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FOR
AGENDA

EBS/86/82
Correction 1

CONFIDENTIAL

April 23, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Provisioning Against Loan Losses in the Context of the Fund

The following corrections have been made in EBS/86/82 (4/15/86):

Page 7, footnote 2, line 2: for "EBS/84/211, 3/9/84"
read "EBS/84/46, 3/9/84"

Page 9, footnote 1, line 3: for "EBS/85/149, 6/18/85"
read "EBD/85/149, 6/18/85"

Page 20, paragraph (xii), last line: for "two years or more"
read "three years or more"

Page 22, footnote 1, line 2: for "1.1 percent...in 1983"
read "1.2 percent...in 1984"

last line: for "0.6 percent to 2 percent"
read "0.8 percent to 2.1 percent"

Corrected pages are attached.

Att: (4)

financial obligations by members. 1/ However, the amount of overdue obligations increased markedly since 1983 and the periods during which some members have remained in arrears to the Fund have lengthened considerably. In a number of instances there are no indications that prompt settlement of arrears can confidently be expected. In the face of these developments as regards overdue financial obligations, the Fund has taken a number of measures since late 1984 to encourage and assist members to meet their financial obligations to the Fund on time, and to safeguard the financial position of the Fund against uncertainties.

a. Measures to encourage settlement of overdue obligations

The economic and financial position of those members that are overdue in their obligations to the Fund for periods longer than could reasonably be considered mainly of a technical character is regularly reviewed by the Executive Board in accordance with agreed policies on the treatment of overdue obligations. 2/ Members are urged to discharge these obligations promptly. The Fund does not engage in discussions regarding the use by the member of the Fund's resources if the member has overdue obligations outstanding. Furthermore, the Executive Board reviews a member's overdue obligations in accordance with agreed procedures and this can lead and has led to the Fund declaring a member ineligible to use the general resources of the Fund. Such a declaration is made public by means of a press release issued by the Fund and reported in more detail in the Fund's Annual Report. The Fund's financial statements also contain information on overdue obligations. 3/

1/ It should also be noted that those countries that withdrew from membership and had outstanding financial obligations at the time of their withdrawal (Cuba, Indonesia and Czechoslovakia) settled their obligations in accordance with the terms of their withdrawal. However, a unique situation is presented by Kampuchea. This member began to incur overdue obligations in 1975 and in 1978 the Fund limited the member's right to use the General Resources of the Fund and suspended its right to use SDRs acquired after the date of suspension. In 1979 the Fund reclassified charges due from Kampuchea as deferred credit. In the context of the total amount of credit extended by the Fund, and by itself alone, the amount overdue by Kampuchea might be regarded as not material.

2/ See "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/46, 3/9/84) and successive six-monthly reports to the Executive Board on overdue financial obligations (EBS/84/211, 10/11/84), (EBS/85/73, 3/27/85) and (EBS/85/245, 11/5/85).

3/ The Notes to the Financial Statements of the General Department contain information on the amounts receivable by the General Department of the Fund from members overdue in payments to the Fund for six months or more. The data include both the total amount of charges receivable and repurchases from members that are late by six months or more in discharging financial obligations to the Fund. Notes to the Financial Statements of the Trust Fund report similar information.

(2) In June 1985, the Executive Board increased the net income target specified in Rule I-6(4)(a) from 3 percent to 5 percent of reserves at the beginning of a year; 1/

(3) In December 1985, the Fund decided, effective February 1986, to introduce a system of special charges aimed at recovering certain costs arising from overdue payments was introduced; 2/

(4) In December 1985, the Fund also raised the rate of charge on the use of its ordinary resources from 7 percent to 7.87 percent per annum, an amount that was projected to yield sufficient income to enable the Fund to meet its net income target for FY 1986, equivalent to 5 percent of its reserves at the beginning of the financial year. The Fund has also considered a reduction in the remuneration coefficient as a means of sharing the burden of reducing its operational expense as a means of carrying the cost of overdue financial obligations.

These measures, including the income-generating safeguard mechanism for the determination of the rate of charge and net income target under Rule I-6(4), emphasize the importance the Fund attaches to the protection of its overall financial position. These measures, which do not in any formal sense substitute for provisioning in the event of a probable loss on some of its lending, provide for some increased cover against the risk of financial loss, including the risk that repurchases are not made. In particular, the increase in the reserve target has to some extent served a similar purpose as provisioning to meet loan losses though the factors bearing on the size of the increase in the reserve target differ from those bearing on the amount of provisioning.

2. Evaluation of probability of loan losses

As noted earlier, any consideration of the possible need for making provisions by the Fund against repurchases becoming delinquent must be preceded by a judgment whether (i) a loss appears probable and (ii) an estimate of the magnitude of the loss. However, some of the traditional elements that might need to be considered in coming to a judgment whether a loss is probable not only raise a number of issues particular to the Fund but might also tend to increase the difficulty of coming to a view as regards the probability of loss.

The view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental and cooperative nature of the institution, in which debtors and creditors collaborate to determine Fund policy, and in view of members' obligations

1/ See "Factors Bearing on the Adequacy of Fund Reserves" (EBS/85/125, 5/14/85) and "Review of Income Position and Related Issues" (EBD/85/149, 6/18/85).

2/ See "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund - Further Consideration" (EBS/85/242, 10/29/85).

(viii) Role of the Fund - In making its assessment as regards the probability of loss on credits extended to members, the Fund also needs to take into account wider considerations that touch on its broad responsibilities and unique functions in the world economy, such as the policies attached to its lending, and its ability to respond to global shortages of conditional and unconditional liquidity and its function as an international lender of last resort. These responsibilities do not relieve the Fund of the duty to come to a judgment whether a loss is probable with respect to credits extended by it, but they could indicate some delay in a decision by the Fund that a loss appears probable until it is satisfied that the problem of overdue obligations is not one of generalized difficulty, for which general action might be needed. In that event, provisioning might be needed at a later stage than at most other financial institutions.

(ix) Overall judgment - When all, or most of the relevant indicators bearing on the probability of loss point in the same direction, it would seem reasonable to conclude that a presumption of loss has been established, unless developments in the international monetary system might indicate a generalized problem, and which would call for action by the Fund in fulfilling its role of safeguarding the global viability of the international monetary system.

(x) Review procedures - The judgment whether there is a need to establish provisions call for periodic reviews of individual members' indebtedness to the Fund, perhaps in addition to reviews that would otherwise be undertaken by the Fund in accordance with its procedures. In this connection, it would be necessary to consider (a) the frequency of the reviews on which the judgment on the probability of loss would need to be made, and (b) whether the Executive Board would have an on-going involvement in making judgments regarding the probability of loss or whether the Executive Board would agree on broad guidelines and their application would be a matter for Management and staff.

(xi) Type of provisioning - In its consideration of the need for provisioning, the Executive Board would need to make a choice of whether to establish general or specific provisions, or to use a combination of the two. The establishment of a specific provision would involve making a judgment that a loss is probable with respect to the overdue obligations of a particular member. It would be for consideration whether the judgment as to probable loss should apply to all the obligations of the member to the Fund, or only to those obligations that are overdue at the time the judgment is made, or to those obligations that have been overdue for, say, three years or more. A system of specific provisioning does not depend on past experience of bad debts in the Fund nor does it imply a possible systematic or pervasive inability or unwillingness of members to repay the Fund.

(a) General provisioning - Such an approach would provide for a certain amount of provisioning which would be determined as a proportion, say, 0.5 percent of the amount of Fund credit outstanding