

MASTER FILES

ROOM C-130

04

## INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 86/73

10:00 a.m., April 30, 1986

J. de Larosière, Chairman  
R. D. Erb, Deputy Managing Director

Executive Directors

C. H. Dallara

M. Finaish

H. Fujino

J. E. Ismael

T. P. Lankester

M. Massé

P. Pérez

H. Ploix

J. J. Polak

G. Salehkhoul

A. K. Sengupta

S. Zecchini

Alternate Executive Directors

Mawakani Samba

M. K. Bush

H. G. Schneider

T. Alhaimus

M. Sugita

B. Goos

Jiang H.

H. A. Arias

M. Foot

H. Fugmann

L. Leonard

W. Parmena, Temporary

M. A. Weitz, Temporary

J. E. Suraisry

G. Ortiz

S. de Forges

J. de Beaufort Wijnholds

A. V. Romuáldez

O. Kabbaj

A. S. Jayawardena

N. Coumbis

L. Van Houtven, Secretary

B. J. Owen, Assistant

1. Fund Income Position for FY 1986 and Review of Remuneration Coefficient; Rate of Charge as of November 1, 1985, and Setoff in Connection with Charges Due by Members in Arrears; and Provisioning Against Loan Losses in Context of Fund - Preliminary Consideration. . . . . Page 3
2. Executive Director . . . . . Page 41
3. Israel - Technical Assistance . . . . . Page 42
4. Approval of Minutes . . . . . Page 42
5. Executive Board Travel . . . . . Page 42

Also Present

Administration Department: H. Wiesner. African Department: G. B. Taplin.  
European Department: L. A. Whittome, Counsellor and Director. External  
Relations Department: H. P. Puentes. Legal Department: F. P. Gianviti,  
Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder,  
R. Munzberg. Middle Eastern Department: C. Sassanpour. Secretary's  
Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's  
Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy  
Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, D. H. Brown,  
P. Clark, J. C. Corr, D. Gupta, P. B. Hicks, Y. Kawakami, B. E. Keuppens,  
J. T. McDonald, G. Wittich. Office of the Managing Director: C. P. McCoy.  
Personal Assistant to the Managing Director: R. M. G. Brown. Advisors  
to Executive Directors: A. A. Agah, W.-R. Bengs, M. B. Chatah,  
L. P. Ebrill, S. Ganjarerndee, S. M. Hassan, G. D. Hodgson, J. Hospedales,  
K. Murakami, G. Nguyen, A. Ouanes, P. Péterfalvy, A. Vasudevan.  
Assistants to Executive Directors: H. Alaoui-Abdallaoui, B. Bogdanovic,  
J. de la Herrán, J. J. Dreizzen, W. N. Engert, S. Geadah, V. Govindarajan,  
L. Hubloue, O. Isleifsson, Z. b. Ismail, S. King, M. Lundsager, R. Msadek,  
D. Saha, B. Tamami, L. Tornetta, H. van der Burg, E. L. Walker,  
B. D. White.

1. FUND INCOME POSITION FOR FY 1986 AND REVIEW OF REMUNERATION COEFFICIENT; RATE OF CHARGE AS OF NOVEMBER 1, 1985, AND SETOFF IN CONNECTION WITH CHARGES DUE BY MEMBERS IN ARREARS; AND PROVISIONING AGAINST LOAN LOSSES IN CONTEXT OF FUND - PRELIMINARY CONSIDERATION

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The Executive Directors considered a staff paper on the Fund's income position for FY 1986 and a review of the rate of remuneration (EBS/86/81, 4/14/86; and Sup. 1, 4/24/86), together with a staff paper on the legal considerations of a setoff in connection with a retroactive reduction of charges due by members in arrears to the Fund (SM/86/90, 4/24/86). Directors also had before them for preliminary consideration a staff paper on provisioning against loan losses in the context of the Fund, together with a memorandum from the President of the World Bank to the Executive Directors of the World Bank on provisions for losses on loans (EBS/86/82, 4/15/86; Cor. 1, 4/23/86; and Sup. 1, 4/29/86).

The Chairman made the following statement:

1. Income projections - The last occasion that the Executive Board discussed the Fund's income position was at the end of February 1986 (EBM/86/38, 2/27/86). It was generally agreed at that time to consider, before the end of April 1986, a decision to reduce retroactively the rate of charge in the light of the Fund's income position for FY 1986. The staff has presented its projections of the Fund's income position for FY 1986 in EBS/86/81 and has updated those projections in Supplement 1 to that paper. The Treasurer will present a further update on the basis of data available as of April 30; the staff expects the variance from these projections in all probability to be small. It would, therefore, seem reasonable to regard these latest income projections as firm figures on which the Executive Board could take a decision today on a retroactive reduction in the present rate of charge.

The projected income figures for FY 1986 show a very considerable improvement over the projections given to the Executive Board in connection with the midyear review in November 1985 (EBS/85/258, 11/20/85). As a result of that midyear review, Executive Directors will recall that effective November 1, 1985, the rate of charge on the use of the Fund's ordinary resources was increased to 7.87 percent in accordance with Rule I-6(4)(b). There seems to be little doubt that the final outcome for FY 1986 permits a substantial retroactive reduction in the present rate of charge on the use of the Fund's ordinary resources. The main issues in this respect would, then, seem to be (i) the period for which the rate of charge would be reduced retroactively, and (ii) the size of the reduction in the rate of charge.

2. Applicable period for retroactive reduction of rate of charge - I believe there was widespread agreement among Executive Directors at our discussion at the end of February 1986 that a

retroactive reduction in the rate of charge would apply for the last half of FY 1986, namely, from November 1, 1985, if it were possible to make offsets with those members with overdue obligations to the Fund. The staff paper on the legal aspects of offsetting arrangements indicates that this is possible, and I will come back to the various alternative options that the staff has presented for the Executive Board's consideration. I would, therefore, propose that Executive Directors consider a retroactive reduction in the rate of charge on the use of the Fund's ordinary resources from November 1, 1985.

3. Retroactive reduction in rate of charge - I believe we can consider two possibilities with respect to the size of the retroactive rate of charge for the second half of FY 1986. First, as Directors are aware, on the basis of the most recent data provided to the Board it seems that the target amount of net income for FY 1986 could be achieved with a rate of charge of approximately 6.74 percent for the second half of FY 1986. While there is a small residual uncertainty regarding the final outcome of the Fund's income for FY 1986, and the final confirmation of the Fund's income can be made only when the Fund's accounts for FY 1986 are closed, consideration might be given to setting the rate of charge for the second half of FY 1986 at 6.74 percent. Such a reduction in the rate of charge to a level that would secure the Fund's income target for FY 1986 would follow the same approach that led to the increase in the rate of charge to 7.87 percent in December 1985.

Second, at the discussions in late November 1985, and more particularly in late February 1986, some Executive Directors expressed the view that the rate of charge should not be reduced below that which prevailed during the first half of FY 1986--i.e., 7 percent--even if net income permitted such a reduction, and it would be for consideration whether to reduce the rate of charge for the second half of FY 1986 to 7 percent. As the Executive Board is aware, there is indeed considerable uncertainty relating to the income projections for the coming year. Furthermore, the volume of arrears to the Fund is rising and Directors may wish to take this into account in considering the disposition of the Fund's income for FY 1986. Consequently, accepting, as was done occasionally in the past, an increase in reserves somewhat larger than the reserve target in FY 1986 might be seen as justifiable not only on the basis of the total of overdue obligations and their rate of increase, but also because it may be appropriate to deem income in excess of the target amount for FY 1986 as income for FY 1987, to the extent necessary. This would help cushion possible income shortfalls in FY 1987, arising, for example, from the need to defer a larger amount of income than is at present indicated in the staff's projections, and this could help to reduce the size of any increase in the rate of charge that might otherwise become necessary in FY 1987.

If the Executive Directors were to follow this second approach, they might wish to consider a reduction in the rate of charge to 7 percent for the second half of FY 1986 and to deem all income in excess of target, i.e., approximately SDR 25 million, as income for FY 1987. Deeming this amount as income in FY 1987 might be necessary to avoid an increase in the rate of charge should there be an unexpected shortfall from target. The safety margin thus provided to the Fund appears to be sufficient for the period during which the Board is considering the adoption of a system for setting the rate of charge retroactively, including the issue of a temporary surcharge and discount on the rate of remuneration in the light of the impact of deferred income, and possibly provisioning.

4. Rate of charge for FY 1987 - I believe there are a number of points to be made as regards income and charges for FY 1987 because we are in a sort of interim situation. Notwithstanding today's discussion and any decisions taken on the rate of charge for the second half of FY 1986, the Fund's Rules provide for a review of the Fund's income shortly after the end of each financial year. Normally this review would take place in late May or early June and would be combined with a decision on the disposition of the Fund's net income. We will need to decide formally on the disposition of the Fund's income when we know exactly the Fund's income position for FY 1986. This review could be held at the usual time in late May or early June. The staff will also provide the Executive Board with a further update of the Fund's financial position at that time. Furthermore, and as indicated in the Supplement to EBS/86/81, the staff might be in a position to take into account in its income projections for FY 1987 the cost of provisioning against loan losses in the event the Executive Board were to favor the adoption of provisioning by the Fund, after its substantive discussion of the staff paper on "Provisioning Against Loan Losses in the Context of the Fund" (EBS/86/82, 4/15/86).

In addition, in EBS/86/81 the staff has mentioned a new, and possibly temporary, scheme to share the burden of prolonged overdue obligations to the Fund by setting retroactively the rate of charge and to apply, if necessary, a system of limited surcharges to the rate of charge and discounts to the remuneration coefficient. If the Executive Board indicates sufficiently widespread interest in this or some other scheme for setting the rate of charge, the staff will submit a further paper to the Executive Board early in FY 1987.

In these circumstances, no proposal has been made with respect to the rate of charge for FY 1987, although the staff has provided initial projections for the Fund's income position for FY 1987 in EBS/86/81 which have been updated in the supplement

to that paper. It will be noted that, in the absence of an agreement on another rate of charge, the rate of charge in effect as of the end of FY 1986 would continue.

5. Other matters - There are a further two items on which it may be useful to comment: (a) the review of the rate of remuneration, and (b) the various options presented by the staff that would enable the Fund to set off the amount due to a member as a result of a reduction of charges against certain overdue financial obligations of that member to the Fund.

(a) The rate of remuneration

When determining the rate of charge, the Executive Board is to take into account the rate of remuneration and the remuneration coefficient. I suggest that our review today, and in particular the outcome of the Board's discussion on the suggestion to consider a new method for determining the rate of charge, be regarded as satisfying the review called for under Rule I-10(c). If this is agreeable to Executive Directors, I understand that it is the desire of the Board to come back to this matter in the course of its discussion on the new method of setting the rate of charge. We may also need to hold another review of the rate of remuneration and the remuneration coefficient not later than at the time of the FY 1987 midyear review of the Fund's financial position.

