

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/86

10:30 a.m., June 12, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors

Dai Q.
J. de Groote
A. Donoso
M. Finaish
G. Grosche
J. E. Ismael

M. Massé
Y. A. Nimatallah
H. Ploix
C. R. Rye
G. Salehkhoul
A. K. Sengupta
K. Yamazaki

Alternate Executive Directors

E. T. El Kogali
M. K. Bush
H. G. Schneider

J. Reddy
J. Hospedales
M. Foot
O. Isleifsson, Temporary

C. V. Santos
I. A. Al-Assaf
E. Ayales, Temporary

J. de Beaufort Wijnholds

O. Kabbaj
L. E. N. Fernando
M. Sugita
F. Di Mauro, Temporary

L. Van Houtven, Secretary and Counsellor
S. J. Fennell, Assistant

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Also Present

African Department: A. D. Ouattara, Counsellor and Director. Asian Department: H. Neiss, Deputy Director; L. H. De Wulf. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; P. J. Quirk. External Relations Department: H. P. Puentes. Legal Department: F. P. Gianviti, Director; P. L. Francotte, W. E. Holder, R. H. Munzberg. Research Department: D. Folkerts-Landau, H. C. Kim. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, D. H. Brown, W. L. Coats, Jr., J. C. Corr, D. Gupta, B. E. Keuppens, F. F. J. Lin, A. F. Moustapha, Y. Ozeki, D. V. Pritchett, P. M. Tillotson, G. Wittich. Western Hemisphere Department: J. Ferrán. Office of the Managing Director: R. Noé, Internal Auditor; R. H. Ronneberg. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, A. Bertuch-Samuels, L. P. Ebrill, S. M. Hassan, A. R. Ismael, Khong K. N., A. Ouanes, P. Péterfalvy, I. Sliper. Assistants to Executive Director: A. R. Al-Abdullatif, F. E. R. Alfiler, M. Arif, O. S.-M. Bethel, H. S. Binay, R. Conotto, M. Hepp, S. King, V. K. Malhotra, R. Manfredi Selvaggi, T. Morita, C. Noriega, D. Saha, G. Seyler, B. Tamami, I. Zaidi.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR JUNE-AUGUST 1987

The Executive Directors considered the designation plan (EBS/87/115, 5/29/87) and operational budget (EBS/87/118, 5/28/87) for the quarterly period June-August 1987.

Without discussion, the Executive Board approved the following decisions:

a. SDR Department - Designation Plan for June-August 1987

The Executive Board approves the designation plan for the quarterly period beginning June 12, 1987 as set out in EBS/87/115 (5/29/87).

Decision No. 8608-(87/86) S, adopted
June 12, 1987

b. Operational Budget for June-August 1987

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/87/118 (5/28/87), page 3, footnote 1, and the operational budget for the quarterly period beginning June 12, 1987, as set out in EBS/87/118.

Decision No. 8609-(87/86), adopted
June 12, 1987

2. PROVISIONING AGAINST LOAN LOSSES IN FUND CONTEXT - FURTHER ASPECTS; OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT, AND REVIEW OF SPECIAL CHARGES

The Executive Directors considered a staff paper on further aspects with respect to provisioning in the context of the Fund (EBS/87/97, 5/6/87), together with a six-monthly report on overdue financial obligations to the Fund and a proposed decision with respect to the review of special charges on overdue financial obligations to the Fund (EBS/87/105, 5/14/87; and Sup. 1, 6/5/87).

Mr. Wijnholds made the following statement:

Since our last discussion on provisioning a year ago, developments have taken place which have clearly strengthened the case for taking additional measures to protect the Fund's financial integrity. First, there is the mounting problem of overdue obligations to the Fund. These arrears are now roughly equal to total reserves and could rise to a multiple of that in coming years, even if no new cases of overdue obligations were to appear. However, as the staff observes in EBS/87/105, "...it cannot be

precluded that other members will encounter serious difficulties in remaining current with the Fund." Second, there has been an increasing recognition among financial organizations that a strengthening of their financial position, either in the form of reserves or provisions or both, is called for in the present international environment. I need to mention only the introduction of provisioning by the World Bank last year and the recent large increases in loan-loss provisions by some large U.S. banks. I note in passing that many European commercial banks involved in international lending had already at an earlier stage started building up provisions at a more gradual pace against so-called country risks.

Another important development has been the strong call by the External Audit Committee for a reconsideration of a more comprehensive and structural approach to dealing with the problem of overdue obligations in the Fund's financial statements. It would be a weighty step indeed for the Fund to depart from Generally Accepted Accounting Principles by electing not to introduce an adequate response to the arrears problem. A qualified assessment by the Audit Committee of the Fund's financial statements could have an adverse impact on the Fund's financial integrity. It could be interpreted by creditors in an unfavorable manner with possibly negative consequences. It should not be forgotten that Fund credits are normally financed out of the reserves of member countries in a sufficiently strong position. Any doubts these countries may feel about the liquidity of their claims on the Fund could call into question their continued readiness in the future to agree to increases in the Fund's general resources.

The Fund has of course already taken a number of measures to try to protect its financial position, including an increase in the annual reserve target, first to 5 percent and last year to 7.5 percent. While the larger additions to the Fund's reserves have been helpful, it should be recognized that they have provided only limited and very general protection. It can be noted in this connection that the Fund's reserves as a percentage of total quotas at present amount to no more than 1.3 percent as against 2.5 percent in 1974. This percentage will obviously decline again when a new quota increase is agreed upon. Moreover, increases in reserves do not entail the setting aside of amounts specifically for and proportional to the increased risks for the Fund stemming from overdue obligations.

The developments and considerations described in the foregoing lead me to conclude, in the same vein as the staff, that additional measures are now needed to protect the Fund's financial position and to give a true picture of that position. A further increase in the reserve target is one possible solution, but would not appear to be adequate as it would not meet the need to

conform to the Generally Accepted Accounting Principles as regards a fair reflection of the value of the Fund's credits. Therefore, I see a need for establishing as soon as possible a system of provisioning in the Fund.

Before discussing how provisioning in the context of the Fund should be structured, I would like to emphasize a few points on which there seems to be scope for misunderstanding. It is important to be as clear as possible on the nature of provisioning, so that sound judgments can be reached which do justice to the interests of the Fund and of its varied membership.

First, it should be fully realized that provisioning against assets is not to be equated with a write-off of assets. Indeed the staff clearly states (page 7 of EBS/87/97) that establishing a provision does not imply that a loss has occurred or that any write-off takes place. A write-off only becomes necessary in the case of actual, irretrievable losses. In the context of the Fund that would, in my view, only need to occur when a member leaves the Fund and does not settle its obligations. It should also be emphasized that provisions will be undone when the value of the assets concerned has been restored. In the context of the Fund this would occur when long outstanding overdues are repaid. The amounts thus released from provisions could then be repaid to the member countries that financed the provisions.

Second, it is necessary to distinguish clearly between provisions and reserves. Unfortunately, there is considerable confusion over these concepts, with provisions often referred to as loan-loss reserves. As the staff has pointed out, however, reserves are part of the equity capital of an organization, providing protection against unforeseen unfavorable events. Provisions, on the other hand, are more in the nature of set asides, not constituting part of capital, and therefore not to be called reserves, and are connected with probable, identifiable, unfavorable events.

Third, a distinction should be made between general and specific provisions. General provisions, also referred to as basket provisions, are related to the probability of loss for all or a certain category of assets in a general sense, and as such are closest to reserves. Specific provisions are related to individually identified claims and can be seen as a tailor-made reaction to a perceived impairment of their value.

In deciding on the structure of provisioning in the context of the Fund, full account should be taken of the organization's unique character. The Fund is an intergovernmental organization and has been widely perceived to be a preferred creditor--although this status appears to have been somewhat undermined lately. This implies that provisioning in the Fund should be of a more limited

character than in commercial organizations and should also proceed at a more gradual pace. Provisioning in the Fund should in my view be limited to cases in which protracted overdue obligations have arisen against the Fund, and not take into account arrears to commercial organizations. The scope for provisioning in the Fund would therefore be considerably smaller than in the case of commercial banks, where the existence of arrears in any form or of rescheduling by the country concerned is often already sufficient ground for making provisions.

As to the exact form provisioning in the Fund should take, I have no strong preference, except to insist that what is needed are specific provisions or contingency allowances, if that term is preferred. At the occasion of the previous Board discussion on provisioning, Mr. Polak advocated the application of an objective formula under which provisions would increase at a steady pace over time. Judgmental elements would have to be avoided as much as possible in order to prevent the Board from having to make difficult subjective assessments which could greatly complicate our task. These ideas are very much in line with the staff's suggestions concerning a presumptive rule.

A number of proposals have been put forward on how to structure provisioning in the Fund. Apart from those mentioned in the staff paper, there is also Mr. Polak's proposal of a year ago, which envisaged that provisions would start to be made whenever a member has been continuously overdue to the Fund for three years. At that time 20 percent could be set aside against all outstanding claims on the overdue member, with additional tranches of 20 percent added annually as long as overdues remain outstanding. Of course, different percentages and a different time path could be chosen. It is also possible to relate provisions only against actual overdue obligations--but then for the full amount--and not against all the claims outstanding against the member in arrears. Whatever system is chosen, the main consideration should be that the system rules out as much as possible subjective elements and ensures uniformity of treatment.

The cost of provisioning will have to be borne by creditors and debtors alike. In other words, I support applying the decision on burden sharing reached last year also with respect to provisioning. The staff explains that there is considerable room under that decision for financing overdue charges as well as provisioning. If the floor on remuneration were to be reached, the Board would have to decide on how to proceed further. I do not think that we should try to settle such matters at this stage. It is important first to reach a decision in principle, which can be done by a simple majority, that a system of provisioning needs to be introduced in the Fund, so that such a decision can be

taken into account by the External Audit Committee in its coming evaluation of the Fund's financial statements. In a second stage we can decide on the exact modalities of provisioning.

I would at this stage like to mention, however, that the implementation of provisioning in the Fund should be accompanied by a reassessment of the reserve target. Indeed, at the time of the increase of this target to 7.5 percent it was understood that it would have to be looked at again if provisioning were introduced. Another important related element which I would like to mention briefly is the discussion on the Fund's income position to be held on June 17. Part of the excess income for financial year 1987 of SDR 49 million could be utilized, as the staff suggests in EBS/87/119, for starting to make provisions.

In conclusion, I believe that the time has, unfortunately, come for the Fund to establish a system of provisioning or contingency allowances. If we fail to do so, and thereby invite a qualified appraisal by the External Audit Committee of our financial statements, the Fund's financial reputation is likely to be affected. Such a development could have serious adverse effects in the future, particularly with respect to the Fund's possibilities to supplement its general resources.

Mr. Ismael made the following statement:

At the last meeting of the Board on provisioning in May 1986, this chair was not fully convinced of the need for provisioning as an additional measure to the increase in the reserves target. Circumstances have changed markedly since then. I note in particular the findings in the latest report on overdue financial obligations (EBS/87/105) that such overdue obligations have continued to increase at a rapid pace. Recently, some major international banks have begun to acknowledge formally that a portion of their assets has been impaired in value. I am now prepared to support provisioning if the reserve target is also reduced and a ceiling is imposed on the rate of charge. I shall return to this point later.

While recognizing the unique character of the Fund as an intergovernmental cooperative institution, I feel that the time has come for the Board to be realistic about the economic risks of nonrepayment and come to grips with provisioning specifically. The political risks--i.e., a formal repudiation of debt--may be remote, but the economic risks--namely, an inability to repurchase even if the overdue members wanted to do so--are real. These risks, as well as the amounts subject to such risks, have also increased significantly in the past twelve months.

Overdue repurchases are concentrated in a small core of members with long-standing overdue obligations, or protracted external payments problems. Prospects point toward an increasing total of overdue obligations from these difficult cases, as well as additional members likely to experience difficulties in repaying the Fund on time, as noted in EBS/87/105. In the worst scenario, my own rough simulations indicate that total credit outstanding to members overdue for two years or more could increase from \$923 million at the end of March 1987 to about \$2.5 billion by the end of March 1989, if all members currently overdue do not repay. This latter sum would represent more than twice the present level of Fund reserves. It would be only prudent for the Fund to begin to provide for a possible loss from nonrepayment. Otherwise, the note on "Overdue Obligations" in the accounts--page 136 of the 1986 Annual Report--will make it increasingly apparent to financial analysts that the Fund's financial position is being seriously impaired, if only in a narrower sense, as defined by the staff in EBS/87/97, than the commercial concept.

Before I come to the specifics of provisioning, let me comment briefly on the problem of overdue financial obligations. I think the Fund policies and measures already in place are adequate to cope with the problem. However, I would emphasize that the Fund should intensify its efforts to help overdue members become current again, including assistance in formulating suitable programs of adjustment, the mobilization of multilateral and bilateral aid, and the provision of additional resources in appropriate cases. While I remain skeptical about the impact, I can support the proposed decision on special charges.

If members continue to be overdue, there are two principal methods to strengthen the Fund's financial position to cope with the problem: a further increase in reserves, or provisioning as a cost of business. Although the ultimate burden on members is about the same, I would prefer provisioning to a further buildup of reserves. Provisioning recognizes explicitly as a business cost the impairment of the effective realizable value of Fund assets, as well as the possible loss. Like the staff and Mr. Wijnholds, I would emphasize, however, that provisioning does not mean a write-off of claims. It would only enable the Fund to be in a better position in the future to write off, or to reduce in value, any of its assets in a separate decision from that on provisioning.

