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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/74

3:00 p.m., April 30, 1986

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	Jiang H.
	S. Ganjarerndee, Temporary
	H. A. Arias
T. P. Lankester	M. Foot
	H. Fugmann
M. Massé	
	W. Parmena, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

Administration Department: H. Wiesner. African Department: G. B. Taplin. 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, J. C. Corr, D. Gupta, R. 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. M. Hassan, G. D. Hodgson, J. Hospedales, K. Murakami, J.-C. Obame, A. Ouanes, P. Péterfalvy, A. Vasudevan. Assistants to Executive Directors: A. Alaoui-Abdallaoui, A. Bertuch-Samuels, J. de la Herrán, J. J. Dreizzen, W. N. Engert, S. Geadah, V. Govindarajan, L. Hubloue, O. Isleifsson, A. R. Ismael, Z. b. Ismail, S. King, H. Kobayashi, 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

The Executive Directors resumed from the previous meeting (EBM/86/73, 4/30/86) their consideration of 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).

Mr. Zecchini considered that the present review of the Fund's income position for FY 1986 was timely because it was taking place in the face both of net income that exceeded the target and before the collection of charges for the second half of FY 1986. The excess income opened the way to a retroactive reduction of the rate of charge, which should not be interpreted as the correction of a mistake made in November 1985, as some might think. That increase had been appropriate under the circumstances prevailing at the time, and also because the volume of arrears had not receded subsequently but on the contrary had continued to rise significantly. In such a situation, it had been important to give the right signal to the Fund's membership about the gravity of the problem and to trigger the examination of a wider range of issues and possible solutions encompassing, inter alia, the rate of remuneration and loan-loss provisioning. The reduction in the rate of charge, like the previous rise, was a sign of flexibility and understanding on the Fund's part in dealing with a problem that had been threatening the financial viability of the institution and that, in a standard monetary institution, would have been dealt with by drastic measures.

He was committed to applying the agreement reached in principle by the Board on the occasion of the midterm review of the Fund's income position in February, Mr. Zecchini continued. On that occasion, it had been agreed that, as a counterpart to the increase of the rate of charge from 7 percent to 7.87 percent, any excess income for FY 1986 would be used to decrease retroactively the rate of charge. His preferred solution would therefore be to decrease to 6.72 percent the rate of charge for the second half of FY 1986. However, it could also be argued that the high net income figure for FY 1986 was partly nominal as opposed to actual. In fact, about SDR 30 million in charges due by Peru in FY 1986 had been reincluded in net income for the current financial year because, after making partial repayments, that country no longer had any overdue obligation outstanding for more than six months. Nevertheless, those charges would be classified as nonaccrued income again after May 6, if they had not been paid by that time.

For those reasons, and in order to facilitate the attainment of the required qualified majority, he could support as an alternative a smaller decrease in the rate of charge for the second half of FY 1986 to a rate no higher than 7 percent, Mr. Zecchini stated. The residual excess income could be transferred either to reserves or deemed as income for FY 1987, thereby reducing the prospective rate of charge for FY 1987 while reserves continued to accumulate in line with the 5 percent target. A decision on the disposition of excess income would have to be taken in light of the broader considerations relating to the method of burden sharing and the provisioning mechanism.

With respect to the effect of the retroactive reduction in the rate of charge for countries having overdue obligations, Mr. Zecchini recalled that, as he had argued on a previous occasion, a setoff provision should be designed to avoid making cash refunds to such countries while helping them to reduce their overdue payments. The issue had been treated thoroughly in SM/86/90. As to the specific modalities for implementing the setoff, his preference was for the option in Attachment 4. That option seemed consistent with the practice followed so far by the Fund for payments received by members in arrears, and it safeguarded the right of a member to determine which obligation it wished to discharge.

Even a rate of charge of 7 percent--the less favorable alternative for debtor countries--would be noticeably lower than the average SDR interest rate, which was estimated at 7.29 percent for the second half of FY 1986 and 7.44 percent for the year as a whole, Mr. Zecchini continued. In that connection, as mentioned in EBS/86/81, Rule I-10 called for a review of both the rate of charge and the rate of remuneration whenever the former exceeded the SDR interest rate. He was of the opinion that it was more appropriate to consider quarterly averages and not weekly SDR interest rates as a trigger for reviews. Quarterly averages were less distorted by possible sharp short-term swings in the SDR rate, and quarterly reviews could provide a better opportunity to deal with those rate differentials in a more systematic way.

