reform package (SDR million)
Members paying surcharges	762.6	97.7	32.6	1.1	1014.6
Of which:					
Angola	33.9	4.3	53.2	1.4	11.3
Argentina	259.2	33.2	23.6	0.9	614.7
Barbados	4.4	0.6	52.2	1.4	1.6
Benin	2.9	0.4	55.6	1.0	0.0
Costa Rica	12.2	1.6	50.8	1.1	3.0
Côte d'Ivoire	14.0	1.8	54.5	0.9	0.0
Ecuador	55.8	7.1	23.9	0.9	129.7
Egypt	100.1	12.8	44.6	1.3	64.9
El Salvador	1.7	0.2	33.8	0.4	0.0
Gabon	1.4	0.2	33.1	0.4	0.0
Georgia	1.1	0.1	30.1	0.3	0.0
Jordan	17.7	2.3	40.4	1.2	15.1
Kenya	17.6	2.3	52.5	1.1	3.4
Moldova, Republic of	3.5	0.5	53.7	0.9	0.0
Pakistan	92.8	11.9	53.7	1.4	29.8
Senegal	7.6	1.0	55.8	1.0	0.0
Seychelles	1.0	0.1	42.6	1.1	0.6
Sri Lanka	18.3	2.3	54.8	1.1	2.2
Suriname	4.2	0.5	51.8	1.1	0.9
Ukraine	113.5	14.5	34.6	1.1	137.5
Members not paying surcharges	18.1	2.3	30.0	0.3	0.0
Total	780.6	100.0	32.6	1.0	1014.6

Source: IMF staff calculations.

[1] Includes projected level of credit outstanding based on staff desk survey conducted in June 2024.

21. The proposed reform package would deliver generally desirable outcomes in terms of the four principles guiding the review.

- **Sustaining effective price-based incentives**. The proposed moderate margin and surcharge rate reductions would broadly preserve the current price-based incentive structure. Moreover, the threshold increases would broadly align the pricing structure of GRA lending with the increases in global erosion metrics and demand for GRA resources;

- **Lowering the cost of borrowing**. As Table 3 illustrates, the package would meaningfully reduce charges and surcharge payments for GRA borrowers, thereby creating some additional policy space and improving their capacity to repay the Fund;

- **Preserving adequate income-generation capacity**. The proposed package would retain a substantial capacity to generate net income, including for possible placement in reserves (see below); and

- **Maintaining policy simplicity**: the proposed package would preserve and, in some parts, even enhance the simplicity of the framework.

22. The impact of the proposed reform package on the demand for GRA credit is likely to be limited. As noted above, the current price-based incentive structure would be broadly maintained. Furthermore, as illustrated in the initial engagement paper, the demand for GRA credit of large borrowers is relatively price inelastic. The proposed modifications are therefore unlikely to trigger a substantial increase in credit demand.

HOLISTIC BALANCE SHEET CONSIDERATIONS

23. The financial outlook for the Fund under current policies remains very robust. The baseline projection in a no-policy change scenario is based on current market projections for the SDRi and investment returns, a lending path consistent with gradual medium-term decline in credit outstanding, and full retention of annual net income in PBs (Box 2). Under this scenario, the Fund would generate net income of about SDR 2.5-2.8 billion per year over the next five years and PBs would reach SDR 38.5 billion by FY2029 in case of full retention (Table 4).

24. Staff conducted an analysis to assess the robustness of medium-term income and PBs under the proposed reform package for different scenarios. This analysis assesses the resilience of the projected income and reserve paths relative to three key assumptions:

- The projected path of GRA credit outstanding (i.e., the demand for Fund resources), which is a key determinant (together with the composition of credit among members) of lending income;
- The possible distribution of net income to the membership, which has implications for the accumulation of PBs and, consequently, non-lending (i.e., investment) income; and
- The projected path of the SDRi and investment returns, which is another key determinant for projected non-lending income.

25. Implementation of the proposed reform package would preserve a considerable net income generation capacity under baseline assumptions for credit outstanding and the SDRi (Table 4). In the baseline, the GRA would maintain a net income capacity of about SDR 1.7 billion annually after policy changes. While considerations regarding the use of any net income—as it materializes—are not the subject of this paper, the projected net income could accommodate significant annual distributions of, for example, SDR 1.4 billion over the next five years (cumulatively SDR 7 billion from FY2025 to FY2029), while also leaving room for further reserve accumulation. The size of the annual net income (after implementation of the proposed reform package and before any distributions) would exceed two historical standard deviations, implying a very low probability that the Fund would post negative net income in any year.[7] The annual income disposition decisions

[7] Annual net income after implementing the reform package would reach SDR 1.7 billion before income distribution, while the standard deviation of annual net income over the past 10 years was about SDR 660 million.

and the bi-annual decisions on the margin provide opportunities for the Executive Board to assess precautionary balances in light of developments and to decide on any income distribution or further reserve accumulation.

26. The reform package would leave room for potential increases in PBs, depending on the size of any distributions. As underlined in the latest review of the Fund's PBs, developments in Fund credit and associated risks have remained generally consistent with the assessment of the adequacy of PBs earlier this year.[8] However, a moderate accumulation beyond the SDR 25 billion target would provide an additional prudential buffer in the current uncertain environment and ensure greater flexibility if unexpected shocks and credit risks arise that may require setting a higher PB target. As noted, even in case of sizeable distributions of net income to the membership, residual net income is expected to be generated that could be retained to increase PBs (for example, with cumulative distributions of SDR 7 billion during FY2025–29, about SDR 2 billion could be retained). Separately, as a matter of policy, the Board could also consider aligning the level of the special reserve with the new SDR 20 billion floor for the PB target set in the last review by allocating net income going forward accordingly.

27. Income and PB generation capacity is broadly robust to adverse shocks in the underlying assumptions. In a low-lending scenario, in which no new Fund lending is assumed beyond the desk survey projections and illustrative net income distributions of about SDR 1.4 billion per year are made, the residual PB accumulation over the 5-year period would fall to about SDR 1 billion.[9] A stress test that assumes a low investment return environment in which the average return of the FI investment portfolio over the medium term falls to the 5th percentile of the historical distribution would have a broadly similar impact on net income and PB accumulation during FY2025–29 (see Boxes 2 and 3 for a broader discussion of investment income risks). A joint shock of low lending and low investment returns and illustrative net income distributions of SDR 1.4 billion annually would leave PBs broadly unchanged at SDR 25.3 billion by end-FY2029 (Figure 5).[10] All these scenarios assume unchanged margin and other relevant policies during the projection period.

28. A range of policy responses could be considered if net income or PBs were to fall below levels deemed appropriate by the Executive Board, or if there were other adverse developments. In response to unforeseen events, such as adverse credit events requiring provisions or materialization of other risks, the Board could consider delaying any distributions of net income or spreading them out over a longer period of time. Under Rule I-6(4), biennial reviews of the margin of charge would also allow raising the margin for the basic rate of charge if a higher level of

[8] See *Review of the Adequacy of the Fund's Precautionary Balances*.

[9] For the purposes of setting the margin, the relevant horizon would be two-years consistent with Rule I-6(4).

[10] Suspension of PRGT reimbursement to GRA beyond FY2026 would reduce the net income of GRA by SDR 300 million cumulatively during FY2027–29 (see "2024 Review of the Poverty Reduction and Growth Facilities and Financing—Reform Proposals").

reserve accumulation is desired or warranted.[11] Finally, the Board could at any time review surcharge policies.

Table 4. Impact of the Proposed Central Reform Package on Fund Income and Precautionary Balances, FY2025–29

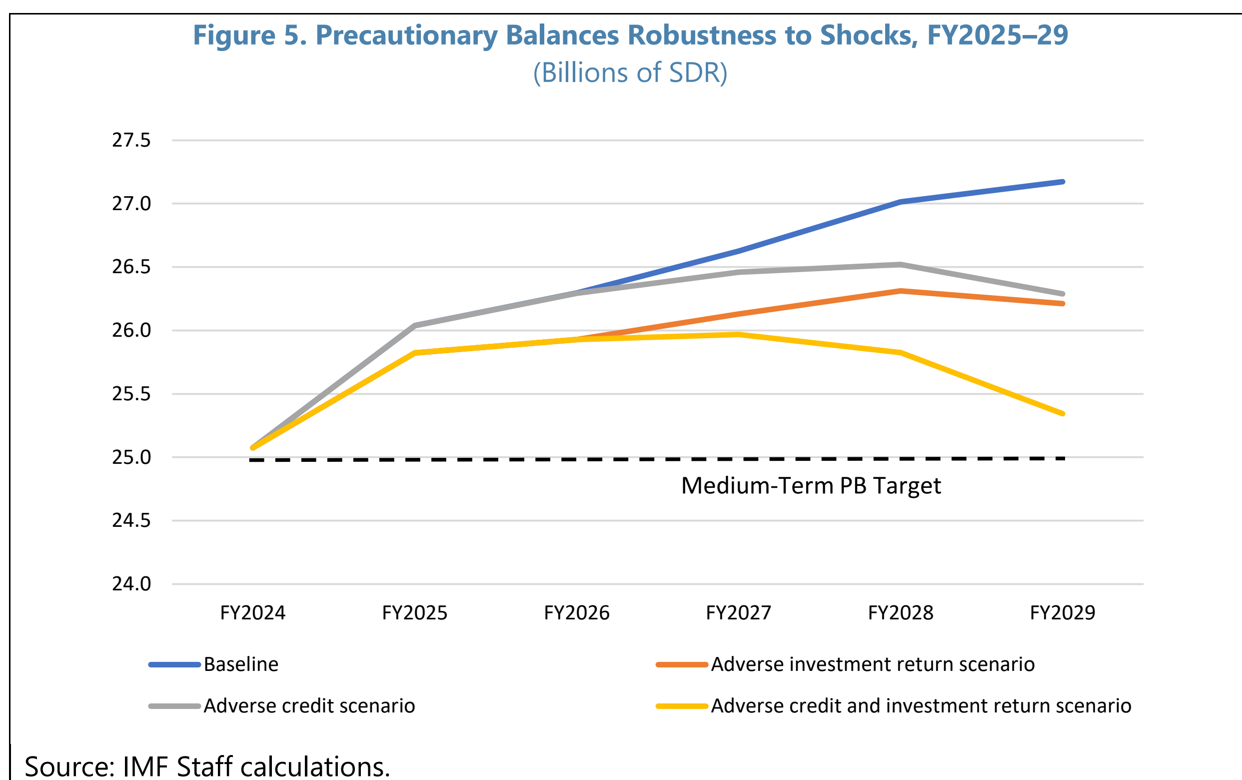
(SDR millions, unless otherwise indicated)