I consider the buildup of additional reserves as less desirable. In addition to the arguments presented in the staff paper, I would also like to point out that under this method, Generally Accepted Accounting Principles require any future reductions in the value of Fund assets to be recognized as an expense in the Fund's income statement. If the additional reserves created are

used for such write-downs in future, large losses would be shown in the statement of income and expenses in the write-down years, as seen in the case of several commercial banks recently. In contrast, eventual write-downs under the provisioning method would only involve balance sheet items, since the allowances had already been recognized as an expense in the income statement. Let me amplify my point. Under provisioning, a deficiency in income can be made up under the burden-sharing formula to achieve the reserves target. But in the reserves method, such deficiencies in the write-down years cannot be covered inter-temporally by the additional surplus income contributed by members in earlier years. I hope the staff can confirm this difference. It seems to me then that the reserves method would only postpone the "day of reckoning" in expensing the impaired assets, if a loss is finally judged to be likely.

If the Board decides on provisioning, there arises the question as to which method is most consistent with Generally Accepted Accounting Principles, while also not imposing an intolerable burden on members. In this connection, I agree with the staff that overdue obligations, or overdues beyond a specified period, represent only a part of the Fund's overall exposure to risk. Hence, Mr. Nimatallah's proposal at the last Board discussion of an allowance for repurchases overdue for a specified period appears inadequate to me. The Fund cannot provision for the protracted overdues only and still make a judgment that the remaining outstanding credit of the members concerned remains unimpaired. Similarly, a provisioning policy to cover only the overdue repurchases of members late in their repayment by two years or more suffers from the same conceptual defect. Under this method, the amount of \$464 million to be provisioned in financial year 1987 may also impose too large a burden. At the same time, I agree with the staff that it might not be appropriate to link provisioning to total Fund credit outstanding, or change in credit outstanding, since the institution does not face a general or broadly predictable risk like the commercial banks.

I am most inclined, therefore, to support the proposal, similar to that suggested by Mr. Polak last year, to link provisioning to the amount of credit outstanding to members overdue for a specified period of time, say, two years. Under this method which would be parallel to that of the World Bank, there would be a presumptive rule that all credit outstanding of members with repayments overdue for two years or more is likely to be impaired in value. Provisioning over a period of time would then be made against such credit outstanding, depending on the maximum amount the members want to finance in a year. Provisioning each year would also depend on the amount of deferred income and the reserves target, subject to a maximum of about \$420 million a year that can be generated through adjustment of the rates of charge and remuneration under burden sharing.

Hence, I am unable to say what period for provisioning would be optimal until I see various financial scenarios prepared by the staff for the next few years. My rough calculations indicate that provisioning over five years may be too burdensome, since the amount required for this purpose alone would peak at \$450-500 million a year in financial years 1989-91, assuming a two-year overdue trigger. I would urge the staff to show the Board various financial scenarios beyond financial year 1987 to enable it to make a sound decision on provisioning. This is to ensure that there would be no "surprises" that may need the Board to change the method of provisioning after a decision is taken.

I would also like to make several general points to put provisioning in its proper perspective. First, a decision on provisioning cannot be made independently of the reserves target. If the Board decides on provisioning, the net income target of 7.5 percent of outstanding reserves ought to be reduced to 3 percent, the level before deferred income and overdue obligations began to feature importantly in the Fund's financial position. The staff should examine the adequacy of such a reduced reserve target, taking account of the decisions on nonaccrual of deferred income and on provisioning. Second, provisioning should be handled with utmost care to minimize any adverse effects on the financial standing of the Fund, and the creditworthiness of the overdue members. Third, provisioning alone cannot deal with the problem of overdue obligations faced by the Fund. It only strengthens the Fund's financial position after the arrears in repayments have occurred. The Fund should continue actively to prevent the occurrence of overdue obligations, through providing timely advice and adequate financing for adjustment. Fourth, the Fund would also need to continue to assist overdue members to become current again, so that those members which financed the provisioning can be repaid. In particular, overdue members must not get the impression that their debt has been written off. It must also be emphasized that they continue to have a legal obligation to the Fund and a moral obligation to the members. Finally, it might be timely for the Fund to examine other options on a case-by-case basis, such as repurchases beyond three to five years, and repayment in domestic currency. In the world today, the Fund seems a rather inflexible institution, not responding adequately to the needs of the circumstances.

Let me return to my first point above. I sometimes find it disconcerting that staff papers and Board decisions deal with financial issues in a piecemeal manner. This occasion seems appropriate to me to start a comprehensive review of all financial issues in a coherent manner. Together with the problems of provisioning and the reserves target, I have in mind the following proposals to be considered in a comprehensive framework. First, the proposed reserves target of 3 percent should be subject to burden sharing. Reserves strengthen the general financial

position of the Fund, a responsibility of all members. If both deferred income and provisioning are subject to burden sharing, there is, in principle, no reason why the same treatment should not be accorded to reserves.

Second, a ceiling on charges should be established, given the existence of a floor on remuneration. In addition to the principle of equity, a ceiling on charges would also help to ensure that Fund charges, which are already much less concessional than in the past, do not get too far out of line with market rates.

Finally, a definite criterion, in terms of the period being overdue, should be set for writing off overdue obligations for which provisioning has already been made. In this regard, the Board should be aware that protracted overdue obligations not written off add to the amount of charges being deferred, so that members "pay twice" in effect--for provisioning of the principal and for the deferred charges not collected every year.

Mr. Nimatallah made the following statement:

Generally Accepted Accounting Principles (GAAP) require that the financial statements of a financial organization should reflect the fair and accurate value of the assets of such an organization. When a discrepancy appears between the book value and the true value of an asset, the organization sets aside amounts to make up for the difference. Citicorp and other large commercial banks have recently taken such action by setting aside reserves or provisions to make up for the difference between the market value and the nominal book value of some of the assets reported on their balance sheets. These banks increased their provisions by a simple accounting transaction, according to which they moved certain amounts from their retained earnings accounts to special reserve accounts. By so doing, they have satisfied their auditors, and have also strengthened their financial position in the eyes of their depositors and shareholders, and the public, in general. The World Bank, as a financial institution, has also set aside some amounts in light of its growing problem of overdue payments, and in line with GAAP.

This brings me to the problem of overdue financial obligations to the Fund. The Fund is a financial institution and, as such, has financial statements, which are also audited by external auditors. The Fund's auditors have signaled their concern by requesting the Board to develop a structured approach for dealing with the impact of overdue obligations on the Fund's balance sheet. As the staff puts it, "in view of the scale and duration of overdue obligations to the Fund, there would seem little doubt that the effective, realizable value to the Fund of a not inconsiderable

portion of its assets, representing overdue credit extended to its members, is less than is indicated by their nominal book value, as shown in the Fund's financial statements." That fact, the auditors indicate, should be recognized by the Fund.

In my judgment, it is a technical matter that has to be recognized by the Board, preferably sooner rather than later, to satisfy the auditors. If the Fund recognizes, in principle, that the value of some of its assets is impaired, the next question is, how to determine the extent of that impairment and set aside an equivalent amount to make up for the estimated impairment in the value of such assets. The third step would be to determine how to finance these amounts. It is certainly much more difficult for the Fund to make a judgment concerning the extent of this impairment, owing to the unique nature of the Fund and of its members, which are sovereign governments. It may even be more difficult for the Fund to reach an agreement on how to finance the amounts or provisions set aside to make up for the impairment in value.

As overdue obligations are continuing to increase, it makes sense for the Board to recognize the negative impact of the problem of overdue obligations on some of the assets in the Fund's balance sheet. I certainly recognize that there is an impairment in some of the Fund's assets owing to the size and the protracted period of the overdue payments.

While still on this subject, I have a couple of observations to make on the six-monthly report. It is clear that countries are beginning to be lax when it comes to making timely payments to the Fund. While many of these cases do not come to the formal attention of the Board, nonetheless, there are members that have been about two weeks late in settling their obligations. This fact further convinces me that there are insufficient incentives for countries to repay on time, owing to the absence of high penalties for delays or of a threat of a cutoff of disbursements, a threat that is available to the World Bank.

As for incentives to encourage the timely settlement of obligations, the Fund can explore possibilities in the form of giving discounts to those members that settle on time and imposing penalties on those that are late. There are financial institutions, such as some funds in Saudi Arabia, which give discounts to customers that pay on time on a regular basis. In my judgment, it is the initial delay in repurchasing that is most serious, as it starts members on the road to falling further into arrears. In this connection, I am pleased to learn from the staff that the Treasurer's Department is following up more intensively in cases of slight delay in settlement, by making continuous contacts with the member concerned.

I do not want to spend too much time on the six-monthly report on overdue obligations, not only because my views are well known to the Board, but also because I have not been inspired by this report. I look forward to the discussion by the Board of the forthcoming papers on issues related to overdue obligations. I also support the decision proposed by the staff concerning the review of the system of special charges. Special charges exist only to retrieve costs incurred by the Fund. They are not penalty charges, and the question of whether or not they encourage members in arrears to pay is therefore irrelevant. It is only when penalty charges are imposed that the Board should assess their impact on at least discouraging initial delays in settlement.

Returning to the question of provisioning, let me explore some issues further. To determine the magnitude of asset impairment, commercial financial institutions go to the market to estimate the market value of their assets, compare this with the book value, and make up the difference by provisioning. In the case of the Fund, this is not so easily done. However, there are some criteria, as the staff indicates, by which the Fund can assess the position of a member with overdue obligations. Nevertheless, for all practical purposes, and given the possibility of sending the wrong signal at this time, it will be very difficult to judge the extent of the impairment. That is why I suggested at our previous discussion on this issue (EBM/86/84 and EBM/86/85, 5/19/87) that it might be a good idea to start with a small and symbolic amount set aside to satisfy the external auditors that the Board is moving in the right direction. I suggested that the Fund provide for only the small amounts that have remained overdue for three years or longer by any members irrespective of the remaining credit outstanding with those members. The Board could look at the issue again in a year or two, in the light of events, to find a better mechanism if needed.

In addition to the fact that my mechanism starts with only small amounts, it also has the merit of ensuring that the amounts will be set aside in a flexible way so that they rise and fall in line with the degree of impairment in the Fund's assets. When overdue obligations are settled, the degree of impairment goes down, and, therefore, amounts set aside as provisions should be returned to those members that contributed to their formation. As a matter of fact, it is this kind of mechanism that will satisfy the external auditors, which is something that the general reserves will not achieve. General reserves, as the staff explains in the paper, usually offer protection against uncertainty, while amounts set aside as provisions serve a specific purpose and fluctuate with changes in the need for their existence.

With respect to financing, the commercial banks are fortunate in that they have profits to dip into to finance provisions against impaired assets. I am certain that even the World Bank

found it easier to set aside provisions, partly because it also has profits from which it is able to finance amounts to make up for the impairment in the value of some of its assets.

However, for the Fund to finance these proposed mechanisms, the Board could possibly rely for now on the mechanism of burden sharing which was put in place to finance the deferred income. Another possibility that is available at this stage, as a one-time action, is to start by using some of net income in excess of the target for financial year 1987. Yet another possibility is to maintain, or, even lower, the present net income target, but to divide its absolute amount between general reserves and the set aside of specific amounts every financial year, in light of developments in the overdue payments problem. It would, perhaps, be best if the Board could take a decision to transfer some of the general reserves to a special reserve account for this purpose, and add to both a certain percentage annually which, in total, would be equivalent to or less than the present 7.5 percent net income target.

Finally, there are some minor issues to consider such as what to name the set-aside amounts. I have an open mind on whether to call them "provisions," "special reserves," supplemental income," or some other name, as long as the criteria for setting these amounts are clear. I only hope that the Board today makes a formal recognition that some of its assets are impaired. Finally, I request that the staff look into further possible options for financing the set-aside amounts.

Mrs. Ploix made the following statement:

Although our previous discussion of provisioning in May 1986 was only preliminary, I think that my statement at that time (EBM/86/85, 5/19/86) already clearly outlined the reasons why provisioning is politically and technically unacceptable. ^{1/} Today's paper tries to convince us that, first, to ensure a fair and accurate reflection of its financial position, the Fund needs to establish provisioning, and second, it is provisioning, not reserve building, that "enables an organization to present a fair and accurate statement of its financial position when the organization concludes that some of its assets may have been impaired or a loss on outstanding credit is probable."

I shall first answer the core question: does the Fund need to establish provisions to ensure a fair and accurate reflection of its financial position? I do not think so.

^{1/} See statement reproduced in Annex.

I will elaborate neither on the damage to international creditworthiness of the members whose holding of currencies will prompt the establishment of provisions, nor on the underlying assumption that such a decision entails for their future membership in the Fund. If the Fund were to act like any other financial institution, provisioning would lead to closing the account, or in Fund terms, terminating the membership.

I would like to comment in detail on the unique nature of the Fund and its special accounting principles which preclude provisioning. The Fund does not extend credits to its members; its transactions take the form of swaps of currencies. In the case of commercial banks, the substantial difference between swap and credit is reflected in different prudential approaches. Before commenting on the intricate problem raised by off-balance sheet operations, let me stress the main argument supporting the idea of the unique nature of the Fund.

I understand that the line "currencies and securities," along with appended Notes 2 and 5, makes the External Audit Committee wonder if it should issue an unqualified opinion. The third paragraph in Note 2 is thus particularly important. It states that "each member is obligated to maintain the value of the balances of its currency held by the Fund in terms of the SDR except for" some accounts which are of no concern to us today.

In my opinion the core of the question lies here: either this obligation is fulfilled, in which case the reporting of the Fund's financial situation is "fair and accurate" and there is no need for provisioning, or, it is not fulfilled because of the member's temporary or permanent inability to pay or because of the Fund's inability to determine the value of a currency in terms of SDRs at a given date. Past records show that, although the amounts due to temporary delays are fairly large--net SDR 1,484.53 million receivable by the Fund on March 31, 1987--members generally settle their obligations within acceptable periods. There is, in my opinion, no risk here that warrants provisioning.

However, I do see a clear risk of losses when countries do not maintain the value of the Fund holdings in their currencies. The claims in this category could amount to approximately SDR 32 million in June 1987. I thus support covering these possible losses.

In the case of the Fund's inability to determine the value of a currency in SDRs on a given date, the member's obligation to maintain the value of the balances of its currency cannot be fulfilled. This situation opens far greater questions which deal directly with the functioning of the whole international monetary system. These questions do not concern only holdings in the currencies of countries in arrears, but all currencies, even the most convertible ones.