The commitment to the principle of sharing the burden of overdue obligations between debtor and creditor countries--and perhaps among the membership at large--was necessary not only in the event that the rate of charge exceeded the SDR interest rate but because it was a more equitable approach than the one applied so far, Mr. Zecchini considered. In that respect, the objective should be twofold: to strengthen the capital base of the Fund to meet the increasing threat of overdue obligations, and to reduce the impact of such strengthening, under the present rules, on the rate of charge. Two main avenues were open for achieving those objectives: first, expenses could be reduced mainly by curtailing the remuneration of creditor positions, since administrative expenses had already been slashed enough; second, the net income target could be changed to decrease the rate of reserve accumulation. However, such action would have to be offset by countervailing measures such as loan-loss provisioning that should not be financed out of current income; otherwise, the consequence would always be an additional charge on the debtor country.

In exploring the first of those two avenues, the staff had proposed a particular system for reducing remuneration that had some interesting features, such as the retroactive adjustment mechanism which would cut short the discussion on the most appropriate rate of charge for the period ahead, Mr. Zecchini continued. However, he was reluctant to support that proposal for important systemic reasons. In spite of the proclaimed transitory nature of the proposed system, it amounted to introducing a de facto permanent system of capping interest rates. Such a consequence represented a major departure from the international debt strategy followed so far, and as such it conveyed a new message to the international banking community without a clear understanding of all the possible implications for the restoration of normal relationships between debtor countries and private financial institutions. Furthermore, the proposal subverted the difficult agreement reached in January 1984 on the fair remuneration of creditor positions. In addition, the proposed method of calculating the SDR interest rate on the basis of a five-year interest rate plus 0.5 percentage point implied a significant reduction of the grant element implicit in the present SDR rate, under normal conditions of an upward-sloping yield curve. That outcome was unacceptable because of the cooperative nature of the Fund and the need to preserve a substantial incentive for countries to resort to the financial support of the Fund.

The French proposal avoided some of those unfavorable consequences in its symmetrical sharing of the burden between the rate of charge and the rate of remuneration, Mr. Zecchini commented. However, that proposal did not overcome his systemic objections.

The present arrears problem should be considered temporary since the prospective improvement in the world economic and financial situation should provide ample opportunities for debtors to strengthen their finances and repay their debt, Mr. Zecchini went on. In line with the temporary nature of the problem, he favored a temporary solution, which could consist of delaying for one or two semesters the scheduled increase of the remuneration coefficient from 92 percent to 97.49 percent. The resources so generated would be used, if necessary, to maintain the rate of charge just below the SDR interest rate but above all to strengthen the reserves of the Fund. Once the reserves had reached a safer level, the reserve accumulation target could be reduced and, consequently, so could the rate of charge.

The second avenue to be explored consisted of a loan-loss provision that would reduce the present reserve accumulation target, Mr. Zecchini said, but he had some doubts about the advisability of that option. In order to obtain a decrease in the rate of charge and to effect burden sharing, the loan-loss provision should be financed by contributions from all members in proportion to quota. However, there might well be legal objections to requiring such contributions from all members. Moreover, such a provision would serve only to offset the negative consequences on current income of writing off debt. The Fund had always avoided writing off debt, and for good reasons, and it did not seem appropriate for the

Fund to give the signal that would emerge from the establishment of a loan-loss provision in the form of a reduced rate of charge imposed to obtain repayment of long overdue debt. Finally, loan-loss provisioning would cover exclusively losses stemming from the overdue payment of principal and not of charges. An income shortfall due to arrears in the payment of charges would affect the Fund's actual income in any event and could trigger an increase in the rate of charge in order to meet the reserve target.

Mr. Sengupta observed that the staff papers amply demonstrated that the outcome of the income position for FY 1986 had turned out to be much better than expected at the time of the Board's previous discussion in February. The settlement of some overdue obligations and a lower SDR interest rate had helped to make it possible to bring down the rate of charge to 6.74 percent for the second half of FY 1986 and at the same time to realize the target amount of net income for FY 1986 of SDR 52 million. The Board had agreed in February to effect a reduction in the rate of charge for the second half of FY 1986 from 7.87 percent once the actual income position became known toward the end of April. He strongly urged the Board to agree to reduce the rate of charge to the extent possible for the second half of FY 1986. The suggestion made by some Directors that that rate should be 7 percent was based on a preference that seemed inexplicable, apart from references to uncertainties in FY 1987. As indicated in the supplement to the staff paper, a rate of charge of 7 percent for the second half of FY 1986 would yield net income of SDR 77 million--or SDR 25 million in excess of the target amount. That excess could well be carried into FY 1987, although there was no reason why it should be. Based on the normal method of projecting the Fund's income, there was already a substantial cushion available for FY 1987. The maintenance of a reserve target of 5 percent--SDR 55 million--would allow the rate of charge to be brought down to 6.35 percent in FY 1987. If the rate of charge for FY 1987 was 6.76 percent--the rate recommended for FY 1986--SDR 80 million would be added to the projection of net income for FY 1987, or about 145 percent of the reserve target. What need was there for another SDR 25 million or another 45 percent of reserves as a cushion? If the purpose was to provide a cushion because the Fund had no faith in its method of projection, then that method should be changed. But as long as the existing method was applied--and he believed that it was as good as any other method--it would be arbitrary in the extreme to choose a rate of charge of 7 percent, the only justification for which seemed to be a sharp preference for a whole number.

