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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 04/17-3

2:30 p.m., February 25, 2004

3. Financial Risk in Fund and Precautionary Balances

Documents: Financial Risk in the Fund and the Level of Precautionary Balances—Background Paper (EBS/04/11, 2/4/04; Sup. 1, 2/4/04; and Sup. 1 Cor. 1, 3/5/04)

Staff: Brau, FIN; Metzgen, FIN

Length: 2 hours, 32 minutes

Executive Board Attendance

A. Kato, Acting Chair

Executive Directors	Alternate Executive Directors
S. Al-Turki (SA)	C. O'Loughlin (CO)
K. Bischofberger (GR)	S. Boitreaud (FF)
M. Callaghan (AU)	I. Alowi (ST)
S. Indrawati (ST)	B. Andersen (NO)
N. Jacklin (UA)	M. Lundsager (UA)
W. Kiekens (BE)	A. Segura (AG), Temporary
A. Mirakhor (MD)	A. Lushin (RU)
L. Martí (CE)	L. Rutayisire (AF)
A.S. Shaalan (MI)	D. Lombardi (IT), Temporary
X. Wang (CC)	A. Tombini (BR), Temporary
F. Zurbrugg (SZ)	R. Jayatissa (IN)
	M. Brooke (UK)
	O. Kanaan (MI)
	A. Atoloye (AE), Temporary
	M. Roovers (NE), Temporary
	T. Miyoshi (JA), Temporary

A.S. Linde Acting Secretary

O. Vongthieres, Assistant

Also Present

IBRD: M. Baroudi, Director and Chief Credit Officer; P. Stella, Principal Economist. African Department: N. Kirmani. Asia and Pacific Department: T. Rumbaugh. External Relations Department: R. Nord, P. Reynolds. Finance Department: E. Brau, Director; M. Kuhn, Deputy Director; S. Bassett, S. Fennell, C. Hatch, S. Khan, F. Lakwijk, J. Lin, Y. Metzgen, P. Ross, A. Ter Martirosyan, N. Wagner, S. Williams, B. Yuen. Independent Evaluation Office: I. Mateos y Lago. Legal Department: H. Elizalde. Office of Budget and Planning: B. Potter, Director. Policy Development and Review Department: M. Allen, Director; M. Fisher, A. Gilmour, J. Hicklin, A. MacArthur, M. Mecagni, M. Shannon, K. Srinivasan. Secretary's Department: A. Blazejewski, L. Hubloue. Senior Advisors to Executive Directors: A. Baukol (UA), C. Duriyaprapan (ST), P. Gitton (FF), A. Ismael (AF), J. Jonas (BE), M. Melhem (SA), T. Moser (SZ), S. Rouai (MD), C. Sia (ST). Advisors to Executive Directors: C. Amador (AU), O. Cuny (FF), A. Dupont (BE), N. Epstein (UA), G. Francis (AU), M. Jamaluddin (ST), J. Kanu (AE), H. Morsy (MI), T. Nguema-Affane (AF), B. Ólafsson (NO), A. Stuart (UK), D. Wang (CC), N. Watanabe (JA), S. Wolff-Hamacher (GR) I. Zakharchenkov (RU).

3. FINANCIAL RISK IN THE FUND AND PRECAUTIONARY BALANCES

Mr. Brooke and Ms. Stuart submitted the following statement:

In the past, the Fund has fallen well short of best practice in its analysis of the credit risks on its own balance sheet and in using this information to help determine the appropriate level of precautionary balances. It is high time the Fund rectified this shortcoming.

This paper attempts to address this weakness but provides contradictory messages. On the one hand, the staff says that there is little promise for direct use of quantitative credit risk assessments. And, on the other hand, they say such approaches can deepen our understanding of the nature of the risks the Fund faces.

We recognize that decisions over the appropriate level of precautionary balances will remain a matter of judgment. However, we firmly believe that credit risk models can, and should, be used to help inform the Board's judgments. The Fund should be at the cutting edge of financial risk analysis and should practice what it preaches to our member countries.

Going forward from here, we think that the staff should be asked to deepen their work in this area and to regularly present information from a range of benchmark models including: (i) a rule-of-thumb adaptation of the standardized model approach under Basel II; (ii) an adaptation of the IBRD's internal ratings based approach; and (iii) scenario analyses. We think that the staff has over-emphasized the difficulties in undertaking this task.

In the November 2002 review of precautionary balances (EBS/02/185), the staff argued that the Fund should target a doubling of precautionary balances to SDR 10 billion due to (a) increases in credit concentration; (b) the need to comply with IAS and obtain an unqualified opinion from the external auditors; (c) the potential for an exceptional access arrears case to exceed the capacity of the burden-sharing mechanism; (d) increases in risks relating to self-insurance; and (e) the fact that other IFIs had much higher reserves ratios. While we accepted the staff's recommendation to double the target for precautionary balances, we joined most other Directors in noting that the recommendation was not based on a detailed and probabilistic consideration of expected losses and did not utilize any of the available best practice risk analysis frameworks. Directors, therefore, called on the staff to make an examination of credit risk models with a view to improve the analytical input into decisions on precautionary balances.

While the staff has responded to Directors' calls for an examination of credit risk frameworks, we were left uncertain of the staff's overall assessment. On the one hand, paragraph 45 notes that such models have "little

promise for direct use by the Fund in estimating a target level for precautionary balances”. While on the other hand, paragraph 48 states that “VaR models and other quantitative approaches can deepen understanding of the nature of risks facing the Fund.” We strongly agree with the latter of these two sentiments. The Fund often recommends to its members to adopt risk management techniques based on sound principles and transparent analytical frameworks. The Fund should, therefore, be at the cutting edge of risk analysis and practice what it preaches.

While we accept that decisions over the appropriate level of the Fund’s precautionary balances will ultimately remain a matter of judgment, we would prefer such decisions to be based on an informed judgment that has benefited from a careful consideration of all the available data together with insights from credit risk models and scenario analyses. Unfortunately, the staff paper does not do full justice the potential insights that could be gained from a comprehensive application of credit risk analysis. Consequently, we are concerned that the Fund’s credit risk analysis techniques will continue to fall short of best practice.

Going beyond this basic concern, we were struck by the apparent inconsistencies between the November 2002 and February 2004 reviews. In 2002, one of the principal reasons cited for targeting a doubling of precautionary balances was that the Fund’s reserves ratio was much lower than that of other IFIs, implying that the Fund was comparable to the other IFIs, given their shared preferred creditor status. In the latest review, however, the staff goes to great lengths to highlight how different the Fund is from other IFIs, emphasizing its policies on arrears, conditionality and access, early repurchase expectations, safeguards assessments and its quota-based financial structure. The staff argues that these elements make the Fund unique relative to other IFIs and imply that it is therefore problematic to apply the risk assessment methods of the other IFIs. This appears to contradict one of the principal reasons given for a doubling of precautionary balances in the November 2002 review, namely that other IFIs face similar risks and, on the basis of their credit risk models, have decided to target higher reserves ratios.

Another disappointing element of the latest review is that it makes no attempt to follow up on two of the other reasons previously cited as justification for a doubling of precautionary balances. In November 2002, we were warned that the Fund might not achieve an unqualified opinion from its external auditor unless we increased the precautionary balances. This surely implies that the auditors have some way of assessing what the appropriate level of precautionary balances is. Regrettably, the latest staff paper provides no information as to what credit risk models the Fund’s own auditors use to formulate such judgments. In addition, no attempt is made to consider whether an analytical framework could be applied to determine what level of precautionary balances the Fund should hold against potential legal and self-

insurance risks (which were highlighted prominently in the November 2002 review).

A new justification of the need for precautionary balances is provided in this paper: the staff claims that precautionary balances are “necessary to provide confidence that members’ reserve tranche positions are safe and liquid”. We were surprised, therefore, that apparently no attempt was made to ask members or their auditors how they assess whether or not IMF reserve tranche positions are sufficiently liquid.

What Should We Be Doing?

We believe that quantitative approaches to risk evaluation can help to deepen our understanding of the potential risks facing the Fund and that careful application of the model and scenario approaches set out in the background paper would help us make better informed decisions about the appropriate level of precautionary balances. We recognize the difficulties in undertaking this task. But we are also conscious that in recent years the World Bank and other multilateral development banks, which also face concentrated exposures and also have the benefit of preferred creditor status, have moved a long way ahead of the Fund in terms of their credit risk assessments.

More specifically, we feel that the staff should maintain a few benchmark models to provide some guidance for the Board’s assessment of precautionary balances. At a minimum, these models should include: (i) a rule of thumb adaptation of the credit rating weighted standardized approach used by commercial banks under Basel II for the assessment of capital requirements for credit risk; (ii) an adaptation of the IBRD’s internal ratings based approach; and (iii) scenario analyses. We would like this work to experiment with different source data for sovereign default probabilities, such as the IBRD’s estimates and figures derived from the average historical experience of sovereign defaults on external credits as highlighted in paragraph 51 of Supplement 1. In addition, we would also appreciate a fuller consideration of the appropriate severity of loss adjuster to use, in light of application of the Fund’s policy on the maintenance of value requirement. In this latter regard, does the staff think that if we moved to quarterly maintenance of value recalculations, it would be appropriate to assume less severe losses in the case of a withdrawal?

If the IBRD was unwilling to share its default probabilities with IMF staff (on a confidential basis), we would favor IMF area department and PDR staff extending the existing vulnerabilities exercise to also assign assumptions for sovereign default probabilities. If the World Bank can manage to undertake such an exercise without leaks and without shareholder concerns about the Bank becoming a credit ratings agency, then it surely must be

possible for the Fund to replicate this process. As in the Bank, the IMF Board would be presented with an aggregated summary of the findings.

Scenario Analysis

As the staff acknowledges, the risk of the Fund realizing a capital loss is very small and would likely take a long time to evolve from the start of arrears. The Fund has, however, had greater experience of prolonged arrears and overdue financial obligations. Here, we see merit in the use of scenario analysis and would have preferred the latest paper to extend the analysis shown in Table 3 of EBS/02/185 using historical probabilities of arrears and the projections of total credit outstanding used in the annual review of the Fund's liquidity. We note that once allowance is made for the full application of the burden-sharing mechanism, the staff's previous analysis suggested that the Fund could withstand an arrears case of SDR 15 billion (assuming credit outstanding of SDR 50 billion) without any income losses and without the need to make use of precautionary balances. This conclusion appears to stand in contrast to the suggestion made in this review that "the burden-sharing mechanism could absorb only about one-third of the interest arrears" arising from a larger borrower (SDR 10 billion) going into arrears. We would appreciate receiving an explanation of this difference.

Speed of Accumulation of Precautionary Balances

As we noted at the 2002 review, the appropriate pace of accumulation of precautionary balances should be determined by two factors: first, the difference between the target and actual levels of precautionary balances; and, second, some consideration of what the Fund membership is prepared to accept. Assuming that the Board endorses the staff's recommendation to target the level of precautionary balances at SDR 10 billion, we wonder whether further thought should be given to the desirable pace of accumulation of reserves. In particular, we note the possibility that the investment return on the existing reserves could be added to the reserves each year, rather than being used as a contribution towards the Fund's administrative budget. We would also be interested to hear from the staff what the external auditor's opinion is on the appropriate pace of reserves accumulation.

Application of Existing Fund Policies

More generally, we continue to recognize that strict application of the Fund's policies on access, appropriate program design and conditionality are essential to safeguard the Fund's balance sheet. The increased concentration of Fund lending in recent years; the fact that a number of large borrowers are prolonged users of IMF funds; and the fact that these features are unlikely to change significantly going forward; mean that it is especially important to ensure that we have strong analytical underpinnings for our determination of

the appropriate level of precautionary balances. It also highlights the unfinished work on the exceptional access agenda: the need to design appropriate exit strategies from exceptional access; the need for further analysis on what it takes for countries to regain market access after a capital account crisis; and the importance of strictly applying the exceptional access framework, including the presumption that financing should be provided on SRF terms.

Mr. Shaalan and Mr. Bakhache submitted the following statement:

We broadly agree with the analysis and the conclusions drawn in the staff papers. The Fund has many safeguards to protect itself against the risks associated with unpaid charges and lost principal, including program conditionality, safeguard assessment of borrowing countries' central banks, arrears strategy, the burden-sharing mechanism, and hidden (gold) reserves. A most critical safeguard however is the preferred creditor status of the institution, which should be upheld by both creditor and debtor countries irrespective of the size of the arrangements the Fund extends to its members or its exposure to member countries.

Precautionary balances provide another layer of protection for the Fund financial integrity. It should be noted here that to the extent that these balances are intended to absorb losses associated with unpaid principal and charges, they can only be used after other mechanisms have been exhausted, including changes in the rate of charge or remuneration rate (beyond the limit allowed under the burden-sharing mechanism) if the required majority at the Board can be mustered. We believe that the present multilayered safeguards provide reasonable protection for the Fund resources and the existing and useable safeguards should be taken into account in determining the adequate level of precautionary balances to be accumulated.

The financial scenario analysis presented in the background paper illustrates the capacity of the system to handle accumulation of arrears by a large borrower, although higher levels of arrears could stress our system. While arrear accumulation by large borrowers cannot be ruled out, it should be noted that the burden of safeguarding resources in high access cases should not fall primarily on precautionary balances. This would be too costly. As we noted earlier, there are many other avenues to address the accumulation of arrears. Nevertheless, the fact that surcharge income is used to accumulate reserves provides a comforting link between the level of reserves and high access cases.

The background paper provides useful information about the practices of a number of other financial institutions in managing the risks they face. It also reveals important differences between these institutions and the Fund which stem from the unique nature of the Fund, its role, and its operations.

Application of methodologies similar to those used in other financial institutions, including the value-at-risk model, to the Fund is not likely to be a useful exercise in light of the many convincing arguments presented in paragraph 43 of the staff report. The existing system of mitigating credit risk and safeguarding resources has proven its adequacy over many years and we do not see a rational for a change.

Finally, we believe that the current target for precautionary balances and the pace of accumulation underway remain valid, but we would be ready to consider revising them as circumstances change.

Mr. Padoan and Mr. Lombardi submitted the following statement:

We thank the staff for providing a set of very informative papers on the management of the financial risk of the Fund.

We concur with most of the observations and assumptions laid out in the papers. We believe that the systematic use of quantitative approaches can deepen our understanding of the nature of the risks faced by the Fund. While they cannot be a substitute for judgment, quantitative approaches can be helpful when assessing the appropriate level of precautionary balances. In this respect, we strongly invite the staff to go ahead along this avenue and build upon the results already achieved.

Importantly, the Fund's lending activities are safeguarded by a set of pillars that protect member claims upon Fund's assets. Strict access criteria qualify a member's access to Fund credit above statutory limits. Conditionality assists a member's economy to revert to a sound and a sustainable position while the arrears strategy is of help in the more extreme cases. Last but not least, the Fund's role as preferred creditor is instrumental in protecting member claims upon Fund assets, ensuring that the Fund is in a position to meet its role as universal financial institution.

A closer inspection to the Fund's credit portfolio reveals that concentration has increased both in absolute and in relative terms since the mid-1990s, with two (Argentina and Turkey) out of the three largest borrowers being prolonged users. This conclusion is robust with respect to a different series of indicators, including the Herfindal Index, which captures not only the weight of the largest borrowers but rather the general distribution of credit. Notably, such a concentration appears unlikely to level off in the near future and is a cause for concern. Furthermore, the role of the Fund as preferred creditor may be—regrettably—challenged by a member country. Needless to say, whenever the Fund's credit reaches a relevant proportion of a member's external debt, the likelihood of such an event may become higher. Furthermore, the arrears strategy—though successful—is, by definition, ex post, while the notion of risk management is inherently ex ante.

Whenever the quality of the Fund's credit claims deteriorates, precautionary balances come into play to make sure that the Fund's ability to lend is not impaired. This Chair has been arguing for a long time that (i) looking ahead, provisioning policies, in terms of both the level and the dynamics of precautionary balances, need to be more forward-looking and should be better integrated with future risks; and (ii) in order to do so, we need to make informed decisions based on a wider set of information, including a quantitative assessment of the financial risks faced by the Fund's credit portfolio. Notably, we view the latter information as strengthening our judgment and not being an alternative to it.

An analysis of the Fund's credit from a portfolio perspective may provide an important additional safeguard since it would be able to establish more clearly and with a greater transparency what our provisioning policy should be in light of the increased credit concentration. A correlation analysis of portfolio risks would be able to provide potentially valuable insights as to the optimal level of precautionary balances. This is not to say that considerations related to the risk of the Fund's portfolio should affect the Fund's lending decisions. Our main point is that a more transparent framework—to be used in conjunction with the experience and judgment from the staff and with the other safeguards outlined above—would greatly strengthen the Fund's provisional policy.

With reference to the current level of precautionary balances, we note with concern that the component of free reserves with respect to the stock of credit outstanding has remained constant from 2002 to 2003, despite an increase of 27 percent in the absolute value. Free reserves—as they currently stand—are unlikely to meet the default of a large borrower and this is even more a cause of concern given the changing attitude about repayments to IFIs by a large borrower. We are, therefore, worried that the present pace of accumulation of precautionary balances is too slow and are in favor of increasing the rate of accumulation of reserves as well as their level. This should be obtained through appropriate burden sharing. In any case, all the possible options should be discussed, and we encourage the staff to present the pros and cons of different alternatives.

