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**Statement by Mr. Chodos, Mr. Herrera, Mr. Lischinsky, and Mr. Corvalan Mendoza on
Interim Review of the Adequacy of the Fund's Precautionary Balances
(Preliminary)
Executive Board Meeting
December 13, 2021**

We thank staff for the report for the Interim Review of the Adequacy of the Fund's Precautionary Balances.

The report is focused on presenting the Fund's Precautionary Balances (FPB) as a key element of the Fund's multilayered framework to mitigate financial risks and proposes to leave the medium-term target unchanged. However, the contribution of the precautionary balances to the Fund was not justified in a clear and convincing way to maintain or continue increasing its level. In this regard, the technical coefficients that justify precautionary balances of such magnitude were not presented, nor the probabilities that the credit, income, and financial risks can occur, or the effectiveness of other mitigating Fund policies before the FPB are put in motion. It seems that it is not enough in credit risk to have a coverage of around 21.4 percent of outstanding credit when there has never been a default against the IMF or arrears larger than SDR 1 billion. Decisions to increase the FPB are not moved by risks, but rather they appear to be driven by a certain comfort in accumulating an excess of net lending income. Oddly, Fund charges and surcharge levels are even presented as a "benefit" of the Fund to debtor countries, compared to the country risk determined by the credit rating agencies. If that is so, should the Fund follow the lead of CRAs? Or should the Fund be a risk adverse commercial institution? Is our mandate even compatible with such conceptual framework of comparing Fund programs with the evolution of market prices? All in all, it seems that staff is not taking into consideration that the Fund is not a commercial bank or Multilateral Development Bank. The Fund is a unique institution, a cooperative to support its membership when needed. The Fund should not adopt a "market risk-based business model". The Fund has its own mandate. Risk taking is the premier tool with which the Fund exercises its mandate. It is not that we have a business model that must assess and constrain its risk. Our mandate is risk itself.

Regarding credit risk, that is the risk taken if a borrower fails to meet its financial obligations to the Fund; the IMF employs a multi-layered risk-management framework, i.e., policies on

access, program design, and conditionality, assessments of members' capacity to implement program policies and repay the Fund, exceptional access policies, safeguards assessments, and requirements for adequate financing assurances, including co-financing. In the extraordinary case that arrears arise, the Fund has a set strategy where the burden sharing mechanism and the cooperative nature of the institution are central and the IMF also benefits from a de facto preferred creditor status (PCS). The PCS is not a Law or a Treaty. It is a de facto status, based on consistent behavior, which in turn it rests on reliably, following its own framework, and being there when others are not. If the Fund were transformed into a commercial type entity, or if it adopted too much of its logic, we may find that the PCS might be affected. Thus, the Fund's behavior would end up being increasingly like that of "not preferred" creditors.

Commitments under precautionary facilities involve very low credit risk and deserve a special treatment in the determination of the target for precautionary balances. Access to precautionary facilities, such as the FCL, PLL, and SLL, is reserved to countries with a consistent track record and a commitment to sound, or very sound, macroeconomic policies and institutions. The probability of an actual withdrawal from one of these facilities is not greater or even less than that of any other average member without access to these facilities. And if resources are withdrawn, strict access requirements ensure that the actual credit risk to the Fund is lower than in any average arrangement. These characteristics should be recognized in determining adequate precautionary balances. For example, in the adverse scenario, using a reserve coverage ratio of 20 to 30 percent on the total commitment to precautionary arrangements seems exaggerated considering the strict qualification of the countries with access to these facilities. The same observations applies to measures of regional credit concentration that group together commitments to precautionary arrangements with actual credit exposures. *Could staff comment on the role of commitments under precautionary arrangements in setting the precautionary balance target?*

Hence, within this framework, Precautionary Balances address only residual risks and are not at the front line of policies regarding credit risks so that the level of FPB to deal with this risk is not justified. In more than 75 years of the Fund's history, credit risk was extremely limited, due in part to a very solid multi-layered risk-management framework and PCS, as mentioned above. However, it is also because protracted arrears (for which staff asks no more than SDR 1 billion in reserves or provisions) are historically limited to a handful of cases, which includes civil war-torn countries or so called "failed states". At the same time, let's consider that in 2021 and until November 26, repurchases were 61.2 percent larger than purchases, which means that the Fund's debtors, as always, are fulfilling their commitments. Argentina's new administration, for instance, has paid until now, for a derailed 2018 SBA program, repurchases for SDR 1.3 billion and charges of SDR 2.8 billion; all of these charges are enough to pay for the total IMF budget for three years. **Moreover, if we take into consideration the five most exposed countries (Argentina, Egypt, Ukraine, Pakistan, and Ecuador) total charges amount to SDR 4.7 billion in the last three years.**

The level of FPB is much less justified if we consider that the total GRA resources on November 26, 2021 were SDR 730.3 billion, including SDR 389 billion of NAB and BBA. Total credit outstanding as of November 26, 2021 was SDR 90.1 billion, (which is less than the SDR 94.2 billion in 2012, the year that the series in Table 2 of the report begins). On this scale, as mentioned, FPB totaling SDR 19.3 billion (end-July 2021) is equivalent to 21.42 percent of outstanding credit. In turn, total outstanding credit represents 12.33 percent of total GRA resources, and if undrawn lending

commitments are included (mainly to countries with strong fundamentals) represents SDR 82.2 billion, and total lending commitments add up to SDR 172.3 billion. These amounts are equivalent to 23.6 percent of total Fund resources, that is, less than 1/4 of total resources. **This is where the unique nature of the Fund lies and as previously mentioned, the Fund cannot be compared to any other institution; it is neither a Multilateral Development Bank, nor a commercial bank. How could any other financial institution have 76.4 percent of its resources idle?**

