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April 15, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Provisioning Against Loan Losses in the Context of the Fund

There is attached for consideration by the Executive Directors a paper on provisioning, which will be brought to the agenda for discussion on Monday, May 19, 1986.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

Provisioning Against Loan Losses in the Context of the Fund

Prepared by the Treasurer's Department

Approved by W. O. Habermeier

April 15, 1986

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I. Introduction

This paper reviews the widely observed commercial accounting practice of provisioning for contingent losses and the applicability of this practice in the context of the Fund. The issue of provisioning has been raised by the Executive Board in connection with its discussion of the midyear review of the Fund's income position (EBM/85/176, 12/6/85 and EBM/85/180, 12/13/85) and the recent special review (EBM/86/37 and EBM/86/38, 2/27/86) as well as during its discussion of the semiannual review of overdue financial obligations to the Fund (EBM/85/170, 11/25/85). Furthermore, last year's External Audit Committee (EAC) raised the issue of the treatment by the Fund of outstanding overdue financial obligations, including the need for periodic reviews to consider whether loss provisions for overdue obligations are necessary, and the establishment of 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. (See Appendix II for an excerpt of the report of the EAC for FY 1985.) This paper considers the issues that bear on provisioning in the context of the Fund, and seeks guidance from the Executive Board as regards the various elements, including procedures, that could comprise an evaluation bearing on the probability of material loss from protracted overdue obligations.

The paper is organized as follows: in Section II the accounting principles that bear on provisioning for contingent losses are reviewed; Section III discusses the relevance of provisioning in the context of the Fund; Section IV provides an extended summary and makes some concluding remarks in which are outlined some of the issues that would need to be considered in the event the Fund decided that provisioning against contingent loss was necessary and desirable. Appendix I summarizes provisioning as practiced by commercial banks and by some intergovernmental international financial institutions--mainly development banks.

II. The Concept of Provisioning

While the Fund is not bound by national or international accounting principles, it has nevertheless followed their precepts as closely as possible, taking into account that its financial structure and mode of operation have many unique features which have no exact counterpart in national accounting presentations and standards. The following exposition of provisioning for contingent loss is based on generally accepted accounting principles, but the applicability of provisioning in the Fund, which is dealt with in Section III below, needs to be considered in the context of the objectives and practices of the Fund itself.

1. <u>Definition and purpose of provisioning</u>

The term "provisioning" in financial accounting means to reduce the value of an asset--its "book value"--to its estimated realizable value through the establishment of an allowance for future losses. 1/ The primary purpose of provisioning is thus to present a fair and accurate statement of the financial statements of an entity at a given time by valuing its assets at their expected realizable value instead of their nominal or book value. A second purpose of provisioning is to guard against an overstatement of the financial results of an entity for any given accounting period by making an appropriate charge against current income--i.e., by a reduction of income--to reflect anticipated losses on its assets.

If and when a loss occurs, the difference between the book value and realized value of the asset would have been provided for and the realized loss would reduce current income only to the extent that the provisions against the realized loss would have been insufficient. The process of making provision for bad or doubtful debts thus requires making a judgment that the historical cost of the asset exceeds the anticipated realizable value of the asset--i.e., that a loss is probable.

2. <u>General accounting practice as regards provisioning</u>

The rules established by nationally or internationally recognized accounting bodies provide broad guidelines to follow when considering the need for making loan-loss provisions. These guidelines must, however, be applied to the circumstances of particular cases. The final decision on whether or not to make provisions is a matter of judgment which is to be made by the management of an institution on the basis of all the relevant considerations.

The effect of provisioning is to increase expenditures and reduce income at the time the judgment is made that a loss is probable rather than at the time a loss is actually incurred. The provision would cover the whole credit if it appears probable that no part of it could be collected. Alternatively, the full amount of a loan could be provided for over a period of time on the assumption that, in the absence of settlement, the amount of probable loss increases <u>pari passu</u> with the passage of time.

1/ The Fund is unable to reduce the "value" of its holdings of currency ("loans") and it cannot make a presentation of net assets, as in the context for a provision for loan losses in commercial banks. In the context of the Fund, a provision would be shown as a liability to meet a loss on an asset if it is written off; the nominal value of the asset would remain unchanged until it is written off. The former method, of a reduction in value of the asset with parathentical disclosure of the amount of the provision is, however, the standard presentation.

The International Accounting Standards Committee concluded on the issue of provisioning as follows:

> "27. The amount of a contingent loss should be accrued by a charge in the income statement if:
>
> (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability incurred at the balance sheet date, and
>
> (b) a reasonable estimate of the amount of the resulting loss can be made.
>
> 28. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 27 is not met, unless the possibility of a loss is remote." 1/

The term "probable" in this context means that a future event is likely to occur, as contrasted to a remote--or slight--or even a reasonable, but less than probable, possibility. 2/

Generally accepted accounting principles thus call for provisioning when (i) a loss appears "probable", and (ii) its magnitude can be estimated. The amount to be provided against loss should reflect the best estimate of the loss; if the size of a loss cannot be estimated, though it is concluded that a loss is probable and the likely outcome is within a range, then at least the amount indicated by the lower end of the range should be provided for, which would be supplemented by additional information in the notes to the financial statements. When no reasonable estimates of loss can be made, no provision may be set up for the contingency, and this should be disclosed in the financial statements. In that event, the auditors may express a qualified opinion on the financial statements if the likely size of the loss, and taking into account the probability of loss if realized, would be material for the reporting entity.

1/ International Accounting Standards Committee, International Accounting Standard No. 10: Contingencies and Events Occurring After the Balance Sheet Date; London, 1978. Rules promulgated by national authorities, such as the Financial Accounting Standards Board (FASB) in the United States, the Institute of Chartered Accountants of England and Wales in the United Kingdom, or the EEC Accounting Directives are essentially similar.

2/ See, e.g., Financial Accounting Standards Board, Accounting Standards: Current Text (General Standards as of June 1, 1984), c 59.104; Stanford, Conn., 1984.

3. Methods of provisioning

The methods usually followed in making provision for contingent losses fall into two broad categories: (i) general provisioning, which usually refers to the establishment of a provision to meet a risk related to classes of assets with a common characteristic or a large number of small loans which make it impractical to assess each loan on its individual merits and to which it would be difficult to provide for each specific asset; and (ii) specific provisioning, which usually refers to the establishment of a provision to meet estimated probable losses on a specific credit of, usually, comparatively large size or on credits which are extended to creditors with unique characteristics and which may not be well captured in a broad aggregation of credit extended. A combination of both general and specific provisions is often used, though the alternative methods of provisioning can have significantly different effects on the financial statements.