Once the rate of charge for the second half of FY 1986 was agreed, the rate of charge for FY 1987 could be determined, Mr. Sengupta continued. There was no reason why that should not be done, notwithstanding the argument that the review was usually held in late May or early June. On the basis of the current projections, the staff had suggested in Supplement 1 to EBS/86/81 that a rate of charge of 6.26 percent would generate the projected target amount of income of about SDR 55 million for FY 1987. According to the statement by the Treasurer, since the SDR interest rate had moved up from the earlier base of 6.20 percent to about

6.27 percent, the rate of charge for FY 1987 would have to be revised upward to 6.35 percent. He strongly recommended that that rate of 6.35 percent be adopted for FY 1987, for the simple reason that it was based on the best possible assumptions, those that were usually made by the Treasurer's Department every year. He was not unduly alarmed by the many uncertainties to which the staff had alluded in making the projections for FY 1987. Uncertainties about the SDR interest rate had always been with the Fund, and the staff's assessments had always been commendably prudent and cautious. He would be very much opposed to allowing the staff's calculations to be influenced by any ad hoc judgment.

On the discharge of overdue obligations, the present indicator method appeared to be the best available for purposes of projecting deferred charges, Mr. Sengupta said. On the basis of the net deferral coefficient of 2.31 percent, to which reference was made in footnote 2 on page 3 of Supplement 1 to EBS/86/81, deferred income from charges would have been SDR 62 million for FY 1987, whereas the projected amount of deferred income for FY 1987 had been SDR 67 million, exactly the same amount as in FY 1986. It was true that the net deferral coefficient varied from time to time, but in the absence of any better method, the use of the coefficient seemed to be the only way to project deferred charges. He recognized in that context that an argument had been made that overdue charges of SDR 22.5 million would have to be considered as deferred income after May 6, 1986, although that fact had not been taken into account in the FY 1987 projections. He continued to maintain that to have made an adjustment against the Fund's income for FY 1986 on that score would have involved changing the definition of income for the purposes of the Fund's accounts, and the staff could not do that only for Peru and not for other members. Yet another possible argument for adjusting the income projection for FY 1987, on grounds of the probability that those charges would not be paid by May 6, 1986, would call for a judgment of the probability of nonpayment that the Fund could not and should not make. In any event, because the net deferral coefficient of 2.31 percent seemed high compared with the coefficient of 2.04 percent mentioned in Table 2 of EBS/86/81, and much higher than the coefficient of 1.83 percent mentioned in Table 1 of the staff paper on the special review of the Fund's income position (EBS/86/32, 2/7/86), such contingencies were well taken care of. The deferral coefficient was no doubt sensitive to the timing of the discharge of overdue obligations but that did not mean that deferred income could be estimated on the basis of a presumption that charges due by members currently in arrears and that became deferred in future would in fact remain deferred for six months or more.

It could be argued further that the projection of deferred income of SDR 67 million for FY 1987 might well be an overstatement, Mr. Sengupta remarked, since the Fund was going to take decisions to approve a setoff in connection with a retroactive reduction of charges due by members in arrears to the Fund. However, the setoff would facilitate the faster settlement of overdue obligations and bring down the net deferral coefficient.

He had noted the fact that the cost of remuneration had been calculated on the basis of the remuneration coefficient of 97.49 percent, the maximum permissible at present under Rule I-10, Mr. Sengupta went on. It appeared that the provision for reviewing the remuneration coefficient when the rate of charge exceeded the SDR interest rate would remain theoretical in current circumstances. That provision had proved ineffective in reality, as shown by the experience of the second half of FY 1986, when the rate of charge had been higher than the SDR interest rate. The review of the remuneration coefficient as such was not an end in itself; the end was, as Rule I-10(4)(d) stated, to see that the coefficient was set so as to permit the rate of charge to be at the same level as the SDR interest rate while meeting the target amount of net income. The same end could be achieved by an agreement to cap the rate of charge, an idea suggested in the staff paper; but that cap should be the short-term SDR interest rate plus 0.5 percentage point, not the five-year SDR rate. If the rate of charge went above the SDR interest rate plus 0.5 percentage point, there would have to be an appropriate downward revision in the rate of remuneration, subject to the range of 80-100 percent mentioned in Article V, Section 9(a).

