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EBS/87/97

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May 6, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Provisioning in the Context of the Fund - Further Aspects

There is attached for consideration by the Executive Directors a paper on further aspects in the provisioning in the context of the Fund, which has been tentatively scheduled for discussion on Friday, June 12, 1987.

Mr. Wittich (ext. 8307) or Mr. Keuppens (ext. 7823) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Provisioning in the Context of the Fund: Further Aspects

Prepared by the Treasurer's Department

(In consultation with the Legal Department)

Approved by David Williams

May 4, 1987

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I. Introduction

In May 1986, the Executive Board considered the applicability in the context of the Fund of the widely observed commercial accounting practice of provisioning, the primary purpose of which is to present a fair and accurate statement of the financial position of an entity at a given time. 1/

The basis of the discussion at the Executive Board was a memorandum prepared by the staff which reviewed, in the context of the Fund, the concept and practice of provisioning under Generally Accepted Accounting Principles (GAAP), against a background of an increasing incidence and a lengthening duration of overdue obligations. The staff memorandum also outlined the considerations that would weigh importantly in a more structured approach towards the evaluation of risk in the Fund in relation to particular overdue repurchase obligations. 2/ In this connection, it was noted that the 1985 External Audit Committee (EAC) had endorsed a proposal of the Treasurer to establish a more comprehensive and structured approach to the evaluation as to whether or not a material loss was probable with respect to members with protracted overdue obligations to the Fund. (The 1986 EAC acknowledged that important progress had been made in developing a more structured approach. The Committee strongly urged the early reconsideration of this matter so that a framework for dealing with overdue obligations as they affect the Fund's financial statements would have been established by the time the 1987 EAC begins its work in June 1987. 3/)

In this context, the Executive Board also discussed the question of the valuation of assets in the General Resources Account, the "writing-down" of assets, and its relation to provisioning. 4/

The staff concluded that in view of the diversity of circumstances that had given rise to the balance of payments problems faced by members with overdue repurchase obligations, it would be difficult, or perhaps not possible, to reach conclusive judgments based on criteria uniformly applicable to all members that outstanding assets which members had not repurchased were impaired or that loss was probable. The staff suggested, therefore, that consideration might be given to the adoption of a presumptive rule that would provide for the establishment of provisions with respect to repurchase obligations that were overdue for a specified time period, say three years. As an interim measure, the staff also

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1/ Executive Board Meeting No. 86/84 and 86/85, May 19, 1986.

2/ See "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86).

3/ The comments by the EAC on overdue financial obligations are reproduced in Appendix I.

4/ See "Valuation of Assets in the General Resources Account - Provisioning and Write-Off - Legal Considerations" (SM/86/108, 5/16/86).

suggested consideration of raising the reserve target in view of the rising volume of arrears to the Fund.

At the discussion, most Executive Directors did not consider that there was a need, at that time, for the Fund to adopt provisioning. A number of reasons were advanced, including the belief that members would eventually meet their financial obligations and, therefore, it might not be possible to establish a probability of loss because members were late in paying the Fund; the fact that the Fund held members' currencies rather than claims in the usual sense of that term was also given as a reason for the difficulty in adopting provisioning in the Fund. Some Executive Directors expressed doubts that provisioning was the appropriate method to deal with the problem of overdue obligations faced by the Fund, and some questioned whether provisioning was consistent with the Fund's character as an intergovernmental cooperative institution and with its Articles. The Managing Director's summing up of the Executive Directors' discussions is reproduced in Appendix II.

Executive Directors agreed that the matter would need to be reviewed again and asked for further analysis of a number of issues. These can broadly be grouped under three headings: (i) the major elements that might be included in a more comprehensive and structured approach to the evaluation of risk to which the Fund may be exposed in its lending to member countries, and the circumstances in which the Fund would need to take action to protect its financial position and ensure a true and fair presentation of its financial position in view of the increasing problem of overdue obligations; (ii) the differences in nature and function between provisions and reserves; and (iii) issues related to the determination and financing of provisions and reserves.

This paper, which is organized around these three issues, is intended to serve as a basis for the further consideration by the Executive Board of provisioning in the context of the Fund.

The earlier staff paper and the discussion in the Executive Board considered provisioning primarily in relation to probable loss on outstanding loans. This followed the language and approach customary in commercial enterprises, which is also reflected in the wording of Generally Accepted Accounting Principles. Subsequent consideration of the concept of loss in the context of the Fund's Articles indicated to the staff that that concept is a much narrower one than the one underlying the requirement of a true and fair representation of the current financial position of an organization. For this reason, and as discussed further on page 5 below, the present paper discusses the need for provisioning in the context of the Fund both in terms of an impairment of the effective realizable value of Fund assets, reflecting the Fund's inability to realize the value of a claim for an indeterminate and possibly prolonged period of time, as well as of probable loss.

II. Structured Approach to the Evaluation of Risks

In view of the marked increase in overdue financial obligations to the Fund over the last few years and the steady lengthening of the period over which members are remaining in arrears, the Fund has adopted a number of measures to assist and to encourage members to become and remain current in payments to the Fund and has, at the same time, acted to strengthen its financial position.

1. Strengthening of financial position

Measures taken by the Fund to strengthen its financial position included the decision no longer to accrue as current income the charges from members that are late for six months or more in meeting their financial obligations to the Fund 1/ and the imposition of special charges on overdue financial obligations. 2/ Charges due from members in arrears for six months or more are recorded as deferred income, and since FY 1987 an equivalent amount is generated by adjustments to the rate of charge and, subject to limitation, the rate of remuneration, so that the Fund's income is no longer affected by the deferral of charges. 3/ In addition, the net income target--the amount the Fund aims at adding to its reserves--was increased for FY 1986 from 3 percent of reserves to 5 percent, and further to 7.5 percent for FY 1987 and FY 1988, accompanied by an understanding that this latter increase would continue beyond FY 1988 if the problem of arrears remained serious, unless a decision by the Executive Board on provisioning would have altered the treatment of the problem. The increase from 5 percent to 7.5 percent is financed simultaneously and symmetrically by a higher rate of charge and a lower rate of remuneration than otherwise would have obtained. Moreover, on a number of occasions in recent years when actual net income has exceeded the target amount, the Executive Board decided to add the excess to reserves rather than reducing the rate of charge or increasing the rate of remuneration, in order to achieve a somewhat faster accumulation of reserves than had originally been planned.

1/ See "Overdue Financial Obligations to the Fund--Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84) and "Overdue Financial Obligations to the Fund - Supplementary Notes" (EBS/85/32, 2/5/85 and Sup. 1, 3/26/85) and Executive Board Decision No. 7930-(85/41), adopted March 13, 1985.

2/ See Executive Board Decision No. 8165-(85/189 G/TR), adopted December 30, 1985.

3/ See Executive Board Decision No. 8348-(86/122), adopted July 25, 1986 on "Principles of Burden Sharing, the Fund's Income Target for FY 1987 and FY 1988, the Rate of Charge, and the Rate of Remuneration" (EBS/86/162, Rev. 1, 7/28/86), and "Managing Director's Concluding Remarks on Principles of Burden Sharing and the Fund's Income Position" (Buff 86/151, 7/31/86).

2. Fund assessment of capacity of member to repurchase

The Fund has recently strengthened its procedures in evaluating members' capacity to repay the Fund. Staff analyses supporting the requests of member countries to use the Fund's resources have increasingly focused on the medium-term balance of payments outlook and attendant uncertainties, and the need for the member to achieve medium-term balance of payments viability. Furthermore, staff analyses address more explicitly than hitherto the member's capacity in the future to service its obligations to the Fund, taking into account also its past record in servicing its obligations to the Fund. (Members that have outstanding arrears may not make further use of the Fund's resources.) These assessments will continue on a regular basis as long as the member has credit outstanding to the Fund. This practice is intended to assist a member in framing a more timely adjustment of policies which affect the balance of payments should this be deemed necessary, and to help the member avoid delays in servicing its indebtedness to the Fund. 1/ The Fund also consults closely with major creditor and donor members regarding the need to take obligations to the Fund into account in drawing up their aid programs to members facing balance of payments difficulties and in the context of rescheduling of such members' debt to them.