	No policy changes without distribution						Proposed reform package with distribution					
	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	Total (FY25-29)	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	Total (FY25-29)
Operational Income	**3,991**	**3,759**	**3,940**	**4,135**	**3,994**	**19,819**	**3,593**	**2,915**	**3,009**	**3,095**	**2,891**	**15,503**
Lending income	2,627	2,600	2,625	2,641	2,347	12,840	2,236	1,805	1,814	1,811	1,551	9,217
Margin for the rate of charge	903	859	873	866	823	4,324	767	601	611	606	576	3,161
Service charge and other income	79	45	44	31	29	228	79	45	44	31	29	228
Commitment fees	143	159	126	159	0	587	142	144	116	131	0	533
Surcharges	1,502	1,537	1,582	1,585	1,495	7,701	1,248	1,015	1,043	1,043	946	5,295
Investment income	1,262	1,101	1,160	1,334	1,489	6,346	1,263	1,072	1,065	1,150	1,209	5,759
Interest-free resources	90	45	42	45	41	263	82	25	17	19	14	157
Reimbursements	12	13	113	115	117	370	12	13	113	115	117	370
PRG Trust	0	0	99	101	103	303	0	0	99	101	103	303
Expenses	**1,229**	**1,258**	**1,281**	**1,306**	**1,332**	**6,406**	**1,229**	**1,258**	**1,281**	**1,306**	**1,332**	**6,406**
Net administrative budget	1,128	1,159	1,184	1,202	1,226	5,899	1,128	1,159	1,184	1,202	1,226	5,899
Net Operational Income	**2,762**	**2,501**	**2,659**	**2,829**	**2,662**	**13,413**	**2,364**	**1,657**	**1,728**	**1,789**	**1,559**	**9,097**
Less: Distribution	0	0	0	0	0	0	-1,400	-1,400	-1,400	-1,400	-1,400	-7,000
Net Operational Income after distribution	**2,762**	**2,501**	**2,659**	**2,829**	**2,662**	**13,413**	**964**	**257**	**328**	**389**	**159**	**2,097**
Net Operating Income Loss compared with No Policy Change without distribution (SDR millions)							**-1,798**	**-2,244**	**-2,331**	**-2,440**	**-2,503**	**-11,316**
Precautionary Balances as of end-FY (SDR billions)	**27.8**	**30.3**	**33.0**	**35.8**	**38.5**		**26.0**	**26.3**	**26.6**	**27.0**	**27.2**	
Memorandum Items:												
Average Credit Outstanding (SDR billion)	90.3	85.9	87.3	86.6	82.3		90.3	85.9	87.3	86.6	82.3	
SDR interest rate (in percent)	3.8	3.2	3.0	3.1	3.2		3.8	3.2	3.0	3.1	3.2	

Source: IMF staff calculations.

[11] The margin could even be adjusted after only one year if there have been fundamental changes in the underlying factors that were relevant for the establishment of the margin at the start of the two-year period. Any change in the margin would have to be decided with a 70 percent majority of voting power of the Executive Board.

Figure 5. Precautionary Balances Robustness to Shocks, FY2025–29
(Billions of SDR)



Source: IMF Staff calculations.

Box 2. Assumptions Under the Baseline and Adverse Scenarios for the Projection of the Medium-Term Income and Precautionary Balances

Under the improved baseline scenario, the pipeline of the short-term demand (June 2024–FY 2026) for Fund financing is based on the Fund's desk survey, which assesses the likelihood and access of Fund program requests in the next 24 months as of end-June 2024. As mentioned above, from FY2027 onward, the lending projections assume that in aggregate, new arrangements will cover about 60 percent of the repurchases during the period. to reflect that the membership is likely to continue to require some lending support in a shock-prone world. Policy changes on the margin for the basic rate of charge, surcharges, and commitment fees are expected to come into effect on November 1, 2024.

The adverse investment return scenario assumes the same demand for Fund financing and hence the same credit path as the baseline. However, the investment income from the Fixed-Income Subaccount (FI) is assumed to be lower than in the baseline scenario. Staff projections, at a 95 percent confidence level, suggest that the annual investment return from the FI over the FY2025 to FY2029 period would at most fall to a minimum of 2.9 percent, or SDR 858 million, per annum on average, compared with the baseline scenario of 3.6 percent or SDR 1,042 million per annum on average.

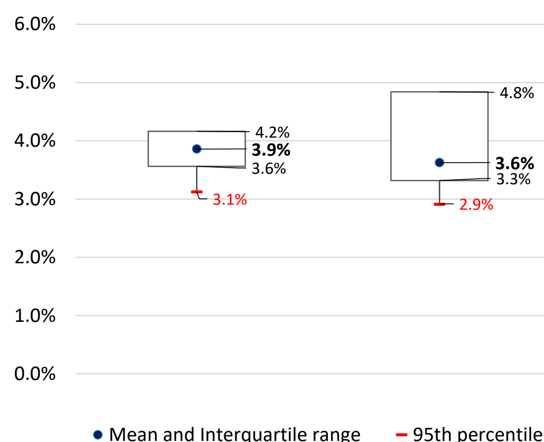
The adverse credit scenario assumes no new Fund lending beyond the arrangements projected until FY2026 in the latest (June 2024) desk survey.

Under both the baseline and adverse scenarios, annual net income not distributed to members would accumulate towards the Fund's PBs and would be transferred to the FI for investment. The proposed reform package is assumed to be implemented under all scenarios (except for the no policy change scenario).

Box 3. Projected Investment Income Under the Baseline and Adverse Scenarios

The Investment Account (IA) consists of the Fixed-Income Subaccount (FI) and the Endowment Subaccount (EA). The two subaccounts have distinct investment objectives and pursue different strategies accordingly.

The FI invests in high grade fixed-income assets and maintains a relatively short interest rate duration (normally in a range of 1.5-2 years). The objective for the investment strategy is to generate an annual return margin over the SDR interest rate of 50 bps on average over the medium term. Generally, the portfolio's average overall investment return over the next 3-4 years is projected to be very close to the current level of short-term bond yields. Beyond that horizon, investment returns will depend more on the future path of the SDR interest rate. Over the next 5 years (FY 2025–29), staff's projections indicate a relatively high level of confidence that the FI strategy will return between 3.3 and 4.8 percent on average, with a mean projected return of 3.6 percent. This would translate to an average annual investment income of SDR 1,042 million. Under the adverse investment return scenario, specifically at the 95th percentile of projected returns, the portfolio is expected to return a minimum of 2.9 percent annually, equating to SDR 858 million.



The EA is a multi-asset portfolio invested across global fixed-income and equity markets, with an objective to achieve a long-term real rate of return of 3 percent in US dollars. While the EA's long-term strategy can result in significant volatility of annual investment returns, these do not directly impact GRA income. To support the EA's financial purpose of providing a meaningful contribution to the Fund's income, the Board established a payout policy to guide annual payouts from the EA to the GRA. The policy sets out a constant real payout rule supplemented by certain safeguards including a mechanism to suspend payouts to the GRA, to help protect the real value of the EA.

Annual payouts from the EA to the GRA have not yet been initiated but are imminent. Staff expects to propose commencing the initial payout in the context of the Review of the Fund's Income Position for FY2025 - barring any major negative developments in markets in the near term. Analysis suggests that payouts of up to 2 percent of the EA's NAV (equivalent to USD 184 million, or SDR 138 million) could be made while preserving the real value of the EA's corpus over a medium to long-term horizon with a relatively high level of confidence. In the baseline scenario, a payout of 1.5 percent (USD 138 million or SDR 104 million) is assumed. In the event the suspension mechanism is activated, no income would be transferred from the EA to the GRA.

