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The Acting Chair's Summing Up
Review of the Role and Adequacy of Precautionary Balances
Executive Board Meeting 08/107
December 8, 2008

Executive Directors welcomed this review of the role and adequacy of the Fund's precautionary balances, which was timely in view of the sharp rise in Fund lending since mid-2008 and the ongoing review of the Fund's financing instruments. This review also provided guidance to staff on the further development within the new income model of a framework for reserve adequacy, reserve accumulation, and dividend payments. In this connection, Directors urged all national authorities to take the necessary domestic legislative steps to make the Fund's new income model effective.

Adequacy of Reserves

Directors noted that the recent and projected continued rapid increase in Fund credit associated with the global financial shock has shifted the balance of risks sharply from income risk to credit risk. Furthermore, they recognized that the establishment of the Short-Term Liquidity Facility could reinforce the existing volatility and concentration of Fund lending. The ongoing review of the Fund's financing facilities and policies—including the proposals to increase access limits, redesign financing instruments, and review surcharges and conditionality policies—could also have a bearing on financial risks. An adequate level of precautionary balances remains an essential buffer to protect the value of reserve assets that members place with the Fund, and would also be critical if the Fund were to borrow substantially to supplement its resources.

Directors stressed that these developments underscore the need for a forward-looking approach to assessing the adequacy of precautionary balances. Most Directors can accept the current target for precautionary balances of SDR 10 billion. Many Directors, however, were not entirely convinced that this target was appropriate. On balance, Directors were willing to retain this target for the time being. They stressed, however, that this target should be kept under close review, and a number of Directors observed that it may need to be raised if lending expands significantly and remains high.

Framework for Reserve Accumulation

Directors endorsed the development of a more transparent and rules-based framework for reserve accumulation. Such a framework should be based on a comprehensive assessment of the risks facing the Fund, and would include how the reserve target would be set and adjusted over time, the modalities for accumulating reserves, and how reserves in excess of the target would be handled. In general, however, Directors cautioned against a mechanistic quantitative approach to risk assessment and reserve targeting, stressing that considerable judgment will need to be applied given the unique nature of the Fund's lending operations, including the use of conditionality and the Fund's preferred creditor status. In this regard, a number of Directors observed that the Basel II framework has limited applicability to the Fund, although some Directors considered that it could be useful in providing general guidance. In the same vein, a number of Directors noted that a reserve target linked to credit outstanding, as is done in other international financial institutions, would need to be adapted to the Fund environment. These Directors cautioned against benchmarking the Fund's precautionary balances to other international financial institutions' practice because of the Fund's unique business model.

Directors emphasized that credit risks should be the primary consideration in assessing reserve adequacy under the new income model, since this model is expected to significantly mitigate the Fund's overall income risks. They re-iterated that the rate of charge should be set in a stable and predictable manner. Some Directors highlighted the need to reform the burden-sharing mechanism in the context of the new income model, while a few Directors urged a prompt reform of the Fund's de-escalation policy to better mitigate income risks.

As to assessments of reserve adequacy, Directors supported utilizing a variety of forward-looking indicators. They also supported the further development of scenario analysis and stress tests. Some Directors considered that a target range for the reserve ratio would be more appropriate than a single ratio to take into account Fund credit volatility and concentration. Some Directors thought that it might be better to also use alternative credit measures, such as average credit levels outstanding, credit commitments, an assessment of possible credit demand over the medium term, or credit capacity. Directors also noted that the Fund will become more exposed to other forms of risk, such as market and operational risk, as its investment mandate expands and the endowment financed from gold sales is established, and these factors would also need to be taken into account.

Directors noted that surcharges have been the most important influence on the pace of reserve accumulation in the past. They agreed that, once the Fund returns to a positive net income position, surcharge income should again be placed directly to reserves to help accelerate the pace of reserve accumulation, observing that this would also tend to insulate the Fund's budget from fluctuations in lending income. Some Directors considered that the pace of reserve accumulation could be faster than projected by the staff, especially given the increased lending—much of it under exceptional access and hence at higher interest rates. A few Directors felt that consideration should be given to again targeting a growth rate for reserves through the basic rate of charge, though a balance would need to be struck with the objective of stability in the margin for the rate of charge.

Most Directors agreed that that the Fund's reserves should be kept in a single pool, and that both credit and income risks should remain important elements in considering the overall adequacy of precautionary balances. However, a number of Directors considered that separate reserves for credit risk and for market and income risk would be more transparent and more consistent with the new income model, and that this issue should be explored further. A number of Directors, while supporting a single pool of reserves, believed that a clearer framework is needed for differentiating the two types of risks, and that different accumulation policies might apply.

Most Directors supported the payment of dividends when precautionary balances exceeded the targeted level. Some Directors favored combining a dividend payout with a downward adjustment in the rate of charge. A few Directors also suggested that decisions on a dividend policy should await the new income model being effective.