The Executive Board over the past three years also has developed an extensive set of policies and procedures to encourage members to avoid delays in payment to the Fund, to encourage those that have fallen into arrears to settle their obligations at the earliest possible time, and to assist these members to overcome the underlying balance of payments problems so as to facilitate payment to the Fund. Under the established procedures, in addition to the normal consultations on a member's economic developments, the Executive Board periodically reviews the position of each member with protracted overdue payments to the Fund and the actions taken by the member to resolve its balance of payments problems and to become current with the Fund. The Fund also considers steps necessary to further encourage settlement and to protect the Fund's position. The Executive Board has on several occasions strengthened the procedures for dealing with arrears. 2/

3. Evaluation of risk in the context of the Fund

The evaluation of sovereign risk would appear particularly difficult in the context of the Fund. The character of the Fund as an intergovernmental cooperative institution, and the fact that--in contrast to private financial institutions--the Fund has no experience of loss that could serve as a guide to possible future developments, make the

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1/ See "Overdue Financial Obligations to the Fund - Six-Monthly Report" (EBS/86/98, 4/28/86), pp. 7-8.
2/ See Ibid., pp. 8-10.

evaluation of the impact of protracted overdue obligations on the effective realizable value of outstanding assets more difficult in the context of the Fund. 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. This raises not only the question whether the nominal value of the Fund's holdings of the member's currency related to overdue obligations shown in the Fund's financial statements continues to represent an accurate and fair representation of these assets in view of the fact that members have not repurchased them as scheduled, but also whether and to what extent the Fund needs to protect its position through the establishment of a provision or similar contingency allowance.

Overdue obligations until recently have been of relatively short duration and so far have been discharged, even by countries that withdrew from the Fund. When arrears became protracted, members have emphasized their intention to settle overdue obligations as soon as circumstances permitted and all members with protracted arrears have made at least some payments to the Fund since the arrears emerged. 1/ In the absence of any experience of loss, there would not appear to be a basis for estimating the Fund's exposure to risk of loss that would be linked to general factors, such as the actual level of credit extended by the Fund or even more broadly based criteria--e.g., some measure of payments imbalances or members' payments performance vis-a-vis other institutions.

The Fund's exposure to risk thus needs to be assessed in relation to individual member countries. In this regard, the Fund faces essentially two risks: (i) the political risk of a member's unwillingness to discharge its obligations, and (ii) the economic risk of a member's inability to do so. The former of these risks--an explicit repudiation of a member's indebtedness to the Fund--may appear remote. If it occurred, it would have to be taken at face value and thereby establish the probability, if not the certainty, of loss as regards the Fund's claims on the member concerned and the need for appropriate action by the Fund.

The second and clearly more likely risk is the economic risk of a member indicating that it intends to meet its obligations to the Fund as soon as circumstances permit but that it currently considers itself not

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1/ See "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86) pp. 6-7. The only exception is with respect to obligations overdue since 1975 from Democratic Kampuchea. The amount of credit extended to Democratic Kampuchea, the total of which is overdue, is not regarded as material in the context of the Fund's total financial position.

in a position to do so. The Fund would thus be deprived of usable resources for some, possibly protracted, period of time and again some action to protect the Fund's financial position would seem to be called for because the effective realizable value of a part of the Fund's claims has not only been diminished by the member not repurchasing as scheduled, but is probably less than the nominal value as shown in the Fund's financial statements.

In these circumstances, it would seem appropriate for the Fund to evaluate regularly the likelihood of the member becoming current in its financial obligations to the Fund within a reasonable period of time. Such an evaluation calls for judgments that may be difficult to make, although relevant factors would include elements relating to the member's arrears and outlook for their settlement, such as foreign indebtedness in general and amounts owed to the Fund; the experience of other international and national creditors with regard to the member's payments performance; recent and prospective economic performance; the policy stance taken, especially as it bears on the balance of payments position; and the member's expressed intentions as to the settlement of arrears to the Fund and the member's revealed priorities in use of its available foreign exchange.

It may be difficult to weigh the importance of such diverse individual factors and to draw firm conclusions from the consideration of them in specific cases, or to come to a clear conclusion when they point in conflicting directions. However, when an obligation has remained overdue for a prolonged period and all or most of these factors point in the same direction, it would be reasonable to presume that from the point of view of true and fair reporting of the Fund's financial position, the effective realizable value of the assets which have not been repurchased as scheduled has been impaired. In these circumstances, it would seem appropriate to establish provisions or a contingency allowance which would compensate for the adverse effects of overdue obligations on the Fund's assets and on its financial position and thus help ensure fair and accurate reporting of the Fund's financial position. 1/

1/ As discussed in "Valuation of Assets in the General Resources Account - Provisioning and Write-Off - Legal Considerations" (SM/86/106, 5/16/86), the Fund maintains the value of its assets or claims on the member in terms of the SDR in accordance with the Articles and the Fund's Rules, which are applied to all holdings of that currency. The member is obligated to maintain the SDR value of the Fund's holdings of the currency, and there are constraints to any reduction in the value of particular currency holdings in the Fund's financial statements reflecting a repurchase obligation that has remained overdue for a protracted period of time. However, these constraints do not impede the Fund from taking steps to protect its financial position which may be adversely affected by prolonged overdue obligations, such as to establish contingency allowances or provisions, and thereby ensure fair and accurate reporting of its financial position.

In view of the need for uniform and equitable treatment of member countries in economic and financial circumstances which almost assuredly will remain very diverse, there would be advantage in establishing a general presumption that the Fund would establish a provision as a contingency allowance 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. 1/ It should be emphasized that the establishment of a provision would not mean, of course, that a loss had occurred or that the corresponding claim would be written off; rather, it would acknowledge that the effective realizable value of the asset had become impaired and that the Fund's financial position has been adversely affected. In these circumstances, providing for a contingency allowance would seem to be an appropriate response to help maintain the financial integrity of the institution and to ensure fair and accurate reporting of the Fund's assets. Any write-off or reduction in the value of any of the Fund's assets would, of course, require a separate decision under the relevant provisions of the Articles, and would arise only under specific circumstances.

III. Provisions and Reserves

Provisions (or contingency allowances) and reserves 2/ both serve to strengthen the financial position of an organization against the risk of actual loss or impairment of the value of its assets. However, allowances and reserves are established for different reasons and have different implications for an organization's net income and for the presentation of its financial statements. This section provides a comparative analysis of the use of provisioning and reserves as a means of strengthening the Fund's financial position, and assesses their relevance for the Fund in the light of the growing problem of overdue finanical obligations to the Fund.

1. Provisioning

As noted above, provisioning enables an organization to present 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. The amount of a provision is related

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1/ The amount of provisioning that might be considered will be discussed further below.

2/ The term "reserves" or "special reserves" has also been used to characterize provisions (see, e.g., World Bank Annual Report 1986, p. 180), but use of the term in this way is gradually disappearing. In this paper, the term "reserves" refers to what more accurately would be called "retained earnings". The terms "general reserves" and "special reserves", each representing income retained by the Fund, are terms that appear in the Articles and are of long standing in the Fund.

to the amount by which the effective realizable value of an asset, or group of assets, is judged below the nominal or book value of the asset and is independent of the level of reserves held by the organization. Provisioning is an expense of conducting business and it is reflected as an element of cost in the determination of net income. 1/ If a provision is no longer regarded to be necessary, the excess in existing provisions would be added to current income in the accounting period so determined and would be disposed of in a manner decided by the organization, which could include a possible return to those who financed its original establishment.