General provisioning is based on past experience and the amount of provisioning is usually determined by establishing a ratio between past losses from bad debts to credit extended or to credit outstanding. A general provision will reflect some average of past experience (and the law of large numbers if numerous small loans are provisioned for). This approach leads to the establishment of adequate provisions to the extent that past experience properly reflects the expected loss on currently outstanding credit. Conversely, it will under- or overstate appropriate provisions if past experience is of limited relevance because of changes, for example, in the organization's credit policy or, in the economic environment which would affect the ability or willingness of debtors to discharge their obligations.

Special provisioning calls for an analysis of specific credits outstanding at the end of a reporting period, and the making of (usually difficult) judgments of whether loss on these individual credits is probable, as well as estimating the potential size of such losses in order to determine the amount of provisioning. It is the more usual form of provisioning by commercial enterprises.

4. Considerations in making provisions

Most kinds of risks can be reduced to some extent by increasing expenditures on precautions. The great difficulty is usually to know how large an increase in costs is justified in order to achieve an uncertain degree of reduction in an uncertain risk. Past experience can provide only an average probability of loss for the present. If the taking of certain precautions changes the timing of loss, and therefore the impact on income, an entity can decide whether precautions are worthwhile. A fundamental consideration in deciding whether or not to make provisions against loss involves a judgment on the probability of loss based on experience and current expectations. If there is uncertainty about a loss and precautions are not made, an important consideration would be the ability of an entity to absorb losses in the absence of provisioning--i.e., through fluctuations in income and reserves if a loss should materialize. In that event current income, and reserves if the loss exceeded income in the period, would have served effectively the same purpose as provisioning though the mechanism for financing losses would have been quite different as would the overall impact of losses on the financial position of the entity in the absence of provisioning.

Provisioning is a cost of conducting business and is, therefore, an item of expense. It also has an important consequence of protecting the income position of an entity against undue fluctuations in the event of losses being realized. The relative stability of income and the cost of provisioning are of particular relevance when attention focuses on current financial results, as usually is the case for profit-oriented enterprises, and may also be of importance for entities that, although not primarily aiming at profit generation, rely for financial resources on capital markets that may be sensitive to developments in an organization's financial results, such as, e.g., international development banks. Stability of income may not be an overriding concern for all financial enterprises and they would take a risk of absorbing realized losses through a reduction of income and, if need be, reserves. While the prospect of (unprovisioned) loss might be met directly by increasing reserves through an increase in income, this would not be in conformity with formal accounting theory nor could it be readily accommodated in the presentation of the financial statements which would need to indicate if a loss was probable.

5. Provisions and reserves

Provisions, which are a charge against operating income, are separate from equity reserves, which reflect the accumulation of net income in earlier years. However, both provisions and reserves serve to protect the entity from loan loss, though reserves also serve a wider purpose including meeting loan losses. 1/ Provisions are established when a loss is judged probable and the amount of the provision is determined irrespective of the level of reserves. Any realized loss is first charged against the provisions and affects current income only if the provision was inadequate to meet the loss. If the loan against which the provision has been established is fully repaid, or if a loss is judged less likely--the excess in existing provisions would be added to, and thus increase, current income.

1/ In this connection, the use of the term "reserves" to characterize provisions is gradually disappearing to avoid confusion with equity reserves, or more properly, retained earnings. Combinations of such terms as "allowance" or "provision" together with the terms "doubtful accounts," "bad debts" or "estimated losses" are found in practice. The trend in commercial banking is to refer to "Allowance for loan losses" in the balance sheet and to "Provisions for loan losses" in the income statement.

While provisioning protects the capital of an organization and its income position from the loss of nonrepayment, it does not afford protection from other forms of losses (e.g., from operational deficits or disaster). It is one of the purposes of retained earnings (reserves) to provide protection of the entity's capital against these more general risks. Reserves also differ from provisions in that they do not provide protection of income: general accounting rules prescribe that unexpected losses cannot be charged directly to reserves--retained earnings--but must be charged to current income and will reduce reserves only when the losses are in excess of current income.

Provisions and reserves thus serve different but related purposes. However, the relationship between provisioning and reserves is sufficiently loose that no presumption can be made as regards the need to change reserves policies because of changes regarding provisioning for bad debts, or vice versa; there is no basis for the automatic offsetting of one against the other. These matters are for decision after a review of all the circumstances.

III. Provisioning in Relation to the Fund

The External Audit Committee (EAC) for FY 1985 in its comments relating to overdue obligations that were addressed to the Managing Director and to the Treasurer (see Appendix II) noted that it is difficult to evaluate the extent of risk to which the Fund may be exposed, because the Fund extends credit only to its members, which constitute the organization, and past experience showed that obligations were eventually discharged. The EAC noted, however, that the probability of loss cannot be ruled out altogether. In the light of growing arrears, both as regards amount and number of members, the EAC emphasized the need for periodic reviews to consider whether loss provisions for overdue obligations are necessary. The EAC endorsed a proposal of the Treasurer to establish a more comprehensive and structured approach to the evaluation process as to whether or not a material loss is probable with respect to members with protracted overdue obligations to the Fund. This Section reviews the responses made by the Fund to the issue of overdue obligations and also discusses various issues, on which the Executive Board might give guidance, that might bear on the probability of loss with respect to protracted obligations.

1. The Fund's response to overdue obligations

Until the beginning of 1983, the Fund had experienced only comparatively few and isolated instances of late payments or prolonged overdue financial obligations by members. 1/ However, the amount of overdue obligations increased markedly since 1983 and the periods during which some members have remained in arrears to the Fund have lengthened considerably. In a number of instances there are no indications that prompt settlement of arrears can confidently be expected. In the face of these developments as regards overdue financial obligations, the Fund has taken a number of measures since late 1984 to encourage and assist members to meet their financial obligations to the Fund on time, and to safeguard the financial position of the Fund against uncertainties.

a. Measures to encourage settlement of overdue obligations

The economic and financial position of those members that are overdue in their obligations to the Fund for periods longer than could reasonably be considered mainly of a technical character is regularly reviewed by the Executive Board in accordance with agreed policies on the treatment of overdue obligations. 2/ Members are urged to discharge these obligations promptly. The Fund does not engage in discussions regarding the use by the member of the Fund's resources if the member has overdue obligations outstanding. Furthermore, the Executive Board reviews a member's overdue obligations in accordance with agreed procedures and this can lead and has led to the Fund declaring a member ineligible to use the general resources of the Fund. Such a declaration is made public by means of a press release issued by the Fund and reported in more detail in the Fund's Annual Report. The Fund's financial statements also contain information on overdue obligations. 3/

1/ It should also be noted that those countries that withdrew from membership and had outstanding financial obligations at the time of their withdrawal (Cuba, Indonesia and Czechoslavakia) settled their obligations in accordance with the terms of their withdrawal. However, a unique situation is presented by Kampuchea. This member began to incur overdue obligations in 1975 and in 1978 the Fund limited the member's right to use the General Resources of the Fund and suspended its right to use SDRs acquired after the date of suspension. In 1979 the Fund reclassified charges due from Kampuchea as deferred credit. In the context of the total amount of credit extended by the Fund, and by itself alone, the amount overdue by Kampuchea might be regarded as not material.