IMPLEMENTATION ISSUES

A. Surcharge Review Cycle

29. Staff proposes to conduct surcharge policy reviews on a five-year cycle going forward, considering the strong support for regular reviews expressed by Directors at the initial engagement. While recently surcharge policy reviews have been conducted on an "as needed" basis—though in practice the reviews have occurred every seven years or so (2009, 2016, and the present review)—global economic and financial conditions and the Fund's financial position could change significantly in the interim, as experienced since the 2016 review, suggesting the desirability of more timely reviews of the overall policy. At the same time, excessively frequent changes in surcharge policy framework would increase uncertainty for members and markets. Moreover, too frequent reviews would add to work pressures. On balance, staff proposes that, going forward, reviews of the Fund's surcharge policy be conducted on a regular five-year cycle. Reviews could be conducted earlier if warranted by significant developments within a review cycle, such as unexpected changes in interest rates, number of surcharge-paying members, the Fund's net income, or effectiveness of future GRQs. The five-year cycle would restart with the conclusion of every review. The thresholds for the commitment fees would be revisited at the regular reviews of precautionary facilities (FCL, SLL, and PLL). The margin for the basic rate of charge would remain on the two-year review cycle established under Rule I-6(4).

B. Effectiveness of the 16th General Review of Quotas

30. As laid out in the earlier paper, staff proposes to conceptually separate changes of surcharge and commitment fee thresholds resulting from this review from adjustments that will be needed when the 16th General Review of Quotas (GRQ) becomes effective. First, changes to thresholds approved by the Executive Board in the current review would be made based on current quotas and would become effective shortly after the Board's decision on surcharge and commitment fee thresholds. Second, when the 16th GRQ comes into effect, the surcharge and commitment fee thresholds in percent of the current quotas would be mechanically divided by 1.5 to keep their value unchanged in nominal terms. The decision on the proposed reform package would include this pre-designed and automatic adjustment mechanism to reflect the quota increases under the 16th GRQ on the surcharge and commitment fee thresholds. In case the effectiveness of the 16th GRQ is notably delayed beyond the currently expected timeline, the Executive Board could consider adjustments to these thresholds to account for additional erosion.

31. Regarding transitional arrangements, staff proposes that the new (adjusted for the new quota) surcharge and commitment fee thresholds become effective for each individual member when the member pays its quota increase, or at the end of the 35 days after the general conditions for the effectiveness of the 16th Review have been met ("Quota Payment Period"), whichever is earlier. This proposal would avoid transitional challenges that accompanied the implementation of the 14th General Review of Quotas in 2016. Under this proposal, by the end of the Quota Payment Period, the thresholds adjusted for the increased new quotas would apply

regardless of whether they have consented to or paid for their respective quota increases under the 16th Review. The proposed rolling effectiveness of the new surcharge and commitment fee thresholds adjusted to the increased new quotas for individual members is designed to avoid disadvantages for members and limit the negative impact on Fund income.[12]

C. Transparency and Communications

32. Staff proposes measures to further enhance the transparency and disclosure of surcharges early in program discussion. The current capacity to repay table embedded in staff reports already provides projections of the total interest costs over the medium term under a prospective or ongoing GRA program. Staff proposes adding a breakdown of total interest costs, separating charges and surcharges in the table and establishing the expectation for mission teams to share and discuss the table and any relevant projections with country authorities during program negotiations. This would help inform country authorities' decisions regarding requested access size and phasing. Staff guidance would be prepared upon the conclusion of the review of charges and surcharge policy as an update to the comprehensive operational guidance note on conditionality.

33. A communications strategy would support the announcement and implementation of the proposed reform package. Staff plans a communications strategy to inform government authorities about the review of the Fund's charges and the surcharge policy, engage and update civil society representatives, academics, think tanks and parliamentarians about the reforms, and leverage media engagements to reach a broader audience. Considering the highly technical nature of the topic, increased understanding and transparency of the IMF's evolving financing and income policies, in conjunction with the lending policies, would be particularly useful for the membership. Consistent with the overall principles guiding the proposed reform package, the messaging will explain *what* the framework of charges and surcharges is and its role in preserving income-generating capacity and incentives for borrowers, *why* the reform was needed to ease the interest burden for members, *which* changes were approved by the IMF's Executive Board with a view to preserving simplicity, and *when* those changes will take effect. This communications strategy will also seek to provide tools, such as a comprehensive FAQ and social media posts, to clarify the framework of charges and the surcharge policy. The specific messaging for the communications strategy would be finalized after approval of the final reform package and considering other recent and forthcoming policy reviews.

[12] Specifically, if the new surcharge and commitment fee thresholds were to become effective immediately upon the effectiveness of the general conditions for the 16th General Review of Quotas, members may not have sufficient time to make quota increase payments and the new thresholds (adjusted to the increased new quotas) applied to members' old quotas would deliver a lower absolute value for surcharge and commitment fee thresholds, resulting in higher surcharges and commitment fees on outstanding Fund credit for affected borrowers. Conversely, if the new surcharge and commitment fee thresholds were to enter into effect for all members only at the end of the quota payment period, members that completed their quota increase payments earlier would have their new, higher quotas applied to the old threshold in percent of quota, which would result in higher absolute values for the surcharges and commitment fee thresholds and therefore lower income for the Fund.

D. Operational Issues

34. Various operational issues would need to be addressed to make the proposed changes to surcharges, the margin, and commitment fees effective. Given the priority of promptly alleviating costs to Fund borrowers, staff proposes a possible start date of November 1, 2024 for the proposed reform package. The tight timeline requires early preparatory work as changes to policies will affect multiple systems and will necessitate a synchronized effort between the Finance (FIN) and Information Technology (ITD) Departments for execution. As outlined in the initial engagement paper, any changes to the margin could be made effective within about two weeks from the decision to change the rate. This timeline also applies to commitment fees, assuming modifications are limited to the fee thresholds, as proposed. System adjustments to accommodate parametric changes to surcharges limited to changes to the threshold and time-based rate, as proposed in the staff reform package, could take about six weeks. Staff has already begun planning for these adjustments and will conduct simultaneously the testing and application of changes to the surcharge, margin, and commitment fees to enable the proposed November 1, 2024 effectiveness date for all measures. Making these changes effective at the start of the Fund's third financial reporting quarter will also facilitate synchronization with the ongoing billing and reporting processes.

ENTERPRISE RISK ASSESSMENT

35. Overall, staff assesses that enterprise risks for the Fund from inaction are higher than risks associated with proposed package. Inaction could lead to disengagement by members, compounding reputational risks. The proposed package addresses the erosion of thresholds of level-based surcharges and commitment fees since the previous review, while the reduced margin and surcharge rates would reduce the interest cost of borrowers substantially. These would help reduce the reputational risks related to the perception of excessively large debt service payments that the Fund imposes on borrowing countries, while the lower cost for borrowers would help improve their capacity to repay and reduce the credit risks to the Fund.

36. Financial risks, including credit, income, and liquidity risks arising from the proposed reform of charges and surcharges require prudent mitigation strategies.

- **The proposed reform package would have a limited impact on the Fund's liquidity as the demand for Fund credit of large borrowers is relatively price inelastic**. In general, access would continue to be determined by rigorous assessments informed by standard access policy criteria, including the size of the BOP need, the strength of program policies, the country's record of using Fund resources in the past, debt sustainability, and capacity to repay the Fund. Furthermore, an increase in GRA credit demand for top surcharge payers owing to the proposed reform package is unlikely as their current credit outstanding already exceeds the new surcharge threshold by a significant margin and they are typically under intense financing pressure. The limited surcharge rate reductions under the proposed package are not expected to considerably affect their decisions of seeking Fund financing. However, demand could increase for countries

seeking access near the current threshold and react more to the incentives provided by surcharges, especially the time-based surcharge rate. This said, given that the current price-based incentive structure remains broadly intact and only a few members are likely to borrow up to the new, higher threshold, the overall impact is expected to be limited. Residual liquidity risks, if any, would be monitored and addressed in the Fund's Liquidity Position – Review and Outlook and the Risk Report.

- **Should credit risks for the Fund increase under the proposed reform package because of higher GRA credit demand, they would be mitigated by an improved capacity to repay.** Credit outstanding could increase as a result of slightly higher demand (see above) and reduced early repurchases, typically from smaller borrowers with moderate financing distress who react more to the price incentives. At the same time, the proposed package would improve borrowing members' capacity to repay to the Fund by reducing interest burden and hence help reduce the credit risks for the Fund. Residual credit risks, if any, would be monitored and addressed in the Risk Reports and review of the adequacy of PBs.

- **Income risk arising from a negative impact on Fund lending or insufficient investment income appears to be relatively low.** Adequate income and PB accumulation are critical to protect the Fund's balance sheet, particularly if credit risk increases. Robustness checks under different scenarios show that the Fund's operating income and PBs are expected to be resilient to adverse scenarios, with PBs remaining at or above the current medium-term target in stress scenarios (see section on Holistic Balance Sheet Considerations). However, there are some residual risks to operational income and reduction of PB coverage in case the GRA credit demand turns out to be lower than the adverse scenario in this paper, which is already conservative. Even when operational income and PBs are resilient to shocks, PB coverage could be lower than the adequate level if residual credit risks materialize. Regular reviews of the surcharge policy, charges and the adequacy of PBs (with a possible increase in the PB target), would help mitigate such risks.

