EBS/90/216

CONFIDENTIAL

December 20, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Financial Consequences of Compulsory Withdrawal

Attached for the information of Executive Directors is a paper on the financial consequences of the compulsory withdrawal of a member from the Fund. A summary and conclusions appear on pages 14 and 15.

Mr. Wittich (ext. 8307) or Mr. Keuppens (ext. 7813) is available to answer technical or factual questions relating to this paper.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Financial Consequences of Compulsory Withdrawal

Prepared by the Treasurer's Department

(In consultation with Other Departments)

Approved by Gerhard Laske

December 19, 1990

I. Introduction

The strengthened cooperative strategy for dealing with overdue financial obligations to the Fund envisages, as a final measure, that the Executive Board exercise its power under Article XXVI to propose to the Board of Governors that a member be requested to withdraw from the Fund. Under the revised timetable of procedures for that strategy, the initiation of steps that could lead to compulsory withdrawal is to be considered by the Executive Board within nine months after a declaration of noncooperation or (after adoption of the Third Amendment of the Articles) within six months after a decision to suspend the voting and representation rights of a member. 1/ Executive Directors have requested an analysis of the financial consequences of a member's withdrawal from the Fund. This paper responds to that request.

The financial impact on the Fund of the withdrawal of a member would depend on the position of the member at the time of withdrawal. The potential effects could be quantified more precisely only at the time the compulsory withdrawal of a particular member is under consideration. This paper, therefore, deals only with the general financial aspects resulting from a withdrawal. It is organized as follows: Section II briefly summarizes the provisions for the settlement of accounts; Section III sets out the Fund's exposure to the risk of loss; Section IV contains a discussion of the consequences following from compulsory withdrawal; and Section V summarizes the impact on the Fund's financial position. A summary and conclusion is given in Section VI.

II. Provisions for the Settlement of Accounts

The relevant provisions of the Articles and the detailed steps that need to be followed in connection with the compulsory withdrawal of a member are discussed in "Overdue Financial Obligations to the Fund--Ineligibility to Use the General Resources and Subsequent Actions by the Fund--Legal Aspects". 2/ These procedures would be initiated by a complaint that a member is not observing obligations under the Articles. There are no specific time periods specified for the various steps that follow the issue of a complaint, and the completion of the procedures, from the time a complaint is issued to a recommendation by the Executive Board to the Board of Governors that a member be requested to withdraw from the Fund, may take several months.

1/ See "Statement by the Managing Director on the Strengthened Cooperative Strategy on Overdue Financial Obligations to the Fund, Executive Board Meeting 90/37 - March 16, 1990" (Buff 90/58, 3/15/90, and revisions of the Attachment of February 28, 1990). See also "Overdue Financial Obligations to the Fund - Six-Monthly Report" (EBS/90/166, 9/20/90).

2/ SM/86/102 (5/14/86), particularly pp.10-18. See also the Appendix to the Statement by the Managing Director on Overdue Financial Obligations to the Fund--Further Considerations at Executive Board Meeting 90/24 (Buff 90/45, 2/22/90).

It should also be noted that a member that withdraws from the Fund is deemed to have simultaneously terminated its participation in the SDR Department. 1/ Moreover, withdrawal from the Fund automatically terminates, after three months, membership in the IBRD unless the Bank by three-fourths of its total voting power agrees to allow the country to remain a member. 2/

After the withdrawal becomes effective, the member is obligated to settle its accounts with the Fund. Settlement with the General Department is to be made by agreement with reasonable dispatch. 3/ As regards the General Resources Account (GRA), the difference between the amount owed to the GRA, including charges accruing after the date of withdrawal, and the member's claims on it (including an amount equal to its quota), is to be paid to the Fund in a freely usable currency. 4/ This redemption is normally to be completed within five years from the date of withdrawal (or such longer period as may be fixed by the Fund). 5/ If a member does not adhere to the schedule of settlement, the Fund may liquidate its remaining holdings of the member's currency in an orderly manner in any market. The Fund's maintenance of value provisions, which require maintenance of the SDR value of the Fund's holdings of the member's currency, no longer apply after withdrawal but the member has the obligation to compensate the Fund for any losses in terms of SDRs on the proceeds of the liquidation of the holdings of the member's currency.

III. The Fund's Exposure to Risk of Loss

In considering exposure to the possibility of loss, the Fund's various accounts--the General Resources Account (GRA), the SDR Department, the Trust Fund and the Special Disbursement Account (SDA)--have to be evaluated separately and dealt with in their own context. The Fund's exposure to loss in the GRA, the SDR Department, and the Trust Fund and SDA in regard to the nine members with protracted arrears to the Fund at October 31, 1990 is shown in Table 1, as well as the Fund's precautionary balances.

1/ Article XXIV, Section 1(b).
2/ IBRD Articles of Agreement, Article VI, Section 3.
3/ Article XXVI, Section 3.
4/ The withdrawal from the Fund would not modify the terms of the member's indebtedness to the Special Disbursement Account or to the Trust Fund, and obligations would continue to fall due at the scheduled payment dates.
5/ Schedule J, Section 4.