I do not think that the External Audit Committee intended to open this far-reaching issue, but it is our duty to stress that, indeed, this Pandora's box would be opened if provisions were established without taking considerable precautions. Obviously, my authorities strongly disagree with the staff's statement in paragraph 5 on page 20.

The second argument I would like to bring out today against provisioning is the following: if there are indeed "adverse effects of overdue obligations on the Fund's assets," these effects do not, in my opinion, endanger "fair and accurate reporting of the Fund's financial position," according to Generally Accepted Accounting Principles, unless countries refuse to comply with the currency valuation process. These effects are rather a question of judgment, since once the revenue aspect is taken care of through the burden sharing and once the value question is offset through the maintenance of value in terms of SDRs, the only consequence of overdue financial obligations is to compel the Fund to retain some assets--holdings of currency--longer than anticipated or desired.

This situation is comparable to that of a bank engaged in "future" markets, with two very special features: first, the date on which the operation will be completed is unknown, and second, the respective values of both terms of the swap are constantly balanced according to computations made by the bank itself.

The question of risk coverage of "off-balance sheet operations" is, as far as I know, still under discussion in most countries, and I wonder how the features I mentioned earlier would be taken into account.

As I strongly challenged the need to establish provisioning, I will not elaborate on the arguments used to favor provisioning against accumulation of reserves; let me just say that they do not convince me. I would like to comment on three points which I will quote directly from the report.

"The accumulation of reserves does not reflect a cost of conducting the operations of an organization. More importantly, it does not reduce net income but rather indicates a specific use of it" (page 9). The footnote on the same page refutes this argument. It recognizes that the relevance of this fact "may be somewhat reduced in the case of the Fund by the fact that the reserve target itself is a factor in the determination of the rate of charge necessary to achieve the agreed level of net income." I am glad to read here that the report recognizes that the Fund is unique and should not be compared to any other financial institution.

b. There is "in neither (provisioning nor reserve accumulation), a requirement to identify the assets against which provisions are established" (page 9, iv). Therefore, provisioning would not pinpoint one country. I do not see how this is possible as the report also reminds us that: "provisions reflect a judgment that the current status of individual loans or classes of receivables makes it advisable...to take corrective action in the form of establishing a contingent allowance with respect to the nominal or book value of some part of the assets of an organization," and "the discharge of an obligation against which a provision has been established would normally...lead to an equivalent reduction of provisions."

c. "The proceeds of a reduction in provisions...could be... refunded to members that had financed the provision through a surcharge on charges or a discount from remuneration." In contrast, a reduction in the reserve target would normally not benefit exactly the same members that originally financed the reserve accumulation and in proportion to their contribution." I do not see why a decision similar to the decision made to "burden share" the increase in reserve target from 5 percent to 7.5 percent is impossible while a decision to "burden share" provisioning is understood.

To sum up, my authorities could go along with further studies on establishing a plan for dealing with a country which does not maintain the value of the Fund holdings in its currency. However, we are not prepared to agree with any more far-reaching provisioning plans.

We think that the problem of the image of the Fund is more acute vis-à-vis debtors than vis-à-vis creditors and private financial markets.

Nevertheless, if management were to consider further steps to protect the Fund's financial position, my authorities would only consider reserve accumulation and would insist that the burden of the resulting necessary financing be shared.

Mr. Nimatalla stated that he had understood Mrs. Ploix to have said that provisioning should take place only when a member country withdrew from the Fund. There was perhaps some confusion between provisioning and the writing off of assets. He agreed that consideration should be given to writing off assets when a member withdrew from the Fund or declared its intention not to repay its obligations to the Fund. However, there were technical factors that warranted provisioning, such as concerns about devaluation of a member's currency.

Mrs. Ploix remarked that she had stated that provisioning was only a step toward terminating a country's membership in the Fund and that such a decision should not be taken lightly. A decision to provision was usually a first step toward writing off the assets of a client.

Ms. Bush made the following statement:

The Board took several essential and important steps last year to begin addressing the problem of overdue obligations, including the establishment of a nonaccrual policy, increasing the Fund's general reserves, and putting in place a mechanism for sharing the costs associated with overdue obligations. However, for some time, we have also been considering provisioning in order to specifically address the problem of overdue repurchase obligations, as we have similarly specifically addressed overdue interest obligations with the establishment of the nonaccrual policy.

As time has passed, provisioning has taken on much more significance because of the growing and protracted nature of the arrears problem. As was pointed out by the External Audit Committee at the time of the 1986 audit, overdue obligations have grown to a size that they are material in relation to the Fund's reserves. I believe that no one would argue that this is not a serious problem for the institution.

The case for taking the appropriate steps to address the problem of overdue repurchase obligations is made clearly in the paper before us. First, the staff recalls that in 1985, the Treasurer of the Fund proposed establishing a comprehensive and structured approach to evaluating the risks associated with overdue obligations. The External Audit Committee also emphasized the importance of this matter, and endorsed the Treasurer's proposal. In view of the worsening of the problem by the time of the 1986 audit, the External Audit Committee strongly urged further work on the Treasurer's proposal for developing such an approach, so that a framework for addressing the matter of arrears as it affects the Fund's financial statements could be established.

The paper before us, together with EBS/86/82, provides an analysis of the criteria relevant to evaluating the risks associated with assets not paid as scheduled. It is correctly pointed out that the Fund has no past experience with loss, making it impractical to use historical experience as a criteria for the Fund. However, there are a number of other important considerations, including members' financial circumstances, economic performance, and the duration of overdue payments which must be weighed heavily by the Fund in judging risks associated with overdue obligations.

The overriding considerations for the Fund are that arrears have mushroomed in the past three to four years, and that some obligations have remained overdue for a prolonged period of time. Given this situation, and according due importance to the criteria of protracted overdue obligations, we cannot avoid the conclusion that the effective realizable value of those assets which have not been repurchased as scheduled, and which have remained overdue for a protracted period of time, has been impaired. Therefore, I fully concur with the observation on page 20 of EBS/87/97 that "the sharp increase in the amount of obligations that are overdue for protracted periods of time suggest that from the point of view of true and accurate reporting of the Fund's financial position, the effective realizable value of the assets which have not been repurchased when due have been diminished relative to the nominal or book value. In these circumstances it would seem appropriate to provide for a means to compensate for the adverse effects of overdue obligations on the Fund's assets and on its financial position and thus ensure fair and accurate reporting of the Fund's financial position."

Related to the issue of fair and accurate reporting, the staff gives a clear explanation as to why reserves and provisions cannot be viewed as substitutes for one another. Generally Accepted Accounting Principles, to which the Fund does adhere in the preparation of its financial statements, clearly require that provisions be established when an organization determines that some of its assets may be impaired or have a value that is less than the nominal value shown in the financial statements. Reserves, or equity capital, on the other hand, protect an organization only from general uncertainty and unforeseen circumstances and are not a specific response to the judgment that some portion of an organization's assets are impaired. In fact, as the staff points out, an increase in reserves would not explicitly recognize the protracted arrears problem and therefore would not obviate the need for provisioning.

Failure to provision could put the Fund in direct conflict with Generally Accepted Accounting Principles. This would be a serious departure from the financial and accounting standards that the Fund has followed. Moreover, there is the risk that the Fund would be subject to a qualified audit, if provisioning is not instituted and our financial statements are consequently judged to be not in accord with Generally Accepted Accounting Principles.

A qualified audit would be most undesirable for the Fund; it would raise questions with regard to the financial principles that govern the institution, and with regard to the financial integrity of the Fund. These in turn would likely weaken the confidence the Fund's creditors now have in the institution, and weaken the Fund's image in the financial system. The institution and its members can afford neither of these.

Undoubtedly, provisioning raises a number of difficult issues for the Fund. I share the view that this is a unique financial institution. One aspect of that uniqueness relates to the nature of the Fund's lending which differs in structure from that of many lending institutions in that it lends by means of an exchange of currencies. However, regardless of the structure of our lending arrangements, we clearly do extend credit. Here again, the key consideration is that financial obligations to the institution, regardless of the unique nature of those obligations, have not been met when due and have remained overdue for a protracted period of time.

There are two other unique features of the Fund's operations that should be viewed in conjunction with each other. One is that members, even members in arrears, are required to maintain the value, in local currency, of the Fund's holdings of their currencies. The second is that the Fund's lending is based on a revolving fund of usable currencies. Despite the maintenance of value obligation, if repurchases are not made on schedule by some members, the Fund is constrained in conducting its operations as other member countries may be deprived of financing that requires usable currencies.

The uniqueness of the institution goes far beyond the nature of its lending arrangements. Its uniqueness also results from the central role that it plays in the international financial system. The role that the Fund plays in helping members formulate economic policies and programs, and the confidence that members, as well as the financial system in general, place in the Fund for that function also put the Fund in a highly unique position. Indeed, the Fund plays such a central role in the international financial system and in addressing the debt problem, that it is even more incumbent upon us to assure that the financial principles and accounting standards that we follow are unquestionable. Otherwise, the central role played by the Fund, and the benefits that this brings to the financial system and to members could be easily endangered.

More specifically, members have looked to the Fund to play a key catalytic role in arranging financing packages with commercial banks. That catalytic role has been possible not only because of the extension of Fund resources, but more important, because of the Fund's role in helping members develop economic programs that address their balance of payments and debt problems. I believe that it is crucial that the Fund continue to be in a position to play that role for members which is central to the debt strategy and central to members obtaining needed financing.

There are a few additional considerations that are important to keep in mind as we consider taking this step. First, provisioning does not mean that a loss has occurred, or that the Fund

is writing off assets. Instead, it would mean that the Fund has taken an important step in protecting its financial position and in fairly reporting its financial condition.

Second, I must note that the members of this institution often must seek additional financing or authority for the Fund from our legislatures in order to enable the Fund to carry out its purposes. We cannot expect these legislative bodies, or governments in general, to be willing to authorize new financing for the Fund, if the institution is lax in protecting its financial position, and if it is remiss in presenting them with an accurate representation of its financial situation.

A third consideration relates to the practices of other financial institutions, and I would cite, in particular, the World Bank. Of course, the Bank has established a policy of provisioning. Some point out that the Bank is partly reliant on the private financial markets for its funding, and that this was key to its decision to provision. I must note that member governments, who provide financing to the Fund through credit and quota resources also expect that the highest principles of prudent financial management will be followed. I believe that official shareholders are as interested in the financial standards of an institution in which they invest as private shareholders.

While the need to establish provisions is clear, the modalities by which we should provision are not so clear. Mr. Dallara put forward a proposal last year that we establish a provision of some 15 percent a year against outstanding credit of members that have been in arrears for a specified period of perhaps 18 or 24 months. After the initial provision of 15 percent, similar amounts would be provisioned for on an annual basis thereafter. We believe that this approach has merit, particularly as it would base the amount of provisions on the credit that the Fund has outstanding to members where there is a problem with overdue payments. It does seem important to recognize that, when a member is in arrears, the status of expected repurchases is also questionable. In other words, there is an added risk factor associated with repurchases that will come due in the future. In sum, we continue to believe that the approach presented by Mr. Dallara is, in general, a practical and feasible one. The staff has suggested a similar approach, although the specific criteria differ. I believe further thinking on this issue to determine the specific criteria and other modalities is warranted.

In establishing provisions, a key issue on which the Board will need to focus is the financing of provisions. Certainly, provisioning is in the interest of the entire membership and there is a logical reason for having both creditors and debtors share in the financing.

In this context, I believe that the Board should explore a range of means of financing provisions. As a first step, we should examine the merits of deeming the income, earned in excess of target in financial year 1987, to the financing of provisions. However, we must also explore additional, more permanent financing techniques. These should include methods of establishing a more equitable basis among all members for contributions, perhaps by looking into the methods for contributions by countries that are neither creditors nor debtors.

In conclusion, this is an extremely important issue for the Fund. It is incumbent upon us, if we are to maintain high standards of prudent financial management, to take the appropriate steps to address the arrears situation. This is necessary both from the standpoint of protecting the Fund's financial position and from the standpoint of fairly and accurately reporting our financial condition. Like other Directors, I will say finally that regardless of the name that we attach to our answer to this problem, it must be addressed in a manner that specifically recognizes the problem, and that preserves the Fund's financial integrity and the accounting standards to which we adhere.

Mr. Grosche made the following statement:

I sincerely hope that Mr. Kafka or Mr. Hospedales can correct the press reports of June 11, 1987, which indicate that the Brazilian Minister of Finance has asked for a postponement of repurchases to the Fund, thereby treating the Fund in a similar manner as commercial banks. No action could have dramatized more the present discussion on provisioning and the six-monthly report on overdue obligations.

The report on overdue obligations alone would have been sufficient to alarm the Board. It shows that arrears have continued to rise, with particularly strong increases in payments that have been outstanding for a protracted period. All the ratios relating overdue obligations to measures of Fund activity have deteriorated. One measure has a particular bearing on the Board's considerations about provisioning: in only six years, overdue obligations have risen from less than 3 percent to almost 100 percent of the level of reserves, and total credit outstanding to members in arrears has reached almost twice the level of reserves.

While the problem of arrears has thus far been contained to a small number of Fund members, the extent to which it has become entrenched in these cases is very disturbing. The difficulties recently encountered by some members in normalizing their financial relations with the Fund clearly demonstrates that solutions may become harder to find the longer the problem lingers on.

These developments lead me to the conclusion that we must strengthen the approach for dealing with the issue. The question is how can this be done.

Steps taken in the past were appropriate, although insufficient to really come to grips with the problem. I welcome the steps taken, as described in the staff report, and look forward to the papers to be produced. I support the proposed decision on the system of special charges. But I share Mr. Nimatallah's view that unless the situation improves, the Board may have to re-examine what additional measures could be introduced to provide stronger incentives for members to pay the Fund on time.