The staff proposal for burden sharing was hardly helpful to users of Fund resources and it was not equitable, Mr. Sengupta considered. If that proposal were accepted, burden sharing would take place only after the rate of charge exceeded what the staff had described as the SDR medium-term rate plus 0.5 percentage point and by way of a reduction in the rate of remuneration within the limits mentioned in Article V, Section 9(a). There would thus be two SDR interest rates--the medium-term rate used as reference for the rate of charge, and the short-term SDR interest rate used as a reference for the rate of remuneration. The former reference rate had tended to move upward faster when interest rates in general tended to rise; in other words, the differential between the short (three-month) SDR interest rate and the medium-term rate tended to be wider when interest rates were high or moving up, based on trends since 1981. Using the SDR medium-term rate as an upper limit for the rate of charge would put little pressure on the Fund to be prudent in its expenses. Use of the Fund's resources would also become costly, whereas the resources of an organization based on international cooperation should be made available to members in balance of payments difficulties quickly and with an element of concessionality. Mr. Zecchini's objection to the method proposed by the staff was timely and appropriate.

He supported Mrs. Ploix's approach to burden sharing because it reflected the spirit of the Fund's Articles, Mr. Sengupta commented. He also liked the staff's idea of working out a regular income position, with a normal rate of charge set to generate an agreed amount of net income in the absence of deferrals. The same argument was to be found in Mrs. Ploix's statement. If that procedure was followed, the rate of charge would be around 6.1 percent--0.34 percentage point lower than the suggested 6.35 percent for FY 1987. The 0.34 percentage point could be covered by way of retroactive surcharges on the rate of charge and retroactive discounts to the rate of remuneration, should deferred income be as high as projected. He endorsed Mrs. Ploix's view that the rates of surcharge and discount should be applied simultaneously, on a six-monthly retroactive basis. Mr. Massé's ideas in that connection were also interesting and should be examined.

During the previous meeting reference had been made by some Directors to an effective rate of remuneration of 72 percent, the figure mentioned by the staff, which had been calculated by taking into account the notional loss of income on unremunerated reserve positions, Mr. Sengupta observed. That method of calculation might not be correct because all members of the Fund, not only creditors, had unremunerated positions. To take account of that fact, an effective rate of charge would have to be calculated in respect of borrowing countries, which would be far above the rate of charge being paid at present by some borrowing countries. Besides, borrowing countries were also paying a service charge that had to be taken into account. Therefore, he suggested that those facts should be taken into account by the staff when it referred to the so-called effective rate of remuneration. It would also be interesting to see what happened to burden sharing when interest rates actually fell.

Having made those observations, Mr. Sengupta added that his understanding of the reason for having an unremunerated reserve position in the Fund was to maintain the cooperative nature of the institution. Therefore, the loss of income on such positions should not be taken into account in assessing the adequacy of remuneration.

As for setting off the Fund's payment to a member in connection with a retroactive reduction in the rate of charge against overdue charges or repurchases, Mr. Sengupta said that he favored the option contained in Attachment 4 because it was important to let members specify the obligations they wished to discharge, in accordance with the current practice. Somewhat longer than three business days should be provided for eliciting a response from members in arrears regarding the categories of obligations to be discharged, as Mr. Ismael had suggested.

On the staff paper on provisioning against loan losses, Mr. Sengupta recalled that his chair's position with respect to the preliminary consideration of the issue at the present meeting had been stated already at EBM/86/65 (4/18/86) and at EBM/86/68 and EBM/86/69 (4/23/86). He agreed entirely with Mr. Salehkhou's comments in that respect. He had nothing to say on the staff paper at the present meeting and reserved his position until the issues involved could be discussed in a more substantive way.

Mr. Fujino said that it had been the consistent position of his chair that any surplus income for FY 1986 resulting from the payment of overdue charges should be used to reduce retroactively the rate of charge for the second half of FY 1986, but not to less than 7 percent, the rate that was applied during the first half of FY 1986. He greatly welcomed the fact that the cooperative efforts of the management, the staff, and other parties concerned had made it possible to reduce the rate of charge to 7 percent, a rate that was well below the projected average SDR interest rate of 7.29 percent for the second half of FY 1986. A 7 percent rate of charge would bring in about SDR 25 million in excess of the target amount of net income for FY 1986, which in his view should be accumulated as reserves.

