EBS/86/82
Supplement 1

CONFIDENTIAL

April 29, 1986

To: Members of the Executive Board

From: The Secretary

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

Attached is a memorandum from the President of the World Bank to the Executive Directors entitled "Provisions for Losses on Loans" dated April 15, 1986.

This paper is circulated to up-date the information contained in EBS/86/82 (4/15/86). It has been requested that its content be treated with utmost discretion.

Att: (1)

THE WORLD BANK
Washington, D. C. 20433
U.S.A.

CONFIDENTIAL

A. W. CLAUSEN
President

April 15, 1986

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Provisions for Losses on Loans

A. Introduction

1. Following adoption of the Bank's policy for non-accrual of interest and charges on loans to borrowers with protracted arrears, extensive discussions were held with individual Board members and with the Joint Audit Committee on the related issue of provisions for possible future losses on loans. These discussions culminated in a set of guidelines for provisions articulated by management and agreed in principle by the Joint Audit Committee (JAC). It was also agreed that endorsement of these guidelines by the full Board was desirable before they were applied in any specific case.

2. It may be necessary before the end of the current financial year to begin provisioning in the case of one member that has not made a debt service payment since June 1, 1984, nearly two years ago. In anticipation of this, the Managing Committee believes that the Board should now review and endorse the guidelines agreed with the JAC. The application of the guidelines, if that becomes necessary, would be determined by management after due consideration of the specific circumstances, and duly reported to the Board.

B. Provisions for Losses on Loans

3. In December 1984, the Bank approved a policy for non-accrual of interest on loans to borrowers with protracted arrears. Generally, the Bank places all loans to a borrower in non-accrual status whenever the borrower is six months in arrears on any loan from the Bank. When a loan is placed in non-accrual status, all entries reflecting income that has been recorded in the Bank's accounts but has not yet been received from the borrower are reversed and subsequent income is recognized only as and when cash payments are received from the borrower. The effect of placing loans in non-accrual status is to postpone recognizing income on loans for which payments are seriously delinquent until cash is received from the borrower. This measure protects the Bank from being accused of overstating its income in a given period; it is not in itself a judgment on the ultimate collectibility of the amounts due.

4. If a borrower remains in non-accrual status for an extended period of time, however, the question arises as to whether the Bank, in addition to accruing no interest on loans to that borrower, should consider making provisions in its financial statements for a possible loss of the principal outstanding to the borrower. The question as to the appropriate circumstances under which provisions for losses on loans should be made was discussed extensively with the Joint Audit Committee on April 24, 1985. The following paragraphs summarize the rationale put forward by management at that time.

C. Basis for Conclusions

5. The primary driving force behind a decision that provisions should be made against loans to a borrower with serious arrearages is the preservation of the Bank's standing in the markets in which it borrows. After extensive discussion, both internally and externally, management concluded that two years of arrears is the longest period for which the Bank can credibly sustain that no provisions for loss are necessary.

6. Generally accepted accounting principles require that provisions for loss be reflected in the financial statements when it is probable that the value of an asset has been impaired. In practice, serious payment delays, in the absence of recoverable collateral, inevitably result in provisions for loan losses. Several years ago, sovereign debt was the notable exception to this rule, as lenders maintained that countries could not declare bankruptcy or cease to exist. However, as debt servicing difficulties on sovereign debt have mounted over the past few years, the practice has changed to one in which financial institutions in virtually every major financial center reflect provisions for loss on certain sovereign loans.

7. The Bank clearly enjoys a different relationship with its borrowers than do commercial financial institutions. As a result, management and the members may be confident that, as long as the relationship between a member and the Bank continues, the obligations of that member will eventually be paid. The "evidence" the Bank can present to the outside world that the Bank is accorded a preferred creditor status by its borrowers is the continued servicing of Bank loans by those borrowers even under difficult economic conditions. The Bank cannot expect, however, that the markets or our external auditors will continue to accept an apparent judgment by management that its preferred creditor status will ensure collection of all of a borrower's obligations to the Bank in the presence of a prolonged absence of payments by the borrower.

8. In order to maintain its credibility in the market, management concluded that the Bank should begin to make provisions for possible loss of principal on loans to borrowers in arrears by more than two years. (These provisions would be in addition to assets already available in the Special Reserve that is being maintained pursuant to the Bank's Articles of Agreement.) Once a decision is made to begin making provisions against loans to a particular borrower, management will have to evaluate all of the relevant circumstances at the time in order to determine the appropriate rate of provisioning.

9. Management also considered, and rejected, making provisions in anticipation of debt servicing problems arising in the portfolio, i.e. general provisions. If the Bank were to make general, unspecified provisions, it might suggest to the markets that the Bank expects continued, pervasive debt servicing problems in its loan portfolio and that, like commercial banks, it is willing to consider loan losses part of the ordinary cost of doing business. The more the Bank can convey the limited extent of the collectibility concerns, the more the negative market reaction can be contained.

10. The need to characterize the provisions as relating to specific isolated cases of serious debt servicing delays is one reason why management believes the identity of the borrower against whom provisions are made should be disclosed in the financial statements. Another important reason is to protect the reputations of member countries who are not seriously delinquent to the Bank by preventing speculation on the identity of the borrower with serious delinquencies. (This position is consistent with that taken for borrowers in non-accrual status. In September, 1985, when two members were in non-accrual status at the same time, their identities were disclosed in the Bank's prospectus.)

11. The background paper for the JAC meeting, IBRD Provisions for Loan Losses (JAC 85-8 dated April 17, 1985) and minutes of the meeting (JAC/M 85-5 dated May 2, 1985) were distributed to all Board members for information. The Annual Report of the Joint Audit Committee (R85-321 dated November 6, 1985) also summarized the discussions. The Committee members agreed in principle with the following guidelines proposed by management:

- The Bank should begin to make provisions no later than when a borrower reaches two years of arrears on debt service to the Bank, unless there is overwhelming evidence to obviate the need for provisions. In other words, at two years of arrears, there is a strong presumption that provisions are necessary.

- Management should consider the circumstances of the particular borrower in reaching a judgment about the appropriate rate of provisioning.

- Loan loss provisions should only be made against loans to specific borrowers whose arrears persist for an extended period of time; the Bank should not make general unspecified provisions against the loan portfolio as a whole.

- The Bank should disclose in its financial statements the identity of the borrower against whose loans provisions have been made.

D. Implication of Provisions

12. There is presently one borrowing member who, under the terms of the guidelines in paragraph 11 and in the absence of a change in circumstances in the next few weeks, would trigger provisions in June, 1986. If provisions are required, the amount of the provisions would reduce fiscal year 1986 net income. The financial statements for the year ended June 30, 1986 would disclose the amount of provisions, the policy for provisioning and the member country against whose loans provisions had been established. In evaluating the Bank's income and reserve targets and adequacy of loan charges (Review of IBRD Net Income Risks and Targets R85-220 dated June 28, 1985; Review of IBRD and IDA Loan Charges R86-24 dated February 6, 1986) possible credit risks as well as interest risks were taken into account. The size of the case referred to in this paragraph would not, of itself, call for any revisions of those targets.

13. With respect to the borrower, the establishment of provisions in the Bank's accounts in no way affects the borrower's obligations to the Bank. Principal and interest obligations would continue to be billed and payable under the original terms.

E. Recommendation

14. I recommend that the Board of Executive Directors endorse the provisioning guidelines agreed with the Joint Audit Committee as enumerated in paragraph 11 of this memorandum.

A. W. Clausen
President

Moeen A Qureshi

By: Moeen A. Qureshi