Table 1. Members in Protracted Arrears
Exposure in the General Department, SDR Department, & Admin. Accounts
as at October 31, 1990
(In million of SDRs)

	Kampuchea	Liberia	Panama	Peru	Sierra Leone	Somalia	Sudan	Viet Nam	Zambia	Total
General Resources Account										
Holdings of currency	37.49	272.84	305.06	873.26	113.26	141.43	773.97	205.19	936.08	3,658.58
Quota	25.00	71.30	102.20	330.90	57.90	44.20	169.70	176.80	270.30	1,248.30
Reserve tranche position	0.01	0.03	0.01	--	0.02	--	0.01	0.01	0.02	0.11
Net holdings	12.48	201.51	202.85	542.36	55.34	97.23	604.26	28.38	665.76	2,410.17
Overdue charges	11.07	106.70	51.01	174.51	19.22	28.09	294.68	18.98	257.13	961.39
Overdue assessments 1/	0.20	0.02	--	--	0.01	--	--	0.06	0.05	0.16
Total obligations to GRA in excess of quota	23.57	308.23	253.86	716.87	74.57	125.32	898.94	47.42	922.94	3,371.72
Less: burden shared charges	3.34	71.77	52.30	169.07	17.59	27.36	194.45	9.54	239.03	784.45
Net GRA obligations	20.23	236.46	201.56	547.80	56.98	97.96	704.49	37.88	683.91	2,587.27
Precautionary balances										
Reserves										1,456.70
SCA-1										249.70
SDR Department										
SDRs below allocation	15.42	21.01	26.32	91.32	17.46	13.70	52.19	47.66	68.30	353.38
Overdue net SDR charges	7.81	4.21	--	--	2.40	--	0.91	9.06	17.39	41.78
Total SDR obligations	23.23	25.22	26.32	91.32	19.86	13.70	53.10	56.72	85.69	395.16
Other										
Trust Fund loans outstanding	--	24.86	--	--	9.21	6.46	67.68	50.12	6.94	165.27
Overdue Trust Fund interest	--	0.69	--	--	0.14	0.06	1.85	1.49	0.11	4.34
SAF loans outstanding	--	--	--	--	11.58	8.84	--	--	--	20.42
Overdue SAF interest	--	--	--	--	0.14	0.09	--	--	--	0.23
Total other obligations	--	25.55	--	--	21.07	15.45	69.53	51.61	7.05	190.26

1/ Assessments to reimburse the GRA for administration of the SDR Department.

1. General Resources Account

The Fund's maximum exposure to loss in the General Resources Account is equal to the amount by which the SDR equivalent of the Fund's holdings of a member's currency exceeds its quota (representing the member's subscription), plus other Fund claims on the member (outstanding charges, 1/ assessments to cover expenses of General Department in conducting the business of the SDR Department, and charges accruing after withdrawal becomes effective).

a. Overdue repurchases

The Fund's exposure in respect of principal is equal to the member's outstanding use of Fund credit, less any outstanding reserve tranche position. Use of Fund credit--purchase of the currencies of other members or SDRs against an equivalent amount, in terms of SDRs, of the member's own currency--results in an increase in the Fund's holdings of the member's currency, and the member has an obligation to maintain the SDR value of the Fund's holdings of its currency by, if necessary, periodically depositing additional amounts of its currency with the Fund. The currency is held in deposit with the member's central bank or designated depository and often currency is substituted by noninterest-bearing promissory notes which are payable upon demand. The Fund's holdings of a member's currency, including any outstanding currency valuation adjustments receivable or payable by the Fund, are then equal to the outstanding use of Fund credit plus the member's quota reduced by any outstanding reserve tranche position. 2/

In the absence of settlement in accordance with the prescribed or an agreed schedule, the Fund may dispose of a member's currency that should have been redeemed in an orderly manner in any market; the member remains liable to compensate the Fund for any loss resulting from the difference between the value of its currency in terms of SDRs at the date of withdrawal and the value realized through the sale. 3/ Any proceeds resulting from such a disposal would reduce the member's obligation and the amount of possible loss. However, since the currency or notes substituting for currency are held by the depository of the member, such sales would require

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1/ The risk of loss on charges that have been covered under the implementation of the Principles of Burden Sharing falls on members that have paid higher charges or received lower remuneration. This aspect is discussed below.

2/ The media used in transactions with the Fund have no influence on the value of the member's obligations which is expressed in SDRs. In particular, the fact that a part of a member's subscription or charges may have been paid in gold is of no relevance in calculating the member's obligation and hence the Fund's exposure to loss, since all media are valued at equal value at the time of the transaction and enter into the unrestricted ownership of the Fund.

3/ Schedule J, paragraphs 4 and 6.

the cooperation of the member in arrears and it may, in practice, be difficult to find a market for the sale of such currency. 1/

b. Overdue charges

Charges in the General Resources Account due from members in protracted arrears to the Fund have not been recognized as income since March 1985 unless they are paid; they are recorded in the Fund's financial statements as an asset item called 'deferred charges' and an offsetting liability item 'deferred income'. 2/ Until May 1986, charges paid by other members included the estimated amount of deferred charges; since that time, the Fund is compensated for deferred charges through the adjustments to the rates of charge and of remuneration under the Principles of Burden Sharing. When these deferred charges turn out to be uncollectible, the Fund forgoes the income that it otherwise would have received; the part corresponding to charges deferred before May 1986 would, at the time of payment, have accrued to the Fund and the remainder been used to reimburse the members that have paid higher charges and received reduced remuneration for the contributions under burden sharing. These members thus would bear part of the cost of the nonpayment of overdue charges.

Special charges overdue from members in protracted arrears have also been deferred and excluded from the Fund's income. To the extent that those special charges remain unpaid, the Fund forgoes the income that would have accrued at the time of their payment. However, as these deferred charges have not been recognized as income in the year when they accrued and therefore are not reflected in retained earnings (i.e. reserves), the Fund would not incur a loss in terms of a reduction of its capital assets. Nor are special charges taken into account in the current income projections; nonpayment of these charges accordingly also would not result in a shortfall of current net income.