(b) Method of effecting an offset

Executive Directors have generally expressed the view that any refunds of charges already paid should not be made in cash to members having overdue obligations to the Fund but should instead be set off against such obligations. SM/86/90 (4/24/86) explains the legal basis for such setoffs, which could apply only to overdue obligations in the General Resources Account, and presents a number of options for the order in which setoffs would be applied. The order decided for setoffs would not affect the Fund's general practice regarding the attribution of payments to overdue obligations, under which members may indicate their desired attribution and, in the absence of any attribution, payments are applied to overdue obligations in the order of their maturity.

There seems to be no strong reason to depart from this practice in the present instance, which would permit the member to settle the overdue obligation(s) in the order it considers most advantageous. This method calls for adoption of the fourth option presented in SM/86/90. If seeking members' preferences regarding the attribution seemed to Executive Directors to be administratively inconvenient for members in relation to the relatively small amounts that will be refunded, adoption of the first option presented in SM/86/90 would establish an order analogous to the rules of most legal systems.

The Treasurer noted that, in accordance with paragraph 1 of the Chairman's statement, the income projections required updating in two respects. First, the Fund's administrative expenditures were projected at SDR 223 million, or SDR 4 million lower than had originally been estimated, as a result of the change in the SDR value of the U.S. dollar. Second, the SDR interest rate had risen from 6.2 percent to 6.3 percent, rounded according to the Fund's rules. That small upward increase would have no effect on the financial year that was ending, but would have a marked effect on the projections for the following financial year.

To summarize the effects of those two changes, the Treasurer said that the rate of charge necessary to generate the target amount of income of SDR 52 million for the current financial year would be reduced by two basis points from 6.74 percent to 6.72 percent. The increase in the SDR interest rate of 10 basis points would raise projected operational expenditure for FY 1987, and thus reduce projected net income by about SDR 20 million. The rate of charge necessary to generate the projected target amount of net income for FY 1987, which was assumed to be SDR 55 million, was therefore raised from 6.2 percent to 6.35 percent.

Mrs. Ploix made the following statement:

Before tackling the broader issues of provisioning and burden sharing, let me first address the specific points to be decided today:

1. The rate of charge for FY 1986

Dramatic and, for the most part, welcome changes have occurred in the field of interest rates and in the behavior of some members since our decision of late December. These changes have been so substantial that one could wonder whether at that time the increase in the rate of charge was really necessary; in fact it was, since it is our clear responsibility to keep the Fund's financial position on a sound footing.

The rate of charge for FY 1986 was set at 7 percent at the beginning of the year. The year proved to be a very troubled one, and the Fund experienced unprecedented uncertainties in its financial position. Even if the outcome appears today more favorable than first feared a few months ago, the uncertainties have not diminished. I can therefore go along with fixing the rate of charge for the second semester of FY 1986 at 7 percent. At this level, the target amount of net income can be met and the debtor countries can take advantage of the latest improvement in the Fund's income position. And this rate seems to be a feasible starting point for our future discussion on the rate of charge for FY 1987.

We shall only be in a position to discuss the rate for 1987 thoroughly and decisively when the projections become less subject to fluctuation and after we have discussed provisioning and burden sharing.

2. Method of setting a retroactive reduction of charges

I do consider that it is important to let members communicate their preferences: it would follow the general practice of the Fund with respect to the attribution of payments; this kind of communication would promote the exchange of information between the Fund and members experiencing difficulties. Should the member not specify its preference, I am of the opinion that the setoff should first apply to those obligations that carry the highest rate of charge so as to minimize the cost of the member's indebtedness to the Fund.

3. The review of the remuneration coefficient

I have no difficulty in supporting the proposal made by the staff in paragraph 5, page 17 of EBS/86/81.

This having been said, I would like to tentatively address the broader issues that will influence our present and future discussions on the Fund's income position, rate of charge, and relations with countries in arrears. These issues are first the burden created by the deferred income, and second provisioning against losses in the context of the Fund.

Before beginning the discussion of these two issues, let me remind you of the often stated interest of this chair in burden sharing, because of the very nature of the Fund, an interest Mr. Camdessus expressed again at the end of his statement during the plenary session of the Interim Committee on April 9, 1986:

The charges on use of the Fund's own resources...are now too high. To remedy this situation, we must essentially return to the cooperative principle on which the Fund is based and to a fair sharing of the costs entering into the charges between the Fund's debtors and creditors.

(1) The burden created by deferred income

Let me restate two basic principles already expressed by Mr. de Maulde on December 6, 1985 (EBM/85/176):

Arrears to the Fund constituted a serious problem for the whole membership....All members should contribute to the effort to handle the arrears problem.

The present problem should be considered as exceptional and temporary and the measures to deal with its consequences should be exceptional, temporary, and easily reversible.

Although it can be seen from my statement that we support the general thrust of the proposal made by the staff on pages 14 and 15 of EBS/86/81, I would modify it in the following way:

- If deferred income is larger than repayments, the rate of charge should be increased and the rate of remuneration should be decreased so that the burden is equally shared.
- If, on the contrary, repayments induce a net negative deferred income, the rate of charge should be decreased and the rate of remuneration increased so that the benefit is the same.
- The surcharge on (or the decrease in) the rate of charge, and the reduction (or the increase) in the rate of remuneration should be applied at the same time to ensure the equality of the charge or of revenue, in the amounts as well as in the duration of the burden or the benefit.
- Both the rates of "surcharge" and of "reduction" in the remuneration could be set on a six-monthly retroactive basis to provide the resources to cover the actual amounts. Retroactivity is needed because experience has proved that there is no way to make reliable provisions on net deferred income.
- Such a system should only apply to the future. All repayments corresponding to charges deferred before its implementation should be added to the Fund's regular income position, since the corresponding burden was already covered at the time of the deferral.

On the basis of the projections presented in EBS/86/81, Supplement 1, and considering that we have begun to operate within this system, 1/ let me illustrate this proposal for FY 1987. It would be possible:

- to set, today or in the near future, the rate of charge at 5.92 percent for FY 1987;

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1/ In the first half year, of course, we would need to calculate the figures on the basis of the gross deferred amounts.

- To establish, in the very last days of the first semester, i.e., at the end of October, a retroactive "surcharge" on the rate of charge of 0.17 percent for this first semester (this supposes that net deferred income will amount to SDR 33.5 million during the first six months of FY 1987);
- To effect a retroactive reduction in the rate (but not in the coefficient) of remuneration of 0.17 percent.

As mentioned earlier, any future repayment would lead, at that time, to a reduction in the net deferred income (which could possibly become negative); consequently, a reduction in the rate of charge and an increase in the rate of remuneration, at that time, would be granted *pari passu*.

(2) Provisioning against losses in the context of the Fund

As we are going to discuss this topic only in a very preliminary way, I shall limit myself to a practical remark:

I do not understand precisely what the actual difference is, in the context of the Fund, between a provision such as the one presented on page 2, footnote 1, of EBS/86/82, and reserves. Indeed, three different reasons are apt to lead a business firm to make loan-loss provisions, but they do not apply to the IMF:

1. Tax considerations. These are not relevant for the IMF.
2. The possibility of charging a loss (against provision) without affecting current income. This "secret war chest" does not seem to be relevant either, given the fact that none of the Fund shareholders would be inclined to manage it by taking into account the income position of the institution.
3. Regulations establishing a link between the balance sheet (especially equity and reserves) and allowed development of activity permitted. This is not relevant to the Fund either.

Moreover, since it appears to me *a priori* difficult to make provisions against pinpointed "doubtful drawings," for reasons I shall develop during the discussion of loan-loss provisioning, the only possibility left is to make a global provision against losses. Therefore, the provisioning issue appears to be the same as the level of reserves issue.

In the course of our forthcoming debate, it would be only a very partial approach to answer the question of provisioning without examining the issue of reserves, their optimal level and,

if necessary, the means of building them up; in other words, general Fund income objectives, and share of Fund members in the buildup of this income.

Finally, I would like to make an additional technical remark on when arrears are considered to be deferred income. The rules that are described in EBS/85/81, Supplement 1, page 2, footnote 1 make our follow-up of deferred income difficult. When a country is in arrears, the overdue charges are first accrued as income. When the overdue obligations have been outstanding for more than six months, they are transformed into deferred income. These arrears should, in my opinion, remain deferred income as long as they have not been paid. It seems to me that their full payment is the only condition that would allow the Fund to consider that the country's creditworthiness has been completely restored, and not the sole fact that the longest overdue obligations remaining have been outstanding for less than six months. I would appreciate hearing the staff's views on the practices generally followed by international creditors in this kind of situation.

Mr. Ismael reiterated the position taken by his chair at EBM/86/37 and EBM/86/38 (2/27/86), when the Board had undertaken a special review of the Fund's income position for FY 1986. At that time, he had accepted the staff's most likely scenario, which projected net income at SDR 115 million for FY 1986, or SDR 63 million in excess of the amount necessary to reach the target of SDR 52 million. Consequently, his chair had supported the staff proposal to lower the rate of charge retroactively from the high level of 7.87 percent. He had also restated his belief that there must be symmetry in the treatment meted out to debtors in good standing that had been made to pay increased charges based on estimates of arrears by some members. Hence, the improvement in the Fund's income position made it only equitable to compensate such punctual debtors by reducing charges.

Regrettably, there had been some disagreement at the time among Board members over the degree of certainty surrounding the estimates, although there had been almost unanimous willingness to lower the rate of charge for the last quarter or the last half of FY 1986, should it prove warranted by the actual net income position at the end of that financial year. The Chairman's summing up had been clear and concise on that point.

Based on the staff's updated revisions of the Fund's income position for FY 1986, which took into account developments through April 30, 1986, the way was clear for the Board to consider reducing the rate of charge retroactively to November 1, 1985, Mr. Ismael considered. The proposal by the staff of a rate of charge of 6.72 percent for the second half of FY 1986 was in line with the understanding reached by the Board in its previous discussion. It also provided a clear signal to debtors that the Fund was an active partner in the efforts of other international financial institutions to consider ways of reducing debt-servicing problems,

especially as it had been encouraging most debtor countries to request early assistance from the Fund in undertaking severe adjustment efforts to alleviate their economic problems. As the Chairman had said in his opening statement: "Such a reduction in the rate of charge to a level that would secure the Fund's income target for FY 1986 would follow the same approach that led to the increase in the rate of charge to 7.87 percent in December 1985."

However, he was not in favor of reducing the rate of charge to 7 percent and of transferring that part of the resulting excess income to FY 1987 so as to cushion possible income shortfalls in the year ahead, Mr. Ismael stated. There were better ways of achieving that objective.

With respect to the setoff in connection with the retroactive reduction of charges due from members in arrears to the Fund, Mr. Ismael said that he supported the option set out in Attachment 4 to SM/86/90. That option was in full accord with the Fund's practices, which he saw no good reason for changing. His only qualification concerned the short time given to members to specify which overdue obligations they wished to discharge with the setoff. The experience of some members in his constituency indicated that three business days was too short a time for effective communication. Therefore, he proposed amending paragraph 1 of Attachment 4 to refer to seven rather than to three business days.

