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**Statement by Mr. Stephan and Mr. Krahnke on Interim Review of the Adequacy of the Fund's Precautionary Balances  
(Preliminary)  
Executive Board Meeting  
December 13, 2021**

We thank staff for the comprehensive interim report and the detailed risk assessments. We fully agree with the necessity to closely monitor the precautionary balances in light of the extraordinary risk situation. As the preventive safeguards have been weakened, the precautionary balances as the ultimate financial risk backstop need to be bolstered to ensure the continued financial integrity of the Fund.

Against this backdrop, we offer the following comments on the issues for discussion.

**Assessment of the credit risks**

**We largely share staff's critical risk assessment. Especially the credit risks are highly elevated.** While the Fund has reached a historically high exposure that "matches the previous peak" during FY 2012-13 (para 11), the average credit quality of the borrowers appears to be weaker than during previous credit cycles. In particular, there is a high negative average market sentiment towards the largest borrowers (sovereign spreads appear to be higher than those attained during previous cycles) and almost half of the Fund's credit exposure is towards borrowers in the lowest rating brackets. A sense of urgency also stems from the fact that the scheduled repurchases of the substantial RFIs and of the largest borrower are bunched in the very near future.

**Medium-term target**

We take positive note that the precautionary balances have increased despite the SCA-1 distribution of SDR 1.1 billion, and we welcome that the coverage ratios have recovered from last year's low levels. At the same time, we continue to see risks that should be

appropriately reflected in the medium-term target. Staff's projections and scenarios only consider non-precautionary Fund programs. We would like to point out that the coverage ratio halves to 10.5 percent once all commitments (including undrawn balances and precautionary balances) are taken into account. The substantial volume of precautionary programs of SDR 84 billion concentrated in one region indeed makes the Fund vulnerable towards the risk "of significantly correlated drawdowns." (para 23) Given the still extraordinarily high levels of uncertainty regarding the recovery from the unprecedented crisis, we would tend to question staff's assessment of a low probability of drawings under precautionary arrangements. *An elaboration of how confident staff is regarding its assessment and the reasons behind it would be appreciated.*

**Given the uncertainty regarding the recovery and the potential for setbacks, we deem it prudent to err on the side of caution and would thus advocate for a higher medium-target of SDR 30 billion.** In any case, we call for a readiness to act timely in case (i) successor programs prolong the high risks for the Fund and/or (ii) drawings under large precautionary arrangements increase risk levels. Because this would directly affect the indicative range in which the target should be placed and make a further increase necessary.

#### **Minimum floor for precautionary balances**

**We can go along with keeping the minimum floor unchanged for the time being,** given that the PBs are still being accumulated to attain the medium-term goal. However, given the floor's role as a protection layer against an unexpected rise in credit risk, revisiting the target should not only be conducted with a view to the investment return prospects, as staff suggests. A review of the minimum level should rather account for the stronger volatility of credit exposure over the past credit cycles. As this trend appears to become more secular, this aspect needs to be accounted for in the discussions going forward.

#### **Pace of precautionary balance accumulation**

We acknowledge that the pace of the accumulation in PBs has picked up and that the target is expected to be attained earlier than previously projected. **This is highly welcome, as it is only prudent that the PBs increase hand in hand with the increased lending activities.** However, we caution not to underestimate the uncertainty of the projections. The actual pace of accumulation may be significantly lower than predicted, due to materialization of income risks. The latter are certainly accentuated due to the strong concentration of lending income (72 percent of the lending income comes from the largest five borrowers, para 18). **To cushion potential setbacks, the pace of accumulation thus needs to remain ambitious.** We would also like to encourage a **discussion on how the accumulation of PBs could be accelerated or put on a broader footing in a medium-term perspective.** In this sense, we feel that the SCA-1-Account through its different financing mechanism should play a role.

#### **Surcharges**

**Surcharges are first and foremost a safeguard for preserving the unique aspects of Fund lending and its financing mechanism.** By encouraging early repurchases (as confirmed by two recent sizable early repurchases), they help to preserve the revolving nature of Fund resources. The level-based charges meanwhile discourage unduly high access requests and the majority of members (37 out of 53) borrowing from the GRA indeed don't pay level-based surcharges.

The surcharges framework gives borrowing members predictability, as credit costs are more stable than the volatile market financing. Financing by the Fund furthermore remains a lot cheaper. This appears especially true for the top five surcharge-paying members, for whom “the effective cost of borrowing from the Fund [...] has remained significantly lower compared to the average market rate for these members.” (para 35; Figure 7 on page 28). In turn, the surcharges help to fund the precautionary balances, which are crucial for maintaining the value of the reserve assets.

**The current framework is proportionate and it fulfils a crucial role as a safeguard for the unique nature of the Fund (as required by the AoA). By helping to maintain the coverage rate of PBs towards the credit exposure, surcharges are a crucial element for the reserve status of assets placed at the Fund.** We thus see no need for reviewing the role and the design of the surcharges framework.

### SCA-1

**In our view, a mechanism for preventing provisions is urgently needed.** We would like to recall that IFRS provisioning was seen as a near-certainty in a Fund survey in this year's mid-year risk update. We thus share staff's view to retain the SCA1-mechanism. However, we would strongly favour starting the accumulation of SCA-1 already at the current juncture. As the Fund's burden sharing capacity remains very compressed at about SDR 15 million, it is clear that SCA-1 would not eliminate the need for provisioning for large exposures. But given that many RFI charges and repurchases – many of them with smaller volumes – are bunched in FY 2024/25, we would like to call on starting the replenishment already with a view to accumulate a meaningful balance over the next years.

We would also propose to modify the framework so that the SCA-1 balances are no longer automatically fully distributed once all arrears are cleared. We strongly encourage staff to continue monitoring the need for further SCA-1 funding and the viability of different funding options and would look forward to further discussions on how the SCA-1 can be filled. In our view, this is essential to maintain the financial solidity of the Fund. *We would appreciate staff's comments on how and when it intends to discuss the issue again.*

### IAS-19

**The build-up of precautionary balances was rendered unpredictable due to the volatility of the Fund's annual income as a result of the amended IAS 19** – as evidenced by the substantial fall of PBs in FY 2020 and the subsequent increase in FY 2021. **We are thus strongly in favour of addressing the volatility induced by IAS 19.** We also agree that the PBs should only include resources that are available for Fund operations and acknowledge that the pension plan assets are dedicated to future benefit payments and therefore not available for Fund operations. Economic gains from those positions should therefore indeed not be considered as an available buffer against operational losses. On the other hand, if an underfunded position for the pension should arise, it might be prudent to take this into account in the PBs as this will most likely reflect an economic risk.