At the same time, Mr. Fujino said that he could endorse the main conclusions of the staff paper on the setoff. With respect to the order in which overdue obligations would be set off, he preferred the option in Attachment 4 because it was in line with the current practice of the Fund. However, he could go along with the option in Attachment 1 or indeed any of the other options presented by the staff.

Any attempt to make projections of the Fund's income for FY 1987 at the present stage would be fraught with a considerable degree of uncertainty, Mr. Fujino continued. One element of uncertainty was the recent relatively large and rapid fall in the SDR interest rate; another was the amount of deferred income for FY 1987. While the recent discharges of overdue obligations had been heartening, there had as yet been no basic improvement in that serious problem. Furthermore, provisioning in the context of the Fund--on which the Board was exchanging preliminary views--would entail additional operational costs. Similarly, if a further upward adjustment of the reserve target was agreed upon, either as an interim or as an alternative course of action, additional costs would be incurred. On top of those elements of uncertainty, an alternative mechanism for determining the rate of charge was being discussed at the present meeting.

In view of the considerations he had mentioned, Mr. Fujino said that it was reasonable to conclude that the Board should return to the question of the Fund's income position for FY 1987 around the beginning of June, when it would normally discuss the subject, and on the assumption that, if a decision was reached on a rate of charge of 7 percent for the second half of FY 1986, that rate would be considered a preliminary rate for FY 1987 until a final decision was taken.

A specific point that he had in mind in that connection, Mr. Fujino remarked, was the considerable risk that the present indicator method would underestimate the amount of deferred income for FY 1987. He believed that the adoption of a more cautious approach deserved serious consideration. One possibility might be to provide a certain safety margin by adding a certain percentage to the projection of deferred income derived from the indicator method, including an allowance based on an element of judgment, as suggested by Mr. Dallara.

With respect to the alternative mechanism for determining the rate of charge suggested on page 14 of EBS/86/81, to include the adjustment of the remuneration coefficient, Mr. Fujino said that he was prepared to consider the matter further, on certain conditions. First, any modification of the established mechanism for gradually raising the remuneration coefficient to the full extent permitted under Rule I-10 should be temporary and applied for one fiscal year only. Second, the figure suggested by the staff of 0.5 percentage point as the margin above the five-year

SDR interest rate to be used as a reference point for the rate of charge at which a reduction of the remuneration coefficient would be needed to meet the net income target must be regarded as a minimum margin. Third, while the remuneration coefficient could be lowered temporarily under certain circumstances, the lowest limit should be somewhere above 80 percent. Fourth, consideration had to be given to the fact that the ratio of remunerated reserve positions varied greatly from country to country, even among creditors.

Finally, he had only a few observations to make on provisioning in the context of the Fund, since the discussion on that topic was a preliminary one, Mr. Fujino said. First, purchases made by members from the Fund were not loans. The Fund sold the currencies of other members, or SDRs, to members in exchange for their own currencies. Even if a repurchase obligation became overdue, the Fund retained in its assets an amount of the currency of the member concerned equivalent to the amount of the repurchase obligation. The process of writing off an asset composed of a member's national currency that was implied in provisioning involved a difficult, complex, and legal problem that went beyond the simple question of sovereign risk or accounting procedures. He would welcome the comment of the Director of the Legal Department in that respect. Second, the primary purpose of provisioning in financial accounting was often to present an estimated realizable value, rather than a book value, of the financial assets of an entity. At the present stage, he was not sure how usefully that purpose could serve the Fund, which was an international and cooperative institution whose main source of resources came from its members' subscriptions. A third, more practical consideration concerned the rather adverse effects of provisioning on the incentives of members to discharge overdue obligations to the Fund.

He hoped that the considerations he had mentioned would be reflected in the Board's next discussion on provisioning, Mr. Fujino concluded. He did not deny that the rising volume of overdue obligations to the Fund was becoming a serious problem that would have to be faced. In searching for ways to resolve that problem, possible courses of action would include raising the reserve target. The issue of provisioning could be discussed in that context.

Mr. Mawakani recalled that, during the midyear review of the Fund's income position in December (EBM/85/180, 12/13/85), his chair had expressed the view that the problem of overdue financial obligations was a temporary one that would be corrected as the financial position of the countries improved, and had considered unnecessary an increase in the rate of charge based on the incidence of overdue obligations. The staff report and the supplement indicated that the December projections had been too pessimistic, and that the income position of the Fund had improved to such an extent that the staff believed that the rate of charge for the second half of FY 1986 could be reduced retroactively. Indeed, a substantial surplus would have arisen even if the rate of charge had not been changed at that time but had been left at 7 percent. In view of the difficult financial situation being experienced by many users of Fund resources and the general decline in interest rates in financial markets, he strongly supported a reduction of the rate of charge, to take effect as of November 1, 1985.