As a matter of presentation in the balance sheet, a provision can be shown as an allowance against an asset, against a class of assets, or against assets in general. This treatment avoids an increase of the total balance sheet of the organization. A provision may also be established and reported as a separate item on the liability side of the balance sheet which is not linked to a particular asset or class of assets.

2. Reserves

In contrast to provisions, reserves represent net income of past accounting periods that has been retained by an organization. One reason for building reserves through retaining past earnings would be the desire to strengthen the equity capital of an organization, e.g., to protect it against loss from unforeseen rather than predictable contingencies or losses, such as operational deficits or disasters. Other reasons--and perhaps the more common ones--for increasing reserves include the accumulation of resources for specific or general business purposes, such as capital investments or an expansion of the organization's activities. Reserves become a part of an organization's equity capital; they serve all of the purposes of capital and would not be considered as a specific response of an organization to its judgment that some part of its assets may have become impaired or that a loss in the realization of an asset is considered probable.

The factors that motivate an accumulation of reserves (more accurately, retained earnings) thus are normally considerably broader in scope than those bearing on the need to provide for contingency allowances. However, it may be reasonable to presume that the existence or establishment of contingency allowances or provisions which offer protection against specified risks or classes of risks would have a bearing on the desirable level of reserves and would thus influence the incentives for further reserve accumulation.

1/ Accounting aspects of provisioning are discussed more fully in "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86).

From the point of view of financial accounting and reporting, 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.

3. Similarities and differences

The main similarities and differences between the establishment of provisions and the accumulation of reserves, then, are:

(i) provisions and reserves both protect an organization against impairment of its equity capital and add to the liquid resources of an organization;

(ii) provisions reflect a judgment that the current status of individual loans or classes of receivables makes it advisable or incumbent for an organization 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. Reserves are a means of safeguarding by way of increasing the equity capital of an organization against uncertainty in general, as well as an accumulation of resources for particular ends;

(iii) the establishment of provisions--an element of the overall cost of conducting operations--reduces net income during the accounting period, while an addition to reserves is a use of net income; 1/

(iv) provisions are shown as an offset to assets or as an increase in liabilities in the financial statements, but in neither case is there a requirement to identify the assets against which provisions are established. As noted above, reserves reflect an increase of the equity of the organization;

(v) the discharge of an obligation against which a provision has been established would normally--that is, unless there are other reasons that require an increase in provisions--lead to an equivalent reduction of provisions. There is no such direct relation between the settlement of doubtful obligations and the accumulation of reserves although a reserve target could, of course, be reduced if the settlement of some doubtful obligations reflected a more general reduction of uncertainties;

(vi) the establishment of provisions is required by Generally Accepted Accounting Principles if the effective realizable value of

1/ Although the difference in the impact on net income of provisioning and reserves usually is important for the interpretation of the financial statements of an organization, its relevance 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.

some part of the assets of an organization is considered to be less than the nominal or book value of the assets or if a loss is judged probable and the extent of the probable reduction in realizable value can reasonably be estimated; there are no equally stringent accounting rules regarding the accumulation of reserves.

4. Approaches to strengthen financial position

The following considerations may be taken into account when evaluating the question of whether the Fund should establish provisions or increase reserves to protect its financial position in the light of a growing problem of overdue obligations:

(i) an increase in the reserve target might be considered a prudent and precautionary step in strengthening the Fund's financial position in the face of uncertainty created by the incidence and, in particular, the persistence and duration of members' overdue financial obligations to the Fund. An increase in reserves is not dependent on politically difficult judgments that the effective realizable value of some part of specific assets may be impaired, but it also does not free the organization from the need to evaluate the value of its assets or the probability of loss in specific cases. Increasing reserves rather than providing for a specific contingency allowance might also reduce the risk that an evaluation by the Fund of specific outstanding credit might become known, which could damage the international creditworthiness of the member whose obligations to the Fund are past due and perhaps make it even more difficult for the member to correct its balance of payments position and to become current in its obligations to the Fund;

(ii) an increase in reserves which responds to the uncertainties posed by overdue obligations would result in an increase in members' apparent equity positions in the Fund. This might appear to be an inappropriate response to the specific issue of the growing problem of overdue obligations and the increasingly protracted nature of some of these obligations;

(iii) the proceeds of a reduction in provisions--e.g., at the time of discharge of an overdue obligation against which the provision may have been established--could be distributed as determined by the Executive Board, e.g., 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, and any refunding of reserves to member countries by way of distribution is limited to General Reserves and would have to be in proportion to quotas rather than on a basis which reflected earlier payments;

(iv) from the point of view of Generally Accepted Accounting Principles, an increase in reserves would not obviate the need to come to a judgment whether the effective realizable value of assets was less than their nominal value or a loss was considered probable because the repurchase of these assets had passed due date and the member's arrears to the Fund had been protracted. While the Fund follows Generally Accepted Accounting Principles, it is not obliged to follow any specific national accounting standards. 1/ However, provisioning is an integral part of Generally Accepted Accounting Principles and an explicit decision not to observe Generally Accepted Accounting Principles in a particular instance, such as provisioning, would raise questions about the meaning of the Fund's financial statements and would run the risk of misunderstandings or misinterpretations as regards the presentation of the Fund's financial position. Furthermore, the existence of protracted overdue financial obligations has become an important element in the consideration of the Fund's financial statements by the External Audit Committee (EAC). In view of the amount of overdue obligations and the protracted period for which some of these obligations have remained undischarged, and in the absence of an explicit evaluation by the Fund on the assets that have not been repurchased, the EAC may conclude that the Fund's financial statements have not been prepared in accordance with Generally Accepted Accounting Principles. If the EAC were to come to such a conclusion, their audit opinion of the Fund's financial statements would be qualified accordingly. Such a qualification could adversely affect the standing of the Fund which in turn could affect its role as the center of the international monetary system, especially in relation to its creditors and its image in the private financial markets.

IV. The Determination and Financing of Provisions and of Reserves

This section provides information bearing on the adequacy of the Fund's reserves as expressed in terms of the relation of reserves to relevant financial variables. It also provides an analysis of the various factors that bear on the determination of the amount of provisions or contingency allowances that might be needed in the light of the increasing risk faced by the Fund as a result of the increase in amount and duration of overdue obligations.

1/ The Fund's By-Laws (Section 20(d)) call for an annual audit of its financial statements to be conducted in accordance with generally accepted auditing standards to ascertain whether they give a true and fair view of the Fund's financial position.

1. Development of arrears and and relation to outstanding credit and reserves

The level of outstanding arrears in payments to the Fund over the last few years is shown in Chart 1, and details are provided in Appendix Table 1. After being fairly small and stable early in the early 1980s, overdue payments have risen sharply in the last three years. Total overdue obligations in the General Resources Account of the General Department, the SDR Departments and the Trust Fund were SDR 1,184 million at the end of March 1987, of which SDR 839 million represented overdue repurchases in the General Resources Account. Of these overdue repurchases--which is the most relevant magnitude in the context of a discussion of provisioning 1/—SDR 544 million were overdue for more than six months, SDR 98 million for more than two years, and SDR 19 million for more than three years.