2/ See "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/211, 3/9/84) and successive six-monthly reports to the Executive Board on overdue financial obligations (EBS/84/211, 10/11/84), (EBS/85/73, 3/27/85) and (EBS/85/245, 11/5/85).

3/ The Notes to the Financial Statements of the General Department contain information on the amounts receivable by the General Department of the Fund from members overdue in payments to the Fund for six months or more. The data include both the total amount of charges receivable and repurchases from members that are late by six months or more in discharging financial obligations to the Fund. Notes to the Financial Statements of the Trust Fund report similar information.

While a declaration by the Fund of a member's ineligibility to use the general resources of the Fund might raise issues about the payment performance of the member, it would not be proper to conclude from such a declaration that a loan loss is probable which would call for making provision against a loss. A declaration of ineligibility is, in the view of the staff, one possible indicator that might be taken into account in coming to a judgment on the probability of loss, but, of itself, it is not conclusive. The Fund maintains its relations with a member following a declaration of ineligibility. The Fund reviews a member's overdue position regularly, including the positions of members that have been declared ineligible. These reviews serve, inter alia, to keep the Fund informed on developments in the member's economy, but they also mean that the Fund remains prepared to discuss with and give assistance to the member on the elements of an economic program that the member could institute. Such a program would strengthen its external payments position and enable the member to reduce or eliminate its overdue obligations to the Fund. In this latter regard, the Fund may assist a member in helping to secure external financing from other sources in connection with the possible implementation of a stabilization program. The Fund also maintains close contact with the member through its periodic surveillance of members' economic, financial and exchange rate policies as part of the Article IV consultation process.

By these and related means, the Fund maintains an ongoing dialogue with members with overdue obligations which can be expected to help a member with overdue obligations to adopt measures that will assist it in discharging its overdue financial obligations to the Fund. On balance, it may reasonably be expected that ongoing contact between the member and the Fund would help to reduce to some extent the probability of loss with respect to the overdue obligations of the member. A declaration of ineligibility does not lessen dialogue between the member and the Fund.

b. Measures to protect the Fund's financial position

As regards the measures taken by the Fund to safeguard its financial position in the light of the increasing problem of overdue financial obligations, the Executive Directors will recall that:

(1) In March 1985, the Executive Board decided to exclude from current income unpaid charges due from members that were overdue in meeting financial obligations to the Fund for six months or more; 1/

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).

(2) In June 1985, the Executive Board increased the net income target specified in Rule I-6(4)(a) from 3 percent to 5 percent of reserves at the beginning of a year; 1/

(3) In December 1985, the Fund decided, effective February 1986, to introduce a system of special charges aimed at recovering certain costs arising from overdue payments was introduced; 2/

(4) In December 1985, the Fund also raised the rate of charge on the use of its ordinary resources from 7 percent to 7.87 percent per annum, an amount that was projected to yield sufficient income to enable the Fund to meet its net income target for FY 1986, equivalent to 5 percent of its reserves at the beginning of the financial year. The Fund has also considered a reduction in the remuneration coefficient as a means of sharing the burden of reducing its operational expense as a means of carrying the cost of overdue financial obligations.

These measures, including the income-generating safeguard mechanism for the determination of the rate of charge and net income target under Rule I-6(4), emphasize the importance the Fund attaches to the protection of its overall financial position. These measures, which do not in any formal sense substitute for provisioning in the event of a probable loss on some of its lending, provide for some increased cover against the risk of financial loss, including the risk that repurchases are not made. In particular, the increase in the reserve target has to some extent served a similar purpose as provisioning to meet loan losses though the factors bearing on the size of the increase in the reserve target differ from those bearing on the amount of provisioning.

2. Evaluation of probability of loan losses

As noted earlier, any consideration of the possible need for making provisions by the Fund against repurchases becoming delinquent must be preceded by a judgment whether (i) a loss appears probable and (ii) an estimate of the magnitude of the loss. However, some of the traditional elements that might need to be considered in coming to a judgment whether a loss is probable not only raise a number of issues particular to the Fund but might also tend to increase the difficulty of coming to a view as regards the probability of loss.

The view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental and cooperative nature of the institution, in which debtors and creditors collaborate to determine Fund policy, and in view of members' obligations

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1/ See "Factors Bearing on the Adequacy of Fund Reserves" (EBS/85/125, 5/14/85) and "Review of Income Position and Related Issues" (EBS/85/149, 6/18/85).

2/ See "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund - Further Consideration" (EBS/85/242, 10/29/85).

under the Articles of Agreement. While these are arguments that are relevant for judging the risk of loss, they do not mean that the Fund is immune from probable loss. It would seem, that the Fund faces in practice two types of risks in its lending: the first is a political risk that the member will repudiate its indebtedness to the Fund or will indicate an explicit unwillingness to discharge its obligations to the Fund. The second type of risk the Fund faces is of an economic nature which fundamentally reflects a member's view that it is unable to service its obligations to the Fund because of its economic and financial circumstances.

a. Unwillingness to discharge debt

No member with overdue obligations to the Fund has given any indication of either a repudiation or unwillingness to discharge its overdue financial obligations to the Fund. On the contrary, all members with overdue financial obligations to the Fund have stated, though with differing degrees of emphasis, their intention to discharge overdue obligations as soon as circumstances permit. While a negative statement on intentions to repay must be taken at its face value, and would face the Fund with different issues, a difficult issue that arises in connection with any decision to provision is how much weight to give to a member's announced intention to actually discharge its overdue obligations when circumstances permit. The intention to repay must be seriously weighed because it indicates the continuing element of cooperation between the member and the Fund to find a solution to the member's financial difficulties. However, it cannot be regarded as a decisive element in the absence of some specific measure bearing directly on the repayment of debt.

b. Criteria to determine probable loss

The burden of coming to a view whether a loss is probable must depend on facts. Among the more relevant sets of facts would be those relating to the member's financial arrears, its economic performance, its policy actions, especially as they bear on the achievement of a viable balance of payments position in the medium term, the member's priorities in the discharge of arrears, the duration that the obligations have been outstanding as well as its expressed intentions to repay the Fund as soon as circumstances permit.

(1) Financial circumstances

Consideration would need to be given to the total of debt owed by the member and specifically the amount owed to the Fund, the member's record and priorities in discharging its debts as well as the length of time the debt has been outstanding, in particular in relation to the Fund. A member's debt profile and the order in which the debts are discharged, which could indicate the priorities in discharging debt, are generally observable facts, though a firm conclusion may not always be drawn from them as to the probability of loss. An "over-indebted" member will, of course, experience relatively greater difficulties in servicing its debt than others, but not necessarily to an extent that it will refrain from acknowledging the debt or taking steps to discharge it over time. Much would depend on the amount and distribution of debt that is outstanding to the Fund in relation, for example, to the member's quota, and in relation to other measures of the member's economic size and capacity to service debt.