2. SDR Department

A withdrawing member has to redeem its net obligation to the SDR Department. 3/ This obligation is equal to the member's net cumulative allocation of SDRs less the member's holdings of SDRs. (The member's obligations to the SDR Department can exceed its net cumulative allocation to the extent that net SDR interest overdue by the member has resulted in the creation of additional SDRs.) If settlement has not taken place, or

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1/ See "Sale and Use of Currencies of Members in Arrears to the Fund" (EBS/86/271, 12/2/86) and Executive Board Meetings 87/2 and 87/3 (1/7/87).

2/ Executive Board Decision No. 7930-(85/41), adopted March 13, 1985 and No. 8433(-86/175), adopted October 31, 1986. See Selected Decisions (15th Issue), p.203

3/ The settlement procedures for members whose participation in the SDR Department has been terminated are governed by Article XXIV, Section 2, and Schedule H.

agreement on settlement not been reached, within six months of termination of participation, the net obligation is to be discharged within three years or such longer period as the Fund may decide. The obligation is to be settled by payment to the Fund in freely usable currency or in SDRs acquired from the General Resources Account or from participants. Currency received by the Fund from a former participant is to be used by the Fund to redeem SDRs held by participants in proportion to the amount by which each participant's holdings of SDRs exceeds its net cumulative allocation at the time the currency is received by the Fund.

No provisions are made in the Articles for the possibility that a member would not settle its account in the SDR Department, and it would be possible to carry forward any potential loss until liquidation of the SDR Department. The liquidity or usability of SDRs held by other participants, which depends on the distribution of SDRs among participants in relation to acceptance limits, would not usually be affected by the failure of one participant to settle obligations to the SDR Account upon withdrawal. 1/ However, additional SDRs would continue to be created each quarter to meet interest payments as long as the potential loss is not realized (i.e. written off). At the time of liquidation of the SDR Department there would be an imbalance between SDRs allocated and claims on participants, which would reduce the net resources available for distribution to participants. The shortfall (loss) would be borne by all participants in proportion to their allocation. 2/

3. Trust Fund and Special Disbursement Account

A withdrawing member with loans outstanding from the Trust Fund and the Special Disbursement Account (SDA) is required to settle these obligations, and the interest accruing thereon, in accordance with the terms of the indebtedness. 3/ To the extent that a member would not discharge its obligations, a loss would be incurred by the Trust Fund or SDA, and reduce the resources available to the SDA to finance assistance provided through the SDA to other members or the transfers to the ESAF Trust Reserve Account, if these resources would not be needed in the SDA. Similar to the treatment in the GRA, overdue interest on Trust Fund and SAF loans from members in protracted arrears is not recognized as income and has been deferred. Nonpayment of interest consequently would not result in additional losses beyond the loss of income already recognized by the deferral of income.

1/ This would not necessarily hold true if several participants accounting for a substantial proportion of allocations were to withdraw.

2/ The procedures for the administration of the liquidation of the SDR Department are set out in Schedule I of the Articles of Agreement.

3/ There are similar provisions for the ESAF Trust. As members with protracted arrears have no obligations outstanding to the ESAF Trust, this memorandum does not cover the issues that would arise if a member requested to withdraw from the Fund had outstanding obligations to that Trust.

IV. Consequences of Compulsory Withdrawal

In light of the marked increase and persistence of overdue financial obligations to the Fund, the Executive Board in 1986 and 1987 considered the implications of arrears for the Fund's financial position. 1/ The protracted failure of some members to discharge repurchases when due and to settle other financial obligations raised questions about the likely settlement of these obligations and the need to take steps to safeguard the Fund's financial position. In addition, questions arose about the appropriate reflection of any uncertainty as to the value of the Fund's claims on these members in the Fund's financial statements. 2/

In the context of these discussions, the Executive Directors agreed that precautionary measures were called for to safeguard the Fund's financial position. The target amount of net income was raised from 3 percent of reserves to 5 percent, and additional precautionary balances were placed in a newly established Special Contingent Account. The majority of Executive Directors did not consider provisioning (or write-offs) an appropriate step for the Fund at that time. However, the issue would need to be reconsidered, if a member in protracted arrears withdrew from the Fund.

Generally accepted accounting principles, which the Fund generally has followed in the preparation of its financial statements, require that these statements accurately and fairly reflect the value of assets and liabilities; the same is also called for by the Fund's Bylaws. 3/ It would therefore seem appropriate that the Fund, when it requests a member to with-

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1/ See "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86), "Valuation of Assets in the General Resources Account--Provisioning and Write-Off--Legal Considerations" (SM/86/106, 5/16/86), and "Provisioning in the Context of the Fund--Further Aspects" (EBS/87/97, 5/6/87). The Executive Board considered these memoranda at Executive Board Meeting 86/85 (5/19/86) and 87/86 and 87/87 (6/12/87).

2/ The following discussions primarily concerns the General Resources Account. Similar considerations apply, mutatis mutandis, to other Fund accounts, although the consequences--e.g., for the financial statements, or for subsequent actions--may be subject to different considerations and therefore not strictly mirror those applicable to the GRA.