However, the amount of overdue obligations represents only a part of the Fund's exposure to risk. The Fund may also face a risk of further arrears when other credit falls due, particularly credit that has been extended to members that are not current in meeting their financial obligations to the Fund. The risk of increasing overdue obligations is acute particularly as regards credit extended to members with protracted arrears. Total credit outstanding to members in arrears for six months or more at end-March 1987 amounted to SDR 2,193 million, credit to members overdue for two years or more amounted to SDR 923 million, and credit to members overdue for three years or more amounted to SDR 113 million (see Appendix Table 2).

The sharp increase in overdue repurchase obligations has undoubtedly increased the financial risks to the Fund, particularly given the large expansion in Fund credit to members with difficult and protracted balance of payments problems. In contrast, the Fund's reserves have risen relatively slowly and in relation to a number of magnitudes that are relevant as indicators of its exposure to risk and uncertainty have declined sharply since 1982.

In absolute terms, the Fund's reserves have increased from about SDR 843 million at the end of FY 1981, when the policy to aim for a positive net income each year was adopted, to SDR 1,206 million at end-FY 1986. 2/ While reserves have increased by about one third over the five-year period, they nevertheless declined in relation to other important variables indicating financial exposure. In relation to credit outstanding, reserves fell from 8.6 percent in April 1981 to about 3.7 percent in March 1987; they declined from 96 percent of

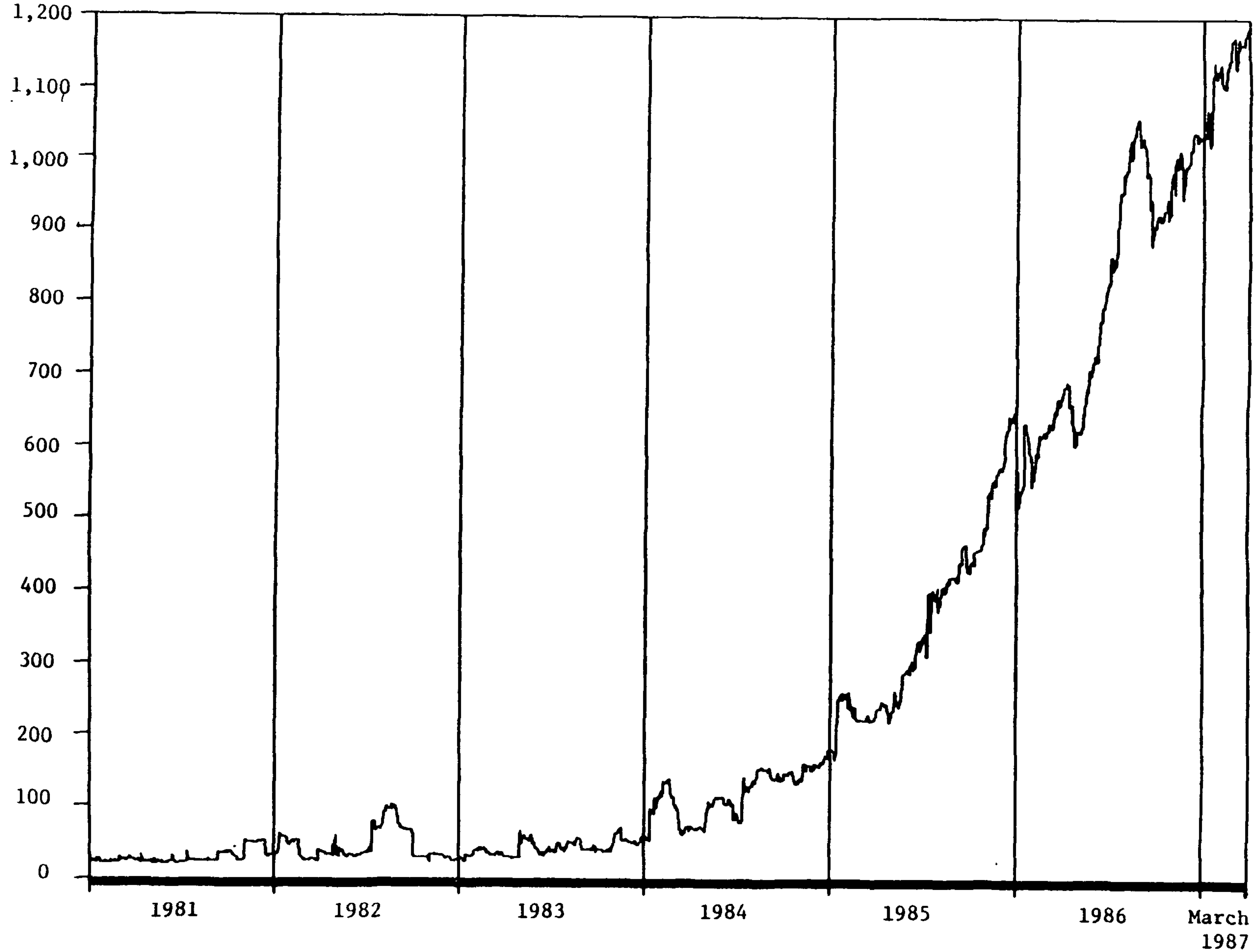
1/ The cost of deferred charges is borne by other member countries rather than the Fund.

2/ See Appendix Table 3. The following comparisons do not take into account net income in excess of target for FY 1987, pending its disposition.

CHART 1

Overdue Financial Obligations
Daily Outstanding Balances
1981 - March 1987

(In millions of SDRs)



operational income to 53 percent, and from almost 20 percent of outstanding borrowing to about 10 percent. In sharp contrast, overdue obligations rose from less than 3 percent of reserves to almost the level of reserves (97 percent). The relation of reserves to credit extended to members with prolonged overdue obligations may be considered a good indicator of the Fund's exposure to risk; at the end of FY 1981, Fund credit outstanding to members in arrears for six months or more was below one sixtieth (1.5 percent) of reserves; by March 1987, credit outstanding to members in arrears for six months or more approached twice the size of reserves (192 percent). 1/

2. Criteria for determining amounts of provisioning and reserve increase

A number of factors need to be considered to determine the amount of a provision or the appropriate increase in reserves which in part depend on the evaluation of the character of the risks faced by the Fund. The following approaches would need to be considered:

a. Credit extended by the Fund

A decision to achieve a given relation between reserves (or provisions) and the amount of Fund credit outstanding or changes in credit outstanding, could be considered akin to the establishment of general provisions by commercial banks against classes of (small) loans. General provisions are, however, normally based on actual loss experience. The comparison thus is less than complete, and it could be argued that the Fund does not face a general or broadly predictable risk in the same way commercial banks experience general risks of late payments late and nonpayment. 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.

Linking the level of reserves or provisions to outstanding credit might result in relatively sharp fluctuations from year to year as Fund credit expands and contracts in the light of members' use of the Fund's resources. It would therefore be advantageous to aim to reach over a period of time any particular target ratio of reserves (or provisions) to credit that were adopted, rather than to adjust reserves immediately to variations in the amount of credit extended. Alternatively, annual additions to reserves (or provisions) could be linked to changes in credit outstanding, rather than setting a target for the level of reserves (or provisions) as a stable proportion of credit outstanding.