We regret the use in the report (paragraph 17 and others) as a comparator of perceived credit risks in sovereign indicators by credit rating agencies. It is well known how the CRA performed in the years before the 2008/2009 crisis, providing technical support to financial institutions to prepare the exact mix of mortgage risks to get a triple A or higher score for the SIVs. These vehicle failures were a main cause at the origin of the subprime crisis. The CRA's methodology is obscure and procyclical. In fact, the G20, at least from 2009 to 2012, worked on several initiatives to curb the negative effects of CRAs. The nature of the IMF differs from the CRA's in that it should be anticyclical in nature. More precisely, we find that relying on CRAs is at odds with the Fund's evolving learning on DSAs.

In relation to income risk, it is a risk that the Fund's income may not be sufficient to cover its activities. The new income model, as agreed before the 2008/2009 crisis, envisaged the idea of broadening the sources of sustainable non-lending income to help mitigate these risks. However, to develop precautionary balances as the key instrument to safeguard the Fund's financing mechanism, a deep analysis would need to be revalidated. Probably, the whole income strategy would need to be reviewed. To buttress on the shoulders of few vulnerable EMDCs (including MICs and LICs), who approach the Fund as a lender of last resort, to contribute to lending income via interest, charges, fees, and surcharges, as the bulk of financing to the Fund activities does not seem fair. Furthermore, to transfer Net Income each fiscal year, coming primarily from lending income from EMDCs, to FPB funds that are later invested mainly in public bonds and corporations' financial assets of Advanced Economies, does not seem fair either. Moreover, the report mentions that financial risks related to these investments remain elevated. This concentrated income policy is also -from an income analysis point of view- not sensible; apart from being inconsistent with the aim of incentivizing graduation (precisely because in a likely scenario of not sufficient market access, graduation becomes protracted by this income policy).

Figure 6. Medium-Term Projected Operational Income and Expenses FY 2022–26 is related to the “baseline scenario with current arrangements” in Table 3 Medium-term Projections on Surcharges Income and Precautionary Balances under Various Scenarios, page 29. This figure and scenario may not be the best projection of the future situation. Table 3 scenarios “desk survey” or “WEO model-based” or a point between them, would be a more accurate projection while considering more real alternatives. Figure 6 is the exact representation of projected scenarios with current arrangements presented each year when budget and income resources are discussed at the Board and where operational income falls overtime (precisely because only current arrangements are considered). In this way, the idea of reinforcing FPB can be characterized as “you see, future income is falling and in a point five year ahead expenses will surpass income”, just like in Figure 6, page 15. We know, however, that the opposite is much more likely to happen; that is, that there will be an increased need for Fund resources, and emergency loans can turn into UCT loans to tackle

increased challenges posed by more unsustainable debt, increased health risks, increased inequality consequences in EMDCs, etc.

Even though surcharges are an integral part of the Fund's multi-layered risk management framework, as mentioned above, within this framework, surcharges and precautionary balances are not at the front line of policies regarding credit risks because surcharges are not primarily a risk management tool and thus, they are not at the core of this framework. Within this framework it seems negligible, as stated in the report, that "surcharges are designed to provide incentives for members to limit exposures to the Fund credit and encourage timely repurchases". This assertion is not verified in reality. A country with huge financial needs and in severe balance-of-payment (BoP) problems with no access or limited access to international financial markets would not be deterred to limit its exposure to the Fund by surcharges. In fact, at that moment it might not even know at all neither the workings nor the characteristics of surcharges. The limits and drivers are imposed by IMF staff's assessments of BoP problems, financial needs, and debt sustainability. On the other hand, the incentives for countries to be encouraged to make timely repurchases would come more from the sovereign benefits of exiting programs to recover certain room for policy maneuver. Argentina and Brazil in 2005-06 and other Latin-American countries are examples that come to mind. Thus, we do not believe that surcharges play an important role in managing credit risks. In our view, other European countries which exited in advance of their exposure to the Fund could have been incentivized not so much by surcharges but by longer maturities and reduced financial costs offered by EU loans. If other EMDCs had this possibility, we might see more early repurchases.

What is driving decisions to increase precautionary balances? They are not motivated because FPB are needed to face risk problems to the Fund. We believe that the drive to increase FPB is because the elevated amount of net lending income continues to increase; thus, something needs to be done about it. The report notes that qualitative considerations do not suggest significant overall risk deterioration, and as mentioned above, outstanding credit is now less than in 2012. At the end of February 2012, FPB had increased to around SDR 9.2 billion, that is less than half the current level of FPB. That is why net lending income including surcharges are placed on precautionary accounts, otherwise it should be distributed, as stated in the Articles of Agreement, among the membership in equal proportion to the quota of each member, which sounds clearly illogical. Probably, then, it would be more sensible to review the policy to not unnecessarily increase the BoP problems, already aggravated by the global pandemic.

Granted, this Board meeting does not aim to discuss surcharges. We believe however, that such a discussion would be warranted at another stage and sooner rather than later.