Concerning the issue of a setoff of the amount due to a member as a result of the reduction of the charges against certain overdue financial obligations of that member to the Fund, Mr. Mawakani said that he supported the proposal in Attachment 4 of SM/86/90. The time for members to respond should be extended from three business days to seven business days, however, because of the difficulty of communication with several member countries, especially those in his constituency.

With respect to the rate of charge for FY 1987, Mr. Mawakani said that he could go along with the rate of 6.35 percent proposed by the staff, although he would prefer a lower rate.

On the subject of sharing the costs of overdue charges, Mr. Mawakani considered that it was neither equitable nor fair to impose the burden of a surcharge on the users of Fund resources only. Such a decision would run counter to the cooperative spirit that was supposed to prevail among Fund members. Therefore, he favored a burden-sharing mechanism that spread the surcharge among both users and nonusers of Fund resources. In that context, he agreed with Mrs. Ploix and he could support her proposal.

On the matter of provisioning against loan losses, Mr. Mawakani stated that he preferred to reserve his position at the present time.

Mr. Jiang said that he fully shared the complaints voiced by some Governors during the recent meetings of the Group of Twenty-Four and Interim Committee that charges on the use of the Fund's general resources were too high. In December 1985, successive decisions had been taken to increase the Fund's rate of charge on the use of the Fund's general resources from 7.0 percent to 7.87 percent, and to impose a special charge on arrears outstanding to the Fund as from February 1, 1986. And those decisions had been taken, moreover, at a time when interest rates elsewhere had been recording a continuing decline. It seemed to him that the Fund was gradually giving up its intergovernmental, cooperative, and nonprofitmaking purposes.

Fortunately, the Fund's income position had been shown to have improved somewhat during the special review in February, when the Executive Board had expressed its clear intention to use income in excess of the target for FY 1986 to reduce retroactively the rate of charge for the second half of that financial year, Mr. Jiang continued. According to the latest projections in Supplement 1 of EBS/86/81, and the most recent information provided by the Treasurer, the position had improved further; the target amount of net income for FY 1986 could be achieved with a rate of charge of 6.72 percent for the second half of that financial year. In order to be fair to debtor members, who had carried the entire burden of the decision to increase the rate of charge, the Fund would have to keep its word and lower the rate of charge on the use of its general resources to 6.72 percent for the second half of FY 1986. That rate was still higher than the prevailing SDR interest rate, although somewhat lower than the average SDR interest rate for the second half of FY 1986.

As for the setoff, he had no difficulty in going along with the option in Attachment 4, with the response period extended to seven working days, Mr. Jiang added.

The projections for FY 1987 showed an even further improvement in the Fund's income position, although some uncertainties were attached to those projections, and the rate of charge needed to generate the targeted amount of income for FY 1986 was 6.35 percent, Mr. Jiang observed. Since most Directors were hoping that the Fund's rate of charge on the use of its general resources would retain its concessional nature and also stay in line with the recent trend of market interest rates, but without the many fluctuations experienced during the past few months, it was necessary to track down the root cause of the recent fluctuations that gave rise to those uncertainties. The staff itself had pinpointed the amount of deferred income as the cause, thereby indicating, as some other Directors had rightly pointed out, that the Fund's current problems with respect to its income position were exceptional and temporary in nature. Therefore, there was every reason to avoid the adverse impact of deferred income on the rate of charge and to distribute the cost of sharing the burden of overdue obligations among all members.

Thus, among the proposals put forward by other Directors and the staff, Mr. Jiang said that he preferred a solution that would set the rate of charge for FY 1987, on a preliminary basis, at 5.92 percent or at any figure calculated by the staff as the normal rate of charge, and to set a surcharge on the rate of charge and simultaneously apply a discount to the remuneration coefficient. In that way, the burden would be shared evenly between the debtor and creditor members according to the actual outturn of the net income position; the surcharge and discount should be applied on a half-yearly basis, with retroactive effect. The solution he favored was more or less in line with Mrs. Ploix's proposal, and he asked the staff to draw up a practical mechanism for incorporating the various modifications to that proposal that he and other Directors had put forward during the discussions.

As he had not so far received any instructions from his authorities with respect to the staff paper on provisioning, he would reserve his comments until a later date.

Mr. Foot remarked that he had not understood the statement by the Chairman in his summing up of the Board's discussion of the special review of the Fund's income position and of the remuneration coefficient in February, that "there is a general, I would say unanimous, willingness to lower the rate of charge for the last quarter or the last half of FY 1986 on the basis of excess net income at the end of FY 1986 and to deem part of that excess as income for FY 1987 so as to cushion possible income shortfalls" represented a commitment to return all the excess income to the borrowers. As he had already suggested at the present meeting, consideration should be given to placing the excess to reserves and subsequently reconsidering the Fund's overall financial position.