(2) Economic performance

A major consideration to be taken into account is the willingness and ability of the borrowing member to implement a policy of economic adjustment and the establishment of possible special safeguards to secure the servicing of debt to the Fund, and also including structural reforms in order to help bring about a viable balance of payments position, and which would include the elimination of arrears towards the Fund. The absence of such an economic program in the face of a deteriorating economic and financial position might be regarded as an indication of a weakening intention by the member to discharge its obligations and, perhaps, a willingness to finance its balance of payments deficit through an accumulation of arrears, including arrears to the Fund. A weak economic performance by a member might well suggest a delay in the discharge of its overdue obligations to the Fund, though by itself the absence of an effective economic adjustment program would not of itself indicate that repayment will not be forthcoming at some time in the future. Circumstances may change, and perhaps change relatively quickly. A member may decide to institute an economic program and make other appropriate reforms, thereby improving the prospects, perhaps with the help of outside financial assistance, of the member discharging its overdue obligations to the Fund.

(3) Duration of overdue payments

While it may be difficult to draw firm conclusions as regards the bearing that a member's financial circumstances and its economic performance may have on a member's willingness and ability to discharge overdue obligations and hence their weight in the judgment as to the probability of loss, the length of time that obligations have been overdue may be regarded as a relatively specific indication of increasing probability of loss. It would be reasonable to presume that the longer an obligation has remained overdue the greater the probability of loss, unless there was specific evidence to the contrary. For example, protracted overdue obligations may be regarded as normally reflecting a lack of foreign exchange resources which could be used to discharge foreign indebtedness and would tend to reflect a decreasing probability that overdue obligations would be discharged. Furthermore, a shortage of foreign assets might well become more severe over time which might reflect an absence of corrective policies or changes in priorities. The argument that a prolonged failure to discharge overdue obligations might be interpreted as indicating a weakening of the particular relationship between the Fund and a member, and could indicate some impairment of the value of the asset, might also have some merit in the absence of an undertaking of an economic program despite declarations of the member of its intention to repay as soon as circumstances permit. In short, the length of time that obligations have remained overdue is a relatively significant indication that the issue of loss was increasingly likely in the absence of other action by the member to service its debt.

(4) Outside opinion

As indicated in Appendix I below, a number of outside bodies, in particular the major international commercial banks and various supervisory and regulatory authorities, make periodic evaluations of their debtors in accordance with the policies and procedures of these institutions regarding provisioning. Some aspects of these policies and procedures may not be altogether appropriate in the context of the Fund. For example, some of the methods are automatic in nature and do not provide for extenuating circumstances. Furthermore, some agencies, for example the Interagency Country Exposure Review Committee (ICERC) in the United States in its evaluation includes whether the country is in the process of adopting, or has adopted, a Fund program or is not adhering to such a program, or is not able to negotiate or unlikely to succeed in the scheduling of its debts. 1/ Thus, these criteria are not judged to be necessarily applicable to the Fund. The existence of arrears to the commercial banks would not appear to be a reason for doubting the obligations of a member which was meeting its payments to the Fund as they fell due or if a member that had fallen into arrears in the past had become current to the Fund.

While it would seem useful and desirable that the Fund take into account the evaluations by outside bodies in reaching its own judgment as to the probability of loss on the credit extended by it to its members, the Fund would, in many instances, not be safely guided by these judgments but would need to reach its judgment in the context of its functions and its relationship with the member. In this regard, it is worth noting that the Fund's judgment as to the probability of loss on loans to a member may have an impact on the judgments that other institutions may need to make on their loans to the same member. Nevertheless, a major consideration is the degree to which a member makes its payment on due time.

(5) Other considerations relevant in the context of the Fund

An assessment of the risks associated with lending by the Fund to its members is essentially an assessment of the overall creditworthiness of each individual borrowing member, after taking into account its overall relations with the Fund. The case-by-case evaluation

1/ The ICERC evaluates the transfer risks associated with particular countries and, where appropriate, issues directives establishing reserves percentages that must be observed by U.S. banks for particular countries.

by the Fund of the creditworthiness of particular members, and also the Fund's lending in general, primarily reflect the Fund's own experience and responsibilities. The Fund's past experience as regards overdue payments is limited, and can be effectively dated from 1983. The increased incidence of overdue obligations has occurred against a background of difficult economic and financial conditions for many countries in the Fund, including in particular the poorer debtor countries, which may be temporary as economic recovery becomes more widespread. In making its assessments as to the probability of loss, the Fund would give due regard to the economic and financial conditions that might affect not only individual members but also the world economy in general.

The Fund has a particular responsibility in assisting its members both individually and collectively in accordance with its generally agreed policies. These responsibilities relate, for example, to the areas of conditional and unconditional liquidity and in its surveillance functions. They do not, in the view of the staff, relieve the Fund from making a judgment as regards the probability of loss on credit extended by the Fund. However, in the event that a relatively large number of countries found it difficult to service their debts to the Fund and to other creditors in view of general balance of payments difficulties, the issue might arise whether the Fund should not also consider action to meet a possible systemic difficulty as well as help individual members to overcome their difficulties before coming to a judgment whether a loss is probable. Any such general action, which would, of course, need to take into account the various elements influencing the working of the world economy, including the level and distribution of international liquidity, but would neither preclude nor obviate a detailed consideration of the position of individual members as regards their overdue obligations to the Fund.

(6) Summary

The probability of loss as regards the discharge of repurchases due to the Fund is a matter of judgment. This judgment has to be made in the special context of the Fund. As discussed above, certain criteria may be established which may help the Fund in arriving at its judgment. The factors discussed above, may sometimes be conflicting. However, when all, or most, of the relevant indications bearing on the probability of loss point in the same direction, some possible impairment in the value of the Fund's assets may be presumed to have occurred. Such indications bearing on the probability of loss could include the length of time that obligations have been overdue; the absence of a set of corrective measures or structural reforms in the debtor country; the existence of continuing, if not worsening, financial and economic imbalances in the country; and outside agencies have made a judgment as to the probability of loss as regards their loans to the country.

However, the Fund needs also to take into account wider considerations that touch on its broad responsibilities and functions in the world economy. In this regard, systemic issues might arise and indicate the possible need for general action, and not only with respect to individual members. Provisioning in the context of the Fund is not only an important accounting procedure. It raises significant issues bearing on the relationship between the Fund and its members and the international economic community in the sense of providing a signal regarding the relative performance, not necessarily confined to an individual member, but also of the performance of the international economy and the Fund itself.