37. Non-financial risks center around reputational risks arising from perceived lack of clear communication on the purpose and impacts on the borrowers of the proposed reform package.

- **Reputational risks.** Margin reduction and threshold increases could lead to fairness concerns as the relative benefit of burden reduction would be higher for smaller debtors, but this effect would be partly mitigated by the higher benefit for large borrowers from the surcharge rate reduction. Separately, creditor members could potentially be concerned about the size of threshold increases and reduction of margin. Careful communication of the purpose of the reform package and impacts on the interest burden of borrowing members and their capacity to repay would be required to mitigate such risks.

- **Business risks—analytical accuracy.** The proposed package is based on assumptions of forward-looking GRA demand and investment income of the Fund. Members' demand could be underestimated while the Fund's investment income could be overestimated. To mitigate such

risks, charges will continue to be reviewed every two years per current policy and surcharges will be reviewed every five years under staff's proposal. The Board could call for a review of surcharge policy in-between the regular review cycle, if deemed necessary.

- **Operational risks.** The implementation of the proposed reform package under a tight timeline poses some challenges as adjustments are needed in multiple systems to implement the reform package. Early planning, proper coordination and testing would help mitigate associated operational risks.

38. Inaction (absence of changes to charges and the surcharge policy) would lead to important risks, which staff sees on balance as more significant than the risks associated with moving ahead with the proposed reform package.

- **Reputational risks.** The Fund would be perceived as lacking alignment with its members' needs, leading to criticism regarding the institution's effectiveness and fairness (i.e., leaning toward creditor countries' interests), including the perception of excessively large debt service payments that the Fund imposes on borrowing countries. Shortcomings in the disclosure of surcharges in Fund staff reports could hinder the monitoring of the burden of members and communication with members.

- **Strategic risks**. An inadequate response to members' financing needs could trigger member disengagement and increased reliance on self-insurance and other sources of financing or may also result in excessive adjustment. These options would be economically and socially costly for members with limited access to alternative sources of financing.

- **Business risks**. Inaction could imply that the Fund would be unable to provide members with much-needed reductions in borrowing costs to facilitate recovery in a shock-prone world. This would increase the member engagement risks, as the Fund would be seen as unable to adapt to changing needs of members.

ISSUES FOR DISCUSSION

39. Directors may wish to comment on the following issues:

- Do Directors agree with the general direction of the proposed reform package, comprising a meaningful reduction in the margin for the basic rate of charge, increases in the level-based surcharge and commitment fee thresholds to adjust for erosion, and a moderate reduction in surcharge rates?
- Do Directors agree that the margin for the basic rate of charge for the remainder of FY2025 and FY2026 should be set at 70 basis points?
- Do Directors agree with the proposed adjustment to the level-based surcharge threshold to 300 percent of quota?
- Do Directors agree with the proposed alignment of commitment fee thresholds with the overall annual and cumulative access limits under the GRA?
- Do Directors agree with the proposal to reduce the time-based surcharge rate by 25 basis points?
- Are Directors comfortable with the net income and reserves outlook that would result from the implementation of the reform package proposed by staff as of November 1, 2024?
- Do Directors agree with the proposed five-year review cycle for the surcharge policy?
- Do Directors agree with the proposed approach to reflect the effectiveness of the 16th GRQ in the thresholds for surcharges and commitment fees?

Annex I. Overview of Charges and Surcharge Policy Framework

This Annex summarizes the policy framework and objectives of charges and surcharges presented in the initial engagement paper.[1]

Surcharge Policy Framework and Objectives

1. There are two types of surcharges: (i) *Level-based* surcharges of 200 basis points are applied on the portion of GRA credit outstanding greater than 187.5 percent of quota; and (ii) *Time-based* surcharges of 100 basis points are applied on the portion of GRA credit exceeding the level-based threshold for more than 36 months (or 51 months in the case of borrowings under the Extended Arrangements under the Extended Fund Facility (EFF)). Concessional Fund lending to low-income countries under the Poverty Reduction and Growth Trusts (PRGT) and lending under the Resilience and Sustainability Trust (RST) are not subject to surcharges.

2. Surcharges are designed to discourage large and prolonged use of resources from the GRA and to help accumulate PBs. PBs protect the Fund's balance sheet by absorbing possible credit and other financial losses, thereby preserving the value of reserve assets that members place with the Fund. Surcharges provide price-based incentives for members to limit the size of borrowing from the Fund and diversify their sources of financing, while encouraging timely repayment of Fund credit once members resolve their imbalances and regain market access, helping preserve the revolving nature of Fund resources. The underlying presumption is that members using Fund financing to help address large BOP problems should be able to gradually find alternative, cheaper financing sources.

3. The current framework of level- and time-based surcharges was introduced in 2009. It simplified the previous Time Based Repurchases Expectation Policy, which had multiple thresholds and rates. The policy framework has remained broadly unchanged since then. The 2016 Review adjusted the level threshold and extended the trigger for time-based surcharges. The 2016 review was prompted by the forthcoming effectiveness of the 14th General Review of Quotas, which doubled the Fund's quotas. The Board concluded that the surcharges' incentive mechanism worked reasonably well and decided to maintain the surcharge rates and modestly increase the nominal SDR value of the threshold for level-based surcharges. The threshold for level-based surcharges was adjusted from 300 percent of (13th General Review) quota to 187.5 percent of (14th General Review) quota, which increased the nominal SDR value of the threshold by 25 percent, and the trigger for time-based surcharges for credit under the Extended Fund Facility (EFF) was increased from 36 months to 51 months to better reflect the expected adjustment path under such arrangements.

[1] See "Initial Considerations for the Review of Charges and the Surcharge Policy".

Framework for Setting the Margin for the Basic Rate of Charge

4. Together with surcharges, the margin on the basic rate of charge is a key determinant for the total cost of borrowing from the Fund. The basic rate of charge is levied on all GRA credit outstanding and is determined as the SDR interest rate plus a fixed margin that is set by the Executive Board every two years in accordance with Rule I-6(4). Under that rule, the level of the margin should be set at a level that is adequate (i) to cover the estimated intermediation expense of the Fund considering income from service charges, and (ii) to generate an amount of net income for placement to reserves. The appropriate amount for reserve contribution shall be assessed taking into account, in particular, the current level of precautionary balances, any floor or target for precautionary balances, and the expected contribution from surcharges and commitment fees to precautionary balances. In addition, the rule contains a cross-check to ensure that the margin shall not be set at a level at which the basic rate of charge would result in the cost of Fund credit becoming too high or too low in relation to long-term credit market conditions as measured by appropriate benchmarks (the "market test"). It also provides for an exceptional circumstances clause to set margin based on other considerations, in particular where income from other sources is not sufficient to cover non-lending related administrative expenses. Application of these criteria requires judgment by the Executive Board, in particular regarding the desirable levels of net income and reserve accumulation and the application of the market test. It should be noted that level of margin has been unchanged at 100 basis points since the current rule for setting the margin was first applied on May 1, 2012.), reflecting a desire for stability and predictability, irrespective of income fluctuations in this period.

Commitment Fee Framework and Objectives

5. Commitment fees compensate the Fund for the cost of establishing and monitoring arrangements and for setting aside resources to be used if a purchase were to be made. They also serve to discourage unnecessarily high precautionary access and thereby help contain risks to the Fund's liquidity. The fee structure is upward sloping: (i) 15 basis points for committed amounts up to 115 percent of quota; (ii) 30 basis points for committed amount above 115 percent and up to 575 percent of quota; and (iii) 60 basis points for committed amounts exceeding 575 percent of quota. This tiered structure was established in 2009 and the thresholds were adjusted in 2016 from 200 percent and 1,000 percent of quota to 115 and 575 percent of quota, respectively.

Annex II. Comparison of the Cost of Borrowing from the Fund, the Market, and International Financial Institutions