The Chairman observed that the willingness of the Executive Board in February to consider deeming part of the excess income as income for FY 1987 did not mean that agreement had been reached on a de facto increase in the reserve target.

Mr. Schneider said that his remarks would be generally preliminary since it was not the intention of the Executive Board to find solutions to all the issues being discussed. Referring first to the question of setting the rate of charge, the Fund's current practices and policies would call for a reduction in the rate of charge to 6.72 percent for the second half of FY 1986 and 6.35 percent for FY 1987, on the basis of the Treasurer's updated figures. However, he doubted whether it was realistic to take decisions along those lines in view of the uncertainties surrounding the future of the Fund's income position, as well as the far-reaching implications of the proposals for burden sharing and possible provisioning. It seemed more reasonable to agree to pursue a cautious middle course of action with respect to both the retroactive reduction of the rate of charge for the second half of FY 1986 and the provisional rate to be applied for the subsequent fiscal year until such time as those currently impending issues had been resolved. Setting the rate of charge for both periods at 7 percent, for example, would have the double advantage of substantially scaling down the previously decided 7.87 percent rate to the level that had prevailed over the past two years, while at the same time smoothing out the possible upward readjustment of the rate that might become necessary in a few months' time.

Two possible developments justified such a cautious approach, Mr. Schneider added. First, it was clear that the Fund's income position, and therefore the rate of charge required to meet the income target, would continue to depend closely on the future evolution of overdue charges to the Fund that could not be predicted with any certainty. Recent experience with income projections had in fact shown that large fluctuations in overdue payments from one year to another could lead to substantial errors in prediction. Therefore, although he welcomed the discharge of overdue payments by a number of members in recent months, as well as the opportunity that was offered of retroactively reducing the rate of charge, it might nonetheless be premature at the present early stage to reflect that favorable development fully in the income projections for FY 1987 and accordingly make a major reduction in the rate of charge to be applied in coming months. Rather, it seemed advisable to begin the new financial year with a somewhat higher rate of charge until it could be confirmed that the most recent developments justified the optimistic expectations that had been created. Within a few months, the Fund would also be in a better position to observe the behavior of the SDR interest rate, following its recent decline, which was another important factor affecting the Fund's projected income.

A second reason for adopting a cautious approach to the rate of charge concerned the forthcoming deliberations on the issue of loan-loss provisioning, Mr. Schneider stated. His authorities, during their preliminary consideration of that issue, had formed the view that the need to protect the Fund's credibility and solvency was an important argument for taking full account of all financial aspects of the problem of overdue obligations. His authorities were fully aware that the establishment of loan-loss provisions involved a number of delicate and complex issues related to the cooperative nature of the Fund and to the danger that such provisioning might send wrong signals to members with overdue obligations. Nonetheless, they felt that that problem had reached such a size that the Fund was obliged to protect itself against the probability of loan losses on the part of a small group of members that had been overdue for a long time with no indication of movement toward normalizing their relations with the Fund. In the view of his authorities, some form of general provisioning would be desirable and would signal to both the Fund's members and the outside world that the institution recognized the problem and was taking the appropriate steps to avert any negative consequences for its financial structure.

A decision to establish provisions against loan losses would clearly benefit the membership as a whole, Mr. Schneider added. His authorities therefore supported further examination of the issue in conjunction with the question of burden sharing. The staff had provided an interesting proposal on the latter issue on pages 14 and 15 of EBS/86/81; he broadly agreed with the basic thrust of that proposal, namely, that any formula for determining the appropriate sharing of the financial burden of overdue obligations among members should preferably take two parameters into account. The first was the relevant market interest rate for medium-term borrowing by debtor countries; and the second, the fact that the rate of remuneration to creditor countries already contained a cooperative element. However, he was not sure whether further consideration of proposals along those lines should necessarily also involve modifying the present practice for establishing the Fund's interest rates in order to begin setting basic rates of charge and remuneration that would later be adjusted retroactively, as suggested by the staff. Another point that could be studied further in coming weeks had to do with the best way of sharing the burden of loan-loss provisions if those were in fact established. It seemed to him that that burden should not simply be passed into the interest rates charged by the Fund. An alternative might be some sort of levy to be paid by all members in proportion to their quotas in the Fund, since provisioning would benefit the whole membership, including those members having neither a creditor nor a debtor position.

In conclusion, and pending further consideration of those important issues, Mr. Schneider said that it seemed preferable to retain some flexibility until the Board could complete its deliberations on the question of loan-loss provisioning. Based on the outcome, the Board could then take up the issue of burden sharing, including the general review of the remuneration coefficient and the method for determining it, which it had been proposed should be concluded before November 1986.