Nevertheless, despite the real difficulties in assessing probable loss, the Fund may need to consider: (a) taking further protective measures when making its resources available and as long as they are outstanding and in improving its procedures in order to help prevent overdue obligations arising; (b) establishing a presumption as to a probability of loss based on the length of time that an obligation has been overdue, unless other indications or evidence of impending payment would strongly suggest otherwise, such as the introduction of an adequate economic adjustment program. In this regard, consideration may be given in coming to a conclusion as to the probability of loss if repurchase and other payment obligations to the Fund were overdue by, say, three years or more. The taking of such action would indicate that the Fund believed that by some future date the overdue debts from a member would not have been discharged, and that the prospects of settlement by the member had seriously diminished.

In the event that it was felt a judgment as regards the probability of loan losses was premature at the present time, consideration could be given to raise somewhat the reserve target. This approach would afford some protection to the Fund's financial position. It will be noted, however, that in the event it was decided later to make provision against probable loss, the Fund's reserves could not be used--or reclassified--to offset the cost of provisioning; though it would be reasonable to review the reserve target in the light of any decision to establish provisions.

3. Financial consequences of provisioning

As indicated earlier, the cost of making provision is a cost of conducting business. Provisioning is an item of expense which has implications for the net income position and, hence, the ability of an organization to retain earnings and increase equity capital. In the context of the Fund, particular issues arise regarding the means of financing provisions against doubtful or bad debt if it is determined that provisioning is necessary and desirable.

Given the Fund's net income target, the cost of provisioning would be met by increasing the Fund's income or reducing expenses. The main element in increasing income would be to raise the rate of charge on the use of the Fund's resources, while the main element of a reduction in expense would come from remuneration expense, i.e., from a reduction in the remuneration coefficient. 1/ Given the assumption in the last review of the Fund's income position for FY 1987 regarding the use of Fund credit and remunerated positions, each SDR 10 million of provisions in addition to the present target amount of net income would require an increase of the rate of charge of five basis points (0.05 percentage point), or a reduction of the remuneration coefficient of approximately 0.75 percentage point (e.g., from 94.99 percent prescribed by Rule I-10(b)(1)(i) for the period starting May 1, 1986 to 94.24 percent), or some combination of an increase in the rate of charge and reduction in the remuneration coefficient. 2/

As indicated above, the different types of provisioning that might be considered have differing effects on the Fund's income position. For example, a provision against total outstanding credit of, say, 0.5 percent (or somewhat below the lower range of provisioning apparently followed by most U.S. commercial banks) would amount to the order of SDR 176 million, or the equivalent of 0.9 percentage point on the rate of charge during one year. Alternatively, a provision allowance established on the basis of a rate of, say, 10 percent of all current overdue payments would amount to SDR 62 million; a provision for individual obligations that are overdue by, say, three years or more, would at present amount to SDR 25 million, though judgment as regards the remaining outstanding credits to such members with overdue obligations would also need to be considered. For example, if remaining loans would also be subject to doubt, it would be possible to provision in successive stages, over a period of, say, five years.

As already indicated, if a loss were no longer considered probable, a provision that had been made with respect to it would be dissolved. If a member had cleared its arrears, including those relating to the doubtful credit, a special provision would normally be dissolved unless other arrears existed and loss was judged probable about the remaining amounts of outstanding credits. The dissolution of general provisions would require a judgment that existing provisions were sufficient to meet probable losses in the light of changed circumstances. The resources that were released by the dissolved provisions would become part of current income, which would at that time allow a lower rate of charge, a higher remuneration coefficient, a faster reserve accumulation than otherwise would be the case, or some combination of these alternative courses of action. Under current procedures, an important consequence of provisioning would be greater instablity in the rate of charge and possibly in the remuneration coefficient because the Fund's income position would be further affected because of changes in the amount of provisioning that would be regarded as necessary or desirable.

1/ It might also be pointed out that the Fund may raise income to meet current expenses of the Fund through other means, such as making investments up to the total of the general and special reserve.

2/ A system of temporary, reversible surcharges, and temporary reversible discounts, has been suggested by the staff for consideration by the Executive Board; see "The Fund's Income Position for FY 1986 and Review of the Remuneration Coefficient" (EBS/86/81, 4/14/86).

IV. Overall Summary and Concluding Remarks

The following summarizes the points made in the analysis presented above, and presents some concluding remarks:

1. The concept of provisioning

(i) Provisioning in financial accounting means the establishment of an allowance to meet a probable loss on an asset or on a class of assets similar in character. The allowance for meeting losses is financed by making a charge against current income, and such an allowance is a cost of conducting business and is, therefore, an expense item.

(ii) Provisioning is intended to ensure a fair and accurate statement of the financial position of an entity (i.e., both its income and its assets), and thereby avoid an overstatement of income and of the equity of an entity, including reserves. Provisioning protects the capital (including equity reserves) of an entity against loss when an asset is written off as a loss is realized.

(iii) Provisioning becomes necessary when it is judged that a loss is probable and the amount of the loss can reasonably be estimated.

(iv) If the size of a loss cannot be estimated, though it is concluded that some loss is probable and the likely outcome is within a range, then at least the amount indicated by the lower end of the range should be provided for.

(v) There are two main methods or provisioning, which are not mutually exclusive. A general provision may be established to meet a risk related to classes of assets with a common characteristic, and when it is impractical to make specific provision because of the relatively large number of small loans being provisioned for. Under this method, the amount to be provided as a loss contingency generally is based on past experience and is determined by establishing a ratio of past losses from bad debts to new credit extended.

(vi) The more usual approach is to establish a special provision to meet an estimated probable loss on specific credits (usually on credits of comparatively large size or which are extended to creditors with unique characteristics).

(vii) Private financial institutions normally make provision against doubtful or bad debts in order to protect their income and equity capital from erosion in the event that losses would be realized. Institutions that do not make provision can experience wide fluctuations in income and, possibly in reserves, if they experience unexpected loss. Prudential requirements established by the supervisory and regulatory authorities may also require provisioning under certain circumstances.

(viii) As indicated in Appendix I, sovereign debt is usually treated separately from other types of debt, and the basis of judging the risks of such loans is generally the assessment of economic and financial factors that bear on the ability of the country to pay, and on the good faith and recent payments performance of the debtor.

(ix) The review of the practices followed by international financial organizations, and presented in Appendix I, shows that except for the International Finance Corporation (IFC), these institutions have not specifically provided against risk of loss or uncollectibility of loans, other than through the accretion of general reserves, largely on the grounds that they do not anticipate incurring losses on their loan portfolios which are composed of sovereign loans or loans guaranteed by their member governments. Nevertheless, though they have not concluded that a loss is probable on any of their overdue obligations, some of them are giving consideration to the issue of provisioning, and may reach the conclusion in the near future that it would be necessary for them to make a provision against doubtful loans. It may be presumed that any action by the Fund on provisioning would exercise considerable influence on their judgment.

2. Provisioning in the context of the Fund

(i) In view of the increasing amount of overdue obligations in the Fund, as well as the rising number of members with overdue payments, some Executive Directors and the FY 1985 External Audit Committee have raised the issue of the need for periodic reviews to consider whether loss provisions for such obligations are necessary.