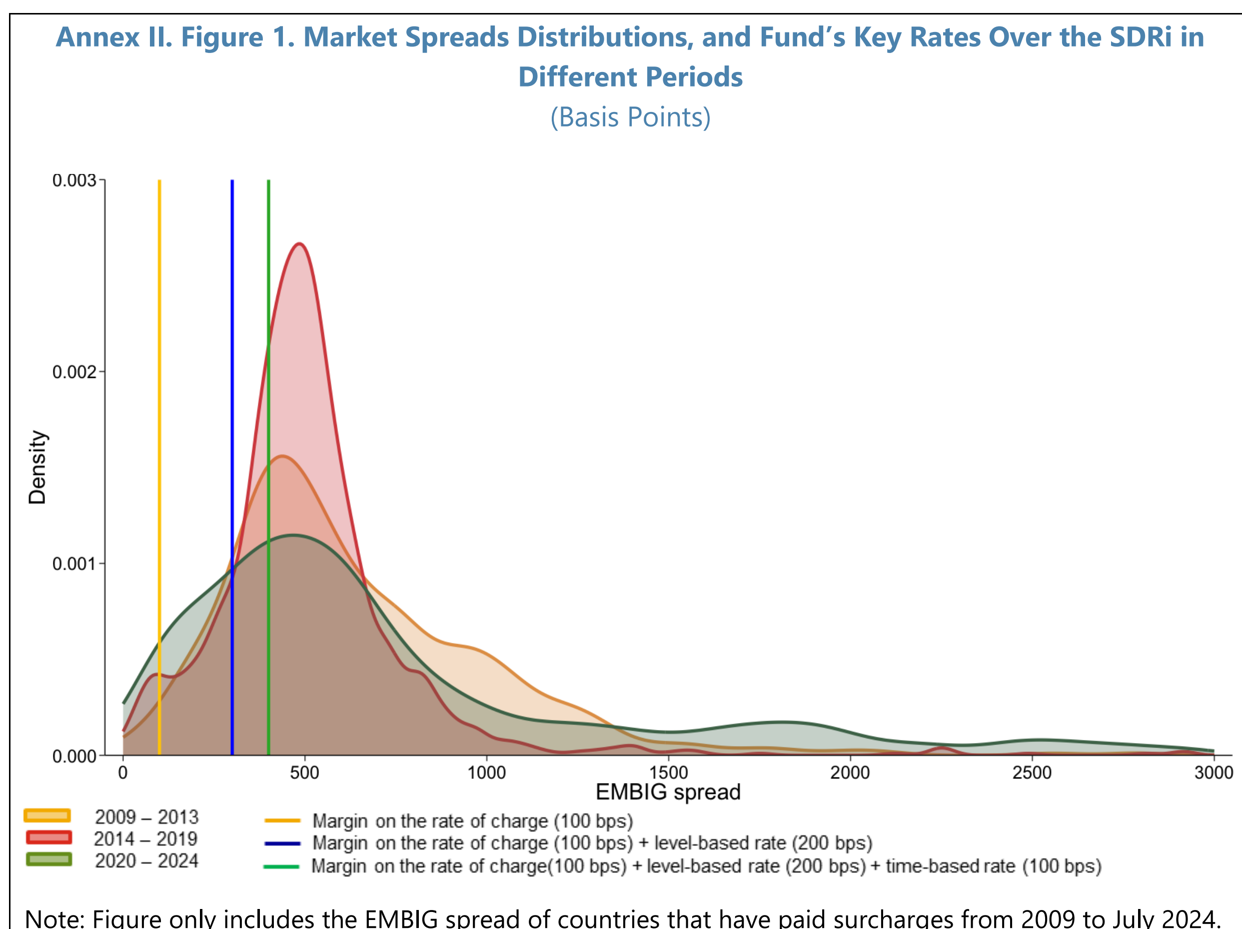
This annex presents additional comparative analysis on the cost of borrowing from the Fund, from the markets, and from other IFIs. Results confirm the findings from the previous paper that the cost of borrowing from the Fund has been consistently lower and more stable than market costs. Charges over base rates applied by the Fund are broadly comparable to those of other multilateral institutions.

1. **Further analysis on the distribution of members' borrowing costs suggests that the marginal cost of GRA borrowing, including time-based surcharges, has remained significantly lower than the cost of market financing.** Figure 1 of the main text shows the distribution of the market cost (proxied by the EMBIG spreads) and the Fund's key marginal rates over the SDR interest rate (SDRi)—the margin for the basic rate of charge (100 basis points) and surcharge rates (200 basis points for credit only subject to level-based surcharges and 300 basis points for credit also subject to time-based surcharges)—during 2009-2024. For countries subject to level-based surcharges only, the marginal financing cost from the Fund is lower than the 25th percentile of the market cost most of the time and even lower than or close to the 10th percentile of the market cost for many periods. Even with time-based surcharges, the marginal cost of financing from the Fund is lower than the median value of the market cost for almost the entire sample period.

2. **The cost of market borrowing became more volatile in the aftermath of global financial crisis and the pandemic, as opposed to the marginal cost of borrowing from the Fund, which has remained stable.** Annex II. Figure 1 shows the distribution of market cost (proxied by EMBIG spreads) in three periods (2009-2013, 2014-2019, 2020-2024) and the key marginal rates of the Fund. Compared to the tranquil period (2014-2019), market rates were more volatile and skewed towards the right tail in the post-global financial crisis and euro crisis period (2009-2013) and the Covid-19 and post-pandemic period (2020-2024). In comparison, the marginal cost of Fund borrowing over the SDRi remained constant, at 3 percent for level-based surcharge payers and 4 percent for level and time-based surcharge payers. As noted in the initial engagement paper, this dynamic holds true also for the total market financing cost, as proxied by EMBIG yields. After the pandemic crisis, the borrowing cost from the Fund increased rapidly due to the increase in the SDRi brought about by the tightening of monetary policy by major central banks, albeit the increase was less than the increase in market financing cost. In general, the difference between the borrowing costs from the market and the Fund widened during global downtowns and crises.

Annex II. Figure 1. Market Spreads Distributions, and Fund's Key Rates Over the SDRi in Different Periods

(Basis Points)



Note: Figure only includes the EMBIG spread of countries that have paid surcharges from 2009 to July 2024.

3. Charges by other IFIs vary according to their characteristics and financial structures. Generally, these organizations, like the Fund, tend to pass on their cost of funds plus a margin and other charges consistent with their operating cost structures, lending objectives, and risk mitigation practices. Lending is typically denominated and settled in one of the major reserve currencies (often the US dollar), unlike SDR-denominated Fund lending. Given the differences in lending objectives, maturity, currency composition, and funding and risk mitigation practices, the costs of borrowing from the Fund and other IFIs are not directly comparable. Cost comparisons provided below are illustrative.

- **The International Bank for Reconstruction and Development (IBRD)** relies on Flexible Loans (IFL) as the leading World Bank loan product for public sector borrowers of middle-income countries. Eligible borrowers can obtain financing for development through Investment Project Financing, Development Policy Financing, Program-for-Results or any combination of those through a Multiphase Programmatic Approach, all based on the IFL as the underlying loan product. IBRD Flexible Loans are subject to different maturity premiums based on income and other factors. Countries are classified into one of four pricing groups (A, B, C, or D) according to their income level (in the order of rising income). The spread is different for different currencies, maturities, and country groups. For instance, the spread for borrowing in USD ranges between 94-209 basis points, depending on maturity and country group. The base rate for USD loans is

the secured overnight financing rate (SOFR). Adding the spread to the SOFR, as of end-July 2024, the lending rate of IBRD flexible loan in USD was about 6.3-7.5 percent, depending on maturity and country group.

- **The Asian Development Bank (ADB)** offers its regular market-based ordinary capital resources (OCR) loans to developing member countries that have attained a higher level of economic development as opposed to the other, lower-income countries that receive concessional lending and grants. ADB's OCR operations cover a variety of infrastructure, industrial, and government service sectors. Countries are classified into six groups (B, C0, C1, C2, C3, C4) based on income level (in order of rising income). The spread for the regular OCR flexible loan is different for different currencies, maturities, and country groups. For instance, the interest spread for USD loans ranges between 87-162 basis points, depending on maturity and country group. The base rate of USD loan is the SOFR. Adding the spread to the SOFR, as of end-July 2024, the lending rate of IBRD flexible loan in USD was about 6.3-7.0 percent, depending on maturity and country group.

- **Reflecting differences in instruments and mandates, the spreads charged by the IBRD and ADB are on average lower than, but still comparable to the Fund's.** As Annex II Table 1 illustrate, as of end-July 2024, for all 23 members paying surcharges, the average effective surcharge rate plus margin of the IMF is 1.77 percent. The spread for borrowing in ADB OCR USD loans is 0.87 percent (with average maturity up to 9 years) and the spread for borrowing in IFL USD loans is 0.94 percent for country groups A-C (with average maturity up to 8 years) and 0.99 percent for country group D (with average maturity up to 8 years). Besides the differences in instruments, these variations in spreads reflect the different mandate of the IMF and the IFIs. The IMF cannot use country loan exposure limits or targets as it needs to respond to its members' needs according to its mandate. The Fund has therefore to absorb ultimate losses using its reserves, and hence may need to compensate higher risks with a higher interest rate to accumulate adequate reserves. In addition, the Fund's lending stems from its role as crisis lender and is mainly based on BOP needs with shorter maturities, while most IFI lending is for development purposes with longer maturities. Total cost comparisons are also more challenging given the range of currency denominations of IFI lending while IMF loans are denominated in SDRs.

- **The European Stability Mechanism (ESM) is another relevant comparator for the Fund given its mandate to provide crisis support to euro area members.** The ESM is a permanent crisis resolution mechanism that provides financial stability support through a number of instruments to euro area countries. The ESM leverages its paid-in capital to issue bonds and bills. It passes on the variable costs of this funding plus fees to cover operating costs and a margin, which reflects the risk profile of financial assistance instruments. As of end-June 2024, the average lending rates of pool funded loans was 1.19 percent for ESM and 1.40 percent for European Financial Stability Facility (EFSF), including margin and fees.

- **The lending rate of the ESM has been lower than Fund lending rates, reflecting mainly lower funding costs and institutional differences.** The ESM funds itself by issuing bills, notes,

and bonds, with access to capital markets at favorable terms due to its strong credit rating and the backing of Eurozone member states. The cost of funding and operations incurred by the ESM, represented by the actual interest accrued on all ESM funding instruments, has been systematically lower in the past than the SDRi, which represents the IMF's cost of using quota and NAB resources for its lending. The lower lending rate charged by the ESM also reflects, at least in part, differences in membership. The ESM provides financial assistance to a group of countries (Eurozone members only) that is relatively more homogenous in terms of institutional and economic capacity than the universe of IMF borrowers, with implications for the riskiness of the loan portfolio and the assessment of risk premia.