All deliberations about possible steps to overcome the arrears problem must start with the recognition of the unique character of the Fund as a cooperative organization at the center of the international monetary system. To be sure, the Fund as the major player in the front line of the battle to overcome the global debt problem has received some bruises. This may have been unavoidable. But now it is essential that every effort be made to shield the institution in order to avoid impairing its ability to carry out its tasks effectively.

To this effect, members must accord first priority to meeting their obligations to the Fund. These obligations cannot be rescheduled. This principle needs to be upheld, whatever the particular reasons for the past and present inability of some members to service their debt to the Fund. In addition, the Fund must continue and, if possible, strengthen its efforts to help those members to overcome their economic difficulties and enable them to normalize their financial relations with the Fund.

Nevertheless, we cannot ignore the increasing risks faced by the Fund, which call for further steps to safeguard and strengthen its financial position. I see risks for the Fund aside from its weakened liquidity position. We cannot exclude the possibility that members may withdraw from the Fund, which would, in my mind, force the Fund to write off instantly the full amount of obligations outstanding. There are also risks that creditors of the Fund may become more concerned and that discussions on the quota review may get even more difficult. We must therefore strengthen the financial position of the Fund. However, the introduction of provisioning at this point in time does not appear to be the appropriate way of achieving this objective, while safeguarding the Fund's central role as the lender of last resort. Instead of provisioning, the Fund must continue to build up its reserves. Let me explain why.

The main argument favoring provisioning over an increase in reserves appears to be based on accounting principles, namely, GAAP. These principles require that the statements of financial

institutions give a fair and accurate reflection of their financial position. If one holds, as the External Audit Committee apparently does, that some of the Fund's assets are impaired because there is a risk that the members in arrears will not repay the Fund, it might be prudent and even necessary to provision against this possible loss. However, in the context of the Fund, I believe that as long as we are convinced that in the final outcome, members will repurchase, it is difficult to state that certain assets are impaired. As the staff admits, there is no experience on which the Fund could base an assessment of asset impairment.

More important, there are several reasons why the Fund cannot be treated the same way as other financial institutions. First, the Fund has a unique character. It is a cooperative organization of sovereign nations, and its financial relations with its members differ considerably from those between a bank and its clients. Thus, the Fund cannot be compared with commercial establishments, which are guided by different motivations in the conduct of their business. As an aside, I might add that commercial banks or enterprises establish provisions against possible losses by no means only to "present a fair and accurate statement of their financial position." Apart from national supervisory regulations and accounting practices, tax considerations feature prominently in commercial enterprises' provisioning practice. Even the World Bank's situation is different from that of the Fund, because it relies on refinancing through international capital markets.

Second, if the Fund were to introduce provisioning, it would raise serious political questions regarding the signals such an action would give to members and the international community. Would it be understood as a departure from the principle of the revolving use of the Fund's resources? Would it not be taken as a weakening of the principle that the Fund in its capacity as a lender of last resort, has to be repaid and that such repayment has priority over members' other financial obligations? Would not the Fund be acting like a bank, exposing itself to the risk of being treated like a bank? I am afraid that the answer to all these questions is, at least a qualified, yes.

Third, as Mrs. Ploix has pointed out, provisioning might have far-reaching implications for the Fund's principle of maintenance of value that stretch beyond the issue of overdue obligations.

In conclusion, despite the very interesting staff paper and the concerns expressed by the external auditors, the reservations against provisioning, as reflected in the Chairman's summing up of the previous Board discussion on the issue are still valid. But let me stress again, overdue obligations pose great risks

for the Fund, against which it has to be protected. However, rather than introducing provisioning, we should aim at boosting the Fund's reserves further. We have an opportunity to act accordingly at the Board's forthcoming discussion on the Fund's income position on June 17, 1987. I am also open to further studies on the characteristics of the Fund's reserves, particularly whether there may be a need for establishing a special reserve account, perhaps as a subaccount to the Fund's general reserves. I hope that members of the external audit committee will be satisfied with this approach, as I would certainly like to avoid having a qualified statement. Of course, if the problem continues to worsen, or if there are new developments, I would be prepared to continue the discussion on provisioning.

Mr. Hospedales commented that the press agencies had misinterpreted the statement by the Minister of Finance of Brazil. The Minister had said, as the press reported, that it would have been helpful in approaching Brazil's official creditors if the Fund would agree to postpone Brazil's obligations to the Fund. However, he had gone on to emphasize that Fund procedures did not allow such a postponement. Brazil was current with the Fund and would continue to adhere to its obligations to the Fund.

Mr. Salehkhoul made the following statement:

The problem of overdue financial obligations to the Fund continues to be a cause for concern. During the six-month period covered in the staff report, overdue obligations increased by SDR 280 million to about SDR 1.2 billion, and they continued to increase by SDR 71 million in April and May 1987. Notwithstanding the sharp rise in arrears to the Fund, it should be emphasized that the number of members subject to complaints remained unchanged, albeit with two countries taking the place of two others, thus reflecting a heavy concentration of arrears among a small group of members that have long-standing overdue obligations to the Fund and are facing protracted external financial imbalances. As indicated in the staff report, the protracted arrears of a duration of six months or more of eight members rose sharply by 63 percent during the period under review and accounted for 97 percent of the total overdue obligations to the Fund. The data provided in the report also suggest that in the absence of a more substantial improvement in their external position, the total amount of overdue obligations of these eight members could grow to an unsustainable level of SDR 3.3 billion, taking into account their forthcoming obligations to the Fund.

Aside from these unpleasant developments, it is heartening to note the staff's comments that in spite of financial difficulties, almost all borrowing members have continued to honor their financial obligations in order to remain current with the Fund.

Even in the case of those members that have been declared ineligible to use Fund resources, some payments have occasionally been made, albeit insufficient to prevent their arrears from rising. This indicates the authorities' strong willingness and commitment to fulfill their obligations to the Fund despite the serious hardship they are facing.

The economic and financial performance of these members with protracted arrears to the Fund clearly indicates that exogenous factors, which had adversely affected their economies, unfortunately show no real improvement in the period under review. Indeed, real international interest rates remained at high levels, primary commodity prices continued to decline, protectionist pressures in major industrial countries intensified further, and debt-servicing difficulties persisted. Moreover, in the past two years unfavorable weather has also had a negative impact on some economies.

The circumstances of members in arrears call for a more careful and comprehensive look at the root causes of the problem of arrears, as I have consistently maintained. Experience has shown that without active collaboration among all parties involved, including the Fund, the donor community, and the creditor nations, the issue of overdue financial obligations to the Fund is unlikely to be resolved.

In this regard, the Fund has taken various steps that might be categorized, in a broad sense, as punitive and corrective. Among the punitive measures, which have been given undue emphasis, the Fund has shortened the maximum period between the emergence of arrears and substantive consideration of the matter by the Executive Board and has imposed special charges on overdue repurchases and overdue charges. As was suspected, the implementation of special charges brought about no positive results owing to the inability, rather than the unwillingness of members to discharge their obligations to the Fund. I wonder whether in view of the staff conclusion that "there is no clear evidence that the system has significantly influenced members' payments behavior," special charges should still be maintained. In fact, the imposition of special charges not only failed to give any incentive to the members in arrears to clear their obligations but also made their debt burden even heavier and, by the same token, diminished the likelihood of the provision of bridge financing by creditor and donor countries.

Under present circumstances, when most creditor nations are supposedly seeking ways and means to alleviate the developing countries' debt burden, the Fund as a cooperative institution should play more actively and positively its important and leading role in resolving the problem of overdue financial obligations of a small number of its members by encouraging them to implement

corrective and appropriate policies rather than by resorting to punitive measures which are inconsistent with the nature of the institution. The imposition of special charges or provisioning not only undermines international efforts in dealing with the debt problem but also would dilute the Fund's main role in helping members to meet their balance of payments needs.

Before further elaborating on provisioning, let me welcome the positive steps taken by the Fund to help members address their external imbalances so that they can generate sufficient international reserves to meet their obligations to the institution. These well-intentioned measures include, inter alia, identifying potential problems at an early stage, preventing the emergence of arrears, assisting members to correct problems, and encouraging them to become current in their obligations to the Fund. However, further bold measures should be taken by the Fund to step up its financial intervention, giving due regard to the balance of payments needs and, feasibility and acceptability of its programs. To be sure, in the last few years Fund policies have themselves been partly responsible for the emergence of these arrears. Indeed, these policies have generally been geared to curtailing potential and actual access, extending and tightening conditionality, increasing the cost of Fund resource utilization toward market interest rates, and deliberately reducing members' outstanding debt to the Fund regardless of their persistent and sometimes worsening balance of payments problems. According to the latest data available for the first five months of 1987, the negative flow of Fund resources from members amounted to SDR 1.9 billion, already exceeding the amount recorded for 1986 as a whole. This sharp rise in negative Fund flows was simultaneously compounded by the virtual interruption of private lending to developing countries, and by the collapse of primary commodity prices. This clearly is in contrast with the developments in the world economy and with the mandate of the Fund under its Articles of Agreement. Moreover, this policy has deprived developing countries of the financial resources required to support the implementation of comprehensive, growth-oriented adjustment programs, which are supposedly designed to help them grow out of their debt problems. While I agree with the principle of maintaining the revolving character of Fund resources and the catalytic role of this institution, it should be mentioned that such assistance would be successful only if it is meaningful and commensurate not only with the adjustment efforts required from the member and its balance of payments needs, but also with prospective contributions from other creditors.

The staff should be commended for its vigorous efforts in candidly contacting donors and creditors to encourage them to provide adequate financing to members in support of their adjustment programs and to help members repay the Fund so that the Fund can approve debtor nations' requests for stand-by arrangements

or arrangements under the structural adjustment facility. The case of Somalia is a welcome example in this connection. I believe that other creditor members would be well advised and should be encouraged to follow Italy's example in helping members to clear their overdue obligations to the Fund by devoting at least a fraction of the enormous terms of trade gains they have made in recent years on oil and other commodities to this end.

The establishment of provisions or contingency allowances for protecting the Fund's financial position against probable losses should be considered only as a last resort. In this respect, I regret that other papers dealing with related matters, which were requested by many colleagues long before the paper on provisioning have not yet been brought to the Board. Specifically, I am referring to matters expressly provided for in the Articles of Agreement, namely, the postponement of repurchases in cases of "exceptional hardship" and the payment of charges in domestic currencies. We should have exhausted all options rightfully and legally at our disposal before even discussing such extreme measures as provisioning.

Provisioning should not be considered as a means to resolve the problem of overdue obligations, as it is inconsistent with the character of the Fund as a cooperative and intergovernmental institution. Here I wish to make some specific remarks and to highlight some important points made by the staff in the report before us. The Fund has so far no experience of loss and as indicated in the staff paper "the evaluation of sovereign risk would appear particularly difficult in the context of the Fund." Provisioning is intended to cover the probable loss, and the probability of a loss is up to the Board's judgment. In the absence of withdrawal of a member from the Fund and explicit repudiation of a member of all its financial obligations to the institution, it is not only difficult but also inappropriate for the Board to conclude that a loss is likely to occur.

It is difficult to reach a precise judgment as to whether a probable loss would in fact occur because, first, all members in arrears to the Fund have expressed their strong commitment to honor, and a willingness to discharge, these obligations. Second, Fund purchases are fully covered by collateral in the form of the Fund's holdings of each member's currency.

Regarding the inappropriateness of provisioning, it should be remembered that the Fund is dealing with sovereign governments who are also members of the institution and not private borrowers from a profit-making financial institution. Loan-loss provisioning is a normal and necessary tool for any entity that depends on the capital markets for its financial resources. The Fund does not fit this description and therefore normal accounting principles are not fully applicable to it. The Fund's financing operation involves the exchange of assets rather than the arrangement

of loan contracts as in other financial institutions. The Fund may take steps, when necessary, to enhance its liquidity and financial position, but provisioning is not an appropriate tool for this purpose. The establishment of loan-loss provisions would alter the Fund's image significantly and make the institution merely another commercial enterprise. Furthermore, the introduction of provisioning would not only raise serious questions about the effectiveness of Fund assistance to members in difficulty and the institution's overall role in the international monetary system, but also hamper its efforts in encouraging private and official creditors to maintain, let alone increase, their exposures in the developing countries. Finally, the provisioning which requires the evaluation of member's creditworthiness is likely to become a very perilous exercise.

In conclusion, there is no need at the present juncture for the establishment of provisioning, and no further action is required in this regard. In any event, even if there was to be a provisioning system, I could not possibly agree that it would be based on the same burden-sharing principles as those applied to special charges, which put a disproportionate burden on borrowing members. It is my conviction that this system of burden sharing should be based instead on the quota shares of all members, since the Fund is a cooperative institution and its operations, including the provision of resources, are ruled by the majority of the membership. It is only fair that all members equitably share the consequences of their actions. I further propose that the staff undertake a comprehensive review of the policy on special charges on overdue obligations and consider the possibility of its termination in view of its ineffectiveness.

Mr. Rye made the following statement:

When the Board last discussed provisioning in the context of the Fund in May 1986, I was among the large group of Directors who expressed uneasiness. I thought that provisioning would represent a watershed in the Fund's history--one that I was reluctant to cross until it became clear that no sensible alternative existed.

Events over the past 12 months have convinced me that the time has come to introduce provisioning. This is an "on-balance" judgment. We all should recognize that those who argue against provisioning do have points that warrant careful consideration. I have in mind particularly the following concerns: there is a question whether provisioning is appropriate for an international cooperative organization like the Fund, as contrasted with other financial institutions such as banks; there could be risks to the credit standing, such as it may be, of those members whose arrears were identified with the provisioning allocation; there may well

be a degree of "moral hazard" whereby members in arrears may feel a reduced obligation to fulfill their responsibilities to the Fund; and further efforts to strengthen the Fund's financial position would reopen the vexed question of burden sharing.