1/ See Appendix III, Table 3.

b. Credit extended to members with protracted overdue obligations

As discussed earlier, there are considerable difficulties in coming to a conclusion as regards an impairment of value of the Fund's assets or exposure to loss on the basis of uniformly applicable criteria. It has been suggested above that it might be desirable, therefore, to adopt a presumptive rule that would lead to provide for a contingency allowance if payments to the Fund become overdue for a specified period of time. Such a rule, by taking account of the persistence and duration of specific overdue obligations, would help maintain an accurate and fair statement of the Fund's financial position. The amount of the allowance could be linked to the amount of credit outstanding to members that are overdue in meeting payments to the Fund for a certain period of time. It would not be necessary to cover immediately all credit outstanding to those members with protracted overdue obligations. Coverage could be achieved progressively as the time during which overdue obligations remain undischarged increases. 1/

c. Overdue repurchase obligations or repurchase obligations overdue for a specified period

A somewhat different approach to determine the amount of the provision to be established (or possibly an increase in reserves) would be directly related to the amount of overdue obligations, or to the amount of obligations overdue for a specified period of time. This approach would not imply conclusions as to a member's payments behavior in the future on the basis of the fact that some obligations are overdue at present, or have remained overdue for more than a specified period of time. However, in this case it would seem reasonable to make allowance for the total amount of protracted overdue obligations, rather than for only part of such overdue obligations. 2/ When obligations are overdue

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1/ This is essentially the approach chosen by the IBRD. It may be recalled that the Bank will begin to establish provisions when service payments on a loan are two years beyond maturity, unless payments are certain to be made shortly. Normally, the Bank each year will set aside an amount equal to 20 percent of loans outstanding to the member; it will thus in five years have made full provisions against loans to the member. See "Provisions Against Loan Losses in the Context of the Fund" (EBS/86/82, Sup. 1, 4/29/86), and Executive Board Meeting 86/84 (5/19/86). A similar system, albeit with different proportions and thus a different period to full provisioning was proposed for the Fund by Mr. Dallara at Executive Board Meeting 86/84 (5/19/86). Details of Mr. Dallara's proposal and consequent provisioning are shown in Appendix IV.

2/ This is the approach proposed by Mr. Nimatallah (Executive Board Meeting No. 86/85 (5/19/86)). See Appendix IV.

Table 1. Potential Indicators of Exposure to Financial Risk
1982 - 1987

(In millions of SDRs)

	April 30 1982	1983	1984	1985	1986	Sept. 30 1986	March 31 1987 1/
1. Total credit outstanding	14,801	23,590	31,742	34,973	34,640	33,147	32,003 2/
2. Credit outstanding to members overdue for two years or more:							
a. Total credit outstanding	12.5	12.5	12.5	12.5	112.6	717.9	923.3
b. Overdue repurchases	12.5	12.5	12.5	12.5	70.0	304.7	463.8
c. Repurchases overdue for six months or more	12.5	12.5	12.5	12.5	59.2	229.4	371.0
d. Repurchases overdue for two years or more	12.5	12.5	12.5	12.5	23.3	41.8	97.0
3. Credit outstanding to members overdue for three years or more:							
a. Total credit outstanding	12.5	12.5	12.5	12.5	12.5	84.2	112.6
b. Overdue repurchases	12.5	12.5	12.5	12.5	12.5	49.5	84.7
c. Repurchases overdue for six months or more	12.5	12.5	12.5	12.5	12.5	41.5	77.9
d. Repurchases overdue for two years or more	12.5	12.5	12.5	12.5	12.5	23.4	28.1
e. Repurchases overdue for three years or more	12.5	12.5	12.5	12.5	12.5	15.6	18.9

1/ As of March 31, 1987. For details, see Appendix III, Table 3.

2/ Excludes SDR 6.24 million purchased in the gold tranche prior to the Second Amendment of the Articles of Agreement. These purchases do not represent use of Fund credit, but must be repurchased in accordance with the provisions of Schedule B of the Amendment. All of Democratic Kampuchea's repurchase obligations became more than ten years overdue as from August 30, 1986.

beyond a particular period, the Fund would automatically increase the amount of allowance or provision to take account of the increase in obligations that are overdue for more than a specific period. No action would be taken as regards obligations that had not become overdue or were overdue for less than the time period specified to trigger an allowance.

Different repurchase obligations from the member would be treated independently. It should be pointed out, however, that the Fund's experience with overdue obligations over the last two years has generally been that once a member has incurred protracted overdue obligations, subsequently maturing obligations have also fallen into arrears rather than being settled on time. The approach to determine the amount of provision outlined above could thus underestimate the Fund's exposure, although this underestimate could to some extent be offset by provisioning to the full extent of overdue repurchases of the member.

3. Financial implications

The impact on the Fund's financial position of a contingency allowance or provisioning would depend on the action the Fund would decide to adopt in the light of its judgment of its perceived exposure to risk. The potential indicators of the Fund's exposure to financial risk which were discussed above are shown in Table 1. The table includes the amount of Fund credit outstanding at the end of the last five financial years, the amount of credit extended to members late for two years or more and three years or more in meeting financial obligations to the Fund, repurchases overdue from these members, and repurchases overdue by more than six months from these members.

Total credit extended by the Fund has increased sharply over the last five years, while protracted arrears have assumed a size that has to be considered material in the context of the Fund during the past two years. 1/ The amount of provision or reserve increase determined on the basis of the amount of overall credit outstanding would accordingly have increased sharply since FY 1982, but would have begun to stabilize by FY 1985, and could have been slightly reduced in FY 1986 and FY 1987 as credit outstanding contracted modestly during those years. For example, a policy that aimed at increasing reserves (and establishing provisions) to an amount equivalent in total to, say, 10 percent of outstanding credit and that would aim to achieve that level over a period of, say, 10 years would have required provisions or reserve increases that would have risen from SDR 54 million in FY 1982 to about SDR 215 million in FY 1985, and declined to about SDR 150 million in FY 1987.

1/ The overdue credit outstanding for extended periods in earlier years is in respect of one member--Democratic Kampuchea (see Appendix III, Table 1). In the context of the external audit of the Fund's financial statements, the amount has not been considered material in relation to the overall amount of credit extended by the Fund.

At the end of FY 1986, three members were overdue in their obligations to the Fund for two years or more; credit outstanding to these members amounted to SDR 113 million, and repurchases overdue from them amounted to SDR 70 million, of which SDR 59 million was overdue for six months or more and SDR 23 million for two years or more. By the end of March 1987, five members were overdue for two years or more, credit outstanding to them amounted to SDR 923 million, and overdue repurchases of these members amounted to SDR 464 million. If it had been decided in FY 1986 to establish an allowance to an extent that aimed at offsetting the amount of credit that was outstanding to these members over a period of, say, five years, the size of the allowance would have been about SDR 23 million in that year; it would have risen to SDR 185 million in FY 1987. 1/ Under a policy which would immediately have covered all repurchases overdue from these members, the amount of the allowance would have been SDR 70 million in FY 1986 which would have risen to SDR 464 million in FY 1987. Lastly, an allowance based on the total amount of repurchases overdue for a specified time period—e.g., three years--would have amounted to SDR 13 million at the end of FY 1986 and SDR 19 million at the end of FY 1987. 2/ In view of the fast increase in the amount of repurchases that are likely to be overdue for more than two and three years, as reflected in the last column of Table 1, the amount of allowance (or increase in reserves) could be expected to be sharply higher in the future.

4. Financing of precautionary balances

Following the extensive discussion of the Fund's income position and the effect of overdue financial obligations in July 1986, the Executive Board decided that the effect on income of the deferral of charges in FY 1987 and FY 1988 should be shared between debtor and creditor member countries in a simultaneous and symmetrical fashion. 3/ The decision on "Principles of 'Burden Sharing'" which is in effect for FY 1987 and FY 1988 also covers the target amount of net income that exceeds 5 percent of reserves at the beginning of the year. It was understood during the discussion that the net income target would remain at 7.5 percent after FY 1988 unless a decision by the Executive Board on provisioning had altered the treatment of the problem of

1/ This parallels the policy adopted by the IBRD. Somewhat different amounts could result under the proposal of Mr. Dallara to consider the need for provisioning if a member had been in arrears on repurchase obligations for perhaps 18 or 24 months with provisions of perhaps 15 percent of outstanding obligations.