The preliminary projections of the staff on the income position for FY 1987 indicated net income of SDR 256 million, which was SDR 201 million in excess of the target of SDR 55 million, Mr. Ismael observed. Based on that projection, and using conservative assumptions, the staff had suggested that the necessary rate of charge for FY 1987 was 6.35 percent. The staff understandably needed to be cautious because of the uncertainties having a bearing on projected net income, especially with respect to overdue charges, which were difficult to project with precision. Nevertheless, he was confident that the outlook was not as pessimistic as had been projected by the staff.

Referring to the burden sharing of the cost of prolonged overdue charges, Mr. Ismael noted that it was his belief, following the Board's earlier discussions on the matter, that most Directors were not averse to some kind of burden sharing that would involve an increase in the rate of charge as well as a reduction in the rate of remuneration. The staff had made a proposal, in principle, in the right direction, although the two-step procedure--of an increase in the rate of charge (or a surcharge) preceding a reduction in the rate of remuneration (or a discount)--did not reflect the spirit of the Board's discussions. The helpful and constructive proposal of Mrs. Ploix offered the best way to deal with the problem of burden sharing. As she had stated, "the surcharge (or the decrease) in the rate of charge, and the reduction (or the increase) in the rate of remuneration should be applied at the same time, to ensure the equality...." Her specific example--using the projections in Supplement 1 to EBS/86/81--in which equal rates were applied to the increase in the rate of charge and to the reduction in the rate of remuneration, should act as a guide to

the staff in preparing its paper on a burden sharing formula. Taking into account the fact that Mrs. Ploix's proposal would automatically cover any shortfalls in the net income target due to overdue charges, he supported her recommendation that the rate of charge be set at 5.92 percent for FY 1987, with a surcharge on the rate of charge of 0.17 percent and a discount on the rate of remuneration of 0.17 percent. Of course, those percentage figures were only indicative; at the time of the subsequent review of the Fund's income position (when firmer figures were available), his chair would accept any change in the percentages that was applied equally between the surcharge and the discount.

Finally, on the subject of provisioning against loan losses, Mr. Ismael said that his chair regretted not being in a position to make helpful comments at the present time. The subject was not only new, but it involved so many other important issues with serious implications in the context of the Fund that it required a clear understanding before a judgment could be reached. However, he was more than willing to discuss the subject of provisioning at a later date, with the benefit of a full briefing and preparation.

Mr. Polak remarked that Mrs. Ploix had made a very helpful contribution by pointing the way toward a solution to difficult problems. The difficulties made it necessary to respect the Fund's rules. Rule I-6(4)(c) stated that the Fund's income position should be reviewed shortly after the end of each financial year. Therefore, the only matter for decision by the Board at the present meeting was to set the rate of charge for the second half of FY 1986.

At the beginning of FY 1986, the rate of charge had been set at 7 percent, but at the midyear review it had been determined that that rate would produce income below the target for FY 1986 as a whole, Mr. Polak recalled. On the basis of estimates available at the time, the rate of charge for the second half of FY 1986 had been set at 7.87 percent in November. With the benefit of virtually complete figures for FY 1986, the need for that midyear correction had been shown to be unnecessary. It was extremely difficult to make accurate forecasts under the Fund's rules; it could be said that, with perfect foresight, the rate of charge should have been kept at 7 percent. In that connection, it should be borne in mind that rule I-6(4)(b) was asymmetrical: it called for an increase in the rate of charge if there was an expectation that the income target would be undershot but not for a decrease in the rate of charge if the expectation was that the target would be overshot. The Board's decision to raise the rate of charge in November, and its special review of that decision in February, had led to a clear understanding that insofar as the additional revenue was not needed to meet the income target, it would be returned to users of Fund credit. Based on those considerations, the rate of charge for the second half of FY 1986 should unquestionably be adjusted retroactively to 7 percent. As a result, the rate of charge for that half year would be below the SDR interest rate, which had been close to 7.29 percent. As the staff had noted, such comparisons should be made over a certain average period, not just for one day.

A decision to reduce the rate of charge for the second half of FY 1986 to 7 percent logically followed from the inability to accurately forecast income in November 1985, and that rate would provide net income of SDR 25 million in excess of the target for FY 1986 as a whole, Mr. Polak noted. In reviewing the Fund's income position under Rule I-6(4)(c) after the end of the financial year, a decision would have to be reached on the use of that excess income in accordance with Rule I-6(4)(c) and (d). He had no definite view as to which of the four possibilities or any combination of them was appropriate on the present occasion--to reduce the rate of charge further, to increase the rate of remuneration, to place excess income to reserve, or to deem any part of that excess as income for FY 1987. His personal preference was to add the excess income to reserves, although he would not oppose some further reduction in the rate of charge. However, the decision on that matter could wait until the Board decided on the rate of charge for FY 1987.

In setting the rate of charge for FY 1987, he favored the basic approach proposed by Mrs. Ploix, Mr. Polak continued. A regular rate of charge would be set in accordance with Rule I-6(4)(a); the rate of remuneration would be set in accordance with the December 1983 decision; and an equal percentage point surcharge and discount would be applied retroactively on a half-yearly basis to those two rates in such a way as to cover exactly the amount of net charges deferred in the preceding half year. When any amounts so covered were later paid, the same mechanism would be applied in reverse. As he understood Mrs. Ploix's proposal, any amounts received in FY 1987, or even later, for charges that had been deferred in FY 1986--the cost of which had been borne entirely by debtors of the Fund--would be applied fully to reduce the charges paid by debtors.

The proposal by Mrs. Ploix for retroactive burden sharing eliminated one major factor of uncertainty about the rate of charge needed to achieve the desired income target, Mr. Polak added. As a consequence, the Board should be able to comply with Rule I-6(4)(a)--as long as the required 70 percent majority was obtained--and set the rate of charge at the beginning of the financial year on the basis of the estimated income and expense of the Fund during the year and the target amount of net income for the year, which at present was set at 5 percent of reserves. In view of the sharp decline in interest rates that had been taking place, he could not envisage that the current rate of charge would be maintained in FY 1987; that would not be compatible with the Rules.

Once the uncertainty associated with the impact of deferred charges had been removed, the only remaining major uncertainty would be whether the initial rate of charge would produce the target income figure related to the SDR interest rate, Mr. Polak observed. As shown on page 3 of Supplement 1 to EBS/86/81, the recent fall in the SDR interest rate by 0.6 percent would improve the Fund's income position by an estimated SDR 91 million in FY 1987. As the Treasurer had noted, a very small change of 0.1 percent in the SDR interest rate could have a not insignificant impact on the amount of income attained on the basis of a given rate of charge, and in both directions. It would be highly desirable to

eliminate, as far as possible, that element of uncertainty so as to reduce, among other things, the importance and the agony of the midyear review. One possible solution would also be to determine the regular rate of charge retroactively; however, it was hardly appropriate for the Fund not to tell borrowers in advance what even the basic rate of interest would be. The alternative would be to let the rate of charge move promptly with market interest rates rather than with the current lag of up to one year that had led to a rate of interest of 7 percent for the past half year. It should be easy to adjust the rate of charge at the end of every quarter by the percentage that the average rate of remuneration in that quarter had differed from the rate of remuneration at the beginning of the fiscal year. All the uncertainties in the calculation could not be removed; among the various causes of such uncertainty was the fact that the Fund held some SDRs on which its income fluctuated with the market interest rate. However, those SDR holdings in FY 1987 would be about 1 percent of outstanding remunerated positions. Of course, it would be useless to try for a high degree of precision because many remaining small factors could induce changes in the outcome in respect of net income. If the two most important factors could be corrected--the uncertainty about overdue charges and the uncertainties following upon the fluctuation in market interest rates--the Fund could come reasonably close to hitting its income target, and normally with a fairly small margin of error.

Finally, on the question of the setoff, Mr. Polak said that he was in favor of applying rules, preferably the established rule of international law. Therefore, he favored the option in Attachment 1. He saw no particular reason to suit the convenience of a member that was in arrears to the Fund.

Mr. Salehkhoul stated that the repeated reviews of the Fund's income position in FY 1986, and large swings in the staff projections and consequently in the required rates of charge, were indicative of serious inherent problems in the method for determining the rate of charge as well as in the various underlying objectives and policies. In December 1985, the automatic provisions of Rule I-6(4) had been triggered for the first time, resulting in a sharp increase in the rate of charge at a time when market interest rates and similar charges by other multilateral financial institutions had been on a declining trend. Subsequent staff projections and actual developments had made it clear not only that the increase in the rate of charge had been unnecessary but that the conflicting objectives of Fund policies with respect to its income needed to be reassessed. Thus, while the Executive Board should concentrate at the present meeting on the need to correct the rate of charge for the second half of FY 1986, in order to take into account the considerable excess above the year's income target and the high surcharge that members in good standing with the Fund had had to bear, the Board should also review the provisions of Rule I-6(4) to ensure, in FY 1987, a more equitable method of financing the Fund's activities, as well as a rate of charge consistent with both the cooperative nature of the institution and its overall policies.

The considerable improvement in the Fund's income position over the past six months reflected the sharp increase in the rate of charge, as well as a significant decline in total deferred income, Mr. Salehkhrou continued. Other positive factors included the decline in the average SDR interest rate from 7.73 percent in the preliminary projections to 6.2 percent the previous week, and the appreciation of the SDR exchange rate vis-à-vis the U.S. dollar. The excess income would have been greater had it not been for the large shortfall in the use of the Fund's ordinary resources, which had reached SDR 2,610 million compared with SDR 4,110 million in the original projections for FY 1986.

Deviations from original assumptions were not surprising, considering the great uncertainty of most factors underlying the Fund's income position, and considering the staff's traditional pessimism in making assumptions for a financial year, Mr. Salehkhrou remarked. Those assumptions had, however, consistently gone beyond the caution necessary for responsible financial management and had often resulted in higher rates of charge and higher increments to the Fund's reserves than required by the Fund's policies, exacerbating the impact of a system whose conflicting objectives normally placed a disproportionate burden on the rate of charge.

The latest staff estimates indicated that a rate of charge of 6.72 percent over the second half of the current financial year was required in order to attain the income target, which had been increased early in FY 1986 from 3 percent to 5 percent of reserves, Mr. Salehkhrou noted. While that rate would continue to put the burden of dealing with overdue financial obligations to the Fund on debtor members, the entailed reduction from the currently excessive rate of 7.87 percent would be a welcome relief to those members, all of which were developing countries and which continued to face major difficulties in settling their external financial obligations.