3/ Although the Fund is not subject to any national or international accounting standards, it consistently has used generally accepted accounting principles as a guide to meeting the requirements under Section 20, paragraph (d) of the By-Laws which calls for a confirmation by the External Auditors that the Fund's financial statements present "a true and fair view of the financial position ... and the results of operations and transactions." The External Audit Committee has consistently based its audit on the understanding that generally accepted accounting principles have been applied. A significant departure from these principles would normally lead the External Audit Committee to give a qualified opinion on the Fund's financial statements.

draw from the organization, evaluate the quality of the claims on a member, and the likelihood that these claims will in due time be settled in full. If that evaluation were to lead to the judgement that the repayments ultimately expected to be received would probably be less than the nominal value of the claims, 1/ the implied reduction in value would need to be recognized and reported in the financial statements, and appropriate action would then need to be taken. In particular, provision should be made for probable loss if a judgement were reached that repayment in full appeared unlikely. 2/

As has been mentioned, the Articles prescribe that upon the withdrawal of a member, agreement on the settlement of outstanding obligations should be reached within six months, and it could be considered that the progress on these negotiations itself would provide important indications as to the eventual settlement. Three scenarios could be envisaged to unfold during and following the negotiation for settlement of outstanding claims: (i) the member agrees to a schedule of settlement and meets its obligations under that schedule; 3/ (ii) the member agrees to a schedule of settlement but does not meet, either from the beginning or at a later stage, payments falling due under it; or (iii) no schedule of payments can be agreed, or the member indicates that it is not able or willing to settle its obligations to the Fund in the foreseeable future.

If the Fund could be confident that agreement on a settlement schedule would be reached in accord with the prescriptions of the Articles, and that the agreed settlement procedures be fully adhered to, there would appear to be no need to take further precautionary measures to protect its financial position, and the only impact of the arrears would be the effect on the Fund's liquidity of the extended delay in the repurchase of the withdrawing member's currency. In view of the possibility of such an outcome, it may be thought that the most appropriate time for a substantive consideration of the need for further precautionary measures, and in particular for the need for provisions against probable loss, would be after a decision by the Board of Governors to request a member to withdraw from the Fund, or at the end of the settlement negotiations or following a possible failure of the former member to observe the agreement reached.

1/ In technical terms, when the conclusion is reached that the ultimate realizable value of an asset is impaired.

2/ The prescriptions of generally accepted accounting principles in cases of probable loss, and their application to the Fund, were discussed more fully in "Overdue Financial Obligations to the Fund--Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84) and "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86).

3/ This has been the experience in the four cases of withdrawal in the Fund's history: Poland (1950), Cuba (1964), and Indonesia (1965) withdrew from the Fund, and Czechoslovakia (1954) was required to withdraw. A brief summary of these withdrawals is given in Appendix I.

However, in the circumstances that might lead to compulsory withdrawal, the second and third possibilities--i.e., a failure of the member to meet payments under an agreed schedule, or the failure to agree on a settlement schedule because of the member's perception of inability, or its unwillingness, to settle outstanding obligations due to the Fund--could not be precluded and might, in fact, appear more likely. Either of these possibilities may indicate a probability that part or all of the Fund's claims could not be realized and that the Fund might incur a loss.

It may not be easy to reach a clear-cut conclusion, at the time the Executive Board makes a recommendation to the Board of Governors to consider the compulsory withdrawal of a member, on the likelihood that an agreement on the settlement of the member's obligations to the Fund would be reached and would thereafter be fully observed. Moreover, any such conclusion--and particularly a judgement that claims on the member may not be fully settled within a reasonable time period, i.e. that there exists a "probable loss"--might run the risk of being prejudicial to, and thereby influencing, the negotiations on the terms of settlement.

The difficulties of making these judgements notwithstanding, the developments that lead the Executive Board to make a recommendation of compulsory withdrawal--in particular, the protracted failure of the member to discharge its overdue obligations, and the lack of corrective policies that would provide the basis for the eventual solution to the economic problems that are reflected in the protracted arrears--would not appear to give much reason for an expectation that the arrears would be settled in an orderly manner over a reasonable period of time. While the probability of such settlement would have to be evaluated in each case in the light of the circumstances at the time the Executive Board considers a recommendation of compulsory withdrawal to the Board of Governors, the persistence of arrears over a long period of time and the fact itself that the Executive Board reaches the conclusion to recommend expulsion may be seen to indicate a progressively increasing probability that a loss will eventually be incurred.

On balance, these consideration suggest to the staff that the evaluation in these circumstances may well lead to the conclusion that it would be appropriate for the Executive Board to consider beginning to establish specific precautionary balances against probable loss at the time the recommendation for compulsory withdrawal of a member is made to the Board of Governors.

V. Impact on the Fund's Financial Position

A judgement by the Executive Board that a member probably would not agree to or observe a schedule to settle its financial obligations to the Fund, and a loss therefore appeared probable, would call for appropriate reflection in the Fund's financial position. The following paragraphs discuss first the treatment of a value impairment (the fact that a loss is judged to

have become probable), the determination of its size, and the effect on the Fund's income position and financial statements. Second, the implications for the accounts of the Fund of the subsequent recognition of a loss--a write-off--are described. 1/

1. Value Impairment and Provisioning

a. Estimate of the amount of probable loss

The potential amount of probable loss and its impact on the Fund's financial position depends upon the size and composition of the obligations of the member with protracted arrears that may be compelled to withdraw from the Fund. Although there may be exceptions, in general there would not appear to be any reason to consider that some of the claims on a withdrawing member are more likely eventually to be repaid than other claims. Accordingly, the exposure to probable loss would extend to all rather than only a part of the claims on that member. It would be necessary to evaluate in each case whether the total amount of the claims needs immediately to be provided for, or whether it would be reasonable to consider that the amount of the ultimately unrealizable claim increases the longer obligations remain outstanding without any payment. In the latter case, the proportion of claims on the member that must be judged a probable loss would increase over time, and could be provided for over a period of time, e.g. over a period of five years.

b. Impact on Fund income and balance sheet

Once a loss has been judged probable and its extent determined, generally accepted accounting principles require that it be reflected in the Fund's (or another Account's) financial position and statements. In the GRA, provisions would need to be established to cover the probable loss.