2/ Based on data at March 31, 1987. This corresponds to the proposal of Mr. Nimatallah at Executive Board Meeting 86/84 (5/19/86). See Appendix IV.

3/ Executive Board Decision No. 8349-(86/122), adopted July 25, 1986.

arrears, and that target amounts above 5 percent would be subject to burden sharing as long as they were required because of the problem of overdue obligations. 1/

The amount that can be financed through a simultaneous and symmetrical adjustment of the rate of charge and the rate of remuneration is limited by the floor to the remuneration coefficient at 85 percent of the SDR interest rate in the decision on "Principles of 'Burden Sharing'" and ultimately by the provisions of Article V, Section 9(a), which set a floor to the remuneration coefficient at 80 percent of the SDR interest rate. Income generated through these adjustments offsets deferred income, provides for part of the target amount of net income, and if agreed, would finance contingency allowances or provisions (or special "reserves" in the form of supplemental income under Section II, paragraph 2 of Decision No. 8349). 2/ The maximum amount that could be so financed depends both on the size of remunerated balances and the SDR rate of interest. At the current level of remunerated balances and an SDR interest rate of about 6 percent, the maximum that could be financed in this manner amounts to about SDR 77 million a quarter or SDR 308 million a year with a floor to the remuneration coefficient of 85 percent; and to about SDR 105 million a quarter or SDR 420 million a year with a floor to the remuneration coefficient of 80 percent. 3/ These figures compare with a total amount of gross deferred charges during FY 1987 projected at SDR 180 million, plus additional net income (reflecting the burden-shared increase in the target amount of net income from 5 percent of reserves to 7.5 percent) of SDR 28 million for a total of SDR 208 million.

1/ See the Managing Director's Concluding Remarks at Executive Board Meeting 86/124 (7/30/86) on Principles of Burden Sharing and the Fund's Income Position, Buff 86/151 (7/31/86).

2/ In accordance with that Decision, supplemental income would be recorded in a separate account and would be refundable to members that contributed to it. This would not become part of the Fund's General or Special Reserves.

3/ The amount that can be financed by a shared reduction in the remuneration rate and increase in the rate of charge on the use of ordinary resources at various levels of the SDR interest rate, and taking into account the increase in FY 1987 and FY 1988 of the net income target of 2.5 percent, is shown in Appendix III, Table 5. The operative limit is the quarterly ceiling, as contingency allowances below the ceiling during one quarter would not create room for additional allowances in the subsequent quarter.

V. Conclusion

1. The Executive Board in May 1986 considered the issues that arise in the context of the Fund in connection with provisioning against a probable reduction in the effective realizable value of an asset below its nominal or book value. The establishment of such provisions would ensure that the Fund's financial statements give a fair and accurate reflection of its financial position. Most Directors did not consider that there was a need, at that time, to adopt provisioning. However, they asked for further analysis of a number of aspects regarding: (i) the major elements that might be included in a more comprehensive and structured approach to the evaluation of risk to which the Fund may be exposed in its lending to member countries and the circumstances in which the Fund would need to take action to protect its financial position to ensure a true and fair representation of the Fund's financial position in view of the increasing problem of overdue obligations; (ii) the difference in nature and function between provisions and reserves; and (iii) issues related to the determination and financing of provisions and reserves.

2. The Fund has taken a number of steps to alleviate the effect of overdue obligations on its financial position. These include increases in the net income and reserve targets from 3 percent of reserves to 5 percent in FY 1985 and to 7.5 percent for FY 1987 and FY 1988, and the addition to reserves of income in excess of the target amount; the decision no longer to accrue as current income charges from members that are overdue for six months or more in meeting financial obligations to the Fund; and the introduction of special charges on overdue obligations.

3. As regards the more comprehensive and structured approach to the evaluation of risk, the Fund has strengthened its procedures in evaluating members' capacity to repay the Fund; staff analyses have focused on the medium-term balance of payments outlook and the need for the member to acheive medium-term viability. The Fund has also developed an extensive set of policies and procedures to deal with members with obligations that have fallen overdue and to encourage members to discharge overdue obligations with the shortest possible delay. The Executive Board has on several occasions tightened the timing of the procedures for dealing with arrears.

4. The Fund also evaluates on a regular basis the position of a member with protracted overdue obligations, taking into account factors such as the member's recent and prospective economic performance and balance of payments outlook and recent policy measures bearing on this outlook; the member's foreign indebtedness; and its expressed intentions and revealed priorities in discharging arrears to the Fund.

5. The sharp increase in the amount of obligations that are overdue for protracted periods of time suggests 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.

6. The Fund does not appear to be confronted with a generalized risk of nonpayment of outstanding credit. Moreover, in view of the different causes giving rise to balance of payments difficulties faced by member countries, it is difficult to define a set of criteria uniformly applicable that might indicate the point at which the effective realizable value of an asset is probably less than its nominal or book value as a result of members' failure to repurchase their currency from the Fund at due date. In these circumstances, there would seem to be an advantage in establishing a general presumption that the Fund would take precautionary action with respect to its claims on a member that has been overdue for a specified period of time, say 36 months, unless settlement of the overdue obligations would be confidently expected shortly.

7. The two most common forms of precautionary action to safeguard the financial position of an organization are provisions and reserves which have a number of common features but also dissimilarities. The former represent an item of expense in conducting the operations of an organization, and are established to ensure a fair and accurate reporting of the financial position of an institution when a judgment is made that the value of an asset has been impaired, i.e., the value of an asset in the balance sheet does not represent a true and fair reflection of its effective realizable value. If the Fund judges that assets have been value-impaired, Generally Accepted Accounting Principles call for the establishment of appropriate provisions. Reserves represent retained earnings, increase the equity capital of the organization, and, among other things, offer protection against uncertainty in general and also provide means to finance an increase in the business activities of an organization.

8. A number of criteria need to be considered to determine the amount of a provision or of an appropriate increase in reserves. These could include the total amount of credit outstanding, or the amount of credit outstanding by members that are in arrears in their payments to the Fund, or the amount of repurchases that are overdue or the amount of protracted arrears.

9. It would appear reasonable that the cost of strengthening the financial position of the Fund under circumstances of increasing overdue obligations should be borne by the membership in general, whether the strengthening would take the form of provisioning or increasing the reserve target. In the absence of a mechanism that would distribute these costs to all member countries, it would appear reasonable to apply the principles of burden sharing to these costs. An issue would remain as to the method of financing provisions or an increase in reserves when the limits specified in the decision on burden sharing and in the Articles have been reached.

1986 External Audit Comments to the Treasurer (Excerpt)

A. Overdue Financial Obligations

In the 1985 External Audit Committee's letter to the Treasurer, that Committee put forth its view that "the sharp increase in overdue obligations gives rise to the need for periodic reviews to consider whether loss provisions for such obligations are necessary." A memorandum (dated June 27, 1985) was provided by the Treasurer to the 1985 Committee indicating that the issue of overdue obligations "will require a judgment by the responsible departments whether it is probable that the Fund will experience protracted arrears. This judgment will need to be reviewed regularly, and a formalized procedure is being developed for this purpose, including establishment of the criteria relevant for assessing whether a loss appears probable." The first of these reviews was expected expected to be completed before the midyear review of the Fund's income position scheduled for mid-November 1985. The 1985 Committee acknowledged this endeavor as follows: "We understand that the Treasurer's Department is in the process of establishing a more comprehensive and structured approach to the evaluation of whether or not a material loss is probable with respect to members with protracted obligations to the Fund. We strongly endorse their effort."

In the 1986 financial year, the problem of overdue obligations to the Fund has grown even larger, with an increase from SDR 214 million as of April 30, 1985 to SDR 588 million as of April 30, 1986. SDR 518 million of this amount related to the General Department. This amount is more than 46 percent of the General Department's reserves as of April 30, 1986.