Some Directors were in favor of a reduction in the rate of charge to no less than 7 percent, Mr. Salehkhrou noted. Besides the arbitrariness of such a rate, which would still leave excess income of about 50 percent of the reserve target for FY 1986, its adoption would certainly be unfair to a large part of the membership. Debtor members agreed to pay charges on the basis of uncertain preliminary projections, on the understanding that the Board would attempt to set the fairest rate possible and that the rules of the game would be observed throughout. Therefore, he urged the Board to give debtor members full compensation for the higher than necessary rate charged over the second half of FY 1986, in line with the broad understanding reached in the previous discussion and with the first approach outlined in the Chairman's statement.

A rate of charge of 6.72 percent was still excessive, considering not only the SDR interest rate of 6.2 percent prevailing in the previous week but also the considerable abatement of market interest rates, Mr. Salehkhrou went on. The London Interbank Offered Rate (LIBOR) had recently fallen to about 6.8 percent, and the cost of the Fund's borrowed

resources had approached 7 percent. The rate of charge required for FY 1987, calculated under Rule I-6(4)(a), was also above the current SDR interest rate and would therefore trigger another review of the rate of remuneration. The staff's proposal to compare, for the purposes of that review, the rate of charge with the average SDR interest rate for a set period might be acceptable as a way of reducing the number of such reviews. However, it was obvious that that proposal would in no way deal with the substance of the issue, namely, the inherent asymmetry of the method for determining the rate of charge and the lack of any meaningful burden sharing between creditors and debtors in financing the Fund's activities and in facing the financial implications of overdue obligations to the Fund.

Thus, the review of the rate of remuneration should not be seen as a mere procedure but rather as an opportunity to seek a new compromise between the Fund's policy of aiming at a rate of remuneration close to market interest rates and other objectives that might be affected by such a policy, inter alia, concessional and more efficient assistance to the users of Fund resources and incentives to members to seek such assistance at an early stage of their difficulties, Mr. Salehkhrou stated. The need for a new compromise was further underlined by the pronounced shift toward a significantly lower level of use of Fund resources, mostly as a result of policies aimed at phasing out the enlarged access policy and at a more active Fund, both in its surveillance function over members' financial policies and as a catalyst for foreign assistance to low-income developing countries. It should be noted in that respect that any reduction in members' purchases translated into a reduction in net income because, as indicated in an earlier staff report on the Fund's income position, "charges forgone--both service and periodic charges--exceed at present the concomitant reduction in operational expense--in the form of remuneration, interest expense on borrowed resources, and interest on SDR holdings." Obviously, that excess in operational costs would increase to more significant proportions, should the current policy trends on the use of Fund resources and on surveillance continue, as had been suggested at the previous Interim Committee meeting, and as a result of the establishment of the structural adjustment facility.

In light of his preceding remarks, Mr. Salehkhrou said that he welcomed the staff's attempts to devise a system of burden sharing between charges and remuneration, even though its proposal in its present form contained a number of provisions that were unsatisfactory to debtor members and that would result in a contribution from members receiving remuneration in only extreme cases. First, while the concept of a regular rate of charge was an interesting innovation that would usefully separate the burden of overdue obligations to the Fund from the required rate of charge, it did not satisfactorily address the issue of financing the Fund's activities. Additional operational costs, which were due more and more to activities unrelated to the use of Fund resources, would continue to lead to higher rates of charge and to a further erosion of concessionality.

Second, the reference to a medium-term market interest rate and, more important, the addition of 0.5 percentage point to such a rate, appeared to be arbitrary, Mr. Salehkhrou considered. Notwithstanding the maturity of Fund credit, the use of the five-year SDR interest rate as the ceiling for triggering the proposed burden-sharing system was unsatisfactory not only in view of the cooperative nature of the institution but equally in view of the top quality and the liquidity of Fund-related assets. That was all the more so because the assessment of burden sharing had to take into account a number of other nonfinancial elements such as members' influence over Fund policies and members' voting power.

Third, an equitable system of burden sharing should not be triggered only under extreme conditions, particularly when debtor members in good standing with the Fund had had absolutely no part in the problem of overdue obligations, Mr. Salehkhrou added. Overdue financial obligations to the Fund were a major and general concern to all members and, as such, there was no justifiable reason why only a limited number of members--and the neediest among them--had to bear the implications for the Fund's income. True burden sharing required that the system of surcharge and discount devised by the staff be triggered each time the estimated regular rate of charge was insufficient to yield the income target for that financial year, with both charges and remuneration contributing to filling the gap. As he understood it, that was also the position of Mrs. Ploix, which he fully supported.

Fourth, the staff proposal for a retroactive determination of both the rate of charge and the remuneration coefficient, which he himself had suggested in earlier discussions, Mr. Salehkhrou recalled, would ensure that both remuneration and charges were calculated in the light of the most current data and that the income target set for the financial year was realized. It would also make it unnecessary to engage in the highly uncertain exercise of projecting deferred income. Finally, it would eliminate the obvious asymmetry of Rule I-6(4), which provided for an automatic increase in the rate of charge to cover any projected income shortfall, but allowed for no automatic reduction to offset income above the income target, thus leading to lengthy negotiations and unnecessary linkages each time a reduction in the rate of charge was justified.

With respect to the item on the agenda for preliminary consideration, Mr. Salehkhrou observed, first, that the relevant staff paper had not yet been received by any of his authorities, who were thus not in a position to express their views on the subject. Therefore, he would not comment on the substance of the paper. He also understood that the Chairman's summing up would not deal with the issue in any substantive way. Second, members of his constituency had been disturbed by the manner in which the item had been added to the agenda. They had noted that the four-week rule had been adopted mostly to accommodate developing countries' specific problems with inefficient communication systems. They therefore regretted that, notwithstanding the lack of urgency of the issue and its irrelevance to setting the rate of charge for FY 1986, its discussion had been decided

in an unusual way (EBM/86/65, 4/18/86; EBM/86/68 and EBM/86/69, 4/23/86) that could result in unduly delaying the appropriate compensation of debtor members for the burden they had borne.

In sum, Mr. Salehkhoul said that he favored a reduction to 6.72 percent in the rate of charge for the second half of 1986. He preferred the option in Attachment 4 for the setoff in connection with the retroactive reduction in the rate of charge. However, like Mr. Ismael, he thought that seven business days following the request, rather than the proposed three, would give members more adequate time to reply. A temporary and tentative rate of charge should be set for FY 1987. While that rate would need to be reviewed in light of the forthcoming formal discussion of the paper on loan-loss provisioning and the finalization of a burden-sharing system, the decision at the present meeting could be limited to setting the so-called regular rate of charge for FY 1987.

Mr. Lankester said that, as Mr. Polak had pointed out, the Board probably would not have changed the rate of charge at midyear if it had had perfect foresight six months previously. He had been most interested in Mr. Polak's ideas on how possibly to set the rate of charge in future; at some stage it would be worth reviewing the modalities, taking into account the ideas he had put forward. But the fact was that the rate of charge had been raised in midyear, based on the best view at that time, and the main task of the Board at the present meeting was to decide by how much to reduce the rate of charge, retroactively. On the basis of the staff's latest projections, the reserve target for FY 1986 could be achieved with a rate of charge of 6.72 percent for the second half of the year. His chair supported the idea of returning to borrowing members all surplus income for FY 1986, over and above the 5 percent growth in reserves that had been targeted, provided it was prudent to do so.

However, in one respect, the Fund's present method of income estimation was at odds with prudence in that SDR 22.5 million of charges currently due from Peru and a further SDR 9 million of charges due after May 1--but that related to the three months to end-April--were counted as income in FY 1986 even though they had not been paid, Mr. Lankester observed. Thus, a borrowing member had gone over the six-month limit once and would do so again early in FY 1987 if no further payments were received. In the circumstances, it seemed rather unwise for the Fund to count that almost SDR 32 million as income on the assumption that it would be paid. His chair hoped that Peru's recent payment of part of its arrears was a forerunner to the early clearance of all its arrears, but it would be premature to presume that that would take place. The rate of charge for the second half of FY 1986 should not take into account the amount due from Peru as income. After making allowance for a retroactive reduction in the rate of charge, a rate of charge of about 7.04 percent for the second half of FY 1986 would be indicated.

It might well be argued that there were enough uncertainties ahead on the income and repurchase fronts to justify a higher rate of charge for both the second half of FY 1986 and for FY 1987, and to place additional

income in reserves, Mr. Lankester continued. But that argument had to be set against the importance of allowing borrowing members--many of which were undertaking very difficult adjustment programs--to obtain a substantial benefit from the recent reduction in interest rates. Accordingly, he would settle for a rate of charge of 7 percent for the second half of FY 1986. The result would be an increase in reserves in FY 1986 of some SDR 75 million against the targeted increase of SDR 52 million, a figure that might be increased by about SDR 4 million as a result of the latest information provided by the Treasurer. Should Peru pay its charges, as he very much hoped it would, that payment could be taken into account in deciding the prudent level of reserves to aim for and hence, the rate of charge for FY 1987.

He fully endorsed the objectives of the staff paper on the setoff, Mr. Lankester remarked, namely, to prevent members in arrears to the Fund from receiving a cash payment following a retroactive reduction in the rate of charge of the type that was being discussed. At first sight, he could go along with any of the options attached to SM/86/90, although the option in Attachment 4, which followed current Fund practice with respect to the attribution of payments, seemed to be the most in keeping with normal procedures.

It would not be possible at the present stage to offer a considered view of the prospects for FY 1987, even if no changes to the existing rules for setting the rate of charge were under discussion, Mr. Lankester observed. The latest projections of the Treasurer's Department for FY 1987 were too new and contained assumptions, for example, on the appropriate size of the allowance for deferred income, that required careful consideration. If those were not good enough reasons for caution, the issues raised by the staff paper on loan-loss provisioning and the various ideas put forward in December and more recently on burden sharing also remained for discussion. For all those reasons, the rate of charge considered appropriate for FY 1986 should be allowed to continue into FY 1987--as the Rules provided in the absence of agreement otherwise--but on the clear understanding that the question of the rate of charge would be taken up again as soon as a more considered view was possible. He hoped that that would be well before the charges for the first quarter of FY 1987 were notified to members in early August. Consequently, borrowing members of the Fund should not regard the rate of charge for FY 1987 that might be set at the present meeting as a first attempt to estimate the actual rate; despite the inconvenience to those members, such a procedure was an inevitable part of the price to be paid for reducing as quickly as possible the rate of charge for FY 1986.

With respect to loan-loss provisioning, Mr. Lankester recalled that his chair had argued consistently that the Fund must take a realistic and prudent view of its finances while continuing to reflect in its accounting the very special nature of the institution. He had been among those who had favored most strongly the introduction of the concept of deferred income and the increase for FY 1986 of the target for reserve growth from 3 percent to 5 percent. Subsequent developments in respect of those

countries that had become ineligible to use the Fund's resources-- especially Sudan, given the size of its purchases from the Fund, as well as Peru--posed awkward questions about the adequacy of the Fund's present approach. The World Bank was considering a plan to write off, over a five-year period, specific loans more than two years in arrears. The Bank's proposal reflected in part its heavy use of world financial markets and the correspondingly greater pressure on it than on the Fund to conform to normal banking accounting practice. The Bank's proposal also reflected recognition of the growing reality of arrears, a reality that in fact confronted the Fund even more starkly than it did the World Bank.