These provisions could be financed from a combination of sources, depending on the circumstances. 2/ First, precautionary balances held in the first Special Contingent Account (SCA-1) have been established to protect the Fund's financial position against the uncertainties connected with protracted arrears, and if no other such arrears existed, any provisions

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1/ The following discussion again is couched, as in the preceding section, mainly in terms of the General Resources Account. However, the same considerations apply, mutatis mutandis, to the Special Disbursement Account, the SDR Department, and administered accounts, even though the reflection in the financial statements or other consequences may differ somewhat.

2/ The following discussion applies to the GRA only, as no precautionary balances exist in the SDA, the SDR Department, or the administered accounts.

should first be charged to balances in that Account. 1/ However, the SCA-1 also provides protection against other arrears, and as long as arrears persist, it would not appear appropriate for reasons of financial prudence, nor would it be consistent with generally accepted accounting principles, to exhaust that Account for the purpose of establishing provisions to cover probable losses on claims on the expelled member. 2/ Charges to the SCA-1 might be limited, e.g., to an amount that reflects the proportion of claims on the withdrawing member to claims on all members with protracted arrears. 3/ Any remainder of the probable loss not covered by balances in the SCA-1 would need to be charged to, and accordingly reduce, the Fund's current income. 4/ If the additional cost were to exceed net income for the year, it would result in a deficit and lead to a reduction in the Fund's reserves; if the deficit--or a cumulation of deficits--exceeded reserves, the losses would be reflected in a reduction of the book value of members' equity in the Fund--the Fund's "capital"--which would thereby be reduced below the total of quotas in the Fund. 5/

For financial reporting purposes, the portion of the provision financed by a charge against current period income is an element of operational cost, separately recognized in the statement of income and expense.

1/ Balances accumulated in the second Special Contingent Account (SCA-2) provide security for purchases outstanding under rights accumulation programs and therefore would not be available to cover a probable loss related to claims on a member that is presently in protracted arrears but has not entered into such a program.

2/ See statement by the Managing Director on Overdue Financial Obligations to the Fund--Further Considerations at Executive Board Meeting 90/24 (Buff 90/45), Section 4.

3/ If the provisions were charged fully to, and possibly exhausted, the SCA-1, the Executive Board then would have to consider the need for the reconstitution of precautionary balances to protect the Fund against remaining protracted arrears. The difference for the Fund between a pro rata charge for provisioning to the SCA-1 in a particular case and a full charge to that Account may not be substantial in economic terms. However, there would be distributional differences, as balances in the SCA when no longer needed will be refunded to members who contributed to these Accounts. These issues would need to be considered further should the need for provisioning arise in a particular case.

4/ If a probable loss were determined during the first half of a financial year, the effect on the Fund's income could lead to an automatic adjustment of the rate of charge under Rule I-6 (4)(b) unless the Executive Board decided otherwise.

5/ Any such shortfall in the book value of the Fund's assets below quotas could, of course, be offset by the realization of part of the excess value of the Fund's gold holdings which are valued at the historical price of SDR 35 an ounce. Any such offset would only affect the impact on the financial statements of the probable loss rather than represent a reduction in its economic costs.

The provision itself would be presented as an allowance account in the liability section in the balance sheet of the GRA. 1/

As mentioned, value impairment or losses for which no provision has so far been made must be reflected in the income for the period during which they occur, in order to be in accordance with generally accepted accounting principles. To charge a probable or realized loss directly against the Fund's reserves would not be an accounting method consistent with these principles. As discussed earlier, to the extent that the cost of a probable loss resulted in a net deficit in any given year, these costs would--after first passing through the Fund's income--reduce the Fund's reserves. 2/

These prescriptions of generally accepted accounting principles apply, mutatis mutandis, to other Fund- or Fund-related accounts (the SDA, the SDR Department, and administered accounts). However, these accounts do not maintain precautionary balances, and probable loss or actual loss would be reflected fully in the financial statements for the affected account.

2. Realization of a Loss and Write-Off

Once the value of a claim has been judged to be impaired, it would need regularly to be reviewed and, unless provisions have been made for the full value of the claim, the adequacy of the provision be evaluated. Furthermore, the probability of future settlement--and in particular, the possibility that the probable loss has turned into a certain one--would need to be considered. 3/

Although the judgement that a loss has become final may be a particularly difficult one to make for claims on sovereign states, at some stage the Fund may find that claims on a former member must be judged uncollectible. They then should be removed from its balance sheet (write-off). A claim would be written off when no recovery of any part of it is in prospect in the foreseeable future. For example, the Fund could consider it appropriate to delete from its balance sheet claims remaining uncollected after a

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1/ An alternative (and for commercial entities more customary) presentation would be to include the provision for probable loss as a deduction from the impaired asset--i.e. from the Fund's holdings of the withdrawing member's currency and securities (or from currencies and securities in general). In view of the maintenance of value provisions of the Articles, such a presentation would not be appropriate to reflect the value impairment of holdings of a member's currency. This form of presentation could, however, be employed for the Special Disbursement Account or administered accounts.

2/ The reflection of a hypothetical probable loss in the Fund's financial statements (balance sheet and income statement) is shown in Appendix II.

3/ It would not be legally possible for the Fund to write off holdings of currencies in the General Resources Account before the withdrawal of a member has become effective and the settlement procedures prescribed by the Articles completed.

specified period (say, 10 or 15 years). The purpose of removing a claim from the financial statements would be to contribute towards the representation of a "true and fair view of the financial position"; it would, of course, not mean that the Fund gives up its claim.