During the course of the 1986 audit, the subject of overdue obligations has consumed a considerable amount of time. This was necessary because, in light of the materiality of overdue obligations to the reserves of the Fund, the Committee did not feel it would be in a position to issue an unqualified opinion on the financial statements of the General Department unless it were able (i) to obtain representation from the Fund's management that losses were not considered to be probable as the result of overdue obligations, and (ii) to obtain a clear understanding of the underlying facts and assessments supporting this conclusion. In this regard, the Committee is very appreciative of the efforts of the Treasurer to provide information and representations to us which have made it possible for us to fulfill our audit responsibilities. As a result, we have been able to issue an unqualified opinion on the financial statements. Because certain of the arrears are of long duration and of significant amount, it does not appear that one presently could conlude that risk of loss can be altogether dismissed; however, appropriate disclosure in the notes to the financial statements have made it unnecessary for us to refer to the possibility of loss in our opinion.

The Committee had hoped that greater progress might have been made in developing the "more comprehensive and structured approach" with respect to this matter which had been proposed by the Treasurer a year ago. Certainly, the development of and experience with such an approach during the financial year would have greatly aided the Committee in performing its work this year. In this respect, we do acknowledge that important progress in this respect has already been made:

1. Procedures for identifying and dealing with cases of overdue financial obligations to the Fund have been strengthened, in particular by the actions taken by the Executive Board last November as proposed by the staff in the six-monthly report on overdue financial obligations and as reflected in the summing up of the Chairman (Buff Statement 85/206, 12/6/85). We note, inter alia, the shortening of the period between the emergence of arrears by a member and their consideration by the Executive Board, the regular reviews of the situation of members that have been declared ineligible to use the Fund's resources, and the more frequent provision of information by the staff to the Executive Board on the arrears situation. We note also that an assessment of the capacity of the member to repay the Fund is to be included in all papers requesting use of Fund resources.

2. The paper prepared by the Treasurer's Department, entitled "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82) constitutes, in our view, a significant step in identifying and describing the key factors relating to this difficult issue. We have noted in particular the identification of possible criteria that could be used in making determinations relative to the probability of loss. We believe that the criteria which have been identified provide an excellent starting point for developing a more comprehensive and structured approach to this issue.

3. In response to our request, the Treasurer has provided to us a summary of facts relative to members which account for the greatest proportion of overdue obligations. These summaries (which we understand were prepared with the assistance and agreement of the responsible departments) include some assessment of the factors presented which give a sense for the possibilities of how the problem of overdue obligations with respect to a particular member might be resolved.

We recognize that there are many difficulties and differences in viewpoint within the Fund which must be resolved before complete progress can be made on this issue. However, if the problem of overdue obligations continues, we strongly urge the reconsideration of the more comprehensive and structured approach proposed by the Treasurer as early as possible so that a framework for dealing with this matter as it affects the Fund's financial statements, and experience in operating within that framework, will have been clearly established by the time the 1987 External Audit Committee arrives a year from now.

The Chairman's Summing Up at the Conclusion of the Discussion on Provisioning Against Loan Losses in the Context of the Fund
Executive Board Meeting 86/85 - May 19, 1986

In summing up our preliminary discussion on this important and difficult subject, I would conclude that the Executive Board does not see the need to take provisioing steps at this time. Eleven Directors, representing some 34 percent of the voting power, were very much against any form of provisioning. Eight Directors, who perhaps did not have the same philisophical approach to the problem, did not see the urgent need at this time to establish loan-loss provisions; those Directors represent some 39 percent of the voting power. Three Directors, representing some 27 percent of the voting power, were for a swift implementation of provisioning.

Many Directors felt that this matter was extremely complex and were not sure that provisioning was the best means of dealing with the relevant problems in the Fund. The arguments most often expressed today by Directors opposed to provisioning stressed the following points: the uniqueness of the nature of the Fund and its relations with sovereign countries; the fact that the Fund holds currencies of members and not claims in the usual sense of the word; the difficulty in establishing that a loss was probable in the case of members that have not expressed an intention to repudiate their debts to the Fund or to withdraw from the Fund; and the experience with countries that have withdrawn from the Fund, which some Directors felt did not suggest the need for provisioning in the narrow concept that would be consistent with the Articles. The same Directors considered that provisioning could create problems for the Fund: doubts might be raised about the Fund's ability to collect payments that are due and, perhaps more important, about its ability to cope with the debt strategy. Those speakers also said that provisioning could undermine members' incentive to repay the Fund as well as members' creditworthiness. A number of Directors felt that the measures already adopted to cope with cases of overdue obligations to the Fund were better suited to the Fund's objectives.

Those who favored the establishment of a structured approach toward evaluating the need for provisioning believed that such a system should be based on specific country-by-country analysis using objective criteria and possibly judgmental assessments.

At the same time, many Directors, constituting a significant proportion of the voting power, stressed the need for the Fund to maintain high standards in its accounting practices and to provide adequate protection against the risk of erosion of its financial assets. A number of Directors questioned in this regard the adequacy of the level of the Fund's reserves. Those Directors also stressed the need for the Fund to assess periodically and carefully, on a country-by-country basis, the adequacy of the level of reserves. Those speakers felt that if this examination should lead to the conclusion that additional "safeguard measures," as some speakers called them, were needed to cope with financial risks to the Fund, the measures should take the form of special reserves. Most Directors who mentioned the possible need for safeguard measures also said that their views on the question of burden sharing they had expressed on previous occasions should be taken into account in the formulation of the safeguard measures.

We will be studying carefully the various suggestions that were made concerning the possible development of a structured method or approach to handling financial risks, be it the provisioning route or special reserves. A number of questions have been raised to which we will have to come back--for example, the link between provisioning and the notion of a write off. What are the practical differences between the technique of provisioning and the technique of increasing reserves? Are some of the objectives of provisioning not reachable within the framework of an increase in reserves, or could an increase in reserves accomplish what provisioning is supposed to accomplish? The question has been raised of a possible refunding of special increases in reserves to members that contributed to that increment if the extra reserves should prove to be unnecessary.

We will come back to this subject, as you have asked us to do. Some Directors have asked for a further discussion in July 1986. The timing of the discussion cannot be ascertained exactly today. The relevant papers will have to be prepared first. This matter is not one of immediate urgency, but it is important.

Table 1. Overdue Financial Obligations

(In millions of SDRs; end of period)

	Less Than 6 Months	6 Months-2 Years	2-3 Years	3 Years or More	Total
1981	11.5	1.1	0.8	14.8	28.2
1982	5.7	1.1	0.7	15.6	23.1
1983	30.5	6.5	0.8	16.3	54.1
1984	123.8	30.4	0.7	17.1	172.0
1985	355.7	235.7	5.8	17.8	615.0
1986 June	411.3	372.7	18.3	18.4	820.7
September	427.8	411.5	43.7	21.4	904.4
December	425.3	493.4	87.9	23.6	1,030.2
1987 March	403.9	634.9	116.9	28.3	1,184.0
of which:					
General Resources Account:					
Repurchases	295.4	446.0	78.7	19.0	839.0
Charges	84.1	139.0	19.8	6.7	249.5
SDR net charges	3.5	9.2	3.3	—	15.9
Trust Fund:					
Repayments	19.7	39.0	14.7	2.6	76.0
Interest	1.2	1.7	0.5	--	3.5

Note: Excludes SDR 6.24 million purchased in the gold tranche prior to the Second Amendment of the Articles of Agreement. These purchases do not represent use of Fund credit, but must be repurchased in accordance with the provisions of Schedule B of the Amendment. All of Democratic Kampuchea's repurchase obligations became more than ten years overdue as from August 30, 1986.