Annex II. Table 1. Interest Spread and Base Interest Rate Comparisons for MDBs as of July 31, 2024 (Percent)

	IMF 1/	IBRD USD Flexible Loan, Country Group C 2/	ADB USD Flexible Loan, Country Group C3 3/	ESM pool funded EUR loans
Base rate at end-July 2024	3.94	5.38	5.38	
Spread 1/	1.77	0.94	0.87	
Overall interest rate (Base rate + spread)	5.71	6.32	6.25	1.19

Sources: Lending Rates & Fees (worldbank.org), Public Sector Financing: Lending Polices and Rates | Asian Development Bank (adb.org), and Financial Assistance Instruments (esm.europa.eu).
1/ The spread for the IMF is the average effective surcharge rate for all 23 members paying surcharges plus the margin. The spread can be higher or lower for specific countries depending on size and duration of borrowing.
2/ Pricing group C for IBRD flexible loan is the group of countries above Graduation Discussion Income (GDI), but below high-income countries (HIC) status, and which do not qualify for an exemption listed in Group A (Blends, small states, countries in fragile and conflict-affected situations (FCS) and recent IDA graduates). GDI is the level of GNI per capita of a member country above which graduation from IBRD starts being discussed, as published annually in the World Bank's Per Capita Income Guidelines for Operational Purposes.
3/ Pricing group C3 for ADB loan is the group of countries who are upper middle-income and above the IBRD income cutoff.

Annex III. Incentive Function of Surcharges

This annex builds on the evidence presented in the initial engagement paper on the effectiveness of the incentive function of level- and time-based surcharges. Complementary evidence confirms an inverse association between the level of financing pressure experienced by a member and the effectiveness of level-based surcharges in providing incentives for moderate borrowing. Time-based surcharges are confirmed to provide the right incentives for early repurchases when borrowers face moderate financing pressures and market access at favorable cost. Even for countries that have not made early repurchases and with access to market financing at a cost lower or close to the cost of borrowing from the Fund, time-based surcharges are found to provide incentives for reducing credit outstanding towards non-surcharge territory. But for countries facing sustained financial stress and high market financing costs, credit outstanding from the Fund has remained significantly above the surcharge threshold even after the time-based surcharges kicked in.

1. **The evidence presented in the initial engagement paper suggested that level-based surcharges have generally worked to discourage large borrowing from the Fund, but their effectiveness is negatively correlated with the level of financing pressures.** The initial engagement paper assessed the effectiveness of the incentive mechanism by analyzing if the level-based threshold has bound members' borrowing decisions over time and by examining the relationship between the borrowing dynamics relative to the threshold and the level of financial pressures experienced throughout the sample period. Three groups of countries were identified based on the observed effectiveness of the incentives associated with level-based surcharges. The first group included relatively small borrowers with generally manageable financial pressures for which borrowing was linked to the level-based surcharge threshold. A second group comprised countries that had borrowed considerably above the threshold in the past, most likely when facing high financing pressures, but have reduced their credit outstanding towards non-surcharge territory —generally through early repayments— relatively soon or once their macroeconomic pressures became more manageable, suggesting that the price-incentive becomes effective as vulnerabilities and financial needs are addressed. The third group included the current top surcharge payers that have faced significant financing pressures for the last several years and had few or no alternative sources of financing. The paper concluded that the level-based surcharge threshold did not appear to be binding for this group of borrowers.

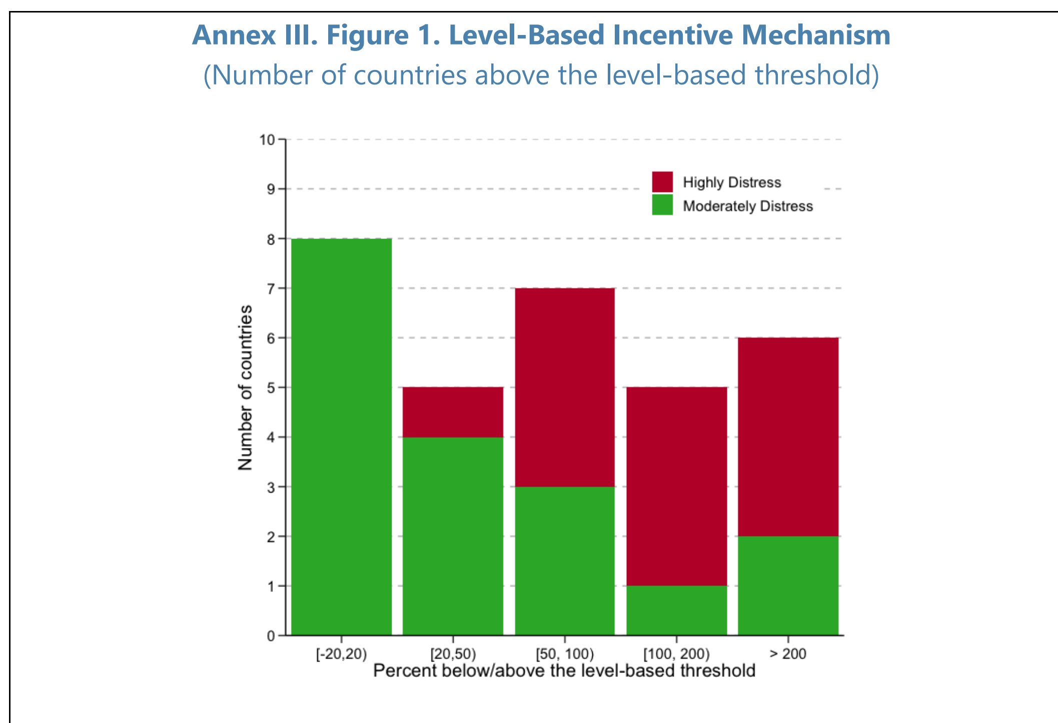
2. **Complementary evidence confirms that the effectiveness of the price incentives provided by level-based surcharges is inversely related to the level of financial distress faced by borrowers.** This Annex provides complementary evidence by examining how members' credit outstanding compares to the threshold at the peak of their borrowing and the financing pressures they were experiencing when reaching the peak. The analysis aims to summarize the evidence on the effectiveness of the level-based surcharge provided in the first engagement paper by classifying members based on how closely or distantly their peak credit outstanding over the sample compares to the level-based threshold. For this, borrowing countries are grouped into five buckets (Annex III. Figure 1) based on the ratio of peak credit outstanding to the level-based surcharge threshold. Borrowers that maintained their credit outstanding close to the level-based threshold, which

suggests that the level-based surcharge was binding (and effective) for them, all had moderate levels of financial distress.[1]

3. However, four out of the six countries whose peak credit outstanding exceeded the level-based threshold by more than 200 percent faced high levels of financial distress, indicating that the incentive appears to have been less effective for highly distressed countries. The two countries with moderate distress in this bucket are Portugal and Ireland, whose financial pressures moderated a few months before credit outstanding peaked, but they experienced severe distress earlier when credit outstanding rose above the surcharge threshold.

Annex III. Figure 1. Level-Based Incentive Mechanism

(Number of countries above the level-based threshold)



4. Regarding time-based surcharges, the previous paper found that while they had provided incentives for borrowers to make early repurchases, their effectiveness was less clear in recent cases of borrowers with large and persistent BOP problems. In the initial engagement Board paper, staff identified three main groups of countries when assessing the efficacy of the price-incentives mechanism of time-based surcharges. This paper uses the same country grouping and provides additional evidence regarding the effectiveness of the time-based surcharges for each group. The first group includes countries that borrowed significantly above the surcharge threshold but made early repayments around the time when time-based surcharges kicked in to bring their credit outstanding closer to or below the threshold. Around the time of early repurchases, countries in this first group experienced moderate financial pressures and favorable market financing cost relative to Fund's borrowing cost. The second group includes relatively small surcharge payers that