The claim would then be written-off and the loss be charged against the provision established earlier. To the extent that the claim had been fully provided for, there would be no further impact on the Fund's income position; should the actual loss exceed the provision, the shortfall could be charged against the SCA-1 or, if necessary, against net income of the period in which the loss is realized. 1/ The only effect would be a reduction of the Fund's assets (holdings of the member's currency or other claims on the member) and a corresponding reduction of the provision established earlier.

The main difference between provisioning and write-off, then, is that the former recognizes the probable impairment of the realizable value of a claim, but does not remove the claim itself from the balance sheet, while the latter removes the claim as well.

3. Subsequent measures to safeguard the Fund's financial position

As discussed above, the recognition of a probable or realized loss when a member withdraws from the Fund is likely to affect the precautionary balances, and possibly the reserves, of the Fund's General Resources Account, depending upon the size and composition of the potential loss. Similarly, it could affect the position of the other Accounts. Following the recognition of such a loss, the Executive Board would need to consider the desirability of corrective financial measures. In particular, the Board may wish to evaluate the adequacy of remaining precautionary balances in the GRA (balances in the Special Contingent Account and the level of the Fund's Reserves) in view of continuing financial uncertainties facing the Fund. It would need to consider both the desirability of measures to rebuild precautionary balances, and the impact any such measures would have on the Fund's operations. For the GRA such measures could include a reduction of the remuneration coefficient (to the extent possible under the Articles) and an increase in the rate of charge, unless a conclusion were reached that circumstances would make the consequences of such a rebuilding undesirable in the then prevailing circumstances. A similar evaluation would need to be undertaken for the other accounts--the SDR Department and the Trust Fund and Special Disbursement Account--which do not hold precautionary balances and

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1/ Conversely, should an actual loss be less than the specific provision, the excess would be restored to the SCA (or to income if the provision had been charged to income); if it were no longer needed in that Account, it could be distributed to the contributors.

are likely to be governed by different considerations. The desirability of such additional measures to protect or strengthen the financial position of any of the Fund's or Fund-related accounts would depend, of course, on the nature of the account and the particular circumstances at that time.

VI. Summary and Conclusions

1. The Strengthened Cooperative Strategy for dealing with protracted overdue financial obligations to the Fund foresees as a last step the initiation of procedures that could lead to the compulsory withdrawal of a member in protracted arrears. This paper reviewed the financial consequences for the Fund of such a withdrawal.

2. Following compulsory withdrawal, a member shall settle its accounts with the Fund's General Resources Account with reasonable dispatch, to be completed within five years from the date of withdrawal or such longer period as may be fixed by the Fund. Obligations to the SDR Department are to be settled within three years or such longer period as the Fund may decide; and obligations to other Fund-related accounts are to be settled in accordance with the terms of the accounts.

3. It would be appropriate for the Fund when it requests a member to withdraw from the organization to evaluate the quality of the claims on the member and the likelihood that they would be settled in due time. That evaluation could be undertaken when the Executive Board recommends to the Board of Governors to consider requesting a member to withdraw, or when the Board of Governors has decided to issue such a request, or when the member fails to observe the schedule of settlement. In the circumstances under discussion in this memorandum--consideration of compulsory withdrawal because of protracted failure to settle overdue financial obligations to the Fund-- it would appear appropriate if such an evaluation is made when the Executive Board makes a recommendation to the Board of Governors to consider requesting a member to withdraw.

4. If such an evaluation indicates that settlements ultimately expected to be received would probably be less than the nominal value of the claims, the implied impairment in the value of the claims (probable loss) would need to be recognized and reported in the Fund's financial statements.

5. While each case will need to be evaluated in the light of prevailing circumstances, the protracted failure of the member to discharge its overdue obligations and the lack of corrective policy measures that would provide the basis for the eventual solution of its economic and balance-of-payments problems may be seen to indicate a progressively increasing probability that a loss would eventually be incurred. Accordingly, it may be appropriate to consider beginning to establish additional precautionary balances in the form of provisions against probable loss at that time.

6. The exposure to loss has to be considered and dealt with separately for each of the various Accounts of the Fund--the General Resources Account, the SDR Department, and the Trust Fund and Special Disbursement Account.

7. The exposure to probable loss would appear likely to extend to all of the claims on the member being requested to withdraw, rather than covering only a part. It may not be unreasonable to consider that the amount of the ultimately unrealizable claim increases the longer obligations remain outstanding. The proportion of claims on the member that must be judged a probable loss then would increase over time, and it may be reasonable to provide for these claims over a period of time, e.g. over a period of five years.

8. Provisions for probable loss could be financed, at least in part, from precautionary balances in the first Special Contingent Account (SCA-1), although it would not be appropriate to leave that Account exhausted while other protracted arrears persist. Charges to the SCA-1 might be limited, e.g., to an amount that reflects the proportion of claims on the withdrawing member to claims on all members with protracted arrears. Any remainder would be charged to the Fund's current income and could lead to a deficit which would reduce the Fund's reserves.

9. Once the value of a claim has been judged to be impaired, it would need to be reviewed regularly and, unless provisions have been made for the full value of the claim, the adequacy of the provision established against it be evaluated. Furthermore, the possibility that the probable loss has turned into a certain one would need to be considered, and at some stage the Fund may find that claims on a former member should be considered uncollectible. They should then be removed from its balance sheet, i.e. written off. To the extent that the claim had been fully provided for, there would be no further impact on the Fund's income position.