However, I have concluded that the arguments for provisioning have greater weight. It would be neither wise nor prudent to ignore the views of the External Audit Committee; I agree with Mr. Wijnholds that a qualified assessment by the Committee of our financial statements could have an adverse impact on the Fund's financial integrity. Of course, the Fund does not borrow in capital markets, but we do seek to exert an influence over the major players in those markets, and in order to retain that influence it is necessary to ensure that the Fund is not open to question about its own financial integrity. Nor should we overlook the possible adverse consequences of qualification of our accounts in the minds of the Fund's major official creditors. I regard this as perhaps the major reasons for taking early action on provisioning. There is also, of course, the fact that arrears continue to grow at a rapid pace and show every indication of doing so for some time, and although there is considerable hidden strength in the Fund's reserves, this is not a trend to be approached with any degree of complacency.

I have very little to say about the paper on overdue financial obligations although I have no objection to the proposed decision. However, I might perhaps interpolate here that my authorities believe that the Board has gone too far toward flexibility in its procedures for declaring a member ineligible. They would like to see more automaticity in those procedures and have pointed out that dilemmas such as we faced in the recent case of Zambia--where the Fund's available actions were constrained by a need not to be seen as reacting spitefully to a deteriorating relationship with that member--would have been substantially eased had a mechanism been in place for automatic ineligibility.

On a personal level, I think that the lack of an effective lever to induce the small number of countries responsible for most of the arrears to live up to their obligations, as is demonstrated by the events of the past year or so, adds strength to the case for provisioning. The External Audit Committee has been rather too kind in describing the steps we have taken so far on overdue obligations as "important progress."

It is true that some of the objectives of provisioning could be achieved by strengthening the Fund's reserves through one mechanism or another. However, I have been convinced by the staff paper that this would be a second best approach. I am particularly impressed by the conclusion that "if the Fund

judges that assets have been value impaired, Generally Accepted Accounting Principles call for the establishment of appropriate provisions." This is the essence of the matter before us.

In that regard, I would have great difficulty accepting any argument that our assets are not value impaired by overdue obligations. To be specific, convertible currencies have been replaced by currencies such as the Peruvian Inti, Sudanese pound, and Vietnamese dong, which, for the Fund's purposes at least, are virtually unusable in present circumstances. I do not think that the argument is disposed of by saying that overdue obligations are only temporary. So long as no end is in sight, it still retains its force. In this regard, Mr. Grosche inquired whether if the Fund acts like a bank, will it not be treated like a bank? My response would be to say that, most regrettably, the Fund is already being treated by some of its members like a bank, and we cannot close our eyes to that fact.

As both Mr. Wijnholds and Mr. Nimatallah have reminded us, reserves usually offer protection against uncertainty only in general, while provisions serve a specific purpose and fluctuate with changes in the need for their existence--two points which carry considerable weight in the present context. Mr. Ismael has made the further pertinent point that writing down reserves, should that unfortunately become necessary, would entail a major loss in the year of write-down, whereas provisioning spreads the costs over a run of years.

As to what kind of scheme might be adopted, I have an open mind. My authorities favor a two-year trigger and a scheme which over time would take up both the longer-standing arrears and the prospective arrears of the members concerned--a scheme, in short, similar to Mr. Dallara's proposal.

As to how provisioning would be financed, initially it would seem appropriate to reduce the income target and rely on the burden-sharing scheme which we have, in arduous negotiation, developed over the past year. But before reaching any detailed conclusions, I should like to see the calculations of various financial scenarios beyond financial year 1987.

In the longer run, my authorities believe that, in principle, reserves and provisions should come from the whole membership according to their quotas, just as such allowances are an asset of, or a cost to, shareholders in a financial institution. They further suggest that the desirability of such a development could be considered in conjunction with the review of quotas, in which context it would be appropriate to contemplate at least a once-off contribution to provisions.

While I favor the provisions route, if the necessary support is not found at the present meeting for such a proposal, I would be prepared to join in any consensus for a Reserve scheme provided it was sufficiently strong to represent an adequate response to the major financial challenges facing this institution.

Mr. Yamazaki made the following statement:

The staff paper on overdue obligations amply illustrates the worrying trend of a rapid increase in the amount of overdue obligations and the lengthening of their duration. While various preventive measures and measures to protect the Fund's financial position have been taken, the seriousness of the problem suggests that further actions are needed in order to protect net equity of the Fund. The Fund's reserves, at SDR 1.2 billion at the end of financial year 1986, are barely equivalent to the total overdue obligations of SDR 1,184 million at end-March 1987. I therefore believe that there is a strong need for the Fund to increase broadly defined reserves to protect its financial position.

Assuming that Directors are in agreement on the need to strengthen broadly defined reserves, we are considering today whether provisioning or a narrowly defined reserves increase would be an appropriate response to overdue obligations when accounting, legal, and other considerations are taken into account. The staff appears to have become more positive than before about provisioning. The view expressed by the 1985 External Audit Committee may have affected to some extent this perceived shift in the staff's position. But, here, it should be noted that the Committee has endorsed the Treasurer's proposal to establish a more comprehensive and structured approach to the problem and not an outright recommendation of provisioning per se.

On the occasion of the preliminary Board discussion on this matter in May 1986, this chair drew the Board's attention to the fact that the Fund's credit is based on an exchange of currencies and differs from lending operations normally carried out by commercial banks. This means that the effective realizable value of the Fund's credit can be judged to be below nominal value only after the value of the currency the Fund holds in exchange for the credit is judged to be insufficient to cover the credit. More important, Article V, Section 11 provides that the value of the currencies of members held in the General Resources Account shall be maintained in terms of the special drawing right. Therefore, a presumption by the Fund that the value of some of its credits has been impaired implies a nonobservance of Article V by the member or the Fund and gives rise to a question of whether the Fund has an appropriate procedure to enforce that provision.

I regret that this legal aspect has not been adequately dealt with in the present paper and urge the staff to give detailed consideration to this matter. In the meantime, the staff may wish to make stronger efforts in making the point relating to this special feature of the Fund's credit to external auditors.

In another consideration, Citicorp and other major American banks have recently decided to set aside a substantial amount of provisions, and the repercussions and effects of this action on the debt problem have not been fully assessed at this moment. As an institution placed in the center of international finance, the Fund may be well advised not to make a hasty move in the wake of the recent uncertainties.

These considerations lead me to conclude that a further and more detailed study is called for before deciding on provisioning, although the possibility of the future adoption of provisioning need not be excluded at this stage.

Nevertheless, as I stated at the outset, the risk of an erosion of the financial position of the Fund is a real one, aside from the legal question I have raised. I therefore have no objection to an increase in the reserve target or an introduction of a reserve target that would be set in a certain proportion to overdue repurchases or to outstanding credit to members with overdue obligations. In considering this matter, financial constraints and implications for the future need to be fully taken into account, but at this stage I have an open mind about the particular modalities.

Mr. Massé made the following statement:

Overdue financial obligations to the Fund have continued to mount in the past year, although the problem remains confined to a limited number of members. The risk of increasing overdue obligations suggests that the Fund must assess the adequacy of the measures currently in place to deal with this problem. In this connection, there seem to be at least two aspects that we should address: to ensure that the financial integrity of the Fund is maintained, and to address the underlying factors that are contributing to the problem in a manner that is consistent with the responsibilities and operations of the Fund. I will begin by addressing the first of these issues, that of ensuring the financial integrity and credibility of the Fund, and the perception of such integrity.

It is a reasonable proposition that sharp increases in the amount of obligations that are overdue for protracted periods suggest a greater risk of impaired value of some part of the Fund's assets. I am convinced that our reaction to this problem

must fully reflect the unique nature of the Fund and its unique role as an intergovernmental cooperative organization. In this connection, it appears that not all aspects of GAAP--specifically provisioning--are relevant to this institution. Provisioning may cast doubt on the good faith of some members and create a moral hazard that would be damaging to the vital cooperative spirit that is at the heart of the Fund. Therefore, my authorities continue to believe that provisioning is an inappropriate response to overdue obligations.

In addition, it is noteworthy that while the fundamental purpose of GAAP is to ensure a full and fair disclosure of financial position, in the case of the Fund, members do have frequent opportunities to review in detail the Fund's income position and other aspects of its financial operations. Generally speaking, member governments do not rely on the published financial statements of the Fund to satisfy this purpose. Therefore, there should be no illusion that the membership is not fully aware of the financial position and operations of the Fund.

However, as I have already noted, there is reasonable evidence suggesting greater risk from several specific sources. We must therefore react to this risk appropriately, while not undermining or eroding the nature of the Fund.

Furthermore, there is the question of a qualified audit. I do not think that the Fund's auditors would question the financial standing of this institution. However, they require us to recognize our problem with overdue obligations, and to develop a coherent and structured response to it. Avoiding a qualified audit can be important vis-à-vis a wider audience of interested observers, including the banking community: if the Fund is to continue to play its active, central, and catalytic role in the international monetary system, it must not only be in fact financially sound and competent, but also appear to be so. In other words, a qualified audit risks undermining the stature and perception of competence of the Fund, and it is to be avoided, while maintaining the Fund's unique nature.

This naturally, and logically, suggests a re-examination of the role of reserves in the Fund. As in the past, my authorities feel that the Fund's reserves should be the principal means of safeguarding the Fund's financial position against payments arrears. It could be useful for us to review fully the question whether the current level of reserves and their rate of increase, given all the potential uses of reserves, provides adequate safeguards. An increase in the reserve level, or a faster pace of reserve accumulation, if needed, clearly should be borne by the membership in general. But in the absence of a mechanism that would distribute these costs to all member countries, it is reasonable to apply the principles of burden sharing to these

costs. In addition, I would agree with the general approach suggested by the staff for determining any needed increase in reserves in respect of overdue obligations, namely, a presumptive rule, which, for example, might be related to the total credit outstanding to members who have been declared ineligible.

Another option for consideration, more closely linked to the particular problem of risk resulting from specific arrears, is to establish a class of reserves outside the context of our general reserves in recognition of the risk stemming from protracted overdue obligations. For instance, we might consider devoting the 2.5 percent of the reserve target that is already burden shared to the funding of a category of reserves for this specific purpose.

A more rigorous connection to outstanding overdue obligations would be to link the annual increase in this special reserve category to a fraction of the total claim on those debtors which, for example, have been declared ineligible, so that over a period of several years, an amount equivalent to the total claim would be added to this class of reserves. Again, I believe that the cost of building up this class of reserves should be borne widely by the membership by applying the burden-sharing formula. This year, a portion of excess income might also be used to help fund this class of reserves, a question we could deal with next week when we discuss the Fund's income position.

Developing this particular class of reserves might go farthest in safeguarding the Fund's position, while maintaining the unique nature of the Fund and satisfying the external auditors. This idea would of course be subject to amounts that could be generated under burden-sharing principles and the reserve target, which we may want to reconsider in view of this proposal. I would like to stress that my own authorities have not yet come to any firm conclusions on these options, but consideration and study by the staff of the Fund's reserve position, in general, and of the various possibilities would be very helpful.

At the outset of my remarks I referred to the need to address underlying factors that are contributing to the problem of existing and prospective overdue obligations. In this respect, a key consideration is the objective of assisting members to strengthen their economies. An enlargement of the resources available under the structural adjustment facility could lead to more efficient adjustment programs over a reasonable time horizon in those members where the risk to the Fund would otherwise be the greatest. It is therefore important that the Managing Director's proposal regarding enhancement of that facility be fully explored, not only because of the contribution that it will make to putting these countries in a sound economic and financial position,

which is of course inherently desirable, but also because this in turn will minimize the probability of incurring arrears to the Fund, and will thereby strengthen the Fund.

Finally, Mr. Chairman, I can support the proposed decision on special charges.

Mr. El Kogali made the following statement:

This chair having in its constituency the majority of the countries in arrears has the most difficult situation at the present meeting and is very much concerned with the issues of overdue obligations and provisioning.

Our position on provisioning has not changed from the one stated at the Board's previous discussion on the subject. Provisioning is neither consistent with the character of the Fund and its Articles of Agreement, nor the appropriate way of addressing the problem of overdue financial obligations. The present staff paper presents no new convincing answers to the many doubts and questions raised by Directors against provisioning in the context of the Fund at the time of our first discussion of the issue. In this regard, I fully share the views expressed by Mrs. Ploix.

Provisioning does not appear to have a proper place in the context of the Fund, which has a unique character as an inter-government cooperative institution dealing with sovereign countries. Its integrity and credibility is more dependent on the collaboration and support of its members than on the market perception of the strength of its financial position.

The Fund makes its resources available to a member in exchange for an equivalent amount of the member's currency, as expressed in terms of the SDR. This valuation is independent of the member's fulfillment or nonfulfillment of its repurchase obligations. As was stated by the Legal Department at our last discussion: "the Fund's holdings of a currency cannot be written off, i.e., accounted for below the SDR rate, even when the member is in arrears." According to the Articles of Agreement, the value of the Fund's holdings of a member's currency must always be maintained in terms of SDRs. Therefore, the effective realizable value of an asset held by the Fund is always equal to its book value, as members are under obligation to compensate for any depreciation in the value of their currencies held by the Fund. The argument that provisioning is needed to compensate for an impairment of the effective realizable value of the Fund's assets has no basis. The only situation in which provisioning might be considered in the context of the Fund and the Articles of Agreement would be if a member refused to maintain the value of the Fund's holdings of its currency or if it withdrew from

the Fund and repudiated its financial obligations to the institution. So far, none of the countries in arrears to the Fund has expressed any such intentions.

Provisioning is not only inconsistent with the nature of the Fund and the Articles of Agreement, but could also prove harmful to both the Fund and members concerned, and may hinder any early settlement of arrears. Rather than strengthening the financial position of the Fund, provisioning might raise more doubts and questions regarding the role of the Fund in helping its members in the current, difficult circumstances, characterized by a systemic liquidity squeeze and widespread problems for a large number of countries. In particular, the catalytic role of the Fund and its ability to arrange concerted financial packages may be impaired by the possible negative implications of provisioning. Provisioning would also require that the Fund make a judgment regarding the creditworthiness of members in arrears which could have serious implications for the countries concerned and make the possibility of finding ways and means for an early clearance of the arrears even more remote. In addition, countries in arrears, under the impression that their debts have been written off by provisioning, may attach less priority to settlement of overdue obligations to the Fund or give up on their efforts to reduce the arrears.