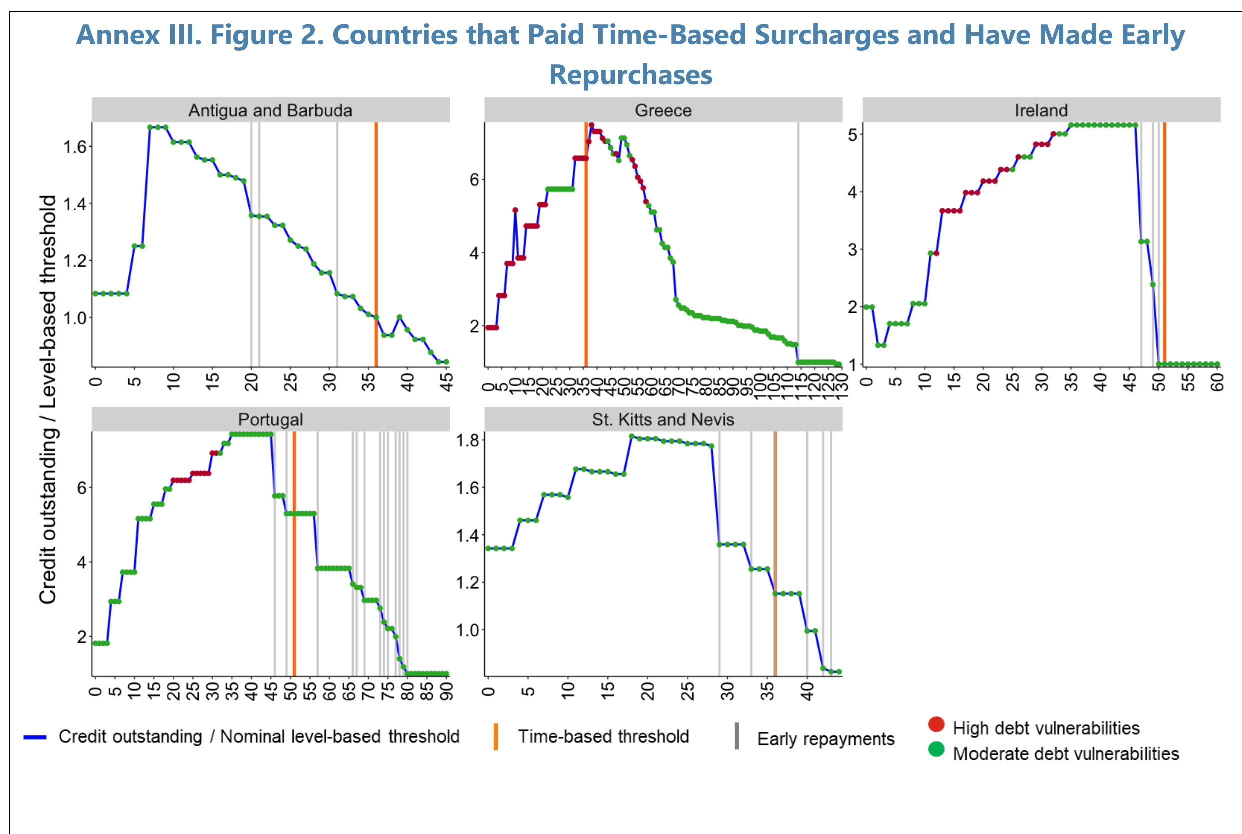
[1] For the definition of financial distress, see Annex II of the "Initial Considerations for the Review of Charges and the Surcharge Policy".

did not make early repurchases even though the spread between the market rate and the basic rate of charge had fallen below the marginal rate of surcharges. The third group includes the current top surcharge payers or repeated borrowers who were subject to time-based surcharges for the second time. Their sovereign spreads remained generally far above the surcharge rates.

5. In this paper, staff expands the exercise to investigate whether time-based surcharges have helped prevent high credit outstanding for prolonged periods even in cases when early repurchases were not made and assesses the role of financial distress in determining the effectiveness of time-based surcharge incentives. The new evidence confirms that, for countries facing moderate financing pressures (group 1), time-based surcharges provided incentives for making early repurchases to reduce or avoid surcharge payments. Time-based surcharges were found to also provide price incentives for countries to reduce credit outstanding over time even when they did not lead to early repurchases (group 2). In contrast, for countries that have faced protracted and severe financial stress (group 3), including the current top surcharge payers and repeated Fund borrowers, time-based surcharges have not provided incentives for early repurchases or for reducing credit outstanding. The remaining of this Annex expands on the identified evidence for each of the groups.

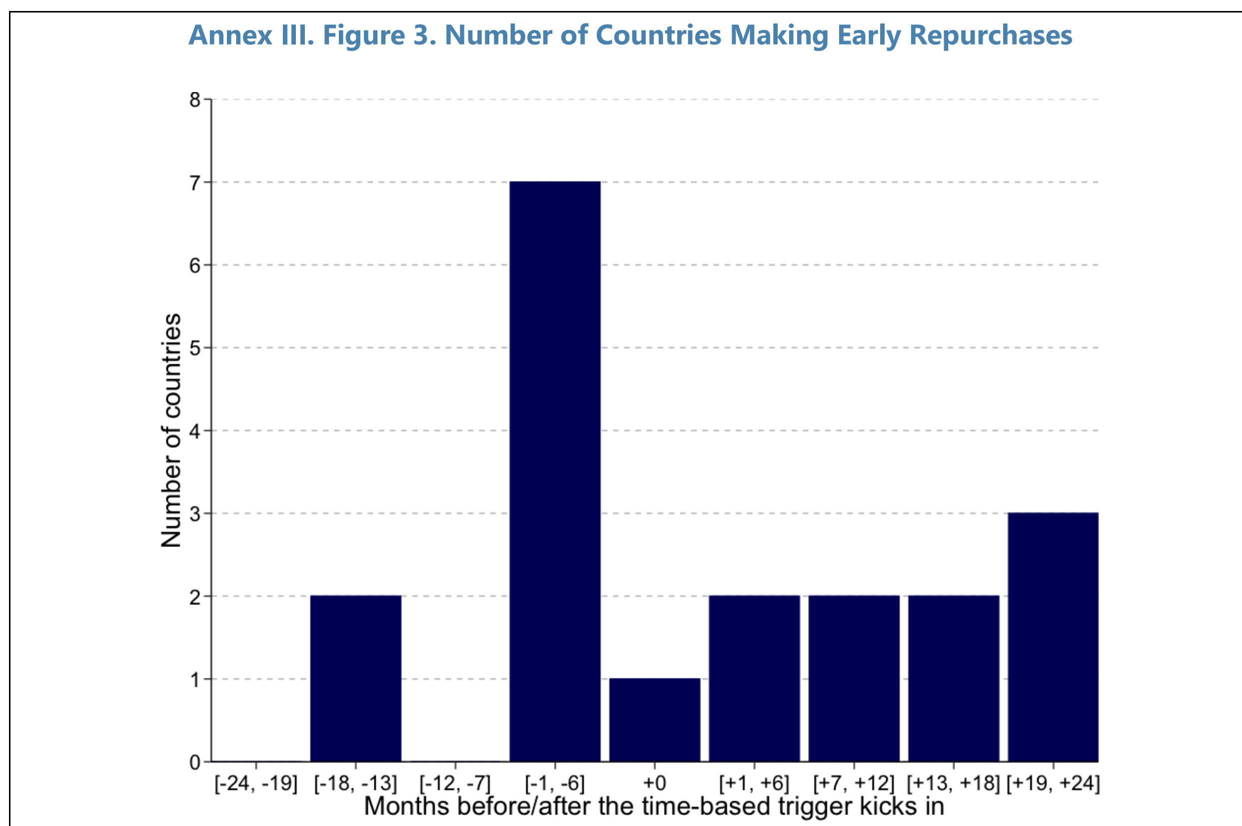
6. Complementary evidence confirms that the incentive of time-based surcharges for making early repurchases has been effective for countries facing moderate financing pressures (group 1). Annex III. Figure 2 displays the credit dynamics of countries in the first group highlighting the degree of financial stress that countries were experiencing at each point in time. In each plot, the x-axis represents the months after credit outstanding exceeded the level-based threshold, while the y-axis shows the ratio of the credit outstanding to the level-based surcharge threshold. The orange vertical line in the figure shows the time when the time-based surcharge kicked in and the grey vertical lines indicate instances when early repayments were made. The data show that some countries started making early repurchases before time-based surcharges were triggered to either lower (Antigua and Barbuda, Portugal, and St. Kitts and Nevis) or completely avoid surcharge payments (Ireland). Greece took longer to make early repayments after time-based surcharges kicked in. Importantly, all countries were under moderate financing pressures when they made early repurchases.

Annex III. Figure 2. Countries that Paid Time-Based Surcharges and Have Made Early Repurchases



7. Furthermore, most borrowers that made early repurchases chose to do so before or around the time when time-based surcharge kicked in, suggesting a motivation to avoid payment of time-based surcharge. Annex III. Figure 3 shows that 12 out of 19 countries made early repurchases within 12 months before or after the time-based surcharge kicked in. Of these 12 countries, one country made early repurchases exactly when it reached the time-based surcharge trigger (x-axis equal to zero), seven countries made early repurchases between six and one month before they reached the time-based surcharges trigger, and two countries made early repurchase within 6 months after they were subject to time-based surcharges.

Annex III. Figure 3. Number of Countries Making Early Repurchases



8. Even for countries that did not make early repurchases (the second group of countries), their generally declining trend of Fund credit suggests that time-based surcharges may have played a role in preventing higher and longer exposures. Annex III. Figure 4 displays the credit dynamics of the second group of countries. For all these countries, credit outstanding was either already showing a downward trend when time-based surcharges kicked in or credit started to decrease close to that time.[15] Importantly, most of these countries exhibited moderate financing distress when (or shortly after) the time-based surcharge kicked in, with Albania being the exception (see Annex III. Figure 4). Although financing conditions and spreads improved and fell below the level of the IMF marginal rate for countries like Mongolia, Jordan, and Albania (margin plus level- and time-based surcharge rates) around the time when the time-based surcharges kicked in (Annex III. Figure 5), these countries did not make early repurchases.[16] However, the difference between market spreads and the Fund's marginal rate for these countries was much smaller compared to those who made early repurchases. [17] Given that credit outstanding of these countries was already

[15] Some countries have been subject to level- and time-based surcharges at two different times as their credit outstanding went above the threshold once, then back to non-surcharge territory, but then came back again above the level-based threshold. These different occasions are labeled by "first time" or "second time".