Mr. Yagi and Mr. Miyoshi submitted the following statement:

We think that the main staff paper provides a concise review of the characteristics of the Fund's financing mechanism and its general policy framework, and rightly clarifies a number of challenges within the Fund's financial operations. In addition, the background paper examines in detail possible options for an analytical approach to assessing the appropriate level of precautionary balances (PBs) in the General Resources Account (GRA). We applaud the staffs' efforts in crafting these insightful papers. We will briefly comment on the issues for discussion.

Issue 1

The Fund has preferred creditor status vis-à-vis other creditors. Also, as long as the conditionality for the use of Fund resources is established correctly, and the debtor countries steadily implement the adjustment policies that incorporate that conditionality, there is a high probability that the Fund's resources will be repaid. However, the credit risk that the Fund has faced since the latter half of the 1990s differs significantly, in both magnitude and character, from the risk of protracted arrears in low-income countries in the 1980s. Behind these developments is the new phenomenon of rapid expansion of international capital flows leading to capital account crises. This has caused credit concentration, which has increased the risks to the Fund's finances in recent years.

On one hand, it is important to ensure the strict application of exceptional access policy in order to preserve the Fund's financial strength. On the other, if the Fund considers the high probability of success of a member's adjustment to be secured, in our view, the Fund should take the necessary risks involved in lending. To do so, the Fund needs to preserve financial soundness pre-emptively against some scale of credit risks, and it is therefore essential for it to accumulate a comfortable level of precautionary balances while preserving sound liquidity.

Issue 2

We concur with the staff that it is difficult to project correctly the future level of credit demand and credit concentration that the Fund will face. It is, therefore, ultimately difficult to predict the extent of arrears or default by large debtor members that may occur, or to what degree the Fund will be able to deal with large-scale credit risks through its burden-sharing mechanism and its strategy on overdue obligations.

In this context, the financial scenario analysis presented in Section IV of the background paper shows us that, even under an alternative scenario in which one of the largest borrowers has incurred overdue obligations to the Fund, the Fund may be able to deal with credit risks by full use of PBs of 10 billion SDR, which is the target amount agreed by the Board. This scenario analysis, however, is undertaken by using a somewhat arbitrary indicator, such as the average non-peak exposure of the top five borrowers. We should note, therefore, that whether or not the current agreed target for accumulation of PBs is sufficient depends largely on the scale of the Fund's credit and of credit concentration.

Issue 3

We support the staff's conclusion that it is difficult to introduce quantitative models or risk management techniques that have been adopted by other financial institutions directly to the Fund's finances in calculating the adequate level of PBs, and that the Fund's decision in this respect has to involve a substantial element of judgment.

Quantitative models associated with risk management, including Value-at-Risk (VaR) and credit risk models, do not function properly in the Fund owing to the following unique characteristics of the Fund's finances as the staff points out: (i) the characteristics of the Fund's finances is credit concentration to some large borrower members and the portfolio diversification is not an objective per se. (ii) the Fund has experienced only limited events of members' overdue obligations or default, which leads to difficulty in calculating the probability of those events. More specifically, the calculation of probability would end up being arbitrary even if these models were to be applied; the size and characteristics of the arrangements that currently pose the greatest risk to the Fund's finances differ fundamentally from those in the past, which makes past experience irrelevant; the probability of the borrowers' overdue obligations or default would crucially depend on actions taken by the Fund itself.

While the role of central banks or MDBs seems to be similar to that of the Fund, it may not be reasonable to apply their credit risk management techniques to the Fund's finances directly. This is because these institutions employ exposure or commitment limits, while some of them apply strict criteria for selecting a counterparty so that they can always grasp their own financial balance sheets in a timely manner. These institutions are also given broader discretion in undertaking their financial transactions. Although we do not necessarily think that it is impossible for the Fund to establish the maximum exposure limit, careful consideration should be given to its implications for the principle of uniform treatment of members. In addition, we find it inappropriate for the Fund to engage in credit rating for each member country.

The financial scenario analysis gives us useful insight into assessing the appropriate level of PBs, but we cannot exclude judgmental factors completely in setting the assumption under any scenarios.

Mr. Kremers submitted the following statement:

Key Points

It is in the interest of the shareholders that they can form a well-informed judgment on the Fund's financial position. As such, recent

developments in the Fund's credit portfolio deserve deeper analysis, also from a wider perspective.

Specifically, while I agree that the level of precautionary balances remains a matter of qualitative judgment, a more in-depth scenario analysis would be welcome. Market risk-based assessment methodologies may be useful in defining possible vulnerabilities, but cannot be mechanically applied.

Current vulnerabilities to the financial position of the Fund are a clear reflection of the need for a proper implementation of existing policies in the field of access, conditionality and facilities. That is the first line of defense, which could be further strengthened by a more concrete exit strategy from exceptional access.

I reconfirm my support for a doubling of precautionary balances, but would like to see a thorough and continuing analysis of the required level and pace of accumulation.

General

I thank the staff for a clear and substantive report on the Fund's financing operations, the state of play in the use of resources, the risks to its creditworthiness and the mechanisms and the safeguards put in place to mitigate these risks. Moreover, I agree with the general observation in the useful background paper that there cannot be a mechanistic link between market-based quantitative risk assessment and management practices and the level of the Fund's precautionary balances. The Fund has a unique mandate as cooperative intergovernmental institution that lays out equal rights and obligations to its members and, in its function as lender of last resort, defends the public good of international financial stability.

However, precisely because of this unique role, it is in the interest of the Fund's shareholders—as creditors (providing financing under the FTP), debtors (in terms of the level of surcharges), and possible future users of Fund financing—that the Fund's creditor position is secure. In this light, the (non-applicability of) risk assessments as well as recent developments do indicate possible vulnerabilities and give no reason for complacency. As such, I would warn against fully relying on past experiences and practices, particularly regarding the following.

Credit Portfolio Dynamics and the Need for Scenario Analyses

Fund lending is almost by definition to countries with very low sovereign ratings (in fact, none of the Fund's total credit portfolio have an investment grade). The concentration of the Fund's credit portfolio has risen further in recent years, where the sum of credit to Brazil, Turkey, and

Argentina has increased from 80 percent of credit under Stand-By and Extended Arrangements in 2002 to 92 percent (83 percent of total Fund credit, including PRGF) at the current stage. With the individual shares of these countries at 38, 32, and 21 percent of GRA credit, respectively, the Fund has become vulnerable to arrears by just one of these individual members.

This situation deserves a more in-depth scenario analysis than has been provided for in the background paper (which briefly discusses one arrears scenario on the basis of the average non-peak exposure of the top 5 borrowers). Indeed, for the sake of our internal assessment, we should not shy away from fully assessing the implications of arrears by the aforementioned exceptional access countries—both in terms of the direct impact of interest arrears on the precautionary balances and burden sharing and the consequences of protracted principle arrears. Although the latter would only constitute a loss after withdrawal of a member from the Fund, it would nevertheless affect the revolving nature of Fund resources and the functioning of the Fund in general. As such, I would call on the staff to update and elaborate on similar calculations made in its paper for the November 2002 discussion.

Reflections on Possible Risks of Fund Exposure in a Broader Context

Of course, credit concentration would reflect a higher risk in case of arrears, but does not necessarily give an indication of the actual probability of such arrears. In this respect, I concur with the broad consensus that there is not much merit in the Fund assigning probabilities of arrears or default to individual debtors, effectively applying a country credit rating. However, in addition to a more in depth scenario analysis, a number of aspects related to Fund exposure might have deserved a deeper assessment in the staff paper—particularly regarding their interrelationship.

First, there is the fact that the current top three resource users have been regularly and for long periods among the top five borrowers.

Second, Fund credit constitutes a large share of these countries' total external sovereign debt, while for the other IFIs, this share has been declining.

Third, the credit exposure of other IFIs in the same countries is also relatively high, while the exposure of the Fund has grown more rapidly.

Fourth, the paper rightly points to the magnitude and liquidity of private capital flows. Here there might be an increasing tendency among private creditors to apply sophisticated financial instruments (i.e., collateralized or secured debt) to contain their credit risk in emerging markets, precisely also because of high (preferred) IFI-exposure.

Finally, we should not ignore the potential leverage debtor countries with high exposure have vis-à-vis the Fund, where recent experience has shown that the ‘threat of arrears’ cannot be ruled out entirely.

These aspects are relatively recent and seem to suggest that we should not take history for granted in assessing possible future financial risks.

First Line of Defense—Adhering to and Strengthening Fund Policies

More generally, however, these potential vulnerabilities to the financial security of the Fund are also a reflection of the Fund’s own decisions and reconfirm the need for keeping a close eye on the coverage and limitations of its mandate. In this respect, it is clear that the firm implementation of existing policies is central to mitigating financial risks. Thus, the first line of defense lies with the consistent application of the access criteria and the exceptional access framework, as well as the proper application of facilities and of sufficiently strong program conditionality. Indeed, a strong, fully owned program provides for the highest chance of successful economic recovery, and, as such, limits the financial risks for the Fund. These policies are also central to the credibility of the Fund’s catalytic role, which should also limit Fund exposure. However, an additional policy tool appears to be needed on possible exit strategies from exceptional access to Fund resources, and I welcome this discussion in the upcoming review of the exceptional access framework as well as in individual program documents. I believe that precautionary and/or low-access arrangements can play an important role in this regard.

Specifically on the use of facilities, I note the fact that surcharge income—the main source for accumulating precautionary balances—could have been twice to three times higher if the SRF had been used in all exceptional access cases (as illustrated in Annex II of the staff paper). Consistent use of the SRF in these cases appears justified by the fact that the Fund has to deal with a significantly higher risk, while the higher charges provide for an incentive not to make unnecessary use of exceptional access. In this light, it appears also reasonable that the lion’s share of the accumulation of the precautionary balances is paid for by exceptional access borrowers, as these credits have led to the need for an increased buffer in the first place. Procedural aspects that would hinder the use of SRF under exceptional access—e.g., in a precautionary setting—should be resolved.

Second Line of Defense—Level of Precautionary Balances

As a second line of defense, and according to the Fund’s guidelines, the precautionary balances should fully cover credit outstanding to members in protracted arrears and include a margin for the potential exposure to risk related to the credit that is in good standing. The appropriate level of

precautionary balances is difficult to determine, may change rather quickly and, as such, is largely a matter of judgment. The staff rightly points out that, in this respect, existing, market-based risk models provide little help as to the exact quantification of the necessary precautionary balances. As usual when insuring against risks, it boils down to a trade-off between actual costs and possible benefits. However, these assessments may be helpful in reaching a well-informed judgment on the overall risks to the Fund. I reconfirm my support for a doubling of precautionary balances to SDR 10 billion in the next five years (as decided in November 2002). However, I would also like to reiterate that, while the reasons for increasing the precautionary balances were clear, a more thorough and continuing analysis of the required level and pace of accumulation would be welcome.

Thus, following its assessment of November 2002, the staff concludes that, in circumstances where the Fund is accumulating adequate precautionary balances, maintains its burden-sharing mechanism, and implements its policies on overdue obligations, the Fund would be able to handle arrears by a member with large Fund credit outstanding if they, regrettably, were to occur. However, in September 2003, the staff also stated that the substantial exposure of the Fund to Argentina entailed important risks. In the event of non-payment of principal, the Fund's precautionary balances would not be sufficient to cover the total amount of arrears that could arise (*Argentina—Assessment of the Risks to the Fund and the Fund's Liquidity Position*, EBS/03/130, September 15, 2003, page 4). Indeed, the likelihood of arrears is not entirely hypothetical, as illustrated by recent indications that Argentina may not repay the Fund SDR 3.1 billion in March in case the second review of the Fund-supported program would not be concluded. Such developments underline once again the importance of not shying away from thinking the unthinkable and of conducting more in-depth scenario analysis. Indeed, this single obligatory repurchase amounts to more than a third of the total precautionary balances and 1.4 times the Special Contingent Account (SCA-1; the part of the precautionary balances that serves as the primary safeguard against potential losses resulting from protracted arrears). The total amount of overdue obligations by members would reach a record high of SDR 3.8 billion (the peak so far has been SDR 3.4 billion).

To conclude, I believe that the staff and the Board should frequently and consistently monitor the appropriateness of the current accumulation of the precautionary balances in the light of developments regarding the financial risks. As such, a more in-depth scenario analysis, for our own use, would add to the Fund's internal conviction (and hence external credibility) to face possible new challenges and may enable a more effective and swift reaction in the unfortunate event that protracted, large arrears were to occur, e.g., regarding procedure and the level and pace of accumulation. In the end, the financial integrity of the Fund should remain beyond dispute.

Mr. Bischofberger and Ms. Wolff-Hamacher submitted the following statement:

Key Points

We agree with the staff that credit concentration and risks to the Fund have increased since 1995. But we are not fully convinced that “since the Board took the decision [in November 2002] to double the target for the Fund’s precautionary balances, there have been no material developments which suggest that this judgment should be reconsidered” (paragraph 40).

To minimize the risk of arrears, most importantly, the preferred creditor status needs to be preserved and the four substantive criteria for exceptional access must be strictly applied. In addition, credit concentration, and in particular, the share of Fund credit in total external debt and public external debt of a member should be closely monitored.

Even with this “first line of defense” against credit risks in place, we feel that the staff should have discussed more in-depth possible approaches for a faster pace of accumulation of precautionary balances and a possible further increase in the target level.

We agree with the staff that, particularly since 1995, credit concentration (in absolute terms and as a percentage of total credit) has increased significantly. This was due mainly to the approval of several arrangements with access above statutory limits. In November 2002 the Executive Board decided that—among other factors—the increased credit risk resulting from higher credit concentration calls for a doubling of the target for precautionary balances to SDR 10 billion. However, in contrast to the staff, we believe that there are some indications that today the future risks to the Fund could seem even higher than in November 2002:

between November 2002 and December 2003, outstanding credit increased by a further 17 percent. In addition, concentration of outstanding credit to the three largest borrowers grew further from 58 percent to 64 percent;

in 2003, one large borrower, Argentina, regrettably, came close to non-payment to the IMF. In September 2003 a new Fund-supported program was adopted, which in fact rolled over credit to the Fund;

the high share of Fund credit in the total external debt and of Fund credit in public debt of the largest borrowers is of particular concern, since there is some indication that such a high share might induce some to question the preferred creditor status of the Fund. The preferred creditor status, however, is the basis for the conclusion that “from the perspective of

members, the financing of the Fund has been safe and entirely risk-free” (paragraph 8).

Staff comments on the implications for future risks to the Fund would be welcome.

To minimize the risk of arrears, as a “first line of defense”, an integrated approach is important. The essential elements of such an approach are:

first, the preferred creditor status of the Fund needs to be preserved. This concept is one of the corner stones of the Fund’s credit policy and indeed its policy in general;

second, conditionality must be designed to ensure that program countries can generate the necessary repayment capacity;

third, strict adherence to the four substantive criteria for exceptional access is essential since credit concentration in recent years was mainly due to the approval of several arrangements with access above statutory limits. It is also important that exceptional access would in general be granted under SRF terms;

fourth, while we acknowledge the staff’s argument that diversification per se is not a goal for the Fund, the Fund should at least closely monitor the heavy credit concentration, and in particular the share of Fund credit of total external debt and public external debt of a country.

The level of precautionary balances needs to be appropriate in a forward-looking way. Therefore, even with the above mentioned “first line of defense” in place we feel that a discussion of a possible faster pace of accumulation of precautionary balances and a possible further increase in the target level would have been appropriate.

We acknowledge the constraints in applying model-based approaches of risk assessment to the Fund. However, like Mr. Brooke and Ms. Stuart as well as Mr. Padoan and Mr. Lombardi, we feel that these models might still be helpful in forming a more informed judgment as to the range of an appropriate level of precautionary balances.

Regarding a possible accumulation of precautionary balances, several approaches to a possible speedier accumulation should be discussed. For example, commitment fees could be raised (including through a change to a progressive scheme), the basic rate of charge could be increased to raise regular income, in the context of the burden-sharing mechanism the rate of

charge could be increased and the rate of remuneration decreased to raise the addition to the SCA-1, and surcharges could be further raised.

Mr. Wang and Ms. Wang submitted the following statement:

First, we thank the staff for the well-prepared report and thorough analysis of precautionary balances.

As staff pointed out in the 2002 review, the increasing role of the Fund in crisis resolution—reflected in the concentration of large borrowers—has given rise to the issue of the Fund's financial vulnerability. The concentration ratio continued to increase and, by end-2003, credit of the largest three borrowers accounted for 72 percent of total credit—an unprecedented high level. The average share of Fund credit in the external debt of the three largest debtors is 20 percent. Moreover, the use of Fund resources in these countries tends to be prolonged, which, again, highlights the Fund's vulnerability to credit risk. Should a large debtor fail to repay, the Fund would face great pressure.

It is not easy to predict the demand for Fund credit and changes in concentration. As the Articles of Agreement state, the Fund will continue to assist a cooperating member country when it is in difficulty, including in extreme circumstances. Therefore, the Fund must be well equipped to protect itself against risks and keep precautionary balances at an appropriate level. The Executive Board decision in 2002 to double the size of precautionary balances in the next five to ten years is being implemented. We are encouraged to see that the balances reached SDR 6 billion at end-October 2003, and that the ratio of precautionary balances to credit outstanding is improving gradually. However, we concur with the staff that the pace of accumulation will need to be kept under close review, considering the risks and the availability of surcharge income. It is also essential that member countries and their creditors continue to treat the Fund as a preferred creditor.