The steps already taken to strengthen the financial position of the Fund--in particular, the building up of reserves by more than doubling the reserve target and retaining income in excess of the target amount--are adequate and no further steps are needed now, whether in the form of provisioning or special reserves. While the question of overdue obligations raises serious concerns, it is neither appropriate nor in the interest of the Fund to present the situation in a crisis form as if the institution were being confronted with a generalized risk of non-payment of outstanding credit. Therefore, our position is that there is no need for provisioning, at least not at this time.

As for the issue of overdue financial obligations to the Fund, we are deeply concerned about the increasing amount and lengthening duration of arrears. It is disturbing to note in the main conclusion of the staff paper that not much progress has been achieved toward a satisfactory resolution of the problem. This finding should at least stimulate critical questions with regard to our policies on the treatment of the problem and reaffirms the view this chair has consistently held that our present approach to the problem of overdue obligations has not contributed in an effective way to the desired solution and that there is therefore a clear need for a more pragmatic approach.

The present policy has been ineffective for a number of reasons we have stressed on previous occasions. I will just mention a few of those reasons. Our policies are based on a generalized approach, while the problem we are facing is more limited, requiring specific and innovative case-by-case solutions. Many of the measures adopted, such as suspending access of countries in arrears to the Fund's resources, declaring them ineligible, and imposing special charges, are more punitive than helpful in creating an environment conducive to enabling these members to meet their obligations. Our policies are preoccupied with addressing the symptoms of the problem rather than going deep to the roots and handling the actual causes and circumstances that lead to the situation.

In this context, I found two of the staff findings, while not new, of particular interest. First, countries in arrears are limited to a small number of members, and serious problems of overdue obligations do not appear to be spreading across a broader range of countries. Second, among those countries in arrears, only three or four countries account for the bulk of overdue obligations, and are experiencing protracted arrears. I should add to these findings that most of those in arrears are small, low-income countries for which the Fund represents a major creditor. These facts clearly indicate that a solution to the problem may be found in concentrating our effort on the few cases and trying to find a workable and realistic solution for each case, not only in clearing the arrears but also in ensuring the necessary conditions for these countries to remain current in their obligations, as many of them have to continue making sizable payments to the Fund for some years. Such a solution would definitely require that we approach the problem with flexibility and an open mind, without any predetermined positions. When such a flexible approach is accepted, I am sure many of us will have specific proposals and contributions as to what can be done.

While recognizing the importance of working together with other multilateral institutions, creditors, and donor countries to find a solution to the problem of overdue obligations to the Fund, it is important to stress here that such collaboration should not become a means to put undue pressure on members in arrears by different parties. Instead, collaboration should be aimed at finding more durable and realistic solutions through enhancing the countries' ability to meet their obligations. The few cases where some members have been able to settle their arrears through bridging finance supported by Fund arrangements have raised a number of questions regarding the essence of Fund arrangements, including whether in this exercise Fund arrangements have not been turned into a refinancing mechanism for repurchases to the Fund, which represents an entire departure from the original objective of Fund arrangements--to provide

necessary financing in support of adjustment efforts. Resources from the Fund are being paid to commercial banks that provided bridging finance to clear the arrears, while the countries' domestic efforts are left without the needed financial support, and, therefore, adjustment can hardly succeed. One does not need to quote examples to prove this point.

With the good news on the enhancement of the structural adjustment facility and the evolving comprehensive strategy to help low-income countries, I hope that a solution will be found to this difficult problem.

On special charges, I see no logic in continuing with these charges which have not achieved any of the intended objectives. On cost recovery, one of the objectives of special charges, the staff concludes that "it remains the case that actual cost recovery thus far has been only very partial." On incentive for timely settlement of obligations the staff again states that "overall, no pattern of differences in payments performance emerges that could be attributed clearly to implementation of the system of special charges." Perhaps the only certain result of the system of special charges is to increase the burden on countries in arrears and make it even more difficult for them to become current.

Mr. de Groote made the following statement:

It must be recognized that the incidence of overdue financial obligations to the Fund poses serious problems for the Fund's credibility and financial position.

At the same time it must be borne in mind that the Fund is an intergovernmental institution whose members are sovereign states, and which is therefore unlikely to become insolvent. Even more important, because the Fund's activities differ fundamentally from those of the commercial banks, responses which are appropriate on the part of the commercial banks may be found quite inappropriate on the part of the Fund. One such difference arises because the Fund's activities consist of the purchase and repurchase of currencies. The Fund's holdings thus consist of its members' currencies, which have inherent value, rather than of claims on those members in the usual sense.

Given the current external circumstances, we agree with Mr. Nimatallah's statement that by introducing provisioning, we would send the wrong signal to the commercial banks. Making provisions would be inconsistent with the leadership role the Fund has taken in the past during its negotiations with the commercial banks. The Fund should be perceived as a leader of banks. For the Fund to seem to follow the lead of the commercial

banks in provisioning could be interpreted as a sign of weakness. Therefore, we should take no decision for the present. This view is reinforced by the fact that the creation of a new account would not change the Fund's liquidity situation in the short term.

The impact of headlines in the press to the effect that the Fund is provisioning its members could also be adverse: the newspapers would not give much emphasis to the background or to the fact that the amounts involved are small, and such headlines would therefore loom larger than any possible qualified statement by the external auditor. For this reason, we disagree here with Mr. Nimatallah, who would set aside a small amount to satisfy the external auditor.

As concerns the pressure from the external auditor for the Fund to follow Generally Accepted Accounting Principles, these principles seem more appropriate to the operations of the commercial banks than to those of the Fund. It is clear that we cannot open a provisioning account for political reasons. Almost everyone on this Board will agree on this point. We would have to give any such account a different name, in which case it would no longer satisfy the Generally Accepted Accounting Principles. All this is to say that what we have before us is an accounting problem, but one not amenable to the Generally Accepted Accounting Principles, which we should therefore not attempt to follow in this case.

There is another fundamental difference between the operations of the Fund and those of the commercial banks which bears on the present discussion. The commercial banks made provisioning of, say, 20 percent because they believe it is highly probable that a similar portion of their claims will not be repaid. In the case of the Fund, however, the staff clearly states on page 13 of its paper:

As noted earlier, the Fund until recently has not had a problem of overdue obligations, nor has it experienced a loss or could it be easily foreseen that it would do so. The major risk facing the Fund arises from the impact of protracted overdue obligations on the Fund's assets and on the financial position of the Fund and the inherent difficulties in coming to a conclusion as to when the Fund is likely to be repaid.

This reflects the staff's conviction that the Fund will be repaid in the end, and that the existing liquidity problem is only temporary. Seen in this light, the problem facing the Fund is completely different from that facing the commercial banks.

The purpose of provisions is not to solve liquidity problems, but to cover probable losses. Liquidity problems should be addressed by the creation of reserves, which is already being done on a continuing basis.

The function of reserves is still another area of divergence between the commercial banks and the Fund. The reserves of a bank have an equity character and are created to broaden the bank's equity base. For the Fund, whose operations consist of purchases and repurchases of currencies, it is the quotas which bear an equity character, while it is the reserves created by the Fund which serve to protect it against adverse future events.

It has been proposed that a "special account" should be opened in order to avoid obstacles to repayments of members posed by the Articles of Agreement, which state that reserves may not be distributed while general reserves can only be distributed in proportion to the quotas of the members. In the event of repayment of the overdue obligations, the balances held in this special account would be reimbursed to the members who had created them.

The argument for opening such an account is considerably weakened, however, because in fact the burden-sharing principle we have adopted makes a repayment of retained income possible by stipulating that the funds generated by this principle are recorded separately. Section II of the principle of burden sharing states that:

The additional net income shall be generated in accordance with the provisions of Section V. It shall be recorded separately in the financial statements of the Fund.

In Section V, we read:

An amount equal to the proceeds of any adjustment made under paragraph 2(a) in order to generate supplemental income in financial year 1988 shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration as a result of the adjustment, when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide.

There is thus no need to open a special account, since this function is already assigned to the burden-sharing mechanism.

In any case, there is little realistic hope that the overdue payments will be repaid in the near future, and consequently little need for us to worry at present about the repayment of resources.

All these arguments seem to compel us to the conclusion that at least for the time being the Fund would be well advised to open neither a provision account nor a special account, but rather to protect its assets by the implementation of the burden-sharing principle, and by the creation of reserves as it has done until now. As to the question whether the level of these resources is presently high enough to protect the Fund against adverse events, this is a completely different question which demands to be considered in a separate discussion.

Mr. Ayales made the following statement:

The view of this chair on provisioning in the context of the Fund has not changed since last year's discussion. We still have some difficulties in supporting the proposition of both general and specific provisions to present a fair and accurate statement of the institution's financial position. We believe that the measures already taken by the Fund are adequate to deal with the problem of the accumulation of arrears by a small number of countries, and we are, if necessary, willing to consider further steps to protect the Fund's financial position.

I agree with the main points expressed by Mr. Grosche, Mr. Salehkhoulou, and Mrs. Ploix and will focus my brief comments on two aspects: the nature of the Fund as an intergovernmental, cooperative institution, and the measures already implemented in order to strengthen the institution's financial position.

We fully share Mrs. Ploix's view that the Fund should not follow commercial accounting practices regarding provisioning. We are particularly concerned about damaging members' credit-worthiness. This would be very unfortunate, as the members in arrears belong to an intergovernmental, cooperative institution, and there is no clear indication that these countries would repudiate their obligations. Furthermore, in some cases it is difficult to assess the probability of a loss to the Fund. We have serious doubts about the compatibility of provisioning with the Articles of Agreement in the context of the Fund as an intergovernmental cooperative institution.

In any case, provisioning in the context of the Fund will send a misleading signal to the financial community and to member countries about the present role of the Fund in dealing with the debt problem and other medium- and long-term structural problems.

Although the Fund is not a financial institution that needs to raise resources in the private financial markets, we fully agree that the revolving character of the Fund's financial resources must be preserved. In this regard, we share the concern about the recent increase of overdue obligations and are

willing to consider further steps to offset the impact of arrears on the Fund's financial position. However, as we pointed out on the occasion of the last Board discussion on the six-monthly report on overdue financial obligations to the Fund, the problem of arrears to the Fund is part of a larger picture, namely, the debt problem, and, in this context, it is not realistic to expect an overall solution.

As arrears have become significant, the Fund has taken the necessary steps to safeguard its financial position: net income target has been increased to 7.5 percent of reserves for financial years 1987 and 1988; income in excess of the targeted amount has been added to reserves; it has been decided that the charges from members that are overdue for six months or more should no longer accrue as current income; special charges on overdue obligations have been introduced; the timing of procedures for dealing with such arrears has been shortened; and periodic evaluation of the financial position of those members with protracted overdue obligations has been introduced. We believe that these measures, reinforced with further initiatives to confront the problem of mounting arrears, could avoid the need to resort to provisioning. The uncertainties surrounding the evolution of the world economy call for more flexibility in tailoring specific actions and procedures to individual countries, instead of the adoption of mechanical rules.

Having expressed our views on this matter, we support the proposed decision on special charges in the paper on overdue financial obligations to the Fund. Regarding provisioning in the context of the Fund, although we are in broad agreement with the policies and procedures implemented thus far, we cannot support provisioning as a means to deal with the problem of an accumulation of arrears to the Fund and by strengthening of the institution's financial position.

To conclude, as Mrs. Ploix stated so clearly, the unique nature of this institution explains the need for accounting practices that, in some cases, should differ from those followed by commercial banks and other financial institutions. I also fully share Mrs. Ploix's views that the Fund's image vis-à-vis its own members should concern us more than the image perceived by the international financial community.

Mr. Di Mauro made the following statement:

Recent developments described in the report on overdue financial obligations highlight two basic considerations. First, the situation of overdue obligations is worsening and is likely to continue to deteriorate. Second, a pattern of two distinct groups of countries in arrears seems to have been established: a group

of "hard case" countries with large and long-standing overdues, and a group of "soft case" countries with small amounts of overdues and short delays in their payments.

The present strategy, however, remains in our opinion still appropriate in spite of the worsening situation. Specifically, it is doubtful that a more lenient approach could induce debtors to adopt appropriate policies for restoring solvency.

In any event, some improvements are possible. First, more emphasis should be placed on preventive measures. In particular, we stress the need to enhance the assessment of members' capacity to meet their financial obligations before allowing them to make use of Fund resources. In addition, Fund surveillance over policies far in advance of the emergence of imbalances should also be enhanced. Second, urgent consideration should be given to the proposal of excluding countries in arrears from the quota increase. Third, cooperation between the Fund, the debtors, and the creditor countries should continue to be improved. To this end we welcome the innovation introduced in the present report which summarizes the status of cooperation between the Fund and members subject to complaints.

As for the system of special charges, we feel that after one year of operation the results are quite disappointing. Only 15 percent of total special charges levied in the period under review have been paid. Furthermore, only minor debtor countries have paid, and none of the five countries ineligible to use Fund resources has paid. Moreover, there is no clear evidence that the system has significantly improved incentive for timely settlement. The only positive aspect is that there might be a probability that some countries' performance would have been worse in the absence of these charges. Despite this skepticism we can support the proposed decision.

As for the question of provisioning, the staff paper has not provided any further evidence that could bring us to reconsider our position against provisioning in the context of the Fund. As in the past discussion on provisioning in May 1986, we believe that provisioning is somewhat at odds with the nature of this institution and that it provides no special features that could not be fulfilled by the present policy of reserve increase.

There are two broad classes of issues which make the case against provisioning in the context of the Fund: the nature of the risk this institution is subject to in its lending policy and the particular nature of the accounting of this institution.