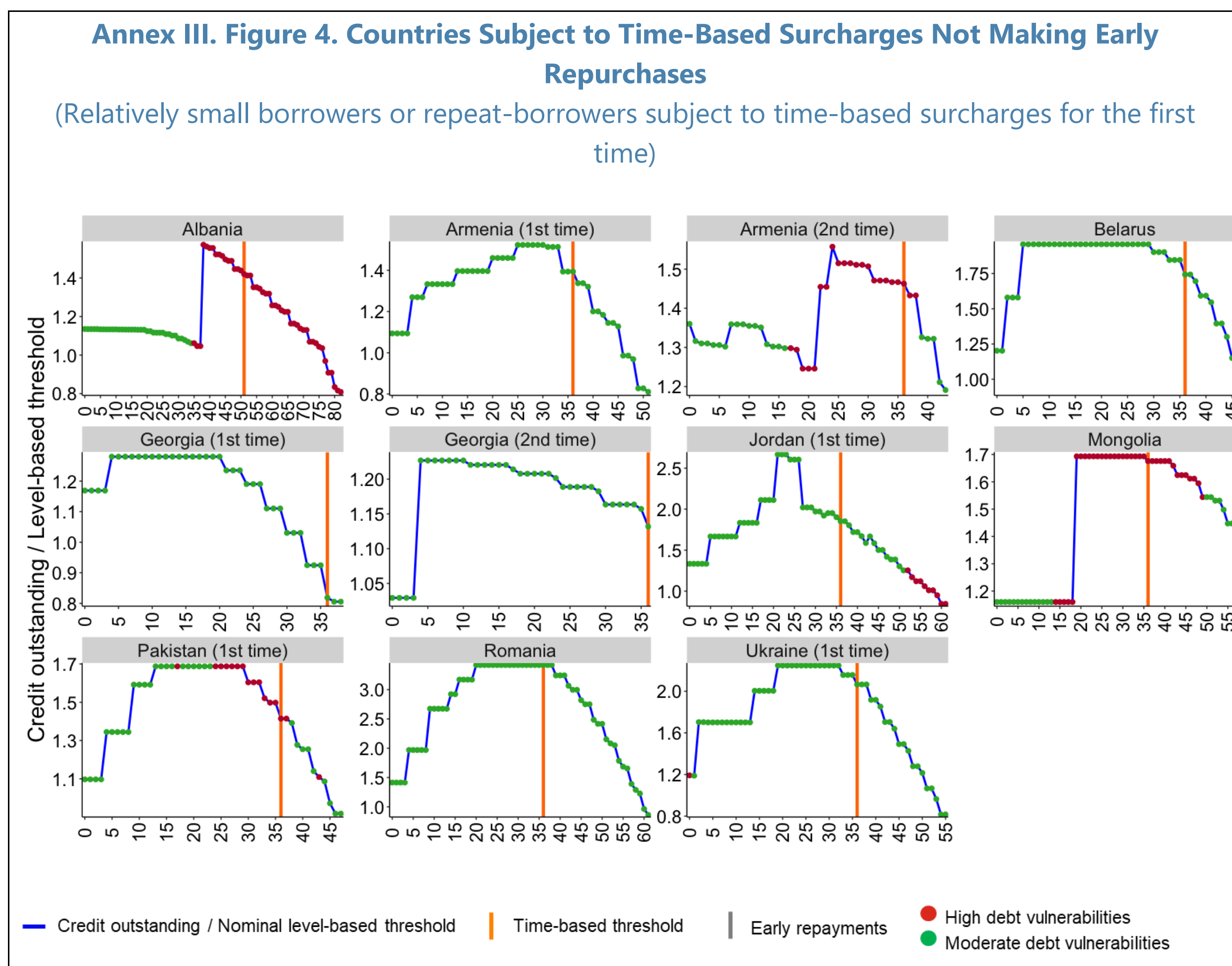
[16] Although the EMBIG spread for Albania dropped below the Fund's marginal rate, Albania was still subject to high debt vulnerabilities when the time-based surcharge kicked in and it did not make early repurchases. But its credit outstanding with the Fund was on a sustained downward trend.

[17] In comparison, as illustrated in Annex III. Figure 5, the gains from early repurchase were significant for Portugal and Ireland as their market cost was significantly below the Fund marginal cost.

on a sustained downward trend and not too far away from the surcharge threshold, the small difference between market rates and the Fund's marginal rates, the limited cost savings may not have provided sufficient incentives to make early repurchases. Still, even in those cases, time-based surcharges could have created incentives to keep the credit on a downward path by keeping the cost of borrowing from the Fund closer to market levels.

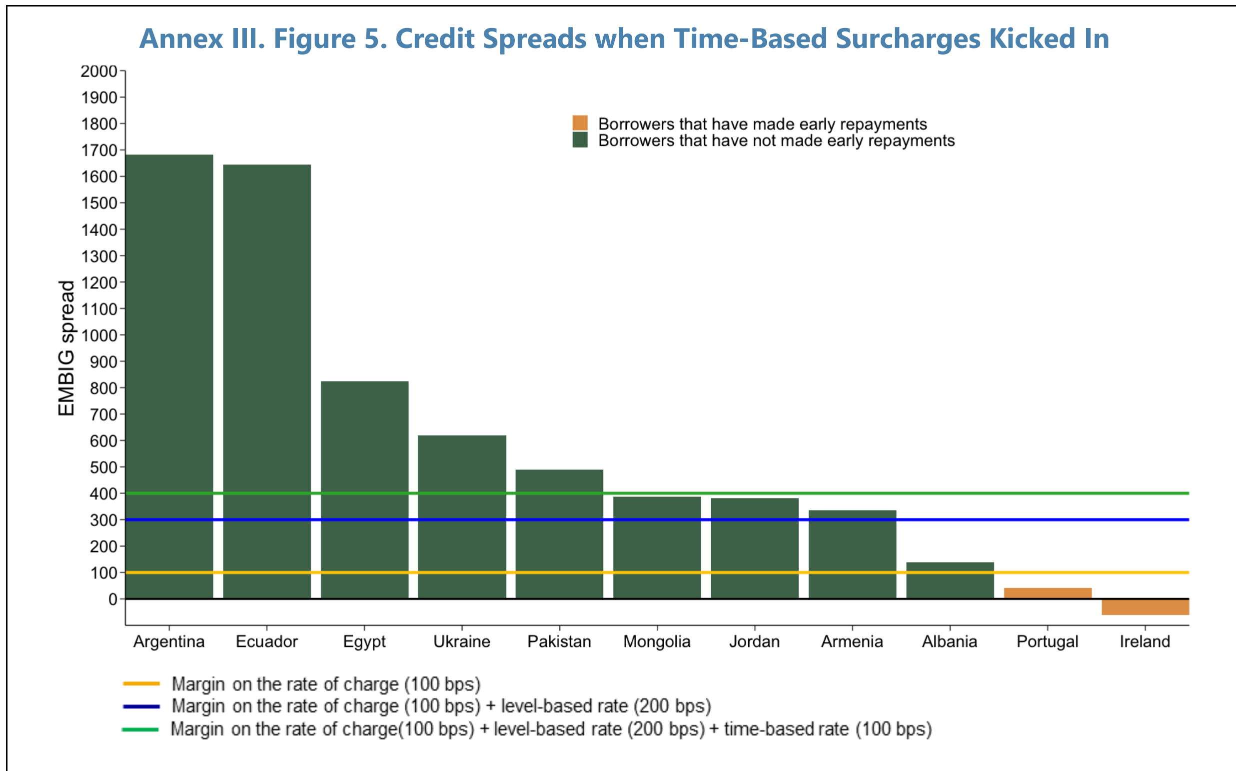
Annex III. Figure 4. Countries Subject to Time-Based Surcharges Not Making Early Repurchases

(Relatively small borrowers or repeat-borrowers subject to time-based surcharges for the first time)



9. Finally, for the current top surcharge payers or repeat-borrowers subject to time-based surcharges for a second time (the third group of countries), sovereign spreads remained far above the surcharge rates, rendering the time-based surcharges ineffective. In contrast to the first two country groups, for these borrowers (Argentina, Ecuador, Egypt, and Ukraine) the market cost was significantly higher than the Fund borrowing cost when time-based surcharge threshold kicked in (and remained higher thereafter) and credit outstanding was (and remained) significantly above the threshold. They also experienced severe financing stress when the time-based surcharges were triggered and continued experiencing such distress subsequently (Annex III. Figures 5 and 6). Only for countries in this group, credit outstanding remained at elevated levels or even increased after the time-based surcharges kicked in, suggesting that the price-based incentive from time-based surcharges was not effective.

Annex III. Figure 5. Credit Spreads when Time-Based Surcharges Kicked In



Annex III. Figure 6. Countries that Paid Time-Based Surcharges and did not Make Early Repurchases

(Top borrowers or repeated borrowers subject to time-based surcharges for the second time)