In addition to maintaining adequate precautionary balances, a number of effective instruments have also been developed. Strengthened surveillance is playing an important role in safeguarding the macroeconomic and financial stability of member countries and the arrears policies and the burden-sharing mechanism together with setting the rate of charge in response to changes in the Fund's financial situation, all serve to mitigate risk to the Fund's financial integrity. These instruments must be strictly implemented in the future. If the Fund's financial integrity is under immediate threat, access to gold could be also considered.

Responding Directors' suggestion at November 2002 review, the staff has made every effort to explore an analytical framework to determine the target for precautionary balances. We appreciate their hard work, clearly

evident in the background paper. The application of the value-at-risk model and the financial scenario analysis are interesting. If we take an extreme scenario with two large borrowers incurring arrears to the Fund at the same time, what is the appropriate level of precautionary balances? We also suggest considering other indicators, such as the ratio of the precautionary level to total credit outstanding.

We agree that the assessment of the adequacy of precautionary balances relies on the Fund's judgment to risk exposure and the policy framework to safeguard its resources. We also recognize that such approaches have some shortcomings and should not be used mechanically. However, we believe the quantitative approaches can help the Fund to better understand the nature of the risks and provide some sense of the appropriate precautionary level. Therefore, we should not totally ignore the usefulness of these approaches. The staff may consider incorporating some elements of the quantitative approaches in their judgment.

In sum, the target for precautionary balances, decided at the last meeting, should be achieved through a carefully-reviewed path of accumulation. Although there is not a perfect way to assess the reasonable level of precautionary balances, we encourage the staff to continue to build on a comprehensive framework, taking various factors into account. Most importantly, the Fund must carefully implement policies governing the use of its resources and mitigating risks to ensure the financial integrity of this institution.

Mr. Steiner and Mr. Tombini submitted the following statement:

We thank the staff for a very informative set of papers, which helps us to better assess the level of financial risk faced by the Fund and provide additional elements for us to make a judgment on the adequacy of the level of precautionary balances, as well as on the pace of accumulation of such balances.

At the outset, we share the view that, from time to time, concentration of credit is an inevitable outcome associated with the nature of the Fund. It is not in the objectives of the Fund to diversify amongst borrowers, making it a unique lending institution. It is also the case that, in the event of an international crisis, not only the concentration of lending occurs, but also the Fund tends to fill up the gap opened by other sources of financing that tend to retrench. Moreover, it is a central objective of the Fund "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity" (Article I (v)).

Hence, lending of the Fund generally occurs under very challenging circumstances.

High exposure is another natural development given the widening discrepancies between the pace of world economic growth and the increase in the size of the Fund observed since its creation. If the relative size of the Fund compared to world GDP were to be preserved, its dimension would have to be three times larger, and the issue of high exposure would certainly be of less importance.

While high exposure and credit concentration might be inevitable, there are a number of characteristics that mitigate financial risks at the Fund. In this respect, important safeguards are in place, including the quality of its policies on the use of its resources. The use of conditionality as a way of ascertaining the willingness and capacity of member countries to undertake the required policy adjustment is another key ingredient to safeguard Fund resources. Perhaps the most important safeguard and the characteristic that makes the Fund unique and able to fulfill its mandate is its preferred creditor status. This chair is of the view that preserving its preferred creditor status is crucial to allow the Fund to step in when no other financial institution is willing to do so, providing financing without risk premia or collateral. Members should strive to uphold this key characteristic of the Fund.

The maintenance of an appropriate level of precautionary balances is required for the Fund to fulfill its mandate with the appropriate safeguards, while assuring members that their reserve tranche positions remain readily available. We thank the staff for the effort made to respond to the Board's request to examine alternative analytical frameworks that could help in determining the appropriate level of precautionary balances. However, as the supplement paper confirms, the use of quantitative approaches to determine the target level for precautionary balances is subject to various shortcomings when applied to the case of the Fund, making them excessively arbitrary. Hence, judgmental considerations should continue to play a central role in assessing the level of precautionary balances at the Fund.

As to the current stance on precautionary balances, we agree with the staff that the target of SDR 10 billion and the path of accumulation are broadly appropriate. The current accumulation of around SDR 800 million a year seems reasonable. We see no need to change the Fund's policy on overdue obligations in the foreseeable future.

On more specific issues, we see no point in the staff simulating (in Annex II) the impact on the Fund's surcharge income of the hypothetical alternative associated to Brazil's recent augmentation. The simulation is predicated on Brazil purchasing the resources available under the augmentation, which, as confirmed by the authorities, consists of an incorrect

assumption. We also question the merit of making a reference (in the third bullet of paragraph 35) to a “club of the top three” largest debtors of the Fund.

Ms. Jacklin and Mr. Baukol submitted the following statement:

Key Points

There is little doubt that the IMF’s preferred creditor status is important to the IMF’s key institutional role in promoting international financial stability, and this helps assure the liquid and revolving character of IMF resources.

Determining the needed size of precautionary balances remains a matter of judgment. Various quantitative approaches used by other private sector institutions and IFIs are not too useful, given the Fund’s unique financial structure and policy role.

Without judging whether our current SDR 10 billion target is sufficient, we would emphasize the Board’s agreement that the Fund needs to build precautionary balances to a level significantly higher than current amounts, in light of the Fund’s traditionally high level of asset concentration. A more rapid accumulation of balances is needed.

In the event of a significant credit event for the IMF, the Board will need to re-evaluate precautionary balances in a comprehensive fashion.

The IMF needs to continue to focus on the policy measures that reduce risk—namely, strong and effective lending policies. We do not favor rigid concentration limits. Nonetheless, in applying our exceptional access policy, the IMF could focus more attention on the assessment to the risks to the Fund arising from high exposure and the member’s capacity to repay.

The Board recognized in 2002 that precautionary balances were too low to protect the Fund comfortably from risk of arrears, particularly given the high concentration of IMF purchases. At that time, the Board decided roughly to double the level of precautionary balances to SDR 10 billion in the medium term. We continue to believe that precautionary balances need to be significantly higher than their current level, and balances need to be accumulated at a faster rate.

Size of Precautionary Balances

As a financial institution with important systemic responsibilities and with creditors who are accountable to their taxpayers, the Fund must pursue high financial standards, even if the Fund’s financial structure is not strictly comparable to MDBs or other financial institutions. To this end, it is

important to adhere to sound lending policies. Strong and consistent implementation of the safeguards policy is also needed

There is no clear method for determining the appropriate level of the Fund's precautionary balances. We concur with the staff's view that quantitative risk assessment techniques used by other financial institutions are not fully applicable to the Fund for several reasons. The IMF does not have "market risk" in its operations, and so VaR models are of little relevance. Moreover, its lending risk does not include traditional credit risk but rather a unique form of "sovereign risk." Given the IMF's role, it assumes a degree of sovereign risk that no other lender assumes, but it also has a unique policy framework for its lending that mitigates these risks. Thus, we concur with the staff that the quantitative approaches 'all have significant shortcomings when applied to the Fund and cannot substitute for the judgment that must necessarily underpin decisions on the level of precautionary balances.'

Nonetheless, some IMF-supported programs are not successful, and the IMF's precautionary balances need to be adequate to protect the liquid and revolving nature of IMF resources. The core issue is to reach our own defensible basis for assessing the adequacy of precautionary balances and to review that assessment with sufficient frequency. The staff should focus on this objective.

One key risk mitigant is our policy on exceptional access. Current procedures call for the staff report for exceptional access cases to include an assessment of the risks to the Fund arising from the exposure and systematic and comprehensive information on the member's capacity to repay the Fund. This assessment could include information on the size of exposure relative to the size of the IMF precautionary balances (a "concentration" factor). This would add a practical assessment of risk, additional to the 100/300 percent borrowing limits based on percentage of quota.

Finally, we note that, while the External Audit Committee has indicated that gold should not be formally included in the definition of precautionary balances, we concur with the staff that gold holdings provide a fundamental strength to the IMF's balance sheet.

Pace and Method for Accumulation

In our view, a more rapid build-up of precautionary balances is needed, due in part to the high concentration of IMF exposure. The Fund could build reserves more quickly through a higher target for net income or higher surcharges. These ideas could be considered at our upcoming meeting on the Fund's income position, depending on circumstances at the time. In our view, increasing the net income target and rate of charge would be appropriate given that:

In past years, the Fund set a net income target equal to 10 percent of reserves rather than the current 5 percent level.

The rate of charge is currently very low. It is based on short-term borrowing rates of the most credit worthy countries, while the IMF provides credit for several years at this short-term rate. On balance, recognizing that the international community benefits from countries undertaking difficult adjustments, the Fund's financial structure provides an excessive subsidy element for borrowers that discourages recourse to private capital and dampens the role of market discipline.

In addition, the Fund has a large amount of interest-free resources that help reduce the rate of charge by lowering remuneration. Here, we concur with Mr. Brooke and Ms. Stuart that consideration could be given to adding the investment return on existing reserves to reserves each year, rather than using them as a contribution towards the Fund's administrative budget.

Surcharge income can be very volatile and an unreliable source of funds for precautionary balances.

A stronger presumption for use of SRF in exceptional access cases can be made.

Other aspects of the Fund's financial framework are already burden-shared. We note that, in determining appropriate levels of burden sharing, one must be mindful of the monetary nature of reserve positions on the balance sheets of our members.

Mr. Andersen and Mr. Ólafsson submitted the following statement:

Key Points

The Fund's preferred creditor status is imperative to protect the financial integrity of the Fund, making it important to closely monitor developments that could potentially weaken the status.

Considerations put forward by the staff do not suggest changes in the previously agreed level of precautionary balances and the rate of accumulation at this stage.

Increased Credit Concentration: A Serious Concern

Strict adherence to the exceptional access framework and sound adjustment programs are vital to limit the Fund's credit risks, and lending under the exceptional access framework should be granted only on SRF terms.

We encourage continued close monitoring of developments in the Fund's financial risk and continued work aiming at supporting an informed judgment about the risks to which the institution is exposed, including further scenario analysis.

General Remarks

The staff papers provide interesting and concise information on the important subject of risk management at the Fund. A sound financial management requires that risks are identified, well understood, closely monitored and that proper actions are taken to deal with potential losses from financial activities. Understanding risk also helps to adapt to a changing financial environment. The analysis contained in the papers shows that the Fund is on the right track in this important area, and points to areas where further work would be welcome.

The Fund plays a unique role in the world financial system and many of the risks it faces are of a special nature, making it difficult to adopt the conventional risk mitigation tools used by other financial institutions as elaborated on in the staff paper. This makes it even more important to safeguard the Fund's balance sheet through a sound architecture of crisis prevention as well as crisis resolution. Strict adherence to the exceptional access framework, appropriate safeguards, enforced conditionality within sound adjustment programs and the promotion of good governance and transparency are all important elements in that respect.

Preferred Creditor Status

The Fund's status as a preferred creditor is a very valuable asset both to the Fund and to the international financial community. While the preferred creditor status is considered secure, we are concerned about developments that could potentially put the status under pressure. This includes the case of sovereign debt restructuring where a large share of external debt is to IFIs and private creditors faced a large haircut proposal, or where a large part of sovereign debt to private creditors is collateralized. Such developments, therefore, need to be monitored closely. Moreover, to protect the preferred creditor status, it will remain essential to maintain adequate precautionary balances, a strong arrears policy and promote the Fund's catalytic role through a cautious and sound lending policy.

Precautionary Balances

Considerations put forward by the staff do not suggest changes to the earlier decision to aim at building up precautionary balances to a level of SDR 10 billion. The pace of accumulating precautionary balances has been as foreseen in late 2002 and this rate of accumulation is acceptable. Accordingly,

we see no need for changing the Fund's rules on provisioning at this juncture. However, further analysis and stress testing of the burden-sharing mechanism and the adequacy of precautionary balances in the face of possible accumulation of large arrears might lead to changes in the assessment of the present rules of provisioning. Like Mr. Padoan and Mr. Lombardi, we are very concerned about the changing attitude about repayments to the IFIs by a large borrower.

Risk Management and Pricing

The credit risk facing the Fund has increased due to the Fund's role in resolving financial crises related to the capital account. The importance of this role is also reflected in a "non-action risk" resulting from insufficient responses to financial crisis originating in a member country of systemic importance. This has resulted in sharply increased credit concentration over the last few years, due mainly to lending to three middle-income countries. Most credit risk models identify credit concentration as undesirable and assume diversification as a key risk-mitigating rule. While diversification is hardly an option to counter credit risk due to the special nature of the Fund's role, we support the staff's view that implementation of access policies is a key risk-mitigating device. In this context, it is regrettable that the newly established criteria for exceptional access were not fully met in the cases where such access was granted.

An important factor in risk management is the pricing of risk. We remain of the view that lending under the exceptional access framework should be granted only on SRF terms. Lending must be on terms that promote incentives for early repayment to secure the revolving character of the Fund's resources and to maintain the Fund's forward commitment capacity. Use of surcharges should reflect increased risks to high access borrowers and encourage borrowers to make early repurchases. There should be a presumption that countries experiencing a rapid improvement in their external balances make early repayments to the Fund. The increased credit concentration also underlines the need for the Fund to be restrictive in extending repurchase expectations to an obligations basis—any extension should be considered on a case-by-case basis. Also the accumulation of reserves is to be financed at the source of the risks, i.e., by surcharges on borrowing.

Use of Credit Risk Models and Scenario Analysis at the Fund

It emerges from the staff's discussion that the most widely used credit risk models are not applicable in the case of Fund's activities, due mainly to a lack of default history, small sample of customers and the often "special event" character of capital account crisis. This applies also to models that abstract from the causes of default. Risk management based on country

exposure limits have been rejected by the Executive Board as they require a form of country rating mechanism that does not appear compatible with equal treatment of members in a quota based institution. Rigorous debt sustainability analysis provides, however, important information on credit risks in general. Scenario analyses of the specific risks to the Fund due to credit concentration also provide important insight and could be further developed. We are especially interested in analyzing in more depth the consequences for income and the burden-sharing mechanism in a hypothetical case of a default of both interest and principal of a very large borrower.

In conclusion, we welcome the staff's effort so far to apply a more systematic approach in this area. We also encourage the staff to continue their analytical work in strengthening risk management at the Fund and to systematically monitor credit concentration developments. While recognizing that judgments need to be made, it is desirable that a consistent framework is put in place to give structure to such judgments. It is, therefore, important that the staff continues to provide the Board with all relevant information to make an informed judgment about the risks to which the institution is exposed and to prepare for an appropriate provisioning policy in the interest of the international monetary system.

Mr. Le Fort and Mr. Segura submitted the following statement:

We thank the staff for a thorough analysis contained in a set of reports for our consideration. Despite the increase in the share of credit allocated to the largest borrowers, a persistent pattern in the Fund's lending, we agree with the staff that portfolio diversification is not an objective per se for the Fund, and, indeed, it should not deter it from pursuing its main goal of aiding member countries in dealing with balance of payments difficulties. Nevertheless, to preserve the integrity of the Fund's financial stability, we welcome the current in-depth analysis aimed at exploring options for further guaranteeing the Fund's financial strength.

We agree with the staff's assertion regarding the uniqueness of the Fund, and its idiosyncrasies that make it unsuitable to apply VaR or other risk diversification models used by institutions in the financial sector or even by other MFIs. For one thing, as opposed to them, the Fund does not have any substitute for the fundamental role it plays as a proxy for a "lender of last resort" of the international financial system, therefore, it cannot turn its back on a member or providing fewer resources than it estimates it requires, since that would be equivalent to allowing instability to unravel. With respect to the use of a specific model to determine the optimum level of precautionary balances, we are open to the exploration of methodological improvement, but have doubts on the extent of progress that can be attained. It is not possible to apply laws of large numbers or probability distributions to the Fund's limited portfolio of borrowers; there is no significant history of defaults, beyond a

limited number of countries in arrears, with which to feed a probabilistic model. In addition, the Fund's preferred creditor status that shares with other MFIs provides additional safeguards against defaulting sovereigns. Moreover, the international financial architecture assigns the Fund a catalytic role for international support for a country's financing needs, which is a powerful incentive for members to comply with their obligations to the institution.

Therefore, in our view, such reasons rule out considerations of limiting the amount of resources that could be devoted to a single member in urgent but temporary need, beyond the criteria of repayment capacity now in place, and the macroeconomic and structural conditionality imposed on Fund lending that would be the underlying reason to adopt any specific model of risk diversification or risk control. Hence, that being the case, this implies that alternatively, attention would have to be shifted towards analyzing if the Fund's mechanisms in place to cope with potential protracted arrears or even losses from loans to member countries are adequate. The main buffer against any such event is the precautionary balances, which, according to the staff's assessment, both its target level and path of accumulation, are broadly appropriate to safeguard the Fund's financial health. If that buffer capacity were to be exceeded, the burden-sharing mechanism would have to be activated, and in extreme cases, reserves could be used to absorb the losses. In our opinion, such a mechanism remains adequate and, therefore, does not need to be modified.

However, we do consider that, if concentration levels keep increasing, perhaps precautionary balances would have to be raised accordingly and, in any event, they must be continuously monitored. This would imply basically to explore ways to accelerate the path of accumulation in order to reach the target level of SDR 10 billion sooner, or even to raise that target level further. Under the present circumstances, however, a wait-and-see attitude is called for. We would appreciate the staff's comments on the feasibility of such an attempt, and their suggestions on how this could be done in a better way under the current mechanisms in place.