On the nature of the risk, we need not add much with respect to the previous discussion on provisioning. We wish to recall, however, that the risk in Fund operations is conceptually and

technically very different from that faced by other financial institutions and will continue to be so. Owing to the cooperative nature of this institution, the loans are, in fact, granted through an exchange of assets between members. Therefore, the losses can occur technically only if a member in arrears withdraws from the Fund--a rather remote possibility.

Having said this, however, the rising trend of the overdue obligations in the past few years and the possible gradual impairment of some of the assets of the Fund has to be dealt with as a matter of priority. The real issue is whether provisioning is a more efficient instrument to deal with these problems than reserve accumulation. Moreover, is provisioning coherent with the nature and therefore the accounting practice of this institution?

A quick look at the features which distinguish the accounting practice of the Fund from other financial institutions can be useful. First, the Fund is a nonprofit, cooperative association. This implies that the income position does not derive from a process of maximization of earnings for the sake of paying dividends and reinforcing the equity base. Rather, income is established, ex ante, through the combination of the rates of charge and remuneration and is retained for the sake of building up reserves. Second, and strictly connected with the former point, the "accuracy" of the reporting on the asset side can be less stringent than in a profit-oriented organization. On the one hand, there is not the risk for the Fund to redistribute excessive earnings by keeping overvalued assets. On the other hand, there are no tax considerations which suggest the necessity to aim at a "fair," in private sector terms, representation of its financial position.

In this respect, we do not believe that in the context of the Fund provisioning represents a necessary step to achieve, as the staff indicate, an "accurate reporting of the Fund's financial position." Accuracy, in fact, cannot be interpreted in the Fund in the same way as in other profit-oriented financial institutions since the asset impairment concerns only the liquidity of assets. Moreover, accuracy should be sought in all parts of the budget, including the gold assets. In this vein, provisioning and reserve accumulation cannot be conceptually distinguished in the context of the Fund so clearly as the staff implies. The accumulation of reserves can accomplish the function of protecting the institution from unexpected operational and administrative expenditures, which in the paper is called the general uncertainty, and also can protect the Fund from impairment or material loss of assets, which is called the uncertainty in conducting operations. In this sense, we do not see reasons to depart from the current practice of protecting the Fund's financial position only through reserve accumulation.

However, while we see no advantages or technical reasons to have an explicit form of loan-loss provisioning, we do see negative consequences. First, the introduction of provisioning could be interpreted as an indication that the Fund is considering the possibility of writing off some of its loans, damaging the image of the institution other than hampering its capacity of collecting overdue obligations. Second, the decision could further negatively affect the financial creditworthiness of those members whose debits would be identified as necessitation of provisioning.

To conclude on this point, while we do not see any specific function that could not be fulfilled by reserve accumulation, we notice some clear disadvantage in having specific provisioning against losses.

On the positive side we must admit that the potential impairment of the Fund's assets is a cause of concern. In the past we have been favorable to all the measures aimed at reinforcing the financial position of the Fund while maintaining its cooperative nature. And we will continue to do so.

In light of present circumstances, we believe, therefore, that some further step in reinforcing the financial position of the Fund can be taken. In particular, we favor the establishment of additional ad hoc special reserves. For instance, and similarly to what Mr. Massé has proposed, one could establish that when a member is declared ineligible to use Fund resources, additional ad hoc reserves in a certain proportion to overdue obligations will be accumulated. These additional reserves, however, should be refunded to the contributor as the individual overdue situation is normalized. Like Mr. Grosche we would welcome further study by the staff on the nature of the Fund's reserves and on the establishment of some kind of special reserve.

In any event, we are open to discussing options similar to the one just mentioned as far as they are not conceived as explicit provisioning and as far as these options are considered in the broader context of burden sharing.

Mr. Nimatallah noted that a number of Directors had referred to the need for some kind of special reserve. He would be prepared to support the establishment of a special reserve account if there was not the necessary support to introduce provisioning. He had an open mind on how the special reserves would be financed.

Mr. Hospedales made the following statement:

The case for provisioning rests wholly on the existence of overdue financial obligations to the Fund and on considerations of the likely impairment of the Fund's assets. What is the record

with respect to overdue obligations? While growing by approximately 23 percent in the current six-month review period, these obligations continue to be limited to a relatively small number of members with protracted problems of external financial management. In fact, two members in ineligible status account for 50 percent of total arrears, and five members for 80 percent of total arrears.

It seems that the present modalities for dealing with the issue are not achieving the established objectives and clearly appear to be inefficient and ineffective. The system of special charges is a case in point, and, like Mr. Salehkhoulou, we continue to believe that its continuation is counterproductive. Accordingly, the problem of a sustained growth of arrears, although limited to a few countries, could become a matter of even more serious concern than at present if not approached through alternative techniques and methods. The increasing proportion of outstanding Fund credit represented by arrears and the fact that arrears are equivalent to Fund reserves are clear evidence of the need for resolute, decisive, and imaginative action.

Most members have continued to meet their obligations to the Fund and they have done so despite a progressively deteriorating external environment for developing countries: weak terms of trade; modest growth in industrial countries--the main market for the exports of developing countries; relatively high interest rates; and critically low financial flows, even to adjusting developing countries. The recent action of a number of large money-center banks is also relevant in this respect. The strengthening of preventive measures, including increased attention to particular elements of program design and the enhancement of collaboration between the Fund, debtors, creditors, and donors, can contribute significantly to the containment of the problem. We urge continued perseverance with respect to this process.

However, we remain convinced that the arrears problem is generally the result of special circumstances pointing to the need for a selective solution that in some cases may have to be different from the one applied so far. Therefore, as a matter of urgency we should accord the highest priority to the resolution of the problem of the special arrears cases; such a focus would undoubtedly ensure the establishment of a process to reignite growth in these countries. But in order to create such a growth-oriented environment, the manner in which we deal with arrears and repurchases must be reviewed.

We are encouraged by the staff's recognition in its four-point strategy for dealing with arrears that the relevant provisions of the Articles of Agreement will be applied so as to encourage members to become and remain current with the Fund. We hope, therefore, that the papers on the legal and technical

aspects of the provisions of the Articles of Agreement relating to a postponement of repurchase obligations and the payment of charges in domestic currency will provide the Fund with additional leverage for dealing with the problem.

The full implementation of these provisions, together with the adoption of growth-oriented adjustment programs by debtors, should attract the appropriate net positive financing from creditors and donors, resolve over the medium term the members' difficulties, and restore normal relations with the Fund. I will take this opportunity to commend the Managing Director's recent initiative for enlarging the structural adjustment facility. In this way, the serious risk of a continued and perhaps substantial deterioration of the Fund's financial position owing to overdue obligations will be avoided.

In the interim, given the Fund's character as an intergovernmental cooperative institution and the resulting difficulty in reaching conclusive judgment as to the likely impairment of assets and the probability of loss arising from overdue obligations, we have strengthened the Fund's financial position in important respects. The increase in net income and reserve targets with associated burden-sharing arrangements have been working as envisaged. They continue to offer considerable protection against current uncertainties created by the persistence of overdue financial obligations to the Fund and do not require further strengthening through the establishment of provisions. Such an approach would send a clear signal to the international financial community that we have reached a judgment on the effective realizable value of our outstanding assets and that, therefore, the probability of loss in a commercial sense is highly likely. This will lead also to increased charges on members least able to bear that additional cost--a development we cannot support, and to lower remuneration payments. These actions will not be in the interest of this institution and the members concerned.

The staff has correctly stressed that all members in arrears are committed to repaying the Fund, and although the situation in these countries remains critical, payments have been made since the emergence of their arrears. Even the adoption of a rule to provide for the establishment of provisions with respect to arrears beyond a specified time period would not constitute a basis for determining that such assets are value-impaired and that a loss is probable.

We look forward to the next review of the burden-sharing arrangements and, while we are not convinced of the practicality of Mr. Ismael's multifaceted scheme, we would be interested in the answers to the questions posed by him. I will also be interested in the staff's examination of the technical issues raised by Mrs. Ploix.

Mr. Foot remarked that while he agreed with aspects of many Directors' interventions, he did not agree entirely with any speakers' comments. It was somewhat encouraging that the number of members with overdue obligations of six months or more had stabilized. However, the overall financial situation of some of the lowest-income member countries had not improved, and the financial health of some members with protracted overdue obligations had worsened. Given current commodity prices, the existing Paris Club arrangements, and the limited availability of funds under the structural adjustment facility, their economies were unlikely to improve dramatically in the short term. Therefore, he found it hard to agree with Mrs. Ploix's insistence on the relevance of the maintenance of the value of the Fund's holdings of some domestic currencies, and he came to the conclusion, like Mr. Nimatallah, that the value of some of those holdings was currently impaired.

Two questions followed from that conclusion, Mr. Foot indicated. First, what action could the Fund take to restore the financial health of those countries in arrears? Clearly, there was considerable political will, through a variety of channels, directly to improve the health of many of the poorest members, which included the great majority of members in arrears. Those were appropriate responses for the international community and the Fund, as a cooperative institution, to be fully involved in. If those initiatives did not exist, the case for provisioning would be much stronger.

The second question was whether the Fund's overall financial strength required protection by means of provisioning, Mr. Foot indicated. Based on the Fund's balance sheet, the answer was no. Even if there were to be a qualified audit, although he hoped that there would not be, it would be mistaken for any observer to conclude that the Fund's overall financial position was unhealthy. If the Fund were a commercial banking institution, it would not be considering such a narrow range of options. Mr. Di Mauro had made some relevant remarks in that respect. The Fund's financial strength might even be weakened by provisioning if it led some members to believe that their obligations might one day be written off. It could also be the case that with the increase in the rate of charge that would follow from provisioning, and which would be considerable even if the burden were fully shared and the reserve target reduced, borrowing members that had successfully struggled to stay current might give up their efforts, thus further undermining the financial health of the Fund. One consequence of that consideration was that his authorities would undoubtedly be prepared to consider provisioning more positively if a substantial number of borrowing members wished to provision and if the financial implications of provisioning had been fully spelled out. He was particularly uneasy about ideas that would involve a start to provisioning by the use of some objective rule, such as X percent of all arrears more than Y years outstanding, which would not cost much in the current financial year, but which could cost a great deal in future years. Nor was he particularly impressed by the "let us put aside what we have to spare"

school of thought, which would be initiated by setting aside some of the excess income from financial year 1987. Any response would have to be consistent with the magnitude of the problem.

In sum, he shared the view of those Directors that were opposed to provisioning at the present time, but he could agree to further studies of the issue, including some detailed and realistic projections of likely costs of provisioning against the likely room left under burden sharing and on the assumption of different rates of reserve target. However, first, the Executive Board must indicate to the External Audit Committee that positive and constructive initiatives were being taken to address the problem of arrears. Furthermore, Directors' doubts about whether provisioning would in fact strengthen the Fund's financial position should also be expressed to the Committee.

Mr. Sengupta made the following statement:

On the two papers on provisioning in the context of the Fund and overdue financial obligations to the Fund, our position has not changed since our last consideration of these subjects. We are of course worried that total overdue obligations at end-May 1987 have been higher than those at the end of 1986, especially in the very short period category of "less than two weeks," and in longer-term categories of over six months. The problem however is not general, as we stated during our last consideration of the subject, and is confined to a few countries. While preventive measures and measures to protect the Fund's financial position are useful, they do not, as the experience of the last two years shows, help to resolve the specific problem. Nor did the introduction of special charges, to provide incentives to clear arrears and perhaps to recover costs and losses to the Fund, succeed in overcoming the problem. We need to intensify collaborative efforts among the Fund, the countries in arrears, and creditors and donors to clear the arrears of the few countries facing acute payments imbalances. Actions here involve three elements: the adoption of adjustment policies by countries in arrears within the framework of social, political, and economic realities, with a view to attaining recovery and growth; the provision of adequate debt relief and finance to these countries by the international community; and the creation of an economic and trading environment that is conducive to these countries' recovery. The six-monthly report on overdue obligations shows that the five countries which have been declared ineligible to use Fund's general resources accounted for almost 80 percent of the total outstanding overdue obligations. For these countries to undertake external as well as structural adjustment, if necessary with assistance from the Fund and World Bank, there has to be initially some debt relief and bridging finance. This requires a change in the attitudes of creditors and donors toward members in arrears, as much as a commitment of the members in arrears to growth-oriented adjustment.

As against this approach to the problem of overdues, the focus of the paper on provisioning in the Fund's financial statements in the context of the overdues is a narrow one. It merely aims at the limited objective of protecting the Fund's financial position. The staff's "structured" approach to the evaluation of risks boils down to what may be called a "presumptive" rule according to which provisions or contingency allowances would be established "against an obligation that has been overdue for a specified period of time, say, 36 months, unless settlement of these overdue obligations in the very near future was confidently expected." The paper, however, does not consider how serious the problems would be if provisioning were introduced in an organization like the Fund, even though it refers to the Fund's character as an intergovernmental cooperative institution. The Fund has to be extremely careful in its relations with members, as any provisioning against a specific asset or a class of assets could be interpreted as an exclusion of the concerned member or as an expression of no confidence in the policies of the member concerned. Besides, the nature of transactions that the Fund carries out is different from the transactions of commercial organizations and banks. This is well known but worth recapitulating. First, the Fund's transactions with its members take the form of sales of currencies or SDRs for an equivalent amount of the purchasing member's currency and do not take the form of loans. Second, the valuation of the Fund's holdings of currencies has to be expressed in terms of SDRs, as outlined in the Articles of Agreement--Article V, Sections 10 and 11 dealing with "computations" and "maintenance of value." Third, the SDR rates for currencies are determined in accordance with the Articles--Article XIX, Section 7(a)--and Rules--Rule O-2. Changes in the values of currencies in terms of the SDR during a given period are taken care of by the maintenance of value provision, and do not therefore suggest an impairment or enhancement in the value of a currency held on account of purchase by the member concerned. It would, therefore, be difficult to establish that a certain proportion of a currency held by the Fund has lost its value or has reduced value, so long as the SDR rate for the said currency has not changed. The staff's presumptive rule seems to suggest that the Fund could establish the "effective realizable" value of its asset that represents its outstanding credit to a member. Could such a value be tested at any place other than the market? How does such a testing at the market take place? In what form? Could the Fund evaluate a member's currency, held by it, in a manner different from its evaluation of other members' currencies? Would not such a procedure be against the uniformity of treatment of members? Can the Fund establish such a procedure in the case of a member merely because that particular member is in arrears to the Fund? Supposing it adopts such a procedure, will it not affect the creditworthiness of the member concerned and thereby, impede, in certain cases, possible correction of the external payments position of the member?