(ii) Criteria for establishing probability of loss - The Fund has only limited experience of overdue payments and no experience of actual losses on income or principal. However, any change that might be introduced regarding the establishment of provisions would need to be systematically followed in the future, and it would therefore seem necessary to receive guidance from the Executive Board on various elements, including procedural matters, that would enter a judgment that a loan loss was probable.

(iii) Types of risk in Fund lending - While the view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental, cooperative nature of the institution, the Fund is not judged to be completely free from the risk of loss on credit extended to its members. There appear to be essentially two types of risk the Fund faces: the first is a political risk of repudiation of debt, which would be an indication of unwillingness to repay the Fund, and the second type of risk is of an economic nature which fundamentally reflects a member's view that it is unable to service its obligations to the Fund in full or in part because of its economic and financial circumstances. The likelihood of either or both of these risks needs to be assessed in the light of certain standard criteria judged relevant in the context of the Fund.

(iv) Political risk (unwillingness to pay) - No member with overdue obligations to the Fund has indicated either a formal repudiation of debt to the Fund or unwillingness to discharge its overdue obligations to the Fund. However, while members with overdue obligations have generally indicated their intention to discharge their overdue obligations promptly, such declarations, although important, are of themselves insufficient, and the judgment regarding the probability of loss must be made on the basis of all the available facts bearing on the circumstances of the member.

(v) Economic risk (ability to pay) - An assessment of economic risk might be based on two sets of facts. The first set of facts are those relating to the financial aspects of the member's indebtedness, such as the total amount of external debt, including outstanding debt to the Fund, the volume and distribution of arrears and the order, if any, of debt repayments which may be indicative of the member's priorities in discharging its debt. The second set of facts on which the economic assessment might be based would include a review of a member's economic and financial policies, its willingness to implement a program of economic adjustment, and the extent and likelihood of external support that would be needed and forthcoming in its economic and financial rehabilitation. The absence of an economic program in the face of a deteriorating economic and financial position might be regarded as an indication of the weakening intention by the member to discharge its arrears. However, circumstances may change as regards a member's willingness to institute an adequate economic program, and the possibility of such change needs also to be taken into account.

(vi) Duration of overdue payments - An assessment of the economic and financial positions and policies of a member are not necessarily conclusive in coming to a judgment as to the probability of loss on overdue obligations. However, the longer an obligation has remained overdue the greater the probability of loss may become, particularly in the absence of evidence to the contrary which would lead to a conclusion that payment may be confidently expected. In this regard, it would be possible to establish a presumption for a period of time after which the probability of loss on the overdue obligations would increase to an extent that would call for making provisions unless the presumption is reversed by material evidence that loss is not probable. It would be a matter of judgment whether obligations should be overdue for, say, three years, before making provision.

(vii) Outside opinion - The Fund would also need to weigh fully the judgments reached by the international financial community and the various national supervisory and regulatory authorities in coming to its own judgment as to the probability of loss. The Fund would, of course, need to relate these judgments to its own experience and criteria which are governed by the purposes of the Fund, including its special role in the international monetary system in assisting its members in both adjusting and temporarily financing balance of payments deficits. Such assistance may, on occasion, be essential just at the time other sources of finance would dry up.

(viii) Role of the Fund - In making its assessment as regards the probability of loss on credits extended to members, the Fund also needs to take into account wider considerations that touch on its broad responsibilities and unique functions in the world economy, such as the policies attached to its lending, and its ability to respond to global shortages of conditional and unconditional liquidity and its function as an international lender of last resort. These responsibilities do not relieve the Fund of the duty to come to a judgment whether a loss is probable with respect to credits extended by it, but they could indicate some delay in a decision by the Fund that a loss appears probable until it is satisfied that the problem of overdue obligations is not one of generalized difficulty, for which general action might be needed. In that event, provisioning might be needed at a later stage than at most other financial institutions.

(ix) Overall judgment - When all, or most of the relevant indicators bearing on the probability of loss point in the same direction, it would seem reasonable to conclude that a presumption of loss has been established, unless developments in the international monetary system might indicate a generalized problem, and which would call for action by the Fund in fulfilling its role of safeguarding the global viability of the international monetary system.

(x) Review procedures - The judgment whether there is a need to establish provisions call for periodic reviews of individual members' indebtedness to the Fund, perhaps in addition to reviews that would otherwise be undertaken by the Fund in accordance with its procedures. In this connection, it would be necessary to consider (a) the frequency of the reviews on which the judgment on the probability of loss would need to be made, and (b) whether the Executive Board would have an ongoing involvement in making judgments regarding the probability of loss or whether the Executive Board would agree on broad guidelines and their application would be a matter for Management and staff.

(xi) Type of provisioning - In its consideration of the need for provisioning, the Executive Board would need to make a choice of whether to establish general or specific provisions, or to use a combination of the two. The establishment of a specific provision would involve making a judgment that a loss is probable with respect to the overdue obligations of a particular member. It would be for consideration whether the judgment as to probable loss should apply to all the obligations of the member to the Fund, or only to those obligations that are overdue at the time the judgment is made, or to those obligations that have been overdue for, say, three years or more. A system of specific provisioning does not depend on past experience of bad debts in the Fund nor does it imply a possible systematic or pervasive inability or unwillingness of members to repay the Fund.

(a) General provisioning - Such an approach would provide for a certain amount of provisioning which would be determined as a proportion, say, 0.5 percent of the amount of Fund credit outstanding or, say, 10 percent of the total amount of overdue obligations, or the amount of obligations that are overdue by, say, three years or more. The amount of the provision would be somewhat arbitrary in the sense that there is no past experience to call upon.

(b) Specific provisioning - In order to establish specific provisions for an individual member, it would not appear necessary for the Fund to conclude that loan loss is probable unless a member has already incurred prolonged overdue obligations with the Fund and unless most of the criteria, on which the judgment would be based, would point towards this conclusion.

(xii) Amount of loss - The amount of the provision to be established when it has been determined that a loss is probable will depend in part on whether general or specific provisioning is adopted and also whether the expectation of loss would cover a member's total obligations to the Fund or only that part of the obligations that are overdue or only the obligations that are overdue by, say, two years or more.

(xiii) Cost of provisioning - Provisioning is a cost of conducting business and is, therefore, an item of expense. It would be necessary to consider various options of financing an increase in the Fund's expense bearing in mind the issues relating to burden sharing.

(xiv) Provisioning and reserves - Provisioning against the probability of loss raises an issue regarding the relationship between provisions and the level of the Fund's reserves. If a loss is judged probable a provision must be established, irrespective of the level of reserves or the policy of the institution as regards the accumulation of reserves. It would, therefore, be appropriate for the Fund to review the reserve target, and consider whether an adjustment (upwards or downwards) in the target would be warranted in the light of all relevant circumstances, in the event the Fund adopted provisioning as a contingency against loss.