Mr. Mirakhor submitted the following statement:

We thank the staff for a concise report on the adequacy of precautionary balances to mitigate financial risks associated with Fund's operations in the General Resources Account. The decision taken by the Board in 2002 to double the level of precautionary balances to SDR 10 billion was sound and we see no need at this stage to change course or modify the present system of reserves accumulation. Since the adoption of this policy, almost all the indicators of financial soundness have improved. In particular, precautionary balances have increased by 30 percent to reach SDR 6 billion. Combined with the continued reduction in arrears to the Fund, the consolidation of precautionary balances allowed a further increase in free

reserves which represent, at end October 2003, 7.5 percent of credit in good standing.

In addition to these positive developments, the Fund is continuing to strengthen its financial operations and policies. Among the actions recently taken to improve the effectiveness of Fund's activities, it is worth noting the review of prolonged use of IMF resources, the evaluation of the role of the Fund in recent capital account crisis, and the strengthening of the exceptional access framework. These policies plus the additional buffer provided by the Fund's preferred creditor status and the continued improvement in the global economy reinforce the conclusion that there is no need for policy change at this time. Additionally, it should be noted that the financial transaction plan has strengthened substantially with the participation of a record number of 45 members, including 19 developing countries, accounting for 77 percent of total quotas.

We also thank the staff for the supplementary analysis on credit risk models and their possible application to the Fund, and share their conclusion that there is little promise in direct use for the Fund of estimating a target level for precautionary balances. While there is higher concentration in Fund exposure, the staff is corrected to point out that, unlike financial institutions, portfolio diversification is not an objective per se for the Fund which remains a cooperative institution. As such, it is worth underlining the fact that the Fund possess particular characteristics in its relations with its members which offer the best safeguards for its resources, including the application of conditionality to promote sound policies, the cooperation in implementing the arrears strategy, and the willingness of our authorities to participate in any cooperative scheme, such as the burden-sharing mechanism, to deal with specific and/or unforeseen risks.

Finally, it is worth noting the following statement in last year's report of the External Audit Committee (EAC) to the Executive Board: "The EAC welcomed the decisions on access policy in capital account crisis and the criteria that had been established recently by the Executive Board for exceptional access to Fund resources by members. These policies were considered to be appropriate alongside the decisions taken earlier in the year to double the Fund's precautionary balances."

Mr. Al-Turki submitted the following statement:

We thank the staff for an insightful set of papers on financial risk in the Fund. We are also in general agreement with the thrust of the staff's conclusions.

The increase in the concentration of the Fund's lending and the rise in the size of the financial packages pose higher risks to the institution. While the

Fund's conditionality and preferred creditor status should limit those risks, it is prudent to continue to accumulate precautionary balances in line with current policies. We should also continue to assess the impact of any future large lending package on the risk profile of the Fund's portfolio.

The cognizance of the increased risks was the driving force behind the interest rate surcharges on large loans. In the same vein, the precautionary balance target was substantially increased. We are of the view that both the target and the pace of accumulation of precautionary balances remain satisfactory at this time. However, like Mr. Shaalan and Mr. Bakhache, we would be ready to consider revising them if circumstances change.

We agree that the appropriate level of precautionary balances will ultimately be a matter of judgment. We also recognize that there are substantial differences in assessing risks between the Fund and the other International Financial Institutions (IFIs) or the private sector. Nevertheless, we are of the view that using quantitative credit risk assessments and scenarios has an important role in informing our judgment regarding the levels of the needed precautionary balances. Therefore, we encourage the staff to move forward with efforts in this area.

Mr. Padoan and Mr. Lombardi rightly note that it will be more likely that the preferred creditor status of the Fund may be challenged whenever the Fund's credit reaches a relevant proportion of a member's external debt. This is an important point that the staff should explore further. Indeed, this reinforces the rationale for the catalytic role of Fund lending, which this Chair has emphasized on many previous occasions.

Mr. Ondo Mañe submitted the following statement:

It is clear from the staff paper that the Fund does not face the same type of risks as other financial institutions, and its financing has been safe. Its preferred creditor status, and the fact that its lending is tranching and requires the borrowing member to implement a strong program of economic and financial adjustment, which is reviewed regularly by the Board, reduces, to a large extent, the riskiness of its lending. Nevertheless, as experience has shown, one risk faced by the Fund has been that of arrears, although we would note that the arrears strategy that we have put in place has been successful in reducing that risk.

The arrears risk, as well as the responsibility to fulfill its statutory commitment towards the membership, specifically helping members to weather shocks when they occur, does call for the Fund to maintain a financial situation beyond reproach. This is of more importance since the approval of the framework for exceptional access to Fund resources last year, which we note, increased Fund exposure. Accordingly, we remain attached to the

maintenance of adequate precautionary balances, in order to preserve Fund's lending operations and the revolving nature of its resources, and safeguard the "risklessness" of the funds made available by its creditors.

In this context, we view the decision taken in late 2002 to increase the level of the precautionary balances to SDR 10 billion as appropriate. Likewise, we view the present mechanism to accumulate these balances as suitable. In this regard, we note that the level of precautionary balances has been always well above the total amount of overdue obligations.

Moreover, we continue to believe that our conditionality and our safeguards assessments provide the best safeguards for the Fund's resources. We, therefore, support the maintenance of the present system.

We would, however, agree that, as our financial exposure becomes larger and the risks of default increase, it would be worth developing a methodology that can help us decide in a more scientific way on the amount of precautionary balances that the Fund needs to hold. We take note of the various credit and market risks evaluation methods and their drawbacks insofar as the Fund is concerned, as described in the background paper. We notice the staff's consideration of CreditRisk+ model and the scenarios analysis as being models that could be useful. We encourage the staff to continue their examinations of these models, and to keep the Board informed of their findings.

Mr. Misra submitted the following statement:

We thank the staff for its well-documented paper on the subject, taking the level of discussion on precautionary balances a step ahead by bringing in the validity and relevance of various credit risk models applied by a variety of institutions including multilateral financial institutions. We broadly concur with the staff that the varied techniques applied by other institutions with greater relevance to them cannot be transplanted to Fund's operations mainly because of the unique nature of the Fund and its role and participation in the international financial system. Particularly, it may be premature to consider the techniques based upon the new Basel Capital Accord, which are still evolving and subject to intense debate.

Overall Perspective

The paper has rightly captured the nuances of various techniques, but the actual application of these techniques; most of them based upon portfolio diversification models are not best suited to the Fund's operations. The Fund's diversifying its operations would be in tension with its purpose of avoiding or preventing crisis or balance of payments maladjustments. In the context of evolving global integration of financial and other markets, the Fund should

nevertheless remain continuously vigilant, a watchful observer and a learner to strengthen its own risk management practices, with suitable modifications.

In our view, given the primary and critical role of the Fund in maintaining the financial stability and integrity of international payments system, its reputational risk of ‘not providing the finance’ at critical times could be much greater than taking on some additional risks ‘by providing finance’. In achieving desired level of precautionary balances, such non-financial risks should be given due consideration.

One key feature in the evolution of the Fund’s finances, facilities, and associated terms and conditions in the decades after the fall of the fixed exchange rate system has been the rapidly changing global financial market environment. First, the financing needs of many emerging and growing markets are met more by banking and capital market channels and flows rather than official flows—both bilateral and multilateral. Second, the volatility and erratic movements of funds across countries combined with exchange rate volatility have made some of the emerging markets (who remain major borrowers from the Fund) more vulnerable and risk prone than others. In this regard, though the ‘incidence’ of demand for Fund’s access could come from a few locations, the causes or sources of this demand cannot be directly attributed to these domestic economies alone. The fact that efficiency of markets and regulatory and public policies have not grown in tandem with the rapidity of growth in volumes of international capital flows has made the ‘insurance cost’ of the Fund’s finance larger. As a result, though the Fund’s size in relation to expanding global markets has become smaller and smaller, the financing needs at the margin to correct market imperfections as also to bring about country adjustments in terms of policies has become larger. In addition, there is also a risk associated with the growing credit concentration among few economies that are more open and exposed to vicissitudes of capital market flows. The net result is the need for enlarged resources base and also for higher precautionary balances.

Given the unique nature of the Fund, we recognize the importance of members remaining current with the Fund. There is a need to preserve the preferred creditor status and safeguard Fund’s use of resources, including through strategic steps regarding overdue financial obligations. It would be difficult to maintain the cooperative nature of the Fund’s operations, without keeping its resources ‘revolving’. We agree with the staff assessment regarding the rationale for precautionary balances as a way of protecting the Fund and its creditor members against potential losses resulting from non-payment and other eventualities like the inadequacy of the rate of charge vis-à-vis growth in expenses and remuneration.

Evaluating Fund's Financial Risk

In the backdrop of above overall perspective, we are inclined to support the analysis that the value of Fund's credit and resources is not affected by changes in interest rates and exchange rates. The Fund is also distinct from other agencies since it does not borrow from international markets and not amenable to rating by international rating agencies. Hence, the principal financial risk faced by the Fund is arrears.

Second, the Fund financing by itself has become precautionary in the context of protecting member countries following sound policies from sudden external shocks. In this regard, the regular review of quotas and the need for strengthening the liquidity base of the Fund becomes highly relevant.

Third, while risk mitigation efforts have been strengthened by refining the access policy and facilities from time to time, the Fund should balance these considerations against the need for larger access by members facing extraordinary crises and hence the adequacy of the Fund's liquidity also needs to be constantly evaluated.

Specific Issues

A comprehensive view on the financial risks of the Fund would be possible only with the proposed review of the exceptional access framework due in early 2004. The financial risks should be balanced against the reputation risk of not meeting the member country needs in time and in adequate volumes. We concur that the Fund continues to be treated as a preferred creditor and that the Fund maintains adequate precautionary balances.

We agree that the VaR models that can be used with some higher relevance in respect of other institutions may be problematic for the Fund and assigning probabilities of default for member countries would make the Fund a credit rating agency, which is not desirable. Such moves, instead of creating confidence will pose a threat to confidence in the smooth functioning of the international financial system. On the other hand, Fund should attempt strengthening its surveillance and other crises prevention efforts, as a confidential advisor to members. In this light, assessing adequacy of precautionary balances would ultimately be a matter of judgment and a strict rules-based "quantitative" approach to targeting precautionary balances may not be a prudent way of looking at Fund's operations.

In conclusion, we share the view that the appropriateness of the precautionary balances has to be assessed as an on going basis taking into consideration the evolving nature of the potential risks.

Ms. Indrawati and Ms. Sia submitted the following statement:

We welcome the opportunity to discuss financial risk in the Fund and to assess the adequacy of precautionary balances, as a follow up to the November 2002 discussion on the Fund's policy on precautionary balances.

The Fund's core function is to provide resources to its members in situations where other creditors are unlikely to do so, thus providing confidence under extreme and usually financially risky circumstances. The Fund can mitigate the heightened financial risk through effective surveillance, application of conditionality, and safeguards assessments. Nevertheless, it is clear that these measures are not foolproof. As such, it is necessary for the Fund to remain a preferred creditor.

It can be observed that, even with its access policy, the Fund has had to accommodate ever-bigger borrowing that is concentrated on a few member countries. In such a situation, repayment difficulties from even a single large borrower could cause a crisis of confidence in the Fund's position. Much effort is put into helping member countries manage repayment and avoid default, resulting in a long and protracted process that could put the Fund's balance sheet in jeopardy. Hence, we agree with the points made in Box 4, that the Fund needs to maintain sufficiently large precautionary balances to offset arrears and demonstrate that its balance sheet is strong even under adverse circumstances, while buttressing the status of the reserve positions in the Fund as high quality international reserve assets.

The Board agreed to the staff's proposal to double the amount of precautionary balances to SDR 10 billion in November 2002, but most Directors called on the staff to look into a more analytical approach in assessing the Fund's credit risk, as well as in determining the appropriate level of precautionary balances. The current staff paper clearly shows that the search for a more systematic approach is complicated and fraught with many uncertainties. The various approaches detailed in the background paper were useful in indicating what was not suitable, and we thank the staff for the thorough review. At the end of the day, we think that the decision is still a matter of judgment. Nevertheless, we agree with other Directors who have stated that an informed judgment based on all available information and data is the way forward. Given the shortcomings of existing credit risk models and scenario analyses, we wonder if the staff could have instead developed a risk assessment model that would take into account the unique characteristics of the Fund. This could mean using a range of models rather than just one, as Mr. Brooke and Ms. Stuart are suggesting, but we would ask the staff to explore further the possibility of developing a financial risk assessment that is consistent with the Fund's mandate as a special creditor.

In raising the level of precautionary balances, we share the view that resources should come more from investment income. We caution that, if the pace of accumulation has to be accelerated, the burden should not be passed unduly to good borrowers of the Fund.

The Fund's Articles of Agreement do not recognize financial losses until the country in arrears withdraws from membership. In considering the way forward, the Fund should review its risk management practices as a whole, including a fundamental relook at the way "losses" are accounted for, and the probabilities of bigger protracted arrears and/or defaults occurring in future. Beyond the provisioning for protracted arrears, i.e., holding sufficient precautionary balances, we might need a more comprehensive review of how to manage financial risk of the Fund effectively. With regard to the Fund's access policy, we look forward to the review of the exceptional access framework. The decisions from the review would need to be taken onboard the Fund's consideration of its financial risk and precautionary balances.

Mr. Usman and Mr. Atoloye submitted the following statement:

Introduction

In line with the Board decision on the subject at the last review, we note that the staff has attempted to incorporate other relevant indicators into the risk analysis. For instance, credit outstanding has been added to credit capacity as part of the measurement of the level of the institution's exposure. The review has also been enriched with detailed analyses on developments in Fund exposure and credit concentration. We welcome these important improvements, as they make for a more balanced analysis of the Fund's financial risk.

However, as the staff admits, assessment of the Fund's financial risks, and by extension its precautionary balances, would still be largely judgmental, especially in light of the unpredictability of the global environment within which the institution operates. Considering this limitation, it must be emphasized, therefore, that this policy lends itself to regular review, as changes occur in the global economy and in emerging markets.

Implementation of Policy on Access and the Level of Fund's Income

We see a problem with the situation in which the Fund's income is closely linked to the surcharges on the SRF. In Box 3 of the paper, the staff alluded to the fact that there is likelihood of income losses in the face of low level of credit. In this respect, there is a need to balance the credit exposure policy with the need to earn income to undertake the Fund's increased responsibilities and run administrative expenses. The staff may want to comment on how to go around this issue, especially in the light of experience

as analyzed in the paper that, members in overdue obligations or arrears often give priority to the repurchase of SRF resources to other outstanding facilities in a bid to avoid the surcharge.

Treatment of the Fund as a Preferred Creditor

From the analysis in Box 1, our understanding is that the Fund has not been confronted with the reality of the need to apply the preferred creditor status. For instance, the staff admitted that, "...creditors have not legally subordinated their claims to those of the Fund." While it can be sensed that the application of the preferred creditor status with the official creditors poses no difficulty, it may not be safe to say the same of the Fund's success with private creditors as recent development with Argentina's creditors seems to indicate. The pertinent question to ask then is, whether the Fund is well positioned to handle this probability, with the potential of completely overhauling the institution's ability to provide financial support to members, and by extension the ability to resolve any resulting emerging crisis and contagion. This could change the picture of the institution's level of financial risk, even beyond what is being projected, thus, calling for a higher than the current level of precautionary balance.

Maintenance of Adequate Precautionary Balances

To hedge against risks and allow the Fund to play its catalytic role in an unpredictable global financial system, it is imperative that adequate level of precautionary balances be held at all times. The staff has vividly brought out the need to do so in the paper, but what remains to be addressed is the appropriate level to set aside, given that a standard approach to the risk model, specific to the institution in view of its peculiarity, is yet to be established. In our opinion, and as the staff admitted, the current role of the Fund in capital account crises is fluid, as it is not expected that the situation will persist, especially in the context of the various policies and guidelines that have put in place to forestall their reoccurrence. What is adequate for one period, therefore, may be otherwise under a different circumstance. To that extent, we agree that the current level of annual reserves being set aside may be adequate for now, considering the amount of stability already established in the emerging markets, and that the level of precautionary balances should be reviewed regularly as the situation demands.

Ability of the Fund to Handle Arrears by a Member with Large Credit Outstanding

We support the maintenance of the burden-sharing mechanism, and believe that in addition to the policies on overdue obligations and adequate precautionary balances, the Fund should be able to weather the storm in the event of a member with large credit outstanding falls into arrears. The staff

has indicated a case in which that has happened without impairing the credit capacity or the credibility of the Fund. We want to add, however, that this exposure can be minimized by ascertaining that, while no single borrower exceeds a reasonable proportion of the total level of credit outstanding, the exposure should also be assessed in proportion to the level of precautionary balances. In other words, a threshold should be established to limit the accumulated purchase by a single large member to the level of precautionary balances.

Finally, we feel that the policy on the appropriate level of precautionary balances should be the subject of constant review without the need to adopt a rigid framework that will tie down usable funds that could otherwise be available to the Fund to play its catalytic role.

Mr. Martí and Mr. Martínez submitted the following statement:

We welcome this report and agree with most of its points. We will limit ourselves to only a few points.