10. Following the recognition of a probable loss, the Executive Board would need to evaluate the adequacy of remaining precautionary balances in the GRA, in view of continuing financial uncertainties facing the Fund. It would need to consider both the desirability of measures to rebuild precautionary balances, and the impact any such measures would have on the Fund's operations. A similar evaluation would need to be undertaken for the other accounts--the SDR Department and the Trust Fund and Special Disbursement Account--which may be governed by different considerations. The desirability of such additional measures to protect or strengthen the financial position of any of the Fund's accounts would, of course, depend on the particular circumstances at the time.

Overview of Withdrawals from the Fund

Four members have withdrawn from the Fund since its inception. Of these Poland, Cuba, and Indonesia elected to withdraw, while Czechoslovakia was required to leave the Fund. This section briefly summarizes the surrounding circumstances.

1. Poland

Under Article XV, Section 1 of the original Articles of Agreement, a member could withdraw from the Fund at any time by transmitting a written notice to the Fund. Withdrawal became effective on the date the notice was received. Effective March 14, 1950, Poland, an original member of the Fund, elected to withdraw.

At the time of its signing of the Articles of Agreement, and in accordance with Article XX, Section 3(d), Poland deposited US$12,500, the equivalent of one-hundredth of one percent of its quota, for the purposes of meeting the administrative expenses of the Fund. As a member who had not established a par value for its currency, Poland was not required to pay the reserve asset portion or the local currency portion of its subscription and had not done so by the time of its withdrawal. 1/ A settlement of accounts pursuant to then Article XV, Section 3 was agreed between Poland and the Fund whereby the Fund retained the US$12,500 deposited by Poland and no further payments were due from either party.

2. Czechoslovakia

On November 4, 1953, the Executive Board declared Czechoslovakia ineligible to use the Fund's resources because it had not fulfilled its obligations to provide information under Article VIII, Section 5, and because it had not fulfilled its obligations to consult with the Fund in respect of its exchange arrangements as required under Article XIV, Section 4. The member argued that the fulfillment of such obligations would violate its national security interests and that, as a result, it was not required under international law to comply with that part of the Articles of Agreement. On September 28, 1954, pursuant to then Article XV, Section 2(b), the Board of Governors resolved to require Czechoslovakia to withdraw from the Fund. The effective date of withdrawal was set for December 31, 1954, unless Czechoslovakia had fulfilled its obligations before that date.

1/ At April 30, 1950, seven other members had not established par values for their currencies and thus, had not paid either the reserve asset or the local currency portions of their quota subscriptions.

Czechoslovakia's obligations had remained unfulfilled through close of business December 31, 1954, and the Fund and Czechoslovakia began negotiations on the settling of accounts. The Fund's holdings of Czech currency in excess of quota of US$125 million amounted to the equivalent of US$3.96 million. In June 1955 the Fund and Czechoslovakia agreed to a settlement of accounts whereby Czechoslovakia would repurchase the Fund's holdings of its currency in twelve equal semi-annual installments, which would commence on January 2, 1956 and be completed on July 2, 1961. 1/ Czechoslovakia proposed that the rate of charge to be levied on the outstanding repurchase obligations be set at 2.5 percent per annum. The Fund agreed to this rate of charge and by July 2, 1961, Czechoslovakia had fully discharged its outstanding financial obligations in accordance with the settlement agreement.

3. Cuba

The withdrawal of Cuba resulted from a disagreement between the member and the Fund over the application of the Fund's policy on the repurchase of outstanding drawings. After agreeing to several requests by the Cuban authorities to defer repurchases of a drawing made in September 1958, the Board and Cuba agreed in December 1961 to a schedule of repurchases that would be completed within the five year period that ended September 1963.

However, in August 1962, Cuba asked for a further deferment and requested that the first repurchase be undertaken in March 1964. In a letter sent to Cuba, the Managing Director stressed that five years was regarded by the Fund as the maximum period for repurchases. Cuba did not respond to this letter.

In September 1963, the Managing Director, pursuant to Rule K-1, notified the Board that Cuba had not fulfilled its obligations under the Articles. The Board then requested the Managing Director to inquire into Cuba's intentions regarding the failure to discharge its repurchase obligations. By January 1963, no response had been received from the member and the Managing Director recommended that the Board consider taking action under Article XV, Section 2(a) which would result in Cuba being declared ineligible to use the Fund's Resources. The Board accepted the Managing Director's recommendation and agreed that on April 15 it would consider whether to take action under Article XV, Section 2(a). However, Cuba elected to withdraw from the Fund in accordance with then Article XV, Section 1, effective April 2, 1964.

1/ For financial statement presentation purposes, the Fund's holdings of Czech currencies were segregated from the Fund's holdings of members' currencies and securities. Also, the subscription of the withdrawing member was reported separately from members' quotas.

In a letter on April 8, 1964, Cuba proposed to repurchase the Fund's holdings of Cuban pesos in excess of Cuba's quota of US$50 million which amounted to US$12.5 million in five equal annual installments that would commence on July 1, 1964 and would be completed on July 1, 1968. Cuba also proposed that a rate of charge of 2 percent per annum be applied to the unpaid portion of the amount subject to repurchase. The Managing Director recommended that the proposal be accepted even though the rate of charge was less than the 6 percent then being levied on Cuba's outstanding repurchase obligations. The Board accepted the Managing Director's recommendation and approved the settlement arrangement. Cuba completed the first four installments as scheduled and requested a six month extension on the final payment. The Fund agreed to this request and Cuba, by January 2, 1969, completed full settlement of its financial obligations in agreement with the revised settlement schedule.