However, he would defer his comments on the respective merits of general and specific provisioning until the Board's discussion on May 19, Mr. Lankester continued. For the time being, he mentioned that, for three reasons, his authorities were likely to conclude that the time had not yet come to introduce loan-loss provisioning. First, the signals given might help to undermine the unique nature of the Fund, reducing it to the status of just another creditor. Second, the Fund's own experience did not yet justify general provisioning. Third, the time was not yet ripe for the major step of specific provisioning, although it might become so in light of developments in specific cases, such as that of Sudan. Nevertheless, his authorities favored a full discussion of the available options, given the possible longer-term relevance of provisioning. At the same time, they might conclude from the forthcoming review that, while provisioning was not yet necessary, the Fund should look again at the adequacy of its reserve target.

To offer some provisional views on burden sharing, Mr. Lankester noted that, after careful consideration, his authorities had concluded that, over an appropriate rate of charge, there was a case for some or all of the burden caused by deferred income to be borne by the creditors. Without going into detail on the factors underlying an appropriate rate of charge, he noted that the proposals set out by the staff on pages 12-15 of EBS/86/81 were along the right lines. The medium-term SDR interest rate, plus 0.5 percent, would constitute a not unreasonable rate of charge for borrowers and would be one that was at or below--often well below--what nearly all Fund borrowers paid in the marketplace. If an increase in deferred income and/or additional reserve provisioning were to take the rate of charge above that rate, it would be acceptable to his authorities if the rate of remuneration were to bear the whole additional burden, down to a coefficient of 85 percent--the level from which the coefficient had begun to rise in 1984. In the first instance, the scheme should run for one year to provide an opportunity to see how it functioned.

The approach he had outlined might not have the immediate attraction to borrowers of the French proposals that Mrs. Ploix had outlined in her statement, Mr. Lankester remarked. If he had understood those proposals correctly, they would require creditors to share half the burden of any deferred income or additional provisioning. Burden sharing would thus begin at a lower rate of charge, and the attraction for many borrowers might outweigh the assured ceiling on the rate of charge that was provided

under the staff proposal. However, as his chair had consistently argued, the effective rate of remuneration to creditors--taking into account the unremunerated reserve tranche position--was at present only just over 70 percent of the average SDR interest rate. And it was about 60 percent of the five-year SDR interest rate, which was a reasonable proxy for market rates and against which concessionality in the credit advanced to and by the Fund might be measured. Therefore, his authorities regarded the staff proposal, with the minor amendment he had noted, as both workable and fair; he hoped that borrowers would come to see it as such.

The staff representative from the Treasurer's Department explained that the criterion that had been adopted by the Executive Board for determining whether or not charges due from a member were to be placed on a nonaccrual basis was that the member's obligations to the Fund must have been overdue for more than six months; by making a partial repurchase in April, Peru had reduced its longest outstanding obligation to less than six months. As a result, about SDR 39 million in charges due to the Fund had been added as accrued income; that amount had been reduced by the payment of charges in the amount of approximately SDR 3.5 million. He had understood Mr. Lankester to be referring to an alternative method of accounting, under which charges would be counted as income only when a member had become fully current with the organization or when it had actually discharged the charges levied by the Fund.

The Chairman stated that it should be clearly understood that the staff, in making its estimates, had applied the procedures approved by the Executive Board relating to the nonaccrual of income.

Mr. Pérez stated that his comments would be focused on the staff papers pertaining to the Fund's income position for FY 1986 and FY 1987 and the review of the remuneration coefficient. As mentioned during the Board's recent discussion on procedural matters related to the present meeting, his chair was not prepared to address the subject of provisioning because, as was the case for several other chairs, his authorities simply had not had the time to review in detail that important issue. However, he was looking forward to discussing the subject in mid-May.

He had noted with satisfaction that the income projections for FY 1986, which had recently been updated by the staff, not only exceeded the staff forecast made during the special review in February but also the most optimistic outcome that had been contemplated on the basis of the information available for the first ten months of FY 1986, Mr. Pérez continued. That development was mostly the result of the welcome settlement of overdue obligations by Peru and Somalia, along with recent positive movements in interest rates. The latter had contributed toward improving the income position of the Fund and, more generally, to lessening somewhat the burden of indebted countries. However, the current oil price situation and the subsequent downward trend in inflation that industrial countries were experiencing offered a unique opportunity for a much more pronounced reduction in real interest rates. As his chair had stated on previous occasions, such a reduction was a necessary condition for a long-term solution to the debt problem.

In line with the position taken during the Board's previous discussion on the issue, his chair was of the view that total income in excess of target should be applied to a retroactive reduction of the rate of charge for the second half of FY 1986, Mr. Pérez said. Consequently, he proposed that the rate of charge for that period be set at 6.72 percent.

Referring to burden sharing, Mr. Pérez recalled that, at the time of the review of the Fund's income position in December, and in order to prevent a repetition of the solution that had been applied at that time for coping with shortfalls in the Fund's income, his chair had considered it advisable to devise formulas resulting in an equitable distribution of shortfalls or losses among all member countries. The issue had been of special concern to his chair for some time, in view of the increasing source of uncertainty in the income projections deriving from the problem of deferred income, and the consequences under the present system for users of Fund resources, which by definition were those members in the weakest financial positions. He fully agreed with the staff that the Fund should operate under the firm expectation that delays in discharging overdue obligations were of a temporary nature. Even if countries with overdue obligations to the Fund were experiencing protracted balance of payments problems, the Fund should continue to search for ways to permit the eventual establishment of a viable balance of payments position, together with the necessary financing to allow for the earliest possible discharge of those obligations. In addition, he agreed with the staff's suggestion for differentiating the normal or regular income position--with which normal rates of charge and remuneration would be associated--from the actual or projected income position that included deferred income. In order to achieve a desired income target, a combination of temporary surcharges on the rate of charge and discount on the rate of remuneration could be devised in order to share the burden of deferred income in an equitable, symmetrical, and simultaneous manner.

The projections for FY 1987, according to the staff, were subject to a considerable degree of uncertainty, due mostly to the rapid fall in the SDR interest rate and to the sharp decline in the amount of deferred income projected for FY 1987, Mr. Pérez continued. The staff had also indicated in Supplement 1 to EBS/86/81 that "the substantial improvement in the projected income position for FY 1987 may reflect somewhat more the conventions adopted for making the projections than an underlying improvement in the Fund's financial position," concluding that the new projections might overstate the net income that might reasonably be expected in FY 1987. Yet in EBS/86/81, Supplement 1, the staff had proposed the continuation of the method at present utilized for projecting deferred income even though the main uncertainties with respect to projected net income, stemmed from that income component. While he understood the concern of the staff and of other Directors about the uncertainties surrounding the current exercise relating to the Fund's income position for FY 1987, it should be noted that projections by definition were subject to considerable uncertainty, and even the staff did not believe that the methods currently being utilized to make those projections should be changed. Reliance had to be placed on some kind

of estimate in order to reach a decision on an indicative rate of charge for FY 1987, and previous experience showed that the staff's projections tended to be on the conservative side.

The improvement in the net income position contemplated in the current projections--SDR 137 million, compared with the projection of SDR 91 million in EBS/86/81--was the result of the lower SDR interest rate being applied, Mr. Pérez noted. It seemed to him that, while there might be grounds for greater caution relating to the projections of deferred income, the Fund should not be reluctant to use the lower interest rate in its projections. The downward trend of interest rates that had been observed for several months past would apparently continue in coming months, reinforced by the deflationary impact of oil prices.

In view of the considerations he had mentioned, Mr. Pérez said that he could support, in principle, Mrs. Ploix's proposal to set an indicative rate of charge of 5.92 percent for FY 1987. According to the latest projections, that rate would permit the normal income target for the period to be attained. The difference between a rate of charge of 5.92 percent and the rate needed to reach an income target that included the component of deferred income should be split between a temporary surcharge and a temporary reduction in the rate of remuneration so that the SDR amount of both the surcharge and the reduction were equal. He also endorsed the other aspects of Mrs. Ploix's proposal, namely, the retroactive nature of the temporary surcharges and discounts, the simultaneity of their application, and the idea that the new formula should be applied beginning with FY 1987. In his view, that proposal met the criteria of equity, symmetry, and simultaneity to a greater degree than the staff's proposal.

As for the trigger mechanisms established for the review of the remuneration coefficient, Mr. Pérez said that he accepted the staff's suggestion that the SDR interest rate to be used for comparison with the rate of charge should be an average for the period under consideration. Given the frequency of variations in the SDR interest rate versus changes in the rate of charge, point comparisons were not relevant.

Finally, on the issue of the setoff in connection with a retroactive reduction of charges to members in arrears with the Fund, Mr. Pérez recalled that his chair had previously supported the idea that a retroactive reduction of the rate of charge should not involve cash payments to members with outstanding obligations to the Fund. Thus, he could agree in principle to the implementation of a setoff mechanism. In that connection, he supported the option in Attachment 4, which gave the member the opportunity to specify the obligation it wished to discharge with the setoff. However, he favored a longer waiting period for the member's response--for instance, seven days as suggested by Mr. Ismael.

Mr. Goos said that he approached the issues before the Board on the clear understanding that a definite decision would be taken at the present meeting only on the disposition of at least part of the excess net income for FY 1986. All other matters under discussion would be left for final

Board consideration on the basis of a comprehensive discussion of all relevant aspects. In particular, the rate of charge for FY 1987 could only be set in a preliminary way, pending substantive discussion of the prospective income situation in FY 1987, the adequacy of reserves, loan-loss provisioning, and so-called burden sharing.

With those reservations in mind, he could go along with a rate of charge of 7 percent for the second half of FY 1986, Mr. Goos said. The excess income remaining after such a reduction in the rate of charge should be added to reserves. A strengthening of the Fund's reserves along those lines--a formal decision which would have to be taken shortly after the beginning of the new financial year--appeared justified in view of the considerable uncertainties affecting the Fund's income position and the value of some of its assets. Furthermore, a stronger reserve position would allow for the fact that, as mentioned by Mr. Lankester, Peru's remaining arrears to the Fund had not been taken into account in the calculation of the Fund's income for FY 1986. Although that procedure was consistent with the practice approved by the Board, Peru's overdue obligations had to be taken into account in the disposition of excess income. If Peru became current in its obligations to the Fund at a later date, consideration could be given to deeming the excess income for FY 1986 as income for FY 1987.