The staff rightly notes the importance of the Fund's preferred creditor status. As it has been mentioned, this status is not based on legal or contractual provisions but on a generally accepted principle. That means that not only the IMF members have to respect the Fund priority when paying debts but also the creditors have to recognize this principle and act accordingly. The most obvious effect of any arrears owed to the Fund would be putting this status into question.

We notice that a great part of the staff document, and also of the statements of my colleagues, is devoted to discussing the concentration of risk in the IMF. That is fully justified as this problem has been identified as one of the main sources of financial risk to the Fund, and we agree with that view. The word concentration is, however, also been used for different concepts. Sometimes concentration is used as a synonym of large exposure for the IMF, sometimes refers to the percentage of the outstanding credit of the largest borrowers of the Fund over the total and sometimes is used as the percentage of Fund credit over the total external sovereign debt of a country. The first two concepts of concentration are well covered by the Fund analysis, however we think that the latter deserves a more in-depth study since its implication to the Fund's preferred credit status are important.

As regards the level of precautionary balances, we think that the target of SDR 10 billion approved by the Executive Board in 2002 remains so far appropriate. Indeed, at the end of the day, the size of precautionary balances is a matter of judgment, as its precise determination is affected by many aspects of the unique character of the Fund (policies, financial exposure, etc.) and it is

susceptible to quick changes. Therefore, we should be prepared to address this issue if the circumstances so require.

Risk evaluation is a basic tool to better understand and quantify the potential risks that the Fund faces. Financial institutions have been using sophisticated approaches to assess credit risk but, given the nature of the institution and the main features of its balance sheet, we would hesitate to advise the Fund to move in the same direction. We have some sympathy for the comments made by the staff on VaR modeling. VaR looks hard at the volatility of the different assets in the portfolio and the correlation between the assets. A strong analytical framework then enables banks to assess losses in case of a market turnaround. The Fund perspective is, however, quite different, because it is concerned with a few large exposures where the risk is a program failure, and therefore inability to repay. Price volatility and correlation are not concepts that relate easily to this kind of portfolio.

We support Mr. Brooke and Ms. Stuart when they refer to the possible use of a scenario analysis. This type of analysis, initially mostly descriptive, has evolved into a sophisticated technique and is highly demanding in terms of endogenous coherence, but finally gives management a well-reasoned account of the risks, or of the cost/benefit associated to the most likely scenarios as a basis for investment decisions. An interesting section of the paper of November 2002 was close to offering this kind of approach but not quite, because numerical alternatives were presented on a stand-alone basis, and not as the result of different scenarios each defined by a unique combination of events. We think that there is room in the Fund for work along these lines.

We find some difficulty in evaluating the real usefulness for the Fund of an approach based on credit ratings. They are commonly used by banks to take risks or set ceilings in their exposure to countries as well as by insurers to stay on cover, or go off cover in certain countries. But we are not sure how this would apply in the Fund. We also know that the World Bank keeps its own internal ratings but are not aware of how they are set or used.

The analysis of the different options to accelerate the pace of accumulation of precautionary balances calls for a more pragmatic approach in the short term. The current low level of the SDR interest rate would negatively impact the process of accumulation of reserves in case a member with a large outstanding Fund credit fall into arrears, as the floor of 80 percent in the rate of remuneration could operate as a constraint. A higher SDR interest rate would increase, from this point of view, the efficiency of the burden-sharing mechanism. From a broader perspective, and if the conditions worsened, a more comprehensive revision of the system to build up precautionary balances could be needed

Mr. Duquesne submitted the following statement:

We thank the staff for an informative and clear set of papers on the level of financial risks facing the Fund.

As a general principle, we agree with the staff that the IMF, due to its unique nature and mission, benefits from several layers of protection to ensure that its financial integrity can be preserved: program conditionality and design, including our four criteria for exceptional access, safeguards assessments of the borrowing countries' central banks, our arrears strategy, and financial reserves. In addition, as emphasized by Messrs. Shalaan and Bakhache and many Directors, the preferred creditor status of the Fund certainly represents a most critical safeguard that should be upheld by creditors as well as by borrowers.

Against this background, the increasing concentration of the Fund's lending over the past years is a matter of concern, in particular since it is likely to remain relatively high, as mentioned by Messrs. Bennett and O'Loughlin:

- SDR 21 billion has been recently shifted from an expectations to an obligations basis for the three largest debtors;

- the Argentine Fund-supported program could be seen as having created a precedent for the roll-over of exceptional access borrowings; and

- Fund credit now represents a substantial proportion of the total external debt of the largest borrowers, which underlines the fundamental role of the IMF and also points to the fragile repayment capacity of the concerned countries.

Indeed, while exceptional access programs were originally designed for short-term assistance to countries hit by a capital account crisis, they seem to be now treated as stable medium-term financings by several large borrowers. This trend is clearly worrisome.

These developments point to the need to target an appropriate level of precautionary balances so as to cover current arrears to the institution and provide a buffer against potential arrears. Given the very unique nature of the Fund, we recognize that determining such an appropriate level remains a matter of judgment but, like Mr. Kremers, we believe that insights from scenario analyses could help the Board reach a fair and balanced judgment. We therefore encourage the staff to further develop in-depth scenario analyses based on estimates for sovereign default probabilities, to assess the consequences of the accumulation of arrears to the Fund by its largest creditors.

Regarding the pace of accumulation of precautionary balances, the staff underlines that surcharge income could have been far higher if the SRF had been used in all exceptional access cases. We, therefore, support Mr. Bischofberger's and Ms. Wolff-Hamacher's insistence that we ensure a consistent application of the rule that exceptional access would in general be granted under SRF terms. A stronger presumption for use of SRF in exceptional access cases could even be worth considering in that regard. Another venue to accelerate the rate of accumulation of reserves lies with the possibility raised by Mr. Brooke and Ms. Stuart that the investment return on the existing reserves could be added to the reserves each year, rather than being used as a contribution towards the Fund's administrative budget.

To conclude, we would like to insist on two points. First, as proposed by Ms. Jacklin and Mr. Baukol, we could build upon our current procedures on exceptional access to request from the staff, in each case, an in-depth scenario analysis of the consequences of the non-repayment of the financing under consideration. Such an analysis should, of course, remain confidential but we believe it would help the Board assess the risks underlying any exceptional access decision. Second, the best safeguard to Fund's lending remains the strict and consistent application of our policies on access and conditionality. Indeed, more than prudent credit management, the strength of our first and main line of protection is ultimately a matter of governance of the institution.

Extending his remarks, Mr. Miyoshi made the following statement:

In our preliminary statement, we focused on the discussion of the possibility of adopting an analytical framework for assessing the level of precautionary balances. However, since many Directors referred to the level and pace of accumulation of precautionary balances, I would like to add our comments on these points.

Our position remains basically unchanged since the last Board discussion in November 2002. First, the Fund's precautionary balances should be increased, possibly even above the current target. The last time we went along with the staff's proposal to roughly double the precautionary balances to the current target of SDR 10 billion, but we are not really convinced that this target was appropriate. The scenario analysis in the background paper is somewhat reassuring, but this is based on arbitrary assumptions, as we pointed out.

Second, while we would not argue strongly at this time, we tend to think that there is a case for accelerating the pace of accumulation. We continue to be concerned about the prospect that the Fund's finances will remain exposed to substantial risks until the precautionary balances reach at least the current target. As Mr. Kremers highlighted in his thoughtful

statement, the likelihood of arrears by our largest borrowers is not entirely hypothetical. We should not ignore the potential leverage to be gained by them through the threat of arrears. In this connection, I would be interested in knowing the projection of the amount of surcharge income, on which the pace of accumulation largely depends.

In any case, we strongly believe that there is no room for complacency. The Board should review the adequacy of the level and the pace of accumulation of precautionary balances with sufficient frequency. On ways to help the Board make an informed judgment about the risks to the Fund, we join Mr. Duquesne in supporting the suggestion by Ms. Jacklin and Mr. Baukol that the staff provide information on the size of the proposed exposure relative to that of the precautionary balances in exceptional access cases.

Finally, I would appreciate the staff's views on the usefulness of scenario analysis, given the severe shortcomings of the mechanical approach. The staff seems to view the scenario analysis as the only method that holds some promise, but it presents negative views at the same time on quantitative approaches, which could include this analysis. Therefore, the staff's comments would be welcome.

Mr. Mirakhor asked whether there was an investment account in the Fund. Mr. Brooke and Ms. Stuart, on page 4 of their preliminary statement, had noted "the possibility that the investment return on the existing reserves could be added to the reserves each year, rather than being used as a contribution towards the Fund's administrative budget." However, the Pamphlet Series No. 45, Sixth Edition, *Financial Organization and Operations of the IMF*, page 24, indicated that although the Fund was authorized to establish an investment account in the General Department; to date, no decision had been taken to this effect.

Mr. Callaghan made the following statement:

There is much food for thought in the staff paper and in Directors' preliminary statements. The issues go well beyond the appropriate level of precautionary balances. The key points we would emphasize are that we need to explicitly acknowledge the risks to the Fund's financial position from all lending decisions, particularly exceptional access, and also the implications for members should these risks eventuate. We cannot assume that the layers of protection will always ensure the financial integrity of the Fund.

As important as it is, we cannot guarantee the continuation of the preferred creditor status, and we cannot ensure that the precautionary balances will always be at a level that would put the financial position of the Fund beyond question. There has to be more explicit recognition that, should a

major debtor go into arrears, then we will need to use maximum flexibility in the burden-sharing arrangements.

If we really wanted to ensure that the Fund's financial position was always beyond question—to use the wording from the paper—we would need to change the policy on exceptional access so that the Fund's exposure to any country is covered by the burden-sharing arrangements and the level of precautionary balances. If this is too limiting, then we have to ensure that lending decisions, particularly involving exceptional access, minimize the risks to the Fund. Most importantly, we need to be explicit as to the cost to members of building precautionary balances, as well as the cost of the possible need to change the burden-sharing arrangements.

The first of the issues listed for discussion seeks Directors' views on whether it is essential that the Fund continue to be treated as a preferred creditor, and that the Fund maintain adequate precautionary balances to ensure that the Fund's financial position is beyond question. "Yes" may be the obvious answer to both propositions, but simply stating it does not make it happen. Rather than a statement, this issue should be posed as a question: Can the preferred creditor status and an adequate level of precautionary balances be maintained such that the Fund's financial position remains beyond question?

The answer to that depends on what lending decisions we take and what risks we incur. The Fund's preferred creditor status does not have any statutory underpinning. It is important, but it cannot be guaranteed or enforced. When a user of Fund resources chooses not to meet repurchase obligations, it is essentially rejecting the concept of Fund preferred creditor status. So, if we cannot rely totally on the preferred creditor status to put the Fund's financial position beyond question, is the answer to rely on precautionary balances?

Events would seem to justify the decision in 2002 to double the target for precautionary balances but, like some other Directors, we were concerned at that time with the arbitrary nature of the decision. We felt that there needed to be more robust underpinnings as to the appropriate target level of precautionary balances. The supplementary paper for today provides an outline of different credit risk modeling techniques, as well as the shortcomings with those approaches when applied to the Fund. Directors have also pointed out the problems that can all add inputs into making judgments about the risks facing the Fund and, as such, they are not a waste of time.

But Mr. Brooke and Ms. Stuart raise a valid point that, looking at this paper and the 2002 paper, the rationale or justification behind a given level of precautionary balances seems to be different. The main operational problem for the Fund is that, unlike other institutions, it cannot rely on diversification

as a key risk-mitigating instrument. It is clear that determining the appropriate level of precautionary balances is a matter of judgment, and financial scenario analyses may be the most useful guide for making that judgment.

The background paper outlines that, if a large borrower with exposure of SDR 10 billion incurred arrears to the Fund, the burden-sharing arrangement—without adjustments—could absorb about one-third of interest arrears, and that precautionary balances of the targeted level—namely, SDR 10 billion—would just be sufficient to offset the impaired credit if there were no other arrears. An immediate reaction is that the level of precautionary balances is well below SDR 10 billion. We have other arrears, and the three largest borrowers have a combined exposure well in excess of SDR 10 billion.

However, as Mr. Brooke and Ms. Stuart point out, the full application of the burden-sharing mechanism could withstand larger arrears cases. Hence, we need to be explicit that, if a major borrower went into arrears, the burden-sharing arrangements will likely have to change, a point that Mr. Shaalan makes. Charges will go up and the rate of remuneration will fall. This is not a palatable outcome, but we need to explicitly acknowledge the risk. Members have to be clearly aware that it is a possible outcome from decisions we take, particularly decisions regarding exceptional access.

Going back to the proposition in the paper, the Fund cannot maintain precautionary balances that will ensure that the financial position of the Fund is always beyond question unless there are changes to our lending practices, particularly involving exceptional access. Credit concentration will likely remain a prominent feature of the Fund's loan portfolio—in fact, we hope that it is very concentrated, because it means economic and financial crises are not widespread—and the use of Fund resources will remain unpredictable.

It is not possible to adjust the level of precautionary balances at the same time as credit and credit concentration change. If precautionary balances are to ensure that the financial position of the Fund is beyond question, then the increased risk to the Fund when credit rises sharply has to be anticipated well ahead of time, which seems impossible. We need to take into account the cost of building up very high precautionary balances to cover future, unspecified risks. It is not costless.

Alternatively, the Fund's lending has to be dictated by the level of precautionary balances and what can be covered by burden sharing, that is, placing a maximum exposure limit for any country such that, in the case of arrears, the loss of income to the Fund would be covered by burden sharing and precautionary balances. Again, this assumes that only one major borrower will go into arrears. But some Directors believe that the maximum exposure limit will be too limiting and, as the staff says, it penalizes large countries. Nevertheless, perhaps we should reflect a bit more on the implications of this

option, or at least have a higher test when access goes beyond the point where exposure to a member is not covered by precautionary balances and burden sharing when, by definition, we are exposing the Fund to increased risks.

So, where does this leave us? We believe that the paper raises issues that need to be taken further. It raises matters that need to be addressed when we review the experience with exceptional access. Importantly, we should ensure that we only enter such arrangements if we believe that the Fund-supported program will lead to a sustainable debt position. Many Directors have emphasized this point. Yet, the application of the principle is sometimes the hard part. The Fund does take the risks—and we take big risks. Then we have to explicitly acknowledge—and accept—that remedial action may be needed to address the financial position of the Fund in case a major borrower goes into arrears.

Building up precautionary balances is one consequence. It may also involve making full use—and even extending—the Fund’s burden-sharing mechanism by increasing charges and lowering the floor on the rate of remuneration. Perhaps most fundamentally, we need to explicitly acknowledge the actual and potential costs to members of the risks incurred with lending decisions, particularly exceptional access. As noted, this includes possibly higher charges and a lower rate of remuneration as part of the burden-sharing arrangements.

Some Directors have suggested that, in advance, we should speed up the rate of accumulation of precautionary balances by lifting the basic rate of charge or the surcharge, or lowering the rate of accumulation. Even now, doubling the level of precautionary balances is not costless; there is an opportunity cost to members. What seems to be missing is more explicit recognition at the time of approving the use of Fund resources—particularly exceptional access—of the potential financial implications to all members, for we are potentially saying to members using Fund resources that, because of decisions taken with respect to exceptional access, the rate of charge they are paying has to be increased or remuneration reduced.

This prospect has to be clearly on the radar screen when lending decisions are made. We need to beef up the assessments of the risks to the Fund—and explicitly the risks to members—when exceptional access decisions are taken. The paper prepared for the Argentine program last September was good, but we need to extend it and specifically incorporate it into the decision-making process—the suggestion by Ms. Jacklin on this point is very relevant—and we need to ensure that exceptional access is always on SRF terms. In particular, we need to take a decision whereby precautionary arrangements involving exceptional access are on SRF terms. When are we going to fix the anomaly exposed by the recent Brazilian program?

Mr. Kiekens made the following statement:

It is imperative for the Fund to protect its financial integrity and the continuity of its functioning, by limiting its risks and by cautiously managing the risks it accepts.

This requires the Fund to give credit to a country only when there are adequate assurances that repayment will be made within the normal period for repayment. There must be adequate conditionality that preserves or restores a sustainable external position. And it also requires a commitment from the borrowing country to scrupulously respect the Fund's preferred creditor status.

I need not comment further on Fund conditionality and access policies, which are not the subjects of today's agenda. But I would like to offer some brief comments on the Fund's preferred creditor status.

From time to time, it has been said that no firm legal basis exists for the Fund's preferred creditor status. This is seen as weakening the expectation that a country having repayment difficulties will repay the Fund prior to other, non-preferred creditors.

I recognize that serious complications could arise if other creditors decide to challenge the Fund's preferred creditor status. But we need not be too disturbed by the absence of an explicit statutory basis for that status. I do not think that an explicit statutory basis is indispensable, as long as there is no statutory mechanism for dealing with defaults by sovereign borrowers.

In private bankruptcy proceedings, a statutory basis for a creditor's preferred status is indispensable. The administrator of a bankrupt estate must use the proceeds of the assets to repay creditors in accordance with well-established legal rules, which basically call for *pari passu* distribution. This can be superseded by preferred creditor status where there is collateral, or where the law recognizes certain claims as preferred. Another exception to the *pari passu* rule applies to creditors who have agreed to be subordinated, and hence to be paid only after other creditors have been fully paid.