4. Indonesia

Indonesia elected to withdraw from the Fund under then Article XV, Section 1 effective August 17, 1965. At the close of business August 17, 1965, the Fund's holdings of Indonesia rupiah in excess of Indonesia's quota of US$165 million were equivalent to US$63.4 million. At that time, Indonesia's outstanding repurchase obligations amounted to US$102.5 million of which US$41.25 million were gold tranche repurchases. Agreement was reached by the Fund and Indonesia on February 16, 1966 whereby Indonesia agreed to repurchase US$63.4 million in nine equal semi-annual installments and a tenth installment equal to the remaining balance. The first installment would be paid on or before February 17, 1966 and the final installment would be completed by August 17, 1970. Indonesia was also permitted to request postponement of any installment for a period of up to six months. The Fund agreed to Indonesia's request to apply amounts due to it from the World Bank upon its withdrawal from that organization to the first installment and to defer the settlement of the first installment until withdrawal from the World Bank was completed. Indonesia also requested, and the Fund accepted, the postponement until February 17, 1967 of the installment due August 17, 1966. Indonesia proposed and the Fund agreed that the rate of charge on outstanding amounts would be fixed over the period at a rate of 2 percent per annum.

Prior to Indonesia's withdrawal, the calculations and recommendations of the Fourth Quota Review were completed. Had Indonesia not left the Fund, it would have been able, if it wished, to consent to an adjustment that would have increased its quota to the equivalent of US$207 million. On July 5, 1966, Indonesia applied for readmission to the Fund under Article II, Section 2 and was permitted a quota equivalent to that recommended under the Fourth Review.

Under the terms and conditions of membership, the repurchase schedule agreed under the settlement of accounts was revised. Indonesia was required to repurchase US$63.4 million in two installments of US$6.3 million each on

February 17, 1967 and August 17, 1967, and the remaining US$50.8 million in accordance with a schedule to be determined by the Board after August 17, 1967 but not later than one year after the effective date of membership. Indonesia completed its requirements for readmission effective February 21, 1967 and had repurchased the first installment in accordance with the revised schedule. Indonesia paid the second installment in August 1967 and by February 1970 had repurchased all amounts due under the revised schedule.

Reflection of Provisioning in the Financial Statements

The attached proforma balance sheet and income statement for the General Resources Account (as of October 31, 1990) shows the impact on the financial statements of the hypothetical withdrawal of a member that has net obligations to the GRA of SDR 500 million. It has been assumed that a decision has been taken to establish provisions against probable loss of the full amount of net obligations over a period of five years. The first column shows the accounts before provisioning, the second column shows the provisions, and the third column shows the revised accounts.

GENERAL RESOURCES ACCOUNT

BALANCE SHEET
as at October 31, 1990

(In millions of SDRs)

	Balances before Adjustment	Adjustment	Revised Balances
ASSETS			
Currencies and securities	90,764		90,764
SDR holdings	893		893
Gold holdings	3,620		3,620
Charges receivable and accrued	497		497
Deferred charges	1,035		1,035
Quota subscription receivable	970		970
Accrued interest on SDR holdings	21		21
Other assets	41		41
TOTAL	97,841		97,841
QUOTAS, RESERVES, AND LIABILITIES			
Quotas			
Subscriptions of members	91,103		91,103
Reserves and net income (deficit)	1,457	(90)	1,367
Special Contingent Accounts	307	(10)	297
Allowance for probable loss		100	100
Liabilities			
Borrowing	3,523		3,523
Accrued remuneration payable	266		266
Accrued interest on borrowing	82		82
Other liabilities and deferred credits	68		68
	3,939		3,939
Deferred income from charges	1,035		1,035
TOTAL	97,841		97,841

GENERAL RESOURCES ACCOUNTS

STATEMENT OF INCOME AND EXPENSE
for the six months ended October 31, 1990

(In millions of SDRs)

	Balances before Adjustment	Adjustment	Revised Balances
OPERATIONAL INCOME			
Periodic charges	927		927
Addition to periodic charges	60		60
Special charges	43		43
Deduct: Income deferred, net	72		71
	959		959
Interest on SDR holdings	36		36
Service charges	6		6
	1,002		1,002
OPERATIONAL EXPENSE			
Remuneration	680		680
Reduction of remuneration	85		85
	595		595
Interest on borrowing	162		162
Allocation to the Special Contingent Accounts	92		92
Allowances for probable loss		90	90
	849		939
NET OPERATIONAL INCOME	153		63
ADMINISTRATIVE EXPENSE			
Personnel	68		68
Travel	14		14
Other, net	10		10
	93		93
NET INCOME-(DEFICIT)	60	(90)	(30)

SDR DEPARTMENT

STATEMENT OF ALLOCATIONS AND HOLDINGS
as at October 31, 1990

(In millions of SDRs)

	Balances before Adjustment	Adjustment	Revised Balances
ALLOCATIONS			
Net cumulative allocations of SDRs to participants	21,433	(40)	21,393
Charges due but not paid	42	(2)	40
Net claim on terminated participant		42	42
	21,475		21,475
HOLDINGS			
Participants with holdings above allocations:			
Allocations	10,479		10,479
Net receipt of SDRs	5,785		5,785
	16,264		16,264
Participants with holdings below allocations:			
Allocations	10,954	(40)	10,914
Net use of SDRs	6,657	2	6,659
	4,297		4,255
Total holdings by participants	20,561		20,519
Holdings below allocation by terminated participant		42	42
General Resources Account	893		893
Prescribed holders	21		21
	21,475		21,475