(xv) Interim action - In the event the Executive Board concludes that it is not possible to come to a judgment regarding the probability of loss, or that it would be appropriate to defer coming to a judgment at this time, consideration may be given to raise the reserve target in view of the rising volume of arrears to the Fund.

The Practice of Provisioning in Financial Organizations

The factors that influence the management of an organization in making judgments regarding the probability of a loss, and hence the possible need to make provision against a loss, are in part associated with the type, nature and purpose of business making the loans; the types of loans actually made and the maturity of the loans; past experience regarding doubtful or bad debts, including the length of time debts have been outstanding; the number of individual loans involved; and the economic and financial data available that bear on the financial position of the borrower. However, such factors have to be looked at within the operational context of the organization, and in particular, within the context of its relation with its clients and its general financial policies. A brief summary of the practices followed by some of the main types of financial institutions would seem helpful in clarifying some of the issues that relate to provisioning by the Fund. But this does not mean that these factors provide, in any way, conclusive guidance for the Fund.

1. Depository institutions

Financial institutions engaged in commercial lending operations have a long standing practice of provisioning for doubtful or bad debts in view of the risks normally associated with commercial lending. Banks and other depository institutions usually establish provisions in anticipation, and usually by quantitative estimation of loan losses, in order to protect their equity capital from erosion. Such institutions recognize that it is preferable to provision over time starting with the first signs of perception of loss, rather than when no further recovery is feasible and the entire loss has to be charged against earnings or reserves in one accounting period. The portion of estimated loan losses that is not covered by effectively realizable collateral is normally provided for by using various techniques of general and specific provisioning or by combining them.

Banks normally establish specific provisions by reviewing individual loans above a certain minimum amount and by ranking them according to risk category as good, substandard, doubtful or loss loans. Specific provisions are then made up to a specified percentage of the loan, amounting to 5 to 20 percent for "substandard loans", 50 percent for "doubtful loans" and 100 percent for "loss category loans." 1/

1/ "Substandard loans" are those loans with well-defined weaknesses that disrupt or jeopardize orderly repayment and that are inadequately protected by the current net worth and paying capacity of the obligor, while "doubtful loans" have the additional characteristic of making complete collection or liquidation improbable based on existing facts, conditions and collateral values. "Loss loans" are considered uncollectible and of such little value that their continuation as a bankable asset is unwarranted. The classification as a "loss loan" does not mean that the asset has absolutely no recovery or salvage value, but it is not considered practical and desirable to defer full loss recognition.

Following the calculation of these specific provisions, a general provision is calculated which represents further estimated losses which relates to that portion of the loan portfolio not covered by specific provisions.

In general, these policies of provisioning reflect a certain quantifiable risk, based in part on past experience, and they broadly relate to risks attached to relatively short to medium-term lending. Furthermore, a process of periodic evaluation and review of provisioning maintains the level of the provisions in accord with the perceived financial risk attached to the loan and the estimated magnitude of loss on the loan portfolio, while allowing losses to be absorbed without abrupt fluctuations in earnings. Typically, commercial banks in the United States allow for loan losses ranging in an amount equivalent to approximately 1-2 percent of loans outstanding, although there are significant fluctuations around this range which depend on portfolio composition (and the degree of quantifiable risk) and the write-off policy of each institution. 1/

In addition to the usual practice reflecting commercial risks, national regulatory or supervisory authorities typically have established additional requirements on banks which are especially aimed at the protection of the depositors and which are geared towards improving the solvency requirements of banks under their supervision. The regulatory requirements range from minimum equity or general reserve requirements to the detailed reporting of nonaccrual loans and recently the establishment of minimum provisions for certain categories of assets. Regulatory prescriptions on provisioning against loss on sovereign debt have increased markedly with the emergence of the debt crisis and the recent problems of some countries to service their government guaranteed debt. Prior to these difficulties, sovereign loans had by and large been considered risk-free as the concept of bankruptcy did not appear applicable to countries; recent events shifted the evaluation of such loans from virtually risk-free to risk-bearing assets and as a consequence certain minimum provisions have been made mandatory against lending to certain countries representing a varying degree of loss risk.

2. Sovereign debt

The regulatory accounting and reporting requirements in relation to sovereign debt vary from country to country, and often the issue of sovereign debt is treated separately from other types of debt because the lender usually has no control over the use of the proceeds received by the borrower and cannot normally monitor such use. The basis of judging the risk of such loans is the assessment of the credit standing of the debtor. The most stringent regulations have been adopted in the

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1/ In the United States, where detailed disclosures are required, approximately 1.1 percent of loan principal was on average in 1983 provided against foreign loans by commercial banks. This percentage varied from 0.6 percent to 2 percent in the ten largest banks.

United States in the Sovereign Lending Act, which was passed in connection with the approval of the increase in the quota of the United States under the Eighth General Review. Under the prescriptions of this Act, countries are evaluated by the regulatory authorities and categorized using pre-established criteria. 1/

Classification in a "value impaired" or "loss" category requires provisioning at varying degrees with annual increments.

In the United Kingdom sovereign loans are not separately reported but are included in the balance sheet with other loans and, where appropriate, provision is made for a potential loss but not identified. There are no specific accounting and disclosure requirements or country classifications requiring specified provisions against sovereign risks although certain confidential information has to be provided to the Bank of England. Furthermore, specific provisions for sovereign exposure vary from one bank to another and depend in practice on their general provision policy.

The German Federal Banking Supervisory Authority has supported the effort of banks in setting up substantial country risk provisions. These provisions are not specifically identified as related to individual country debt but are included in the general provisions against loan losses. German banking law allows banks to set up provisions comprising an element of "hidden" reserves without describing this fact. In addition, banking authorities require statutory contingency reserves to be set up for all loans, reflected in the balance sheets among a bank's liabilities.

1/ Countries are classified as "substandard" when one of the following conditions is fulfilled: a country is not complying with its external service obligations as evidenced by arrears, forced restructuring, or rollovers; the country is not in the process of adopting a Fund program or other suitable economic adjustment programs or is not adhering to such a program, or is not able to negotiate or unlikely to succeed in the scheduling of its debts. This classification could deteriorate to a "value impaired" category when one or more of the following would apply and provisioning in varying degrees would start: the country has not fully paid its interest for six months, the country has not complied with Fund programs (and there is no immediate prospect for compliance); the country has not met rescheduling terms for over a year or the country has not shown a definite prospect for an orderly restoration of debt service in the near future. These two classification categories are in addition to a loss category for country debt, when the loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by a country which repudiates obligations to banks, the Fund or other lenders. According to the classification used by the Interagency Country Exposure Review Committee in the United States, sovereign lending to seven countries is classified as value impaired--Bolivia, Liberia, Nicaragua, Peru, Poland, Sudan and Zaire--and is subject to mandatory provisioning varying from 15 to 75 percent in the United States.