So far, however, none of this applies when a sovereign country has payment difficulties. Whom a sovereign debtor pays first is essentially determined by its own decision. As long as a country is strongly determined to uphold the Fund's preferred creditor status and pay the Fund first, there is little risk that other creditors could succeed in preventing it. In fact, the present international legal order provides that sovereign assets, including a country's international reserves, benefit from immunities of attachment, unless that country has waived its immunity.

It is thus critical for central banks and other agencies holding a country's international reserves not to waive their immunity from attachment. The Fund should further examine whether this should not be an explicit commitment by countries that draw on the Fund. Such commitments should not be part of Fund conditionality, which, as we know, is not legally binding, but is merely an expression of policy intentions. The commitment not to waive immunity should be made legally binding and ancillary to the country's repurchase obligations to the Fund.

In the same vein, I invite the staff to examine further whether it would be useful to seek explicit commitments from borrowing countries that, in the event they experience payment difficulties, they will repay the Fund before any other creditor (unless that other creditor is recognized by the Fund as a *pari passu* preferred creditor).

In addition, I ask the staff to monitor closely any potential threat to the Fund's preferred creditor status, and to consult closely with any country whose intention to repay the Fund first is challenged by its private creditors.

Let me now come to the real topic of today's agenda, namely, the level of the Fund's precautionary reserves, the pace at which these are built up, and the sources of their financing.

Let me begin by confirming my continued support for the Fund's decision, in November 2002, to build up precautionary reserves to an amount of SDR 10 billion. We do not have to decide today whether or not a higher level is needed. That question will have to be answered once we have reached the goal of SDR 10 billion. At that time, we could decide to go on building up reserves by continuing to levy the present rate of charge and surcharges. Or we could decide to stabilize the reserves by lowering the rate of charge and surcharges. And a third option might be to keep the Fund's net income, including from surcharges, substantially positive while distributing to the membership that amount of reserves that would become excessive, i.e., above SDR 10 billion.

I think it is most likely that, when reserves reach SDR 10 billion, the Fund will choose Option 1, which is to continue to build up higher reserves without lowering surcharges, while automatically narrowing the spread between the SDR rate and the rate of charge.

Should the Fund increase the pace at which it is building up precautionary reserves of SDR 10 billion?

This question has no easy answer, since the level of the Fund's risk of defaults by its debtors during the next five years is hard to assess. It is true that Argentina's crisis has significantly increased the likelihood that Argentina

will be temporarily unable to repay the Fund. But up to now, the Argentine authorities have recognized the Fund's preferred creditor status. The difficulty of reliably predicting the default risk of the Fund's loan portfolio stems from two factors. First, the probability of default is very low and not well documented by statistically significant observations. Second, the dispersion of risk is very limited, because the Fund normally enters into only about 10 new arrangements a year, which typically last about two years. More importantly, the Fund's loan portfolio has always been highly concentrated on a few large borrowers. The present level of high concentration is not unique. Indeed, substantially higher concentration levels have been observed in the past. Today, the Fund's largest claim represents about 30 percent of its total portfolio, and the three largest claims total about 70 percent. This concentration of risk falls just short of last year's peak, which was the highest concentration over several decades. However, during most of the 1960s, the Fund's claim on its single largest borrower exceeded 50 percent, at times rising to 60 percent, of its total portfolio. During that period, the Fund's three largest claims totaled well above 70 percent and peaked at 80 percent of its portfolio.

I believe that risk-based assessment methods have significant limitations in the case of the Fund. They cannot take the place of the political judgment that must necessarily underpin decisions about the level of precautionary reserves, and the speed of their accumulation. Like Mr. Kremers and Mr. Duquesne, I encourage the staff to develop scenarios illustrating the effects of possible defaults on the evolution of the Fund's precautionary reserves, and the rate of charge that would be needed if the total amount of deferred payments should exceed the limits of the burden-sharing mechanism.

I regret that today's paper, unlike the paper of November 2002, does not provide such illustrative scenarios. For example, it was informative to learn from the November 2002 paper that, if the portfolio of credit in good standing was SDR 40 billion, the nonpayment of a credit of SDR 15 billion would require a margin of 233 basis points above the SDR rate for borrowers. If the portfolio of credit in good standing were only SDR 20 billion, the required margin would rise to no less than 738 basis points.

In addition to this margin over the SDR rate, borrowers under the SRF would incur surcharges of 300 to 500 basis points. This convincingly shows that the Fund would very quickly surpass the upper limit of the burden of deferred income stemming from defaults that borrowing countries could shoulder on top of the financing of that part of the administrative budget (including the administration of the PRGF-HIPC Trust) that is not financed by income from non-remunerated reserves.

Indeed, countries like Russia, Algeria, and even Brazil and Turkey, would seriously consider repaying the Fund early if the total cost of Fund lending were to exceed the cost of borrowing on the international capital market. And for the Fund to charge interest rates that approach or exceed market rates would undermine the economic rationale for its preferred creditor status.

This brings me to a serious weakness in the Fund's financial strength, namely, the narrow and lopsided basis of the income from which it must finance the costs of its operations (i.e., the administrative budget). This weakness is not addressed in the staff paper.

The founders of the IMF in 1945 were visionary in giving the Fund an unprecedented jurisdiction over exchange rates and exchange restrictions for current transactions. But they created a financially weak institution when they denied it the authority to levy fees from its members to finance its many services. The only significant source of income for the Fund allowed by the Articles of Agreement is the margin in its lending transactions, with the possibility of asking creditor countries to provide convertible currency at a rate of only 80 percent of the risk-free market rate, and to ask borrowers to pay whatever margin over the basic rate that may be decided by a 70 percent majority of voting power.

It is not surprising that with such a narrow income base, the Fund has made losses in many years of its history. Indeed, the Fund ran losses in every year but one between its inception to 1956, in most of the 1970s, and in 1985. From 1958 until 1972, the Fund utilized a gold investment program to generate additional income to offset losses and build up reserves against future losses. But nowadays, gold is not used at all to generate real income for the Fund. The infamous gold transactions of five years ago to finance the HIPC Trust Fund were machinations to shift the burden of transferring resources to the poorest countries onto the shoulders of borrowing emerging markets.

Today, the Fund's real annual income from the subscription of quotas is limited to about SDR 13 million (consisting of the SDR income from about SDR 730 million in the non-remunerated reserve tranche). This is about one percent of the amount that is annually paid by the borrowers in the form of commitment fees, charges, and surcharges, and the SDR 100 million income generated by the non-remunerated precautionary balances that have been almost entirely built out of contributions from borrowers.

The speed with which the precautionary balances accumulate depends almost exclusively on surcharges over and above the rate of charge. But the Fund's deliberate policy is to avoid exceptional access, which means also avoiding surcharges. This weakness should be remedied in a balanced and

neutral fashion by broadening the base for surcharges, lowering the rate of remuneration for the Fund's creditors, and eliminating the illogical disparities between the surcharges for the SRF and those for high access under Stand-By and Extended Arrangements. This broadening should not aim at increasing the speed of reserve accumulation but should strive to stabilize the sources of financing.

Today, surcharges are levied solely for high access credit. However, defining high access as 100 percent of a country's actual quota is often economically irrelevant and therefore arbitrary. If we continue to use escalating surcharges, they should be based on more relevant criteria for measuring the relative size of a loan, and should escalate with the duration of outstanding obligations. Today, the Fund charges the highest interest rates on the credit facility with the shortest maturity. This is an aberration. The best way to correct it would be to abolish the SRF.

It is not only reserve accumulation that has a narrow and unstable financing base. The same is true for the Fund's budget, which creates another serious financial vulnerability. Today, financing the costs of the functioning of the Fund almost entirely depends on the Fund's ability to give new valuable credits to its members. It is well accepted that the cost of credit should cover the administrative expenditures related to credit activity and the financial risk that credit implies. But the Fund charges borrowers not only for the cost of credit but for all other Fund expenditures, such as the cost of surveillance, the cost of monitoring standards and codes (including AML/CFT), the cost of technical assistance, the cost of managing the PRGF-HIPC Trust, the cost of actuarial shortfalls in the pension Fund, and the costs of other operational risks of the Fund that are not or cannot be covered by insurance. The latter could include some catastrophic costs connected with the pension fund, the health care plan, or the Fund's buildings.

As I see it, the recent decisions to levy substantial interest surcharges for certain kinds of credit were occasioned not only by the risk of those credits, but also by the need to accumulate financial resources to finance future budgets in case the Fund's loan portfolio should suffer a substantial decline. This is candidly (though cryptically) acknowledged on paragraph 40 of the staff paper, which says that: "other potential risks (than credit risks)... point to the need for higher precautionary balances, including the risks from the Fund's increased responsibilities and related growth in administrative expenses." In other words, the Fund needs to build a capital base whose income will help cover salaries and other administrative expenditures. Today, countries that draw on the Fund's general resources are asked to finance or cover not only the costs and risks associated with those credits, but also all other costs of the Fund for the current fiscal year, and to some extent for future years.

I would like to conclude as follows:

The Fund should continue to build up precautionary reserves to a targeted amount of SDR 10 billion.

There is no convincing argument for speeding the pace of reserve accumulation. And in any case, there is little room to do so under the Articles of Agreement, if the Fund, as a preferred creditor, wants to give credit at a “preferred” interest rate.

We must become fully aware that the Fund’s financial base is small, lopsided, and unstable. We should strive for a broader, more stable base. Ideally, this would involve the entire membership in financing the cost of surveillance (including FSAPs and ROSCs); and finding a more equitable way of financing technical assistance and the Fund’s work for the HIPC-PRGF Trust. This could require a change in the Articles of Agreement, but even without such a change, there is room to involve creditors in the financing of the Fund, by lowering the rate of remuneration, and in the financing of the PRGF Trust, by obtaining more contributions.

We must also be aware of the distorted incentives that stem from the present financial structure. Creditor countries do not hesitate to give the Fund new tasks because the majority of them do not have to contribute to the costs that the new duties entail. Any additional Fund credit implies a reduction of the cost for other users of Fund credit. This gives borrowing countries no strong incentive to exercise prudence when deciding on new credits, or to insist that other debtors make early repurchases when their balance of payments improves. Creditor countries also prefer to avoid enforcing the early repurchase rule because countries with a strong balance of payments are seen as a good source of income without significant risks. Even worse, if the Fund’s finances ever become seriously strained, it would create an incentive to weaken the rigor with which the Fund grants credit, because such credit is the Fund’s only source of income.

We should be careful about the message we give the public concerning the topics we are discussing today because of the difficulties in our relations with a certain important debtor country.

Mr. Mirakhor thanked Mr. Kiekens for his excellent and substantive statement, which traced the fragility of the Fund’s financial structure to 1945, and he requested that Mr. Kiekens’s statement be circulated. He wondered whether Mr. Kiekens would agree that, if the Fund had been allowed to issue SDRs as predicted, perhaps the situation would not have been as critical as it currently was. Mr. Kiekens also had laid the foundation for the decision that the Board should not change the policy on precautionary balances at the present time. Of particular concern was the signaling effect of changes to the present policy on precautionary balances. Credit risk analysis, in itself, was acceptable, but, as some Directors

had pointed out in their preliminary statements, there was a risk of self-fulfilling prophecies associated with it, particularly at the current juncture.

Mr. Kiekens said that he agreed with Mr. Mirakhor on the latter point, as the Fund was currently in a difficult situation with a major debtor country, which might have some difficulties in repaying the Fund. Thus, special care should be exercised in sending out the message related to the current discussion to the markets.

With respect to Mr. Mirakhor's comment about the issuance of SDRs, he did not see it as a possible solution, Mr. Kiekens continued. The SDR Department of the Fund was not functioning as a central bank. It would not have seigniorage from issuing SDRs because the accounts in the SDR Department were balanced on a net basis, with participants that were net users of SDRs paying those who had SDR holdings in excess of their initial allocation. The SDR Department was therefore a closed department, without any revenue potential for the Fund. There was a cost, to some extent, which had to be administered, but that was covered by the users of SDRs. The staff might wish to elaborate further whether the SDR would have been a solution.

Mr. Mirakhor added that Mr. Kiekens would agree that, aside from the factors that he had mentioned, had the Fund been permitted to issue SDRs, as predicted, it would have positively affected the resource base of members, thus helping to prevent some of them from falling into the difficult situations as at the present time.

Mr. Zurbrugg made the following statement:

I thought I had a pretty good grip on how the Fund is financed and I have been reading a lot of things, but after this comprehensive statement of Mr. Kiekens, I think I have to go back to the books or maybe ask the staff to give us a briefing. Anyhow, I listened carefully and will try to digest that afterwards but I might need some help to understand all the intricacies. I cannot offer such a comprehensive statement, and I will try to stick more to the question of financial risk in the Fund and be relatively brief.

After reading the preliminary statements and hearing the various statements, there seems to be a general concern that risks have increased, but in drawing the conclusions, Directors seem to be divided into two camps. One camp adopts the wait-and-see attitude and adheres to the decision taken in 2002. The other camp considers that that is definitely not the right approach; we need to do something now and be more proactive. Mr. Kiekens has highlighted that, as of now, we are not in a critical situation in terms of credit concentration compared to the 1960s. But I think that we have to be careful not to use that as a standard.

Some of the recent incidents have made the situation a bit more difficult and complex than it was in the 1960s. Here, I particularly would like to underline the problem that a large borrower has fallen temporarily into

arrears; I do not think that the United Kingdom was ever close to that. There is pressure to roll over outstanding credit, and this has underscored the risks associated with large credit packages. Last, but not least, the Fund's lending into arrears policy has created a new environment that poses new risks to the Fund's preferred creditor status. I took note of Mr. Kiekens's comments on this issue that we might be well-advised to look into forms of increasing a country's commitment to the preferred creditor status, and I look forward to the staff's comments on his proposals.

What do these increased risks imply for the Fund's risk control system, which was built basically on two pillars—the application of adequate safeguards to Fund resources and the maintenance of the appropriate level of precautionary balances? In our view, we are among those who find that both pillars need strengthening. Like Mr. Bischofberger and Ms. Wolff-Hamacher, I do not quite agree with the staff's assessment that there has been no material development that would suggest reconsidering the judgment regarding the target level of the Fund's precautionary balances. I think that there has been a qualitative change since our last discussion and, like Mr. Padoan and Mr. Lombardi, and others, I think that a faster rate of accumulation and a higher level of precautionary balance should be our goal.

Let me first turn to the application of the safeguards, which is the first pillar. Like Mr. Miyoshi, Mr. Kremers, and others, I think that strict implementation of the framework for exceptional access is particularly important for maintaining the safeguards, given that the above-mentioned developments in the Fund's loan portfolio were very much driven by a few cases of high access. Several colleagues have suggested proposals to modify our exceptional access policy, and looked into ways of how we can reinforce it. My bottom line would be that, if we were implementing the decision that we have adopted, we would have probably taken a lot of the problems that we are currently facing out of the system.

It is important that the surcharge is applied both to internalize the costs of higher financial risk to the Fund and to set the incentives for prompt repayment. The fact that one large borrower has been a constant member of the top 5 for the last 20 years is quite revealing, as is the evidence presented by the staff that surcharges have prompted early repayment. The increasing provision of exceptional access on credit tranche instead of SRF terms undermines the principle of adequately pricing risk. As noted by Ms. Indrawati and Ms. Sia, we must ensure that the costs of higher precautionary balances are not unduly carried by normal borrowers.

As noted earlier, our lending into arrears policy poses new risks to the Fund's already preferred creditor status. Recent events and attempts to challenge the status are worrisome. I agree with colleagues who have stressed

that members act in a manner that reinforces the Fund's preferred creditor status.

The second pillar of risk control is the maintenance of the adequate level of precautionary balances. I agree with the staff that assessing the adequacy of precautionary balances is ultimately a matter of judgment. However, like Mr. Brooke and Ms. Stuart, Mr. Padoan and Mr. Lombardi, and others, I strongly believe that the Fund should apply credit risk models and financial scenario analysis for such an assessment. What we need is an informed judgment. Alan Blinder once remarked that we can either obtain quantitative information from admittedly fallible statistical relations, or we can ask our uncle.

The staff's criticism of the applicability of credit risk models to the Fund are sensible; no doubt about it. But the point I would make is that these comments should be taken as a call for caution and flexibility, not as an excuse to take the uncle-asking approach. As noted by the staff, as a principle, precautionary balances should fully cover credit outstanding to members in protracted arrears, and include a margin for the potential exposure to risk-related credit that is in good standing. This margin must necessarily be linked to Fund exposure.

In my view, we need a link between credit outstanding, credit concentration, and the target for precautionary balances. In addition, we need to determine the desired pace of adjustment. While a highly sophisticated model is not imperative, it is important to clarify the links and make the underlying assumptions transparent. Mr. Callaghan made a very strong point about the communication to members about the risks in terms of potential costs at the time of deciding on exceptional access cases.

I was very interested in the supplement. One of the models that were presented there, the CreditRisk+ model, was interesting because it could be relatively easy to implement and would require relatively few assumptions. I wonder if the staff could continue to study how this application could provide a more rational basis for determining our precautionary balance strategy.

A consequence of linking precautionary balances with creditor exposure would, of course, be that the target for precautionary balances would fluctuate. This would deviate from our past policy. I realize that I am on unstable ground, but what I would like to do is just to illustrate the point and see if the staff can come up with something workable. The idea would be that a strict application of surcharges in case of exceptional access is one part of it; that has been covered. The other element would be to use the burden-sharing mechanism. For instance, the rate of charge and the rate of remuneration could be symmetrically adjusted on a regular basis, for example, each financial year,

in order to achieve the desired adjustment in the level of precautionary balances.