With respect to the setoff in connection with the reduction of charges for the second half of FY 1986, Mr. Goos said that he joined Mr. Polak in supporting the option in Attachment 1. The Fund should follow the most commonly accepted practice. Moreover, overdue charges were at the root of the Fund's income difficulties, which had given rise to higher rates of charge. Accordingly, the excess income should be used in the first instance to remedy the immediate cause of the problem--namely, to reduce overdue charges, including special charges.

As for the rate of charge that should be applied provisionally in FY 1987, Mr. Goos said that his first preference was to maintain the existing rate. Such an approach would give the clear message--and in the clearest possible form--that the Fund had not yet been able to decide on the appropriate rate of charge for FY 1987. Nevertheless, he acknowledged that, following the reduction in the rate of charge for FY 1986, a need for a separate decision to reinstate the existing rate of 7.87 percent for FY 1987 would be awkward and no doubt politically difficult. As his second preference, therefore, he could support a preliminary rate of charge for FY 1987 of 7 percent, thereby obviating the need for two separate decisions to be taken at the present meeting.

Referring to the review of the rate of remuneration, Mr. Goos noted that the preliminary rate of charge to be set for FY 1987 was certainly not an appropriate basis for triggering such a review. That matter should be left for the comprehensive discussion of all the relevant issues, at which time the Board would also conduct the substantial review, required under Rule I-10, of the rate of remuneration for FY 1987. In that respect,

he also supported the proposal to review the rate of remuneration for the purposes of Rule I-10 on the basis of weekly average SDR rates for the periods in question.

His authorities had not yet come to firm conclusions about the appropriate course of action with respect to burden sharing, Mr. Goos continued, but their present thinking was based on certain basic presumptions. To begin with, the acknowledged cooperative character of the Fund implied that the rate of charge could not be regarded a priori as the natural corrective for shortfalls in interest payments to the Fund and the resulting losses in net income, the more so since only debtors that were current in their obligations to the Fund would be bearing the burden. On the other hand, consideration had to be given to the fact that the Fund's creditor countries already shouldered part of the burden inasmuch as they accepted a rate of remuneration below market rates. As a matter of fact, as pointed out in the staff paper, the effective rate of remuneration amounted to only 72 percent of the SDR interest rate and to approximately 60 percent of the five-year SDR rate, which was more representative of actual market rates. While the latter ratio, which had not been mentioned in the paper under discussion but in an earlier staff paper, might no longer be accurate, it was probably close to the actual situation. It was by accepting such a low rate of remuneration that the creditor countries enabled the Fund to set the rate of charge at a significantly concessional level. Against that background, his authorities felt strongly that placing an additional burden on creditors would be acceptable only on the assurance that the rate of remuneration--or, more appropriately, the underlying rate of remuneration--would be steadily and irreversibly increased to the level of the SDR interest rate.

With those reservations in mind, Mr. Goos considered that the model of burden sharing proposed by the staff merited further consideration. However, that model seemed to have the serious shortcoming of distributing the burden only among debtors and creditors. The concept of the Fund as a cooperative institution suggested that all members should participate in the burden sharing, not only creditors and debtors. Therefore, he encouraged the staff to develop such a broad-based model of burden sharing.

As for loan-loss provisioning, his authorities were still pondering the issue, Mr. Goos stated. However, they felt strongly that something had to be done about the problem of potential loan losses, be it by the introduction of provisioning or by an increase in the reserve target. In any event, the concerns expressed by the External Audit Committee would have to be met in order to prevent the issuance of a qualified statement by the External Auditors. The criteria presented by the staff for establishing the probability of a loan loss were quite helpful, including the idea of taking into account the duration of overdue payments as a sort of final trigger for provisioning. However, he recognized that specific provisioning could have serious drawbacks because it could weaken the Fund's prospects of eventually recovering overdue obligations. While that point argued in favor of general provisioning, he wished to stress once again that his remarks were very preliminary and did not prejudice his chair's final position on the issue.

Mr. Dallara made the following statement:

Let me first offer my appreciation for the Chairman's statement, which not only helps frame our discussion of the complex issues before us but points us in the direction of how we may proceed on these issues. We approach today's discussion with one basic consideration in mind--to take, or to move forward on, decisions that will enable the Fund to continue to fulfill effectively its functions in the monetary system. In particular, I have in mind the Fund's role in providing temporary balance of payments financing to members in support of economic programs. Clearly, a key element in preserving the Fund's ability to carry out that function is preserving the financial strength of the Fund. Recently, our financial position has been threatened by a growing arrears problem which has adversely affected the Fund's income position and required the Fund to take a number of prudential steps.

The situation has not, however, been entirely negative. Recently, there have been two positive developments that have improved somewhat the Fund's income position. The first has been the large decline in interest rates, which has already been reflected in the rate of remuneration, and which should be reflected as feasible and as appropriate in our income position and the rate of charge. Second, we have seen some resolution of specific arrears cases through cooperative efforts of debtors and creditors supported actively by the Fund, thereby not only strengthening the Fund's financial position retrospectively but making the outlook somewhat better than it would have been otherwise.

These developments notwithstanding, there remain, as the staff paper points out, particular uncertainties about income during the period ahead, due in part to the future course of interest rates, the amount of income that will need to be deferred, and the possible need to take other prudential measures in light of the arrears problem. The need to consider such actions has been underscored by the evidence, which suggests that arrears cases remain in which efforts by the member and apparent support from bilateral donors appear insufficient to resolve the problems in the near future. These cases, with which we are all familiar, are evident from the worsening of the overall arrears problem in the six months to March 1986, as reviewed in the six monthly report just issued to the Board. The total amount of overdue obligations, for example, increased by more than 50 percent since end-September, while the amounts overdue for more than six months have more than doubled during this period. These developments highlight the need for us to proceed with considerable caution today, and when we return to these issues again in the not too distant future.

Referring to the income position and the rate of charge for FY 1986, which we understand will serve temporarily as a rate for FY 1987, as noted in the Chairman's statement, it had been agreed in principle at the special review of the Fund's income position in February that charges would be reduced retroactively for the last half of FY 1986 in light of prospective improvements in the Fund's income position for FY 1986. Indeed, the update on the income position for FY 1986 provided by the Treasurer indicates that net income for FY 1986 will be higher than estimated earlier, providing scope for a significant reduction in the rate of charge. In determining the appropriate retroactive rate of charge for the second half of FY 1986, a number of considerations should be borne in mind:

First, there is the situation with regard to Peru, already mentioned by Mr. Lankester and a number of other Directors. The recent payment of SDR 30 million has had an effect on deferred income, by reducing the longest overdue charge to less than six months. It is proper, of course, under the Fund's procedures, for charges from Peru now to be accrued as income, even if unpaid. Unfortunately, the fact remains that SDR 22.5 million in charge obligations continue to be overdue. We join others in hoping that Peru will settle their obligations promptly, but in the absence of further payment by May 6, deferral will again be required for those charges.

Second, the rate of charge established retroactively for FY 1986 will provide a rate of charge for entering FY 1987. While it is my understanding that it will be only a temporary rate, we nevertheless must give some consideration at this time to the uncertainties we face in the coming financial year.

As the staff paper points out, these uncertainties include those relating to projected use of Fund resources; interest rate developments; the possibilities of provisioning; and estimates of deferred income. Unfortunately, it would appear that the recent developments regarding Peru, which have affected income in FY 1986, also have had an effect on estimated Fund income for FY 1987.

I might add that we would suggest that consideration be given to a new approach in estimating deferred income. We wonder if the deferral coefficient could be used as only one factor in estimating deferred income for an upcoming financial period. In our view, the results of the deferral coefficient, actual past deferred income, and other factors considered relevant by the staff could all be taken into account in making an overall judgmental estimate of future deferred income. It is clear that this may be difficult, but it is also clear that the staff does not have confidence in their projection of net income in FY 1987, and we would welcome further consideration of this approach.

Considering the above, and keeping in mind the need to pay high regard to prudential considerations at this time, we believe that a case can be made for a retroactive rate of charge for FY 1986, and therefore a temporary rate of charge for FY 1987, of somewhat above 7 percent--say, 7.2 percent. However, a retroactive rate of charge of 7 percent for FY 1986 would be consistent with the earlier understandings reached by the Board regarding charges for this period. My authorities are prepared to support 7 percent as a retroactive rate of charge for the second half of FY 1986, as mentioned in the Chairman's statement, if it is also agreed to be the provisional indicative rate for FY 1987 and on the understanding that there is willingness on the part of my colleagues to give the issue of provisioning further consideration prior to reaching a more definitive view on the rate of charge for FY 1987 early in that financial year.

With regard to excess income for FY 1986, I can support the Chairman's suggestion to place it in reserves but I would defer a view on deeming the excess as income for FY 1987. My authorities have not found deeming to be particularly productive in the past, although I would be prepared to consider it further.

With regard to setoff arrangements, several of the options presented have some elements in their favor. On balance, I am prepared to support the option put forward in the Chairman's statement--the option in Attachment 4 to EBS/86/90--which follows our current practice of giving the initial choice to the member. This option, of course, allows the member to make the judgment based on its own particular circumstances, and at the same time does not tie the Fund's hands should the member not indicate a choice, since in such a situation setoff amounts to the longest overdue obligation.

Let me now turn my attention to the Fund's paper on "Provisioning Against Loan Losses in the Context of the Fund," recognizing that this is only a preliminary discussion. I begin by focusing on the views of the External Audit Committee, which must be given considerable weight. In the FY 1985 Audit Committee's comments relating to overdue obligations, endorsement was given to the 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." The staff has given us a number of criteria. Several of these criteria are, in my view, relevant to any decision on loan loss probability. These include the amount of overdue payments to the Fund, the member's record in discharging obligations, and the country's debt profile; the willingness and ability of a member to adopt an economic adjustment program that would improve the prospects of a member discharging its obligations to the Fund; and the length of time obligations have been overdue.

Unfortunately, in spite of these helpful criteria, we were somewhat disappointed to find that the paper before us stops short of outlining the more "comprehensive and structured approach" proposed last year by the Treasurer.

While it is clear that the Board must provide some guidance on this issue, and we do not wish to shy away from our responsibilities on this matter, we find it difficult to provide the kind of guidance necessary without a more explicit formulation of various "comprehensive and structured" approaches. It appears to us, in fact, that there are really two issues before us preliminarily today, and to which we must return soon in detail. The first is to establish criteria appropriate for the Fund that can be used to determine whether a loss is probable--the "comprehensive and structured" approach referred to above. Once that is done, and it seems to us that we have no choice but to develop and agree upon such criteria promptly, then we can use those criteria to perform the second task--to determine in fact whether loan loss is probable, to estimate the possible amount of that loss if possible, and to establish provisions as appropriate.