Japanese banks are required to establish provisions against specific overseas losses under the guidelines of the Ministry of Finance. These provisions are established against losses on loans to governments and private borrowers in specified problem countries. Periodic reports are required to be submitted to the Ministry of Finance of sovereign loan loss exposure and of specific reserves against them, and approval is required to have a provision allowed as a tax-deductible expense. The provision may be recorded as a charge to income or against retained earnings.

3. Public international financial organizations

To date, the international development banks have not specifically provided against risk of loss or uncollectibility of loans, other than through the accretion of general reserves. The notable exception is the International Finance Corporation which, by the nature of its activity as a partner in financing risk-bearing equity capital ventures, is confronted by risks normally absent in sovereign lending, and from its inception until 1974 followed a policy of allocating all of its net income to a provision called "reserve against losses". The Corporation changed this policy after 1974 when it began directly to charge against income an amount of provision for losses on investments, which was added to the "reserve against losses." The annual charge is based on the Corporation's historical loss experience, the amount of investments in respect of which a significant and relatively permanent decline in value is recognized and the amount of investments in respect of which losses cannot yet be identified.

The IBRD until 1964, allocated specified revenues 1/ directly to a special reserve against loan losses and held invested assets corresponding to this reserve. In addition, from 1951 to 1963, the Bank's net income was allocated automatically to a "supplemental reserve against losses on loans and guarantees", which was part of General Reserves. In 1975, the IBRD incorporated this reserve into the General Reserves, since accounting pronouncements in that year did not allow such an unspecified general business risk reserve to function as a provision account, to which losses could be charged in case of loss. The IBRD has to date, continued to indicate in its latest prospectus and S.E.C. filing that no material loss is expected as a result of payment delays. The staff understands tht the IBRD will soon consider the issue of provisioning in view of its overdue obligations.

1/ The Bank collected loan commissions to be added to the Special Reserve which was to be held in liquid assets and to be used only for the purpose of meeting liabilities on its borrowing and guarantees. This practice was discontinued in July 1961 in respect of subsequent loans.

4. Conclusion

As can be seen from this brief survey, private financial institutions that extend credit to commercial and official borrowers make provision with regard to their loan portfolio in anticipation of incurring some losses on their loans. Public international financial institutions such as the World Bank generally have not made provision for loan losses, largely on the grounds that they do not anticipate incurring a loss on their loan portfolios which is composed of sovereign loans or loans guaranteed by governments. 1/ However, with the increasing incidence of arrears, the IBRD will soon consider the issue of provisioning.

1/ The Notes to the Financial Statements of the IBRD, for example, note:

> It is the policy of the IBRD to place in nonaccrual status all loans made to or guaranteed by a member of the IBRD, if for any such loan interest, other charges or principal is overdue by more than six months, unless the IBRD's management determines that the overdue amount will be collected in the immediate future....
>
> It is not expected that these payment delays will result in any material loss to the IBRD. (IBRD, The World Bank Annual Report 1985, p. 206.)

A similar indication is found in the Notes to the Financial Statements of some of the regional development banks.

1985 EAC Comments to the Managing Director (excerpt)

Overdue financial obligations

We observe that there was a sharp increase in the amount of overdue financial obligations during the second half of FY 1985. The increase was not only in the matter of outstanding overdue obligations but also in respect of the number of countries and period of nonpayment. Deduction from operational income of deferred income relating to overdue charges resulted in a net loss of SDR 30 million in FY 1985 with a corresponding decrease in the reserves. This, coupled with the sharp increase in overdue financial obligations in the recent past, gives rise to the need for periodic reviews to consider whether loss provisions for such obligations are necessary.

Generally accepted accounting principles require that provisions be made when a loss is probable and the amount of loss can reasonably be estimated. Unlike other financial institutions, the Fund extends credit facilities only to sovereign Governments and past experience shows that the obligations were eventually discharged. It is therefore difficult to evaluate the extent of risk to which the Fund may be exposed. The probability of loss cannot, however, be ruled out altogether.

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 this effort.

1985 EAC Comments to the Treasurer (excerpt)

Overdue Financial Obligations

We observe that there was a sharp increase in the amount of overdue financial obligations during the second half of FY 1985. The total amount of overdues rose from SDR 138 million in September 1984 to SDR 224 million at the end of April 1985. The increase was not only in the matter of outstanding overdue obligations but also in respect of the number of countries and period of nonpayment.

(a) The overdue position had caused serious concern in the Fund. The Board, after due consideration, has taken certain measures, one of which is the adoption of the accounting practice of deferring the recognition as current income, charges receivable from members that are late by six months or more in discharging their financial obligations to the Fund unless such members have remained current in the payment of their charges. We believe that the application of this policy for FY 1985 was consistent with the generally accepted accounting principle which allows for the deferral of revenue recognition when there is uncertainty regarding the timing of collection. However, we believe that this policy could create some accounting presentation problems in the future. For example, if a member with outstanding obligations five months past due at April 30, 1985 delays in the payment of obligations beyond six months, under the present policy a portion of charges included as income in FY 1986 would be deducted as deferred income in 1986. However, is it logical that a deduction can be made from periodic charges in FY 1986 that do not include the amount being deducted? Accordingly, the Treasurer's Department needs to examine how to properly present,in accordance with generally accepted accounting principles, those amounts recognized as income in one year but because the member continues to be in arrears, are treated as a reduction of income in the succeeding year. The effect of amounts collected in the succeeding year should also be considered in this connection.

Also, there may be a potential conflict in the future between the strict application of the Fund's policy on charges relating to overdue obligations, and the requirements of GAAP. GAAP permits deferral of revenue recognition when there are uncertainties regarding collection. It is possible, however, that in strictly implementing the Board's decision, a deferral of revenue would be made even though, at the time of financial reporting, uncertainties may no longer exist (if material amounts, for example, were deferred as of a reporting date but collected before the report was released).

While we are satisfied that compliance with GAAP has occurred this year, we recommend that consideration be given by the Treasurer's Department to possible future conflicts to assure that the financial statement presentation, while reflecting the Executive Board Decision, will also be in accordance with GAAP.

(b) Deduction from operational income of deferred income relating to overdue charges resulted in a net loss of SDR 30 million in FY 1985 with a corresponding decrease in the reserves. This, coupled with the sharp increase in overdue financial obligations in the recent past, gives rise to the need for periodic reviews to consider whether loss provisions for such obligations are necessary. Although the Fund has so far not concluded that a material loss is probable with respect to these overdue obligations, the present situation indicates that the Fund's exposure to risk has considerably increased.

Generally accepted accounting principles require that provisions be made when a loss is probable and the amount of loss can reasonably be estimated. Unlike other financial institutions, the Fund extends credit facilities only to sovereign Governments and past experience shows that the obligations were eventually discharged. It is therefore difficult to evaluate the extent of risk to which the Fund may be exposed. The probability of loss, cannot, however, be ruled out altogether.

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 this effort.