This might sound a bit strange right now, because we are moving away from what we have always been aiming at and, as Mr. Kiekens underlined in his statement, this is a long-term goal and we should not be worried about the level yet. But my fundamental point is that this level should not be arbitrarily fixed, but should be linked to our lending decisions. The attractive point here would be that this link to the financial risk to the Fund, which would clearly demonstrate to members that this also could translate into costs for all members—and here I stress all members—would hopefully strengthen the careful application of the safeguards to Fund resources.

Again, my point is that we could try to find a way to link the credit concentration levels to our precautionary balance target. This would then take some form of a moving average, because the pace of increase and the level would both be changing in time. This would again provide the direct link that Mr. Callaghan particularly underlined. Maybe I can follow up with the staff on more details, but the basic idea was the link between Fund exposure and the level of precautionary balances.

Mr. Lushin made the following statement:

We thank the staff for an interesting set of papers. Our specific comments on the issues raised in these papers are as follows.

The main risk to the Fund's resource base comes from the high credit concentration to a few member countries. In our view, this may reflect the fact that our exceptional access framework is not fully coherent. It neither links the amount of exceptional financing with the adjustment effort undertaken by a member country nor provides adequate assurances that this country will be in a position to meet its financial obligations to the Fund. Also, this framework lacks provisions on possible exit strategies from exceptional access to Fund resources, as underlined by Mr. Kremers. If one wants to put in place stronger safeguards for the Fund's resource base, it may be necessary to strengthen the exceptional access framework along with the refinement of our policy on precautionary balances.

Apart from precautionary balances, the Fund also has a prudential balance of about SDR 33 billion, which represents the level of uncommitted usable resources that the Fund would normally not expect to use for financial commitments. We would be interested to hear from the staff if this prudential balance could serve as a temporary safety valve for Fund resources in case of a large non-payment. As described in paragraph 23 of the paper, a prudential balance seems to have the economic meaning and serve the purposes that are not very different from those of precautionary balances. If this is the case,

then the current level of prudential and precautionary balances taken together seems sufficient to deal with potential arrears by a member with large credit outstanding without unduly jeopardizing the Fund's liquidity position. Also we would like to ask the staff if there is any linkage between the target level of precautionary balances and the way the staff determines the size of a prudential balance.

As we have stated on some previous occasions, we are of the view that it is not reasonable to determine the appropriate size of precautionary balances using strictly mechanistic approach. It is important to judge the adequacy of the Fund's precautionary balances within the context of the unique nature of this institution and being mindful about many safeguard mechanisms that are already in place.

On balance, we see the target level of precautionary balances set in November 2002 as broadly appropriate. Regarding the current pace of precautionary balances' accumulation, we note that it is not out of line with our earlier projections. And although today we consider it to be generally acceptable, recent developments indicate that, at some point in a not-so-distant future, the pace of accumulation may need to be accelerated. If this were to happen, we think that both efficiency and equity considerations should be taken into account. Though it is technically easier to lay this additional burden on debtors through a higher basic rate of charge and/or different surcharges, we think that equity considerations would require creditors' participation as well in the context of an enhanced burden-sharing mechanism.

In this framework, we see merit in Messrs. Bennett's and O'Loughlin's proposal that programs with an exceptionally high exposure of the Fund should immediately trigger accumulation of additional precautionary balances as a supplementary safeguard. We agree with them that this option would increase incentives for more prudent lending by exposing other debtor and creditor countries to additional costs of a new large commitment. We also see merit in the proposal of Mr. Zurbrugg to link more closely the required level of precautionary balances with the amount of Fund credit outstanding and credit concentration. In some respects, this proposal echoes the idea of Messrs. Bennett and O'Loughlin.

Finally, concerning the often made proposal to provide exceptional financing only on SRF terms, we would mention that, although the idea is appealing, it already failed to pass the real life test. Let us not forget that, in cases of both Turkey and Brazil, we actually have had to switch from SRF to Stand-By Arrangement financing terms because the former were too heavy for the countries emerging from capital account crises.

Mr. Rutayisire noted that the discussion on precautionary balances seemed to relate to capital adequacy issues. In the context of the latter, the Board, on several occasions, confirmed its view that the Fund's capital remained adequate. He asked if the staff could clarify the linkage between the two topics.

The Director of the Finance Department (Mr. Brau), responding to questions and comments from Executive Directors, made the following statement:

Let me try to address some of the major, more central issues first, before responding to some specific questions. Let me start with Mr. Kiekens and his wish that the Fund had a different financing mechanism. The staff, of course, proceeded with their analysis based on the existing mechanism, and this paper was not the occasion to consider alternatives. In the early 1990s, the Board had extensive discussions about alternatives to address some of the perceived constraints—vulnerabilities, as Mr. Kiekens terms it—and developed the concept of the unremunerated variable norm, which would place costs of the administrative budget differently from the current practice and would call for a change in the Articles of Agreement. I believe Mr. Kiekens alluded to that. During the Board discussions in the early 1990's, there was little appetite for doing so, and perhaps there is limited appetite for doing so now. We have proceeded using the financing mechanism of the Fund that is presently in place.

What I note from the discussion, in particular, are the references of many Directors to the preferred creditor status of the Fund and how important it is to preserve this status going forward in order to protect the financing mechanism of the Fund. The staff agrees completely with this point. Given the fact that the financing mechanism grounded on the preferred creditor status, the Fund is charged, through its Articles of Agreement, to assist member countries in difficult circumstances, subject to adequate safeguards to its resources. Discharging this duty gives rise inevitably to high exposures, because the Fund does not select its clients. Also, it gives rise inevitably to potentially high credit concentration and raises financial risks to the institution in terms of a member not being in a position to discharge its repurchase obligations promptly.

The key financial risk mitigation device, which we have at our disposal and which the Board recognizes, is, of course, the framework for access to Fund resources subject to conditionality and, in particular, given relative magnitudes, the application of the exceptional access framework. This is, from the staff's point of view, the most important risk mitigation device. It calls for, as many Directors have stressed, a strict application of the four criteria in capital account cases that the Board has established under that framework. The staff agrees with that position. We do not discuss details in this paper, because they will be considered by the Board in a separate paper

that reviews exceptional access policy that the Board will discuss in the near future.

I noticed several Directors emphasizing the point that the presumption that exceptional access be provided on SRF terms should be stronger than it has been in the past. There is such a presumption but, as several Directors have noted, the current definition of exceptional access in precautionary circumstances does not allow the application of SRF terms; this is an issue to which the Board will also return to later.

On the appropriate level of precautionary balances, I heard that Directors, at a minimum, reconfirmed the decision taken in 2002 to double the level to SDR 10 billion, and several were of the view that perhaps the level should be somewhat higher. I did not hear any Director call into question the decision that was taken in 2002.

Here, I would rather agree with the position taken by Mr. Kiekens that, under the current system of accumulation of precautionary balances, agreed by the Board, it will take us four to five years to reach the target level. Also, it would be appropriate when the target is reached, and in the meantime, to monitor the adequacy of the level of precautionary balances carefully. Further, when this level has been reached the Board will decide whether it wishes to establish a different target level for Fund precautionary balances in light of the situation at that time.

Several Directors called for consideration of a faster accumulation of precautionary balances and suggested different options for achieving that objective, including (i) activating the burden-sharing mechanism at an earlier stage than currently, perhaps even as certain decisions on access are being taken; and (ii) establishing a higher income target than the current one, which implies a higher rate of charge; possibly by explicitly factoring in that the Fund does not need to pay remuneration, or interest, on its precautionary balances, which currently is used to lower the rate of charge.

These various options are available, and I was rather attracted to Ms. Jacklin's suggestion that these options should be considered in more detail in the forthcoming paper on the income target for the next financial year, scheduled for discussion in April. In that context, the Board will take a decision on establishing the rate of charge for FY 2005, and will have an opportunity to return to the question of potentially faster accumulation of precautionary balances, in light of the circumstances at that time.

A question was also asked in one of the preliminary statements whether it is broadly reasonable to target precautionary balances at SDR 10 billion. This seems reasonable now in light of the Fund's average exposure to large borrowers in the recent past and members' repayments

records. What would happen in an extreme event where two large borrowers failed to repay promptly? If that were the case such an extreme event were to occur, in which a very large share—say, up to 50 percent—of total Fund exposure is not being repaid, the Fund would be in very serious trouble, as would any financial institution. I think that this is a logical response to that question, but I would simply come back to say that it is the strict application of the exceptional access criteria that need to guard against the institution ever finding itself in this kind of extreme circumstance.

We have laid out in the staff paper why we believe that a quantitative modeling of credit risk, the way it is being done in other financial institutions, is very difficult to do, if not impossible, in the Fund. I believe there is fairly wide agreement in the sense that the Board recognizes that the application of actual historical experience—i.e., empirically founded—of nonpayment by a borrower with large exposure to the Fund does not exist.

The historical experience of nonpayment by members relates to many countries that are now PRGF-eligible and, importantly, it relates to a period before the Fund adopted its arrears strategy, which I consider quite successful. So, there has been a parameter shift. Therefore, even if a credit risk model were built that is Fund idiosyncratic, the key parameter of the probability of a member to whom we have large exposure falling into arrears would have to be assumed in a judgmental manner. Given this key consideration, one really wonders how useful or informative such an approach would be for the Fund and whether it merits the considerable efforts that would be needed to pursue it.

Mr. Mirakhor said that he agreed with the staff in at least trying to limit the “what if” questions, the kind of analysis that moved out of the realm of realism and into a fantasy. He called attention to the discussions on the unremunerated variable norm—an idea based on the proposal by one of Mr. Kremers’s predecessors—where hypothetical cases had been considered. In that context, much of the discussion had been repeated over time in an attempt to find alternatives to the pre-existing financing mechanism of the Fund, although Mr. Kiekens’s statement included ideas that went beyond that of the unremunerated variable norm. During that time, the case for the borrowing countries had been that, if the Board were to go to such an extent to consider the hypothetical cases of large defaults, it should first consider, before raising the rate of charge, what to do with its holding of a major asset that remained dormant, earned no returns, and was enormously underpriced. The borrowing countries had the right to ask that question. The Board should be cognizant of the fact that, by venturing too far into the hypothetical realm, it ran the risk of raising some fundamental and basic questions to which there might not necessarily be productive answers.

Mr. Brooke commented that he could not dispute the fact that the Director of the Finance Department had pointed out regarding the lack of historical data for credit risk models. However, data on sovereign performance related to external debt to other creditors existed for a large sample, and those had been used extensively by credit rating agencies and

investment banks to build up their probabilities of default database, given the different credit ratings of sovereigns. Based on the premise that the Fund had the preferred creditor status, credit risk models using those default probabilities could at least provide an upper boundary for a sensible target level of precautionary balances, as, by definition, the Fund would be repaid before any other creditors. That could still be useful information to inform the Board's judgments. The staff was, therefore, encouraged to explore more imaginatively how to apply credit risk models to the Fund.

Ms. Jacklin, reacting to Mr. Brooke's comment, said that she was skeptical about credit risk modeling and agreed with the Director of the Finance Department's opinion that sovereign credit ratings were useful in predicting the likelihood of the Fund being repaid on time if countries were to draw on the Fund in the future. Such ratings, however, were not particularly useful in assessing the adequacy of the Fund's precautionary balances, as the Fund had a unique risk on its balance sheet. The Fund typically lent to countries that were otherwise not creditworthy. Conditionality attached to Fund-supported programs—an effective, unique feature, which commercial creditors lacked—helped to bring those countries back to creditworthiness. It was the Fund's assessments of the degree of ownership, of implementation capacity, and of the potential success of that program that determined whether an arrears problem would be likely to occur in the future. It would, of course, be useful if credit risk models could be created for direct use in the Fund, drawing upon the interesting work that had been done in the private sector. Nevertheless, the risk faced by the Fund and the way the Fund manages that risk were quite different from those of other financial institutions.

Some of the “what if” scenario analyses could be a helpful guide in terms of financial planning, Ms. Jacklin continued. These included, for example, what if one of the large exceptional access borrowers were not to pay on time; what if that were to be a short-term event; what if that were to be a longer-term, more protracted event; what would be the implications for the Fund's income position, and for how long; to what extent could the ordinary burden-sharing mechanism deal with those income effects; to what extent should the rate of charge be increased; and to what extent should consideration be given to the level of administrative expenses and contribution to the Fund's balance sheet.

Mr. Zurbrugg remarked that he shared Mr. Brooke's comments, as he had difficulty with the concept of fixing a quantitative target without a quantitative underpinning. From the transparency perspective, the Fund should be able to defend that target. Ms. Jacklin was correct in saying that there was no model that could be directly applied to the Fund, given its unique characteristics. However, models could be used as a proxy; they could be adjusted to suit the Fund's particular characteristics. For example, CreditRisk+—a model that had been developed by a Swiss Bank—made no assumption about default probabilities and was rather simple. The objective was not to look for a complex mechanistic approach, but one that could offer a quantitative basis for determining the target level of precautionary balances.

The Director of the Finance Department (Mr. Brau) responded that, given the lack of empirical basis, the results of credit risk modeling would depend on the assumptions. Ms. Jacklin had rightly pointed out that using sovereign ratings from the credit rating

agencies in credit risk modeling at the Fund could be problematic, as those ratings were meant for private creditors, who, unlike the Fund, could not influence the policies of country authorities through conditionality.

The staff, however, generally agreed that scenario analysis, which was much simpler, was potentially more useful, the Director said. In fact, the staff had used it, as highlighted in the staff paper for the November 2002 Board discussion and also in the current background paper. As suggested by a number of Directors, the staff could extend its work on scenario analysis in two directions. First, the staff would propose to monitor on an ongoing basis, and, if warranted, inform the Board of, the risk to the Fund's credit portfolio, including the risk of non-repayment and its implications for the capacity of the burden-sharing mechanism. This could be undertaken annually, perhaps in conjunction with a review of the Fund's liquidity.

Second, the staff could include, if the Board wished, a scenario analysis when presenting an exceptional access case to the Board, as suggested by a number of Directors, including Mr. Duquesne, Ms. Jacklin, Mr. Kremers, Mr. Bennett, Mr. Andersen, and Mr. Martí, the Director agreed. Specifically, it could explicitly analyze the impact on the capacity of the burden-sharing mechanism and the adequacy of precautionary balances in case the member requesting exceptional access faced payment difficulties in the future.

Ms. Indrawati remarked that it would be difficult to avoid assigning default probabilities, even in scenario analysis. Whether such analysis would be conducted in the exceptional access exercise, the staff was expected to assign a probability of program success. While she fully agreed with Ms. Jacklin that credit risk modeling and scenario analysis were difficult to apply to the Fund, as Fund operations and risk management were totally different from commercial or investment banks, she had sympathy with Mr. Zurbrugg's and Mr. Brooke's call for an analytical framework for determining the appropriate level of precautionary balances. Although the Fund was not a credit-rating institution, its operations were similar to those of financial institutions. However, there was a danger of self-fulfilling prophecies in Mr. Zurbrugg's argument for transparency in the Fund's assessment of risks, which would be counterproductive. The staff was put in a difficult dilemma—to arbitrarily pick the target level for precautionary balances, or to try to defend that level quantitatively, which ran the risk of venturing into a sensitive issue of assigning default probabilities.

Mr. Callaghan said that, with regard to the implications of a possible default by a member with exceptional access, the case of Argentina came to mind. In the context of the Board discussion in September 2003, a separate paper on *Argentina—Assessment of the Risks to the Fund and the Fund's Liquidity Position* had been circulated to the Board. The paper had noted superficially that, should the country go into arrears, it would be beyond the ability of the current burden-sharing mechanism to accommodate. The staff could go further and examine beyond that simple assessment. In particular, it should indicate what would be the implications for the rate of charge and the rate of remuneration. That type of information would be useful when judging the real extent of the risks.

The Director of the Finance Department (Mr. Brau) replied that the staff could extend that analysis further.

In response to Ms. Indrawati's comment about the arbitrariness in choosing SDR 10 billion as a target level, the Director explained that, in its deliberation in 2002, the Board had considered a scenario analysis presented by the staff, based on the average of high exposure cases in the recent past of about SDR 10 billion. The SDR 10 billion target had been set in this context and fixed arbitrarily. As a central monetary institution, the Fund should be in a position to deal with a situation where a large Fund borrower went into arrears if it were to occur. As it was difficult to anticipate such an occurrence on a probabilistic basis, given lack of empirical evidence, the staff was not making a probabilistic assessment.

Mr. Zurbrugg asserted that that was exactly the point he was trying to make in his preliminary statement. If that was the basis for the staff's rationale for aiming at SDR 10 billion, perhaps the staff should look again at the average of high-access cases and adjust the target level for precautionary balances accordingly. The target could not be static while the Fund's loan portfolio was evolving, which could call for a doubling of that target.

Ms. Indrawati added that there was consensus on the need for adequate precautionary balances; the issue was more on the methodology. As shown in the background paper, with the application of one of the credit risk models to the Fund's portfolio, the appropriate level of precautionary balances turned out to be SDR 14 billion. She fully agreed that assessing the appropriate level of precautionary balances was a matter of judgment, based on reasonable considerations, and not necessarily on a quantitative methodology. Given the nature of the Fund, it would be impossible to apply an explicit quantitative model, and the staff was not encouraged to do so just for fun.