These are important questions that have not been addressed in the paper.

Apart from these questions, there is the point that if the Fund can establish the "effective realizable" value of one of its assets, it should be able to establish such values for all its assets, presumably also gold, and present the financial statements in as fair a manner as possible. But this is not the approach we have followed so far, because the character of the Fund is distinct and is not to be regarded as a commercial organization. But you cannot have it both ways--if some asset's value is "impaired" because of market perception, then some other asset's value which has been enhanced should also be considered. This could open up a large number of issues, including the concept of reserves and the role of gold, which is held in the Fund as an asset and is not included in the definition of reserves.

The staff raises the point that, in view of the large and protracted overdue financial obligations, "and in the absence of an explicit evaluation by the Fund on the assets that have not been repurchased," the External Audit Committee (EAC) "may conclude that the Fund's financial statements have not been prepared in accordance with Generally Accepted Accounting Principles." Let me here raise a question which, to many Directors, may look like a minor one. But it is crucial. I am tempted to quote Section 20(d) of the By-Laws, which is the relevant one for understanding the issue raised by the staff. This section of the By-Laws states: "The annual audit shall be conducted in accordance with generally accepted auditing standards, and shall include such tests of the accounting records and such other auditing procedures as are considered necessary." There is no mention of Principles here nor is there any mention of "accounting" principles. Besides, the staff report capitalizes the first letters of the words, Generally Accepted Accounting Principles, as if these are given and universally accepted as such.

Let me here allude to what the Generally Accepted Accounting Principles state about provisioning. On this issue, the earlier staff paper (EBS/86/82), quoting the International Accounting Standards Committee (IASC), stated that provisioning would be called for if (a) a loss of an asset appears "probable," and (b) its magnitude can be estimated. In the paper before us today, the staff argue that the concept of loss in the context of the Fund's Articles of Agreement is too narrow, a piece of wisdom that has dawned upon the staff subsequently to the earlier discussion, based on its own paper. The way and the reason for this change would be a very interesting subject of research by a future historian of the Fund. The Legal Department's staff paper SM/86/106 of May 1986 had established that the concept of loss as used in the Articles of Agreement can be used only in two

instances: in connection with the liquidation of the Fund and the withdrawal of a member. The Legal Department also stated then that the probability of a loss could arise in connection with the withdrawal of a member, for instance, if the member has expressly repudiated all its obligations to the Fund. Nonfulfillment of a repurchase obligation, the Legal Department stated then, does not necessarily result in a loss for the Fund: it has a negative impact on the liquidity of the Fund, but it does not affect the SDR value of the Fund's currency holdings, if the SDR rate for the member's currency has not changed. This paper also held that the nonfulfillment of the maintenance of value obligation reduces the value of the Fund's holdings but it does not reduce the value of the Fund's assets because the Fund has a claim for the difference on the member.

Since the probability of loss cannot be established, the staff paper for today's discussion states that the need for provisioning in the context of the Fund should be both in terms of an impairment of the effective realizable value of Fund assets as well as of probable loss. It is thus an extension of what the International Accounting Standards Committee stipulated in the sense that it adds one more dimension, namely, the impairment of the effective realizable value of Fund assets. But the paper does not explicitly state that the added dimension is an alternative to the concept of probable loss. As I understand it, the paper seems to suggest that probable loss cannot be estimated "in the absence of any experience of loss." It concentrates only on the issue of impairment of the effective realizable value of Fund assets, but here, it does not make any estimates of probability. It merely links the said impairment to the duration of the overdue payment, as a matter of a rule. In other words, impairment of the effective realizable value of Fund assets is determined, not estimated, on the basis of an agreed, but arbitrarily agreed, duration of overdue repurchases. It cannot be judged as a probable loss, as there is no objective criteria to estimate that probability. Obviously the principles that the staff refer to are its own, and not those of the IASC.

As I see it, the effective realizable value of Fund's holdings of currencies cannot be found out except at the market. But the Articles of Agreement do not give any authority to the Fund for sale of currencies in the market by the Fund except after withdrawal of a member. If that is so, how can there be a presumptive rule of the sort that the staff suggests?

Now let me turn to the suggestion that the effective realizable value of assets with respect to repurchase obligations that are overdue by three years could be considered to be impaired. The staff argues that provisions may be made for such overdues or that reserves may be increased so as to protect the Fund's financial position. Table 2 of Appendix III shows that only

SDR 19 million of repurchases are overdue for three years or more, while the credit outstanding of members overdue for three years or more amounted to about SDR 113 million at end-March 1987. Assuming reserves to be SDR 1,206.2 million, reserves would represent 1,071 percent of total credit outstanding. Reserves in relation to repurchases overdue for more than three years amounts to 6,348 percent. I cannot see any reason for provisioning in terms of increase in reserves as suggested by the staff on the grounds of its presumptive rule. I have heard Mr. de Groote on Mr. Massé's suggestion about special reserves and I agree that there is no reason why general reserves cannot do what special reserves are supposed to do. But more important, I see no reason to be worried about the adequacy of reserves, general or special, in the context of provisioning, as the figures we have quoted would show. Here I may point out that the staff paper can give some misleading signals, especially when it refers to Table 3 to show the reserves to credit ratio as an indicator of the Fund's exposure to risk, to say that "by March 1987, credit outstanding to members in arrears for six months or more approached twice the size of reserves" (192 percent). But "arrears for six months or more" is not the relevant category. The relevant category is "three years or more" and the figure would be only 9.3 percent in 1987.

There is also the question whether provisioning will not act as a disincentive for members to clear arrears to the Fund. The paper does not address this issue. In this connection, I have noted the suggestion that the costs involved in provisioning or in increasing the reserve target should be borne by the membership in general. While this is no doubt well intentioned, it is hardly adequate in view of the floor set to the remuneration coefficient. The paper does not raise any issues concerning the burdens that would be imposed on the debtor countries in the event provisioning is introduced, even under the burden-sharing principle. The rate of charge on the use of Fund's resources is already high and the adjustments entailed by the burden-sharing principles adopted last year are substantial. If the purposes of the Fund are to be met, it is necessary to ensure that Fund resources are made available not only adequately but also on reasonable terms.

Once again, this chair is opposed at this stage to any form of provisioning or increase in reserves due to evaluation of the type suggested in the staff paper.

The Executive Directors agreed to continue their discussion in the afternoon.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Schneider, Alternate Executive Director, upon the completion of his service with the Board.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/85 (6/8/87) and EBM/87/86 (6/12/87).

4. GUYANA - OVERDUE FINANCIAL OBLIGATIONS - NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

1. The notice of the Managing Director dated June 1, 1987 in EBS/87/120 (6/1/87) on the failure by Guyana to fulfill obligations under Decision No. 5069-(76/72) is noted. The notice shall be placed on the agenda of the Executive Board for June 19, 1987.

2. Consideration of the notice of failure to settle Trust Fund obligations particularly affects Guyana. The member shall be informed by rapid means of communication of this matter and of its right to present views through an appropriately authorized representative.

Decision No. 8610-(87/86), adopted
June 8, 1987

5. MOROCCO - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Morocco has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Morocco (EBS/86/262, Sup. 3 (12/17/86), concerning the nonobservance of the performance criterion on outstanding external payments arrears referred to in paragraph 4(a)(vii) of the stand-by arrangement.

2. The Fund finds that, in view of the circumstances pertaining to the nonobservance of the performance criterion on outstanding external payments arrears as of March 31, 1987, as described in EBS/87/121 (6/3/87), no additional understandings are necessary and Morocco may resume purchases under the stand-by arrangement.

Decision No. 8611-(87/86), adopted
June 9, 1987

6. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION
ON COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE
TRUST FUND OBLIGATIONS - RESCHEDULING

Paragraph 5 of Decision No. 8540-(87/35) G/TR, adopted March 2, 1987, as amended by Decision No. 8602-(87/80), adopted June 1, 1987, shall be further amended to read: "The Fund shall review this decision not later than June 17, 1987." (EBS/87/113, Sup. 3, 6/10/87)

Decision No. 8612-(87/86), adopted
June 11, 1987

7. EXTERNAL ASSIGNMENTS PROGRAM

The Executive Board approves the recommendation of the Committee on Administrative Policies that the ceiling on the maximum number of staff members who may participate at any one time in the External Assignments Program for Professional and Career Development be increased from five to ten. (EBAP/87/131, 6/9/87)

Adopted June 11, 1987

8. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/127 (6/3/87).

Adopted June 8, 1987

9. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/164 through 86/166 are approved. (EBD/87/152, 6/5/87)

Adopted June 11, 1987

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/129 (6/5/87), EBAP/87/130 (6/8/87), and EBAP/87/132 (6/9/87) and by Advisors to Executive Directors as set forth in EBAP/87/129 (6/5/87) and EBAP/87/133 (6/10/87), is approved.

APPROVED: December 16, 1987

LEO VAN HOUTVEN
Secretary

Statement by Mrs. Ploix at EBM/86/85, 5/19/86

Mrs. Ploix noted that the present discussion was a preliminary one; many of the points that had been made about the Fund's accounting structure required further study. The External Audit Committee had endorsed the Treasurer's proposal to establish a more comprehensive and structured approach to whether or not a material loss was probable with respect to members with protracted overdue obligations to the Fund. Although that endorsement did not specifically support a provisioning system, there was clearly a need to hold regular reviews of the risks of protracted arrears.

The staff had noted the number of technical problems with respect to provisioning, Mrs. Ploix remarked. The first one concerned accounting principles governing the preparation of the Fund's financial statements. The staff had suggested introducing a line on the liability side of the Fund's financial statements that would distinguish the "credits" that were to be covered. Provisioning by reducing assets was not practical, as the Fund did not extend credits like a bank. Instead, members made purchases and the Fund held the counterpart of the purchases in the national currency of the member making the purchases. Under Article V, Section 11, that counterpart was subject to periodic re-evaluation at the Fund's initiative. To reduce that "debt" denominated in SDRs would imply a reduction in its counterpart in national currency. Such a reduction could not be made, since it would involve the Fund's existing assets. That conclusion had been supported by the staff's discussion linking the idea of loss with the concepts of withdrawal and writing-off.

An important issue was how to determine a loss in the context of the Fund, Mrs. Ploix continued. If a member had clearly expressed its intention not to repay the Fund, the loss for the Fund would depend on the market value of the currencies held by the Fund. However, such a loss had never been recorded by the Fund. In order to provision against such a loss, the Fund would have to assess the possible amount of the loss--a delicate matter--and would have to assess the chances that the country would break all ties with the Fund and would freeze all the Fund's assets in the country's central bank--an even more delicate matter. Although those events were unlikely to occur, it was conceivable that a member would withdraw voluntarily or as a result of a decision by the Board of Governors under the provisions of Schedule J.

Another technical problem had to do with the financial consequences of provisioning, Mrs. Ploix remarked. As provisioning was an item of expense, provisions raised certain financing issues. The staff had mentioned on page 15 of EBS/86/82 several means of financing provisions and the costs involved. Other means were conceivable. The main issue was who should bear the cost of provisions. In her view, the cost must be borne by the entire community through a system of burden sharing. That subject was to be discussed separately in the near future. However, the suggestion to introduce provisioning stemmed from the wish to protect the Fund's financial position, and the aim of the discussion on the issue

was to enable the Fund's financial structure to absorb losses. Those matters, as well as the role and the appropriate level of the Fund's reserves should be considered separately.

Provisioning would cause serious political problems in members, Mrs. Ploix noted. A system of provisioning should not run the risk of internal slippages; once a system was established, it might be tempting to provision against less obvious and less widely recognized risks. Problems with respect to the Paris Club and international financial practices would then arise, particularly if the provisions had to be tailored to individual country cases. In any event, a multistep system for dealing with overdue financial obligations had slowly taken shape and had yielded positive results. The introduction of provisioning could reduce the pressure on members to reduce their arrears to the Fund. The question might arise whether a particular member needed the Fund or vice versa, since the Fund dealt with sovereign nations rather than with individuals and business concerns. Moreover, a creditor that introduced provisions usually did not make debtors with poor payment records aware of the creditor's provisions; that fact might well be an argument against the introduction of specific provisioning in the context of the Fund.

While she agreed with Mr. Dallara that in many areas the international financial community looked to the Fund for guidance and leadership, there was no clear evidence that the Fund had to take a leading role with respect to provisioning, Mrs. Ploix said. The Fund must not be mistaken for a credit institution for the reasons that she had mentioned during the discussion on provisioning on April 30, 1986. The nature of the Fund was unique, owing to the Fund's particular mechanisms, its nonprofit status, and its relations with its members, both net borrowers and lenders. The need to maintain confidence in the Fund was a separate matter from the issue of provisioning. It was important to preserve the cooperative character of the Fund; all members should help the Fund to deal with problems facing the institution. While the Fund could use its reserves to absorb slight income deficits, solving significant problems was the responsibility of the entire membership.

The World Bank was prepared to adopt a system of provisioning in the near future, but that fact was not relevant for the Fund, as the natures of the institutions were very different, especially with respect to their accounting, lending, and borrowing practices, Mrs. Ploix remarked. While collaboration between the institutions and symmetry in their practices were desirable in general, provisioning was not a common area of interest. The issue of provisioning was closely linked to the nature of the Fund in general, and to its rules and accounting principles in particular. The issue of provisioning deserved a more thorough analysis, including an evaluation of the usefulness and suitability of increasing the Fund's reserves and of proposals on how to share the corresponding burden of that effort.