Table 2. Overdue Repurchases as at March 31, 1987

(In millions of SDRs)

	Number of Countries	Total Credit Outstanding	Overdue Repurchases Total	Of which overdue for more than: 6 Months	2 Years	3 Years
All Members		32,003.3	845.3	543.8	97.6	19.0
of which:						
Members overdue for six months or more	7	2,193.3	796.2	543.8	97.6	19.0
Members overdue for two years or more	5	923.3	463.8	371.0	97.6	19.0
Members overdue for three years or more	3	112.6	84.7	77.9	43.0	19.0

Note: Excludes SDR 6.24 million purchased in the gold tranche prior to the Second Amendment of the Articles of Agreement. These purchases do not represent use of Fund credit, but must be repurchased in accordance with the provisions of Schedule B of the Amendment. All of Democratic Kampuchea's repurchase obligations became more than ten years overdue as from August 30, 1986.

Table 3. The Fund's Reserves and Other Financial Variables 1974-87

(In millions of SDRs)

Year Ending April 30	Net income (deficit)	Opera- tional income	Total reserves	Percent increase (decrease) over pre- vious year	Total reserves as a percentage of: Quotas	Out- standing purchases	Opera- tional income	Out- standing borrowing	Assets	Percentage of reserves: Total overdue payments	Fund credit to members late by 6 months or more
1974	(37.2)	38.5	717.3	(4.9)	2.5	20.7	1,863.1	--	2.4	--	--
1975	(9.7)	166.5	707.6	(1.4)	2.4	10.7	425.0	28.3	2.2	--	--
1976	(2.9)	455.9	704.7	(0.4)	2.4	5.8	154.6	10.9	1.9	1.5	1.8
1977	(18.2)	774.6	686.5	(2.6)	2.3	4.3	88.6	8.9	1.8	2.0	1.8
1978	27.5	839.6	714.0	4.0	2.2	5.1	85.0	8.9	1.5	2.0	1.8
1979	46.1	753.3	760.1	6.5	1.9	7.4	100.8	15.1	1.7	2.0	1.6
1980	3.1	614.2	763.2	0.4	2.0	8.6	124.3	20.3	1.7	2.1	1.6
1981	80.1	882.3	843.3	10.5	1.4	8.6	95.6	19.3	1.3	2.8	1.5
1982	92.0	1,788.9	935.3	10.9	1.4	6.2	52.3	13.8	1.3	3.5	1.3
1983	65.4	2,045.0	1,000.7	7.0	1.6	4.2	48.9	9.1	1.3	3.6	1.2
1984	73.1	2,792.0	1,073.8	7.3	1.2	3.4	38.5	7.8	1.0	6.3	9.3
1985	(29.9)	3,482.1	1,043.9	(2.8)	1.2	3.0	30.0	7.3	1.0	21.4	60.2
1986	78.1	3,202.2	1,122.1	7.5	1.3	3.2	35.0	7.7	1.1	55.1	92.1
1987	135.0	2,270.0	1,206.2 1/	7.5	1.3	3.7	53.1	9.7	1.1	96.6	191.7

1/ Provisional; only includes net income equivalent to the target amount for the year, pending a decision by the Executive Board on the use of FY 1987 net income in excess of the target amount. Percentages are based on data as of March 31, 1987.

Table 4. Overdue and Forthcoming Repurchase Obligations and Fund Credit of Members in Arrears as at March 31, 1987

(In millions of SDRs)

	Guyana	Democratic Kampuchea 1/	Liberia	Peru	Sudan	Viet Nam	Other	Total
Repurchases Overdue:								
3 years or more	6.5	12.5	—	—	—	—	—	19.0 1/
2-3 years	9.8	—	1.8	—	52.8	14.2	—	78.7
6 months-2 years	20.7	—	64.5	132.3	173.9	14.2	40.4	446.0
Less than 6 months	6.8	—	23.0	73.6	63.2	—	128.8	295.4
Total Overdue	43.8	12.5	89.3	205.9	289.9	28.4	169.5	839.3
Repurchases Coming Due:								
April 1987	—	—	7.3	—	7.5	—	32.5	47.3
FY 1988	12.2	—	42.0	121.4	130.5	—	570.2	876.3
FY 1989	6.1	—	28.3	101.0	79.8	—	306.3	521.5
After FY 1989	9.6	—	38.5	167.2	97.6	—	425.8	738.7
Total Coming Due	27.9	—	116.1	389.6	315.4	—	1,334.8	2,183.8
Total Outstanding Credit	71.8	12.5	205.4	595.5	605.3	28.4	1,504.3	3,023.1

Note: Totals may not add due to rounding.

1/ Excludes SDR 6.24 million purchased in the gold tranche prior to the Second Amendment of the Articles of Agreement. These purchases do not represent use of Fund credit, but must be repurchased in accordance with the provisions of Schedule B of the Amendment. All of Democratic Kampuchea's repurchase obligations became more than ten years overdue as from August 20, 1986.

Table 5. Amounts Recoverable Under Burden Sharing Assuming Symmetrical Adjustments 1/

(In millions of SDRs)

	Limit on Remuneration Coefficient					
	85 percent			80 percent		
SDR interest rate	Present balances 2/	Present balances increased by SDR 1 billion	Present balances decreased by SDR 1 billion	Present balances 2/	Present balances increased by SDR 1 billion	Present balances decreased by SDR 1 billion
5.0	62.9	66.7	59.1	86.2	91.2	81.1
6.0	76.9	81.4	72.3	104.8	110.9	98.8
7.0	90.8	96.1	85.5	123.4	130.5	116.4
8.0	104.8	110.9	98.8	142.1	150.1	134.0

1/ Amounts of deferred income in quarterly adjustment period that would cause limit on remuneration coefficient to be reached.

2/ Balances subject to charges on ordinary resources and remunerated positions at January 31, 1987.

Provisioning: Mr. Dallara's Proposal

After a member had been in arrears in payments to the Fund for a specified period--say 18 or 24 months--a presumption would arise that loss is probable on the credit outstanding to the member. Provisions (called Allowance for Credit Extended) would be established at a certain proportion--say 15 percent per annum--of the total outstanding repurchase obligations to the Fund of the member.

Had such a system (with a 24-month criterion) been in effect since FY 1986, the following provisions would have been established:

	Allowance for Credit Extended	
	New	Cumulative
FY 1986 first quarter	3.2	3.2
FY 1986 second quarter	3.2	6.4
FY 1986 third quarter	3.2	9.6
FY 1986 fourth quarter	4.2	13.8
FY 1987 first quarter	27.0	40.8
FY 1987 second quarter	27.0	67.8
FY 1987 third quarter	34.6	102.4
FY 1987 fourth quarter (March)	34.6	137.0

Provisioning: Mr. Nimatallah's Proposal

Repurchases overdue for more than, say, three years should be considered a probable loss for the purpose of establishing provisions. Unless the member is in the process of taking adjustment measures that will lead to balance of payments viability in the medium-term, provisions should be established covering the full amount of repurchases overdue for three years or more. Within the boundaries of these two criteria, Management would propose the establishment of provisions for a lapse of time decision.

Had such a system (with a three-year criterion) been in effect when arrears began to exceed that period, the following provisions would have been established:

	Allowance for Credit Extended	
	New	Cumulative
FY 1986 first quarter	12.5	12.5
FY 1986 second quarter	-	12.5
FY 1986 third quarter	-	12.5
FY 1986 fourth quarter	-	12.5
FY 1987 first quarter	3.2	15.7
FY 1987 second quarter	0.8	16.5
FY 1987 third quarter	1.8	18.3
FY 1987 fourth quarter (March)	5.1	18.9