Mr. Brooke said that he had asked for a full explanation as to why the target had been set at SDR 10 billion. At the previous Board discussion, he had accepted that the target level for precautionary balances should be increased to keep pace with the increase in the risks faced by the Fund. However, he had not been satisfied with the explanations and justifications provided in the November 2002 staff paper, which he and a number of other Directors had considered insufficient. That opinion still held.

The staff's arguments for targeting the level of precautionary balances at SDR 10 billion were different from those made in November 2002, Mr. Brooke observed. The Director of the Finance Department had explained that the target level had been determined as the average of the large Fund exposures, but that was certainly not the central argument in the November 2002 staff paper. In that paper, the staff had provided a number of reasons in support of the SDR 10 billion target, including increases in credit concentration, increases in risks related to self-insurance; and the fact that the World Bank had much higher reserves ratios. In the current staff paper, new explanations were given. Determining the appropriate level of precautionary balances should be based on a more rigorous analysis. Such an approach should provide a sensible range, within which the Board could determine how judgment should be applied.

Extending his remarks, Mr. Kiekens made the following further statement:

Ms. Indrawati said that she sympathized with Mr. Zurbrügg and Mr. Brooke, and I sympathize with Ms. Indrawati, Mr. Zurbrügg, and Mr. Brooke, and with all the others. But I disagreed with what they ask, that is, more sophisticated models to underpin the SDR 10 billion target. I have a very simple explanation for the SDR 10 billion. It was a very opportunistic number, and I will explain why. We decided, first, to increase the rate of charge, in fact the surcharges. That was the outcome of a political discussion after the infamous Okinawa Summit in Japan, where the G-7 determined how much it should be, and then we discussed it in the Board. There was a long debate on that, and we ended up with these surcharges.

Then we had to decide what to do with this income, and we decided for the first time that it should go to the free reserves. The staff—and rightly so—skillfully said that we should preserve these decisions in the future, too, but that could only be done if the Board accepts that we would have to build these reserves up somewhat in order to be sure that the additional income that would be generated, SDR 0.5–1 billion a year, thanks to the surcharges, would indeed not be captured in another way but would go to the Fund's precautionary reserves. The amount has been set such that it would be high enough, but not excessively high. So, we agreed on a timeframe of 5–10 years; that would yield about SDR 10 billion. All the other rocket science that may be behind that is, I think, an illustration to show how intelligent we are, but I think it was not more difficult than that.

Second, many Directors advocated a faster accumulation of precautionary reserves. I want to caution that the potential financial survey for doing so is extremely limited. One can consider levying more on the borrowers, but I think, as I have explained, we can quickly achieve a level where the Fund's interest rates approach levels at which countries are borrowing on international capital markets. Turkey is now raising money in the international bond market at 450 basis points. Uruguay—the Fund's largest debtor, with its claim on Uruguay accounting for 24 percent of the country's GDP, hence the Fund's largest risk, which is ten times larger than the risk from Fund exposure to Brazil in terms of GDP—raises money in the international bond market at 5 basis points over the comparable market. So, that is a limited source of financing for increasing our precautionary balances.

On the creditor countries' side, the amount is extremely limited. If we have a portfolio of SDR 55–56 billion, that would mean a remunerated reserve position of SDR 50 billion. At the present SDR interest rates, the net annual contribution from creditors, at the maximum, today is no more than SDR 105 million. You will not build up much more if we see that we have been building up our reserves at the speed of SDR 1 billion a year. At this point in time, SDR 105 million is the maximum that we can ask, under the

present Articles of Agreement, from our creditors. It is SDR 50 billion, times the SDR interest rate of 1.61 percent, times 1/5, minus what we are already charging creditors in the burden-sharing mechanism. If we want to change that limit, we need to change the Articles of Agreement. I accept that Mr. Brau is proposing and discussing something within the framework of the Articles of Agreement but, at some point in time, after one full decade, it could be useful to think about that framework, at least if we are conscious of the very limited financial survey that the Fund has provided under the Articles of Agreement, as I have explained.

I must say that, in 1994, I was in very good company; I signed off on a common preliminary statement at that time with Mr. Posthumus, Mr. Kremers's predecessor, and Ms. Lissakers and Mr. Zoccali, from Argentina, who were equally in agreement with that proposal. I can produce that famous statement for those who are interested. It was supported by 7–8 Directors, from both emerging markets and the largest creditor countries. I am not totally desperate that we could come to something new, because the fundamental problem that we are facing is the following.

Many Directors said—and Mr. Brau also agreed—that the only valid effective answer today is to be much stricter on exceptional access, and that seems appealing. But the question is what we do in reality when we are confronted with a request for SDR 20–30 billion credit again in the future. We would come to the conclusion that, economically speaking, that is the right thing to do, but—and here is the other aspect—the financial survey of the Fund is not large enough to accept that risk. The risk can be large, but the risk or the economic cost for the world economy of not giving that loan can be even larger. We have a very limited financial service, because we have not been given the power to ask our shareholders more than we can. At present—I repeat—it is a meager SDR 105 million from the creditors, not any cent more. We should reflect on whether that is indeed the right position.

Again, colleagues have suggested that we speed up the accumulation of these precautionary reserves. Apart from the SDR 105 million, all of them must come, under the present circumstances, from borrowers, regardless of whether we have an ingenious scheme, as Mr. Brooke said, by not using the income from the nonremunerated reserves for the financing of the budget. If we would do that, the only consequence would be to increase the rate of charge for the debtors. In any case, and Mr. Brau accepted to discuss that in April, when we discuss the income target. Mr. Chairman, I hope you will chair that meeting and you will have an interesting meeting.

The Director of the Finance Department (Mr. Brau) commented that, on the views of the external auditors, as Mr. Mirakhor had recalled in his preliminary statement, in 2003, the external auditors had informed the Board that they welcomed the Board's decision to target SDR 10 billion and the Board's adoption of the framework on exceptional access. The

external auditors had not expressed any views on the pace of accumulation of precautionary balances.

On Mr. Callaghan's question of whether the Fund could ask for a commitment, as part of the standard terms of use of Fund resources arrangements, from a borrowing member to repay the Fund ahead of other creditors, the staff would discuss that possibility with the Legal Department, the Director said.

With respect to Mr. Lushin's question of whether it would be possible, in extreme circumstances, to make use of the prudential balance (a component used to calculate the Fund's forward commitment capacity), the Director explained that the prudential balance, currently defined as 20 percent of the quotas of members participating in the Financial Transactions Plan, served two purposes. First, it was to ensure the liquidity of reserve tranche positions. The second purpose of the prudential balance was to guard against the erosion of Fund liquidity base in the event that creditor members, who were participating in the Financial Transactions Plan, dropped out because of weakness in their external positions. While the Board had agreed generally not to use the prudential balance for financing the Fund's extension of credit, it had discussed the possibility of using the prudential balance on a strictly temporary basis when the institution had limited liquidity, and the use of the prudential balance would be strictly temporary.

Mr. Brooke added that, in his preliminary statement, he had asked how the external auditors had reached the opinion that the SDR 10 billion target was appropriate. It would be interesting to know if that judgment had been made on the basis of any model or analytical framework.

The Director of the Finance Department (Mr. Brau) replied that they had exercised that judgment. They had reviewed the basis on which the staff had made the recommendation to the Board, together with the prevailing circumstances, and had considered the proposed target level of precautionary balances reasonable.

Mr. Lombardi added that, in addition to the views expressed in his preliminary statement on the level of balances, the adequacy of the pace of accumulation, and the importance of having a more articulated framework for determining the optimal level of balances, his chair would like to be associated with the latest remarks made by Mr. Brooke and Mr. Zurbrugg.

The staff representative from the Finance Department (Ms. Metzgen), responding to technical questions from Executive Directors, made the following statement:

I will do my best to respond to a few questions. There was one question concerning the application of the burden-sharing mechanism in the event of arrears by a large borrower, comparing the treatment of this matter in the 2002 paper versus the current paper. In the current paper, the analysis is based on the existing burden-sharing mechanism where the current floor for the rate of remuneration is 85 percent of the SDR interest rate. In addition, the

analysis assumes that all charges, including surcharges, are burden-shared. In the 2002 paper, the analysis was based on the assumption that the burden-sharing mechanism would be modified to set the floor for the rate of remuneration at 80 percent of the SDR interest rate so that overdue charges being burden-shared would only be based on the current rate of charge. Assumptions underlying the model are different.

There was another question concerning the usefulness of an analytical framework in determining what level of precautionary balances the Fund should hold against potential legal and self-insurance risks. Directors will recall that the 2002 paper noted the areas where the Fund self-insures, and explained that estimates of potential losses the Fund might incur in this respect are subject to a great deal of uncertainty. I would note that self-insurance and legal risks as part of the overall risks that the Fund faces are small. Also, these are extreme and unknown events. Though they could be modeled, this might be one case where “my uncle’s view” might have as much weight as the model.

There was a question concerning surcharge income. For 2004, on the basis of existing credit, this would amount to some SDR 600 million, assuming no advance repurchases of SRF credit. We will return to this topic in the context of the paper on the review of the Fund’s income position.

Finally, there were a few very technical questions and also some proposals that were advanced, to which I intend to respond bilaterally.

Mr. Kiekens said that he wished to ask a fundamental question. In accordance with the International Accounting Standards (IAS), the Fund had to maintain precautionary balances that fully covered the amount of impaired loans in case of arrears. Suppose there was a default on an SDR 15 billion loan and interest arrears could be accommodated, the Fund would still need to have precautionary assets of at least SDR 15 billion to comply with the IAS. The current level of precautionary balances was still far below that, which was acceptable. However, it would mean that the Fund was not in compliance with the IAS. How would the Fund deal with that problem?

The Director of the Finance Department (Mr. Brau) responded that, in the event of non-repayment by a borrower with a large exposure that exceeded the Fund’s precautionary balances by a considerable amount, the external auditors might feel compelled to issue a qualified opinion, in view of the associated uncertainty over repayment of the Fund’s exposure. The auditors would explain their reasons for the opinion and would inform the Executive Board and the Board of Governors. The opinion would not, in and of itself, change the facts on the ground concerning (non) payments by the borrower and their impact on the Fund’s financial position.

Mr. Kiekens asked if the Fund would be required to do anything more than reading the auditors’ qualified opinion. Could the Fund continue its normal business despite its not

being in compliance with the IAS? Would that be an irresponsible action? The Director of the Finance Department had mentioned earlier that the Fund would be in deep trouble if two large creditors went into arrears. The problem would not be that serious, however, if that were to be only temporary. Suppose an SDR 40 billion loan were not to be paid, the interest charge—at the current interest rate plus the margin to cover administrative expenditures, which would be about 1.2 percent—would amount to around SDR 800 million a year. The Fund could absorb those interest arrears by using precautionary reserves, which currently stood at SDR 6 billion, without being in deep financial trouble. While that was quite a dramatic situation, it would not force the Fund to stop paying the salaries to its staff, to massively lay off staff, or to stop further lending to member countries as long as this event would not last for more than four years at the maximum. How would the staff see that scenario?

The Director of the Finance Department (Mr. Brau) replied that, if there were arrears from a member with a large exposure to the Fund well in excess of precautionary balances, and if the external auditors would indeed feel compelled to issue a qualified opinion, the Fund would consider activating the burden-sharing mechanism early. The Board had discussed this issue. Also, as provided for under existing policies, measures to address overdue obligations would be implemented. The Board might choose, in the light of the outlook, to supplement the resources mobilized through the burden-sharing mechanism by raising the income target, thus increasing the rate of charge, which required a 70-percent majority of the total voting power. In extreme cases where nonpayment of charges could not be recouped through the burden-sharing mechanism, and in the absence of an agreement in the Board on an increase in the rate of charge, there was indeed a possibility to charge losses of income to precautionary balances. This possibility was one of the reasons for the Fund holding precautionary balances.

Mr. Kiekens noted that the Director of the Finance Department had agreed with the final conclusion, that the Fund had the resources within the limits. The burden-sharing mechanism could, indeed, be activated, as the Director had suggested. Nonetheless, at the current interest rate, only SDR 105 million, at the maximum, would come from the creditors, unless they agreed to voluntarily contribute more or unless the Articles of Agreement were changed. The rest must be borne by those few debtors that were, at that particular point in time, borrowing or continue to borrow from the Fund. If the Fund were willing to charge them whatever interest rate until they made the repayment, there would be nothing else left than to charge to precautionary reserves. In case of a default on an SDR 40 billion loan, interest arrears would amount to about SDR 800 million a year. That was the bottom line beyond all the statements that the Fund would deliver and all the insistence on the few countries to pay what they had to pay.

The Acting Chair made the following summing up:

Executive Directors had a broad-ranging exchange of views on financial risk in the General Resources Account of the Fund and the role of precautionary balances, following up on their discussion of this topic in November 2002. They agreed that mitigating financial risk at the Fund rests

heavily on rigorous implementation of the policies governing the use of Fund resources and careful management of the Fund's liquidity, along with an adequate level and pace of accumulation of precautionary balances. Recognizing that credit risk to the Fund stems mainly from large arrangements with middle-income countries, Directors stressed that sound risk management requires the Fund to be prepared for the possibility of payments disruptions, which could arise from the increase and concentration of its outstanding credit.

Directors emphasized that the Fund's preferred creditor status—that is, members giving priority to repayment of their obligations to the Fund over other creditors—is fundamental to the Fund's role in the international financial system and to the Fund's financing mechanism. They noted that the preferred creditor status has allowed the Fund to take the necessary risk to provide financial assistance to members in exceptionally difficult balance of payments situations, in support of their efforts to implement strong adjustment policies without resorting to measures destructive of national and international prosperity. Directors observed that Fund members have a long history of supporting the Fund's preferred creditor status, which benefits the Fund's membership, official and private creditors alike.

Directors viewed the Fund's policies on access to, and the use of, Fund resources as the most important element of the Fund's risk management framework, along with effective crisis prevention and conditionality in support of strong country-owned programs. They also highlighted the importance of the Fund's safeguards assessments as valuable ex ante mechanisms to prevent the possible misuse of Fund resources.

Directors noted the profound changes in the Fund's lending policies in recent years in response to the changing global environment and the growing financial interdependence of members. They saw the framework for exceptional access approved by the Executive Board in 2003 as a key pillar of the Fund's enhanced risk management framework to cope with the challenges of this new lending environment. In particular, Directors stressed the need for firm application of the criteria governing exceptional access to Fund resources, and for rigorous assessments of the risks to the Fund arising from high access and the member's capacity to repay. They also noted the importance of Fund policies on access to include incentives for members to repay the Fund as their balance of payments improves, including the presumption that exceptional access will be on SRF terms. Directors will further discuss exceptional access policies, including incentives to repay the Fund and exit strategies from exceptional access, before the Spring 2004 IMFC meetings.

Directors highlighted the increased Fund exposure and concentration of that exposure with a few large borrowers, which is inevitably associated

with instances of large access to Fund resources. They also observed that Fund credit now represents a substantial proportion of the total external debt of the largest borrowers. Directors stressed that this large and concentrated exposure calls for close monitoring, in view of the financial risks to the Fund and the costs to the membership that could arise from large arrears. At the same time, Directors recognized that high concentration does not embody the same overall risk for the Fund as other financial institutions, and that, in view of the cooperative nature of the Fund and its public good role in promoting global stability, diversification of lending is not, and cannot be, an objective of the Fund.

Directors underlined the critical importance of precautionary balances in safeguarding the Fund's financial basis, as part of a multi-layered framework that also includes the Fund's arrears strategy and burden-sharing mechanism. They viewed precautionary balances as an essential buffer to help protect the value of reserve assets that members place with the Fund and safeguard the Fund's unique financing structure, which is based on exchanges of reserve assets.

Directors expressed a range of views on possible approaches to refine the framework for determining the target level of precautionary balances. They recognized the difficulties in quantifying the credit risk that the Fund faces. While quantitative approaches can deepen the understanding of the risks facing the Fund, most Directors observed that these approaches have significant shortcomings when directly applied to the Fund. In light of the Fund's role in the international financial system and its cooperative nature, as well as the Fund's unique financial structure, Directors agreed that judgment must necessarily underpin decisions on the level of precautionary balances.

While recognizing the limitations of quantitative risk assessment approaches, many Directors, nevertheless, suggested that possible ways to strengthen the analytical underpinnings for making judgments about the level of precautionary balances be kept under review. Many Directors encouraged more in-depth scenario analysis of the financial impact on the Fund—and explicit recognition of the potential costs for borrowers—of members incurring arrears to the Fund. This should be done annually or when making specific decisions on exceptional access to Fund resources. A number of Directors also felt that credit risk models, which are best practices in other financial institutions, should be used to inform the Board's judgment.

Directors reconfirmed as broadly appropriate the decision taken in 2002 for a target level of precautionary balances of some SDR 10 billion, with a few Directors suggesting that a higher level may be called for. A number of Directors saw a need for further consideration of a range of options that would allow the Fund to achieve a faster pace of accumulation, given the potentially large financial risks that the Fund faces and the uncertainties

regarding the availability of surcharge income. Overall, Directors agreed that the adequacy of the level of precautionary balances and the pace of their accumulation, as well as the application of the burden-sharing mechanism, will need to be kept under close review.

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Secretary