I note from preliminary comments made today that there are those who do not appear inclined to support provisioning. Regardless of how one feels about provisioning, however, there is a need, indeed an obligation, to develop a more comprehensive approach to this issue. We would hope that this preliminary discussion would enable the staff to prepare a more detailed proposal for consideration in June in connection with a more definitive judgment on charges for FY 1987. The urgency of action on this matter is underscored by the fact that the External Audit Committee will, if previous schedules are adhered to, be conducting its review of the Fund's financial position over the next few months: the 1985 report, for example, was dated June 28. In light of the comments of the Audit Committee, it would seem particularly important that this institution be in a position to respond to its concerns if we are to ensure a continued unqualified audit opinion. As the staff paper on provisioning notes, in discussing generally accepted accounting principles--and without particular reference to the Fund--auditors may express a qualified opinion on financial statements if the likely size of a loss, and taking into account the probability of loss if realized, would be material for the reporting entity.

In recent years, both public and private financial institutions have taken measures to modify past accounting practices to reflect the consequences of growing arrears and the possibility of losses on loans. We recognize that the Fund is a unique institution with a balance sheet and modes of operation that differ from other public and private entities. But these differences, in our view, do not obviate the need for the Fund to take prudential measures to protect against possible losses and

Finally, I recognize that any decisions we might take to provision or to increase the reserve target would require some thought as to how the "costs" arising from these actions might be met. The staff has offered a suggestion, as has Mrs. Ploix. As far as the staff approach is concerned, my authorities have only given it preliminary consideration, and will consider it further. I can say at this stage that we would have considerable difficulty with any approach along the line suggested by Mrs. Ploix.

My authorities would, however, be willing to consider these various issues further. In any such consideration, we would expect attention to be given not only to charges, income, and remuneration, but also to the effective rate of remuneration. This was dealt with in an earlier paper on this subject (EBS/85/126, 5/14/86). I would appreciate an update of the data in that paper, and any further thoughts the staff may have on this aspect of the issue. Also relevant is the effective rate of concessionality in Fund lending. Furthermore, there are countries that are neither creditors nor debtors to the Fund, and it is worth considering whether there is a role for these members to play as well.

Mr. Polak remarked that the Executive Board could only agree to an indicative rate of charge for FY 1987 if it considered that the rate was compatible with Rule I-6(4)(a). However, no decision could be taken with respect to the rate of charge for FY 1986 continuing to apply for FY 1987 until a decision had been reached on the disposition of net income for FY 1986 following the forthcoming review of the Fund's income position.

Mr. Sengupta asked whether, if a decision on the rate of charge for FY 1987 and other related issues was not taken until later, it would still be technically feasible to use part of the excess income for FY 1986, amounting to about SDR 26 million, to further reduce the rate of charge for FY 1986.

The Treasurer responded that any excess income for FY 1986 would be placed provisionally to reserves. The Executive Board would reach a final decision on whether to place part of that excess income to reserves and whether to deem part as income for FY 1987 when it considered the rate of charge for FY 1987 after the end of the financial year. The option mentioned by Mr. Sengupta thus remained.

The Director of the Legal Department confirmed that it would be possible at that time, under Rule I-6(4)(c), to decide on a further reduction of the rate of charge for FY 1986.

The Chairman noted that, if the Board decided at the present meeting on a rate of charge of 7 percent for the second half of FY 1986, that rate would carry over into FY 1987 unless the Board reached a different decision when it reviewed the Fund's financial position following the end of the financial year.

Mr. Sengupta, reverting to the issue raised by Mr. Lankester and Mr. Dallara, said that whether or not Peru settled its overdue obligations--as he expected that it would--the question to be considered was the feasibility of introducing in the agreed procedure for treating income as accrued or deferred an element of judgment with respect to the probability that a specific member's obligations would be settled. As it was, the use of the averaging concept inherent in the application of a deferral coefficient led to uncertainty. There had been significant changes in the coefficient, which had risen recently from 2.04 percent, as mentioned in Table 2 of EBS/86/81, to 2.31 percent, according to Supplement 1 to that paper. In addition, the fact that the projected amount of deferred income was always the higher of the amount calculated by the coefficient and the absolute amount of income deferred in the previous year indicated a cautious approach on the part of the Fund. It was for those reasons that he wished to ask whether it would in fact be possible, under the existing procedure, to implement Mr. Dallara's suggestion that a judgmental estimate be made of future deferred income.

Mr. Zecchini considered that the point raised by Mr. Sengupta was a relevant one. He himself had had an exchange of views with the staff recently on the interpretation of the existing procedure. One possible option that would not entail a difficult appraisal of the probability of a specific member failing to meet its obligations might be to resort to a practice that had been discussed when the existing procedure had been agreed. He had in mind applying the principle that, when a country's obligations to the Fund were overdue for more than six months, there would be a strong presumption that income was deferred.

The Chairman remarked that the application of such a principle, which would by definition mean that the member was overdue on obligations other than charges, would not be in accordance with the present procedure, which had been approved by the Board.

The Treasurer noted that it could not really be claimed that the projection of income for FY 1986--and thus for FY 1987 as well--had been overstated because of the way in which charges due on Peru's overdue obligations had been treated, since the agreed procedure for estimating deferred income had been applied. Underlying the comments by Mr. Dallara and Mr. Zecchini was the suggestion that the existing procedure should be amended, to place greater emphasis on the risk that even if a country was momentarily not overdue in meeting its obligations to the Fund for six months or more, charges due on those obligations would have to be considered as deferred income. Another possible amendment, to which Mr. Sengupta had referred, concerned the deferral coefficient, which the Board had agreed should be applied cautiously, the higher of two measurements of deferred income being taken. Even though it had had little experience with deferrals, the Fund had geared the procedure to past developments but had at the same time taken a prudential approach because of the vacillating nature of the coefficient.

As for the introduction of an element of judgment into the projection of deferred income, experience argued for an objective system, forecasts having often been proved wrong by events, the Treasurer said. The staff always took care to inject its own judgment on the validity of the projections it presented in its papers to the Executive Board; for instance, the recent discharge of overdue obligations, which had led to a sharp downward movement in the coefficient from 3.96 percent to 2.31 percent, might not necessarily be repeated. The Executive Board might wish to keep in mind, in considering the Fund's income position for FY 1987, that the coefficient might be on the low side and that actual deferrals might be larger.

Mr. Sengupta said that he accepted that the use of a deferral coefficient was a sufficiently prudent approach to allow for deviations. If any other approach was to be explored, along the lines suggested by Mr. Zecchini or other Directors, careful simulations of the results would have to be made to see whether or not different approaches would in fact yield any better results.

Mr. Fujino remarked that the discussion seemed to be overlooking the difference between accounting for cash flow and projections. As he understood it, accrued income was not classified as deferred income, until after the close of the financial year, whether or not there was any cash flow. The coefficient was used simply for purposes of projections. He agreed that caution was advisable in making projections of deferred income.

Mr. Lankester said that he recognized that the way in which Peru's overdue obligations had been treated in the projections was in accordance with the existing procedure for projecting deferred income for FY 1986. He also agreed that his remarks in that connection could be taken to imply that the current procedure was not entirely appropriate. The Board should not be considering any changes in the procedure at the present meeting, but neither should it feel obliged, in setting the rate of charge retroactively for the second half of FY 1986, to base its decision on the amount of deferred income deriving from the present method of calculation. The Board should be able to exercise some judgment on the matter. The gist of his earlier remarks was that, in commonsense terms, it would not be wise to distribute income that had not yet been received. That reason had led him to suggest that the correct rate of charge was 7 percent.

Mr. Sengupta observed that Peru's obligations would not be overdue, according to the present procedure, until FY 1987, and they would not be reflected in deferred income until that fiscal year began.

The Chairman commented that Mr. Lankester nevertheless had a point in noting that part of the income for FY 1986 had not been received, and that the rate of charge should not be reduced too sharply. At the same time, as Mr. Fujino had observed, the way in which the amounts in question were treated in the accounts, in accordance with existing procedures, was correct.

Mr. Polak said that he wondered whether it was necessary to take the time to discuss better techniques for forecasting deferred income, since the procedures suggested by Mrs. Ploix and the staff for burden sharing provided for an ex post determination of deferred income. Any change in the procedures could be discussed at that time.

The Chairman remarked that, although deferred income under a retroactive system would be known with more certainty, members themselves would be exposed to greater uncertainty by not knowing in advance what the rate of charge would be. The advantage of the existing procedure was that it provided stability together with the opportunity of making any necessary corrections in the rate of charge at the time of the midyear review, based on the actual outcome. It was a question for judgment whether, in an uncertain world, retroactive accounting for deferred income would be a better technique. As Mr. Polak had remarked, the refinement of existing forecasting methods would be less necessary if such an alternative technique was applied.

Mr. Dallara commented that there might be good reasons for users of the Fund's resources to want to give serious consideration to the implications of a retroactive approach. If he understood the way in which it would be applied, other things being equal, the rate of charge would be increased in order to permit the Fund to compensate for the interest it had forgone during the intervening period. On the assumption that the rate of charge that would produce the targeted amount of income could not be forecast with precision, it seemed to him that there would inevitably be such a cost to the Fund, which would be passed on to members using its resources.

The Treasurer explained that, under a system in which a distinction was made between a normal rate of charge and a rate of charge that incorporated a surcharge to offset the impact of deferred income, the Executive Board would have to set a rate of charge at the beginning of the financial year. The total rate of charge, consisting of both components, would have to be applied uniformly to all balances outstanding, in accordance with the Articles of Agreement. At the end of an accounting period--be it half yearly or yearly--an adjustment would be made to the total rate of charge, to the extent that deferred income had been paid. Such a system would be consistent with the Articles of Agreement; the Fund would not be collecting charges any later or earlier than it did at present.

The Chairman remarked that it might be useful to have numerical examples of how both the existing system and a retroactive system of surcharges would work.

Mr. Dallara remarked that the issue was so complex that its further discussion at the present meeting seemed to have only marginal benefits. However, in order to clarify the thrust of his earlier suggestion with respect to the estimation of deferred income, he noted that it was not so much a question of whether or not judgment was applied at all as of whether the judgment was applied in arriving at the estimate of deferred

income or afterward. He thought that it might be useful to consider incorporating the judgmental step before the estimate of deferred income was tabulated in staff papers.

Mr. Sengupta said that he had the same concern as the Chairman about the uncertainty of a rate of charge agreed under a retroactive system, which avoided the definitional problem of deferred income. The uncertainty could be avoided, however, if the charges were adjusted for the subsequent period. For instance, if the initial rate of charge was set for six months, on the assumption that there would be no deferred income, and a review was held after three months or six months, the rate of charge for the following quarter could be raised to the extent necessary. There would always be certainty for the quarter ahead.

The Chairman observed that Mr. Sengupta's suggestion was a workable variant of what the staff had in mind.

Mr. Salehkhoulou noted that debtor countries consistently had had to pay a price in the form of higher charges for the element of certainty in the existing system. Faced with a choice between two evils, some uncertainty was preferable to higher charges.

Mr. Massé noted that Supplement 1 to EBS/86/81 showed that a combination of factors had led to the income target for FY 1986 being exceeded by some SDR 100 million. As a result, the rate of charge for the second half of FY 1986 could, strictly speaking, be reduced to as low as 6.72 percent. However, it needed to be recognized that some of the factors influencing that much stronger than projected income position might not be permanent. He had in mind in particular the situation with respect to Peru's overdue obligations to the Fund. Consequently, the conclusion to be reached was that there should be a reduction in the rate of charge retroactive to November 1, 1985, but, given continuing uncertainties, to about 7 percent only, or the rate prevailing in the first half of FY 1986 and the rate that probably would have continued to prevail, had the problem of overdue obligations not worsened during the financial year. Reducing the rate of charge retroactively to 7 percent would yield net income of some SDR 25 million in excess of the target. The excess income could be added to reserves or treated as income for FY 1987. At the present juncture, it seemed to him that a reasonable course to follow would be to treat the excess as income for FY 1987, while leaving open the possibility of deciding later in FY 1987 to add it to reserves.

One further issue that should be dealt with in the context of FY 1986 concerned the setoff for countries that might be in arrears to the Fund but that were eligible for a retroactive reduction in the rate of charge, Mr. Massé continued. The staff had made a convincing case that there was a generally accepted legal principle of setoff. The only remaining question was the order in which the setoff would be applied. Having reviewed the four options provided in the attachments to SM/86/90, his preference was for the option in Attachment 1, namely, for determining the order of

setoff by rules analogous to those commonly used in most legal systems. Such a procedure was slightly less favorable to the Fund than the option in Attachment 3, but it would have the firmest basis in law.

Referring to the Fund's income position for FY 1987, Mr. Massé noted that the staff's projections continued to be plagued by the same uncertainties that had emerged during FY 1986. In fact, the considerable shift over the past three weeks in projected income for FY 1987 indicated how sensitive the income position was to changes in deferred income, and to changes in market interest rates as well. The instability that had also been introduced into the rate of charge itself should preferably be avoided for considerations of equity among countries using the Fund's resources. Indeed, the considerable difficulties that continued to be encountered in projecting deferred income suggested the need to re-examine the entire process of evaluating the income position and setting charges. Consideration might be given, for instance, to methods by which deferred income could be financed by the entire membership. Those were the sort of fundamental issues that would have to be addressed if the current unsatisfactory situation was to be dealt with.

To underline a few key elements, Mr. Massé observed first that, as a general principle, the rate of remuneration should continue to increase toward 100 percent of the SDR interest rate as provided for under Rule I-10. That principle remained important if the rate of return on all Fund-related assets was to become roughly equal, and was also important if Fund members were to be encouraged to retain SDRs in their reserves. Yet, under present circumstances, it was also necessary to keep in mind the principle of burden sharing when setting the rate of charge. Thus, some equitable way would have to be found to deal with the mounting problem of deferred income while respecting the long-term goal of increasing the rate of remuneration toward 100 percent.

Further reflection was required before a firm decision could be taken on those fundamental issues, Mr. Massé added. In EBS/86/81, the staff had made one proposal that would put the initial burden on the debtor by having the rate of charge rise to some arbitrary ceiling; should that ceiling be reached, reductions in the rate of remuneration would then take place. That proposal was interesting and would present a move away from the ad hoc approach being used at present, but he had found it fell short of equalizing the burden among Fund members. Mrs. Ploix had also advanced a proposal, which would divide the impact of overdue obligations on Fund income more or less equally between the rate of charge and the rate of remuneration. Her proposal was superior to that of the staff, since net creditors as well as users of Fund resources would make some contribution toward net income in a given year. However, under both proposals there would be members that would not be called upon to contribute to the income shortfall arising from overdue obligations.

Therefore, he proposed that thought be given to other options under which the entire membership would finance deferred income, Mr. Massé said. One option might be a levy upon all members, based on quota, to cover

income shortfalls. The staff might wish to reflect upon that possibility and to examine different mechanisms for applying that approach or other comparable approaches to equitable burden sharing. In the interim, he was prepared to fix a rate of charge of 6 percent--roughly in accordance with Mrs. Ploix's proposal--while reserving judgment on the principle of how to share any burden arising from deferred income and on the precise amounts to be shared. In any event, whatever decision was taken at the present meeting must be an interim one. The Board would have to reflect further upon the Fund's income position in light of actual developments and the staff's analysis of burden-sharing proposals.

Finally, Mr. Massé said that the view of his chair was that the concept of provisioning was not very useful in the context of an institution like the Fund. For a cooperative governmental institution, it did not seem appropriate to use practices, such as provisioning, that were more relevant to profit-making commercial institutions that had to borrow in the marketplace. Even if the collection of obligations to the Fund continued to pose problems, the continued existence of the Fund and its ability to repay its creditors was not in doubt, given its reserves, its gold holdings, and, more fundamentally, the support of its membership. On a more practical level, provisioning would be an added expense to the Fund and, as such, would introduce a further degree of instability into its income position.

It was not that he was unconcerned about the growing amount of overdue repurchases, Mr. Massé concluded. Action was necessary to protect the Fund and its membership under current circumstances. However, it was more appropriate to provide for that protection through the Fund's general reserves than provisioning. The Board's efforts should be concentrated on a review of the optimal reserve position for the Fund and on how each member could make an appropriate contribution.

Mr. Suraisry stated that it was crucial for the Fund to have a healthy income position, given its central role in the international monetary system. He had therefore been pleased to note that the projected income position for FY 1986 had improved significantly since the Board's previous discussion of the Fund's income position in February (EBM/86/37 and EBM/86/38, 2/27/86). More specifically, as pointed out in the most recent staff paper (EBS/86/81, Sup. 1), the Fund's income for FY 1986 was projected to be in the neighborhood of SDR 107 million in excess of the income target. In line with the views expressed by many Executive Directors at the February meeting, he could support a retroactive reduction to 6.72 percent in the rate of charge for the second half of FY 1986. As the staff paper indicated, that rate should be sufficient to achieve the agreed target. In light of the staff paper proposing a setoff in connection with a retroactive reduction of charges, he had no problem with making that rate effective as of November 1, 1985.

The decline in market interest rates in recent months had led to a situation in which the current rate of charge, at 7.87 percent, exceeded the market interest rate, Mr. Suraisry continued. Such a situation was

not consistent with the cooperative nature of the Fund. Perhaps more important, Fund members might thereby be inhibited from making use of the Fund's resources at an early stage of their difficulties. Clearly, that was not in the best interest of those members and was contrary to Fund advice. In fact, persistent delays in approaching the Fund might compromise the gains recently achieved in advancing the international adjustment process.

The projection for FY 1987 was very tentative and subject to many uncertainties, as the staff had indicated, Mr. Suraisry went on. Evidence to that effect could be found in the significant differences between the projections for FY 1986 and FY 1987 in the staff paper issued on April 14 and the supplement issued on April 24. It followed, therefore, that the staff projection for FY 1987 should be evaluated with great care. In his view, it was too early to consider a rate of charge lower than 6.72 percent for FY 1987. It was his understanding that the rate of charge would be considered in depth at a later date. Therefore, any rate of charge for FY 1987 that might be agreed at the present meeting would be only an indicative rate.

On the issue of burden sharing, Mr. Suraisry said that his authorities had full understanding for those users of Fund resources who were bearing an additional burden as a result of overdue obligations to the Fund. The additional increase in the rate of charge was obviously one of the consequences of those overdue obligations, against which his authorities had been cautioning all along; their concern had thus been fully justified. He hoped that every effort would be made by all concerned to put an end to the problem since no lasting improvement in the Fund's income position could be achieved as long as it existed.

He had an open mind on how to resolve the problem of burden sharing, Mr. Suraisry reiterated. More specifically, he could support the staff proposal for a surcharge on the rate of charge and a discount from the remuneration coefficient. He was also prepared to consider any other proposal that might achieve the same objective, including the broader burden-sharing approach mentioned by Mr. Goos and Mr. Massé. He agreed with the Chairman that the present discussion satisfied the need for a review under Rule I-10(c).

He wished to emphasize that the proposed discount from the remuneration coefficient would not be the first step taken by creditors toward sharing the burden of higher charges, Mr. Suraisry added. To illustrate that point, he could do no better than quote from page 15 of EBS/86/81: "it will be recalled that the rate of remuneration not only stands at a discount to the SDR interest rate, but, on average, only 91.7 percent of reserve tranche positions are presently remunerated. The 'effective' rate of remuneration is approximately 72 percent of the SDR interest rate, which is considerably lower than the actual rate of remuneration." The issue therefore was one of additional burden sharing and not of the introduction of burden sharing.

On provisioning, it was clear that the problem of overdue obligations had been, and would continue to be, with the Fund for some time to come, Mr. Suraisry said. In that context, he had noted from the six monthly report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86) that those obligations had continued to increase. At the end of March 1986, overdue obligations amounted to SDR 669 million, compared with SDR 462 million at end-September 1985. If the problem was not successfully resolved, it would pose a threat to the Fund's income position, which would have to be protected to allow the Fund to remain strong--a matter of particular importance for the international monetary system. Provisioning might be a good method of protecting the Fund's income. However, a number of difficult issues would have to be examined fully before any decision on the matter could be taken. Those issues included, among others, how to finance provisioning, how to reconcile provisioning with the Fund's cooperative nature, and whether there were better options available to the Fund at the present stage, such as relying on increased reserves. On balance, even though the problem of overdue obligations clearly continued to be a serious one, he did not believe that it had yet reached a stage necessitating the adoption of some sort of provisioning. However, the door to provisioning should be kept open so as to facilitate its consideration, should the need arise. With that in mind, he encouraged the staff to continue its examination of the technical issues involved.

Finally, on the setoff proposals, Mr. Suraisry said that he remained convinced that it was not logical to give cash payments resulting from a retroactive reduction in the rate of charge to members in arrears to the Fund. Therefore, he welcomed the setoff proposals presented in the staff paper. Those proposals should facilitate reaching a constructive decision on the rate of charge. However, to the extent possible, the decision on the setoff should not lead to further complications in relations between the Fund and those members with overdue obligations. Consequently, he supported the option in Attachment 4. He had no problem with Mr. Ismael's proposal to increase the reporting period from three to seven business days.

The Executive Directors agreed to resume their discussion in the afternoon.

## 2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Coumbis, Alternate Executive Director, on the completion of his service with the Executive Board.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/72 (4/28/86) and EBM/86/73 (4/30/86).

3. ISRAEL - TECHNICAL ASSISTANCE

In response to a request from the Israeli authorities for technical assistance in the area of budgetary accounting and control, the Executive Board approves the proposal set forth in EBD/86/122 (4/23/86).

Adopted April 29, 1986

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/113 and 85/114 are approved. (EBD/86/119, 4/22/86)

Adopted April 28, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/98 (4/25/86) and EBAP/86/100 (4/28/86) is approved.

APPROVED: January 21, 1987

LEO VAN HOUTVEN  
Secretary