Finally, on the question of the setoff, Mr. Schneider stated that his first preference was the scheme proposed in Attachment 1 to SM/86/90 because it was analogous with the rules currently accepted in most legal systems.

Mr. Arias recalled that, at the time of the Board's discussion on the special review of the Fund's income position and remuneration coefficient, his chair had clearly stated its objection to an increase in the rate of charge. An increase in the burden of adjustment on member countries with programs supported by use of Fund resources was unacceptable, and such an increase was also inconsistent with the downward trend in international interest rates. On the occasion of the special review, sound reasons had existed to reduce the rate of charge to 7.29 percent retroactive to November 1, 1985. Current projections underlined the substantial improvement in the Fund's income position, and in line with his previous arguments, he supported a rate of charge of 6.72 percent for the second half of FY 1986.

With respect to the setoff, Mr. Arias said that his preference was to let the member specify the obligation it intended to discharge. However, if no instruction was received from the member country, then the obligation should be discharged in accordance with the priorities described on page 6 of SM/86/90. For that reason, he could support the option in Attachment 4 but with the modification suggested by Mr. Ismael to expand the notification period from three to seven days.

In reviewing the remuneration coefficient, his chair strongly believed that the objective should be stability and consistency in the relationship between the SDR interest rate and the rate of charge, Mr. Arias continued. For that reason, he supported the staff recommendation that, for purposes of comparing the rate of charge and the SDR interest rate, the latter rate could be an average of the weekly rates for a quarter, thereby reducing the need for frequent reviews of the remuneration coefficient. In any event, a comprehensive review of the rate of remuneration should be conducted before November 1, 1986.

The method of sharing the costs of prolonged overdue charges through a retroactive rate of charge and a surcharge when necessary seemed reasonable, Mr. Arias considered. The Board should pursue the matter in an equitable manner and with its characteristic responsibility. Accordingly, all members--creditors and debtors--should share the burden and not only those countries that were debtors in good standing. After all, the Fund was a cooperative institution. As Mrs. Ploix had suggested, an indicative rate of charge could be set for FY 1987, of 5.92 percent, with the rate of charge and the rate of remuneration sharing the burden of deferred income equally. Such an approach would not have an adverse influence on creditor positions and would be an appropriate way of sharing the costs to the Fund.

While the issue of provisioning was important, it was also complex, and required appropriate reflection on the part of member countries, Mr. Arias considered. Consequently, he was not in a position to comment on the issue at the present time, but would prefer to do so on May 19, when the Executive Board was scheduled to take up the matter.

Mr. Weitz observed that the Fund's income position and related issues had been brought to the Board's attention on a number of occasions during FY 1986. The increase in the rate of charge during that time had imposed a heavy burden on members using the Fund's resources for purposes of adjustment. It was essential to retain an appropriate element of concessionality in the rate of charge on the use of the Fund's ordinary resources. His authorities were deeply concerned because the Fund's rate of charge was higher than the London Interbank Offered Rate (LIBOR) and the cost of the Fund's borrowed resources, an unreasonable situation that should be urgently reversed.

The staff had provided a useful supplement to its paper, showing that the Fund's income for FY 1986 was projected at SDR 159 million, or SDR 107 million in excess of the target of SDR 52 million, Mr. Weitz noted. He had also taken note of the position as updated by the Treasurer. There was no doubt that the final outcome for FY 1986 permitted a substantial retroactive reduction in the current rate of charge on the use of the Fund's ordinary resources. In light of the current projections, indicating a significant improvement in the Fund's income position, his authorities considered that it was important to reduce the rate of charge to 6.72 percent for the second half of FY 1986. Such a reduction in the rate of charge would secure the Fund's income target for FY 1986, retroactive to November 1, 1985. Such a decision would be in line with the approach that had led to the increase in the rate of charge.

On burden sharing, his chair felt strongly that it was inappropriate for the users of Fund resources to bear the entire cost of overdue charges, Mr. Weitz continued. An adequate mechanism for sharing the costs of prolonged overdue charges would be to impose a retroactive rate of charge, incorporating a surcharge whenever necessary, combined with a modest reduction in the remuneration coefficient. The proposal on pages 14 and 15 of EBS/86/81, with the changes suggested by Mrs. Ploix, was acceptable to his chair. Therefore, an agreement on burden sharing along the lines suggested by Mrs. Ploix seemed to be within reach.

Regarding the projections for FY 1987, and based on the figures in Supplement 1 to EBS/86/81, he supported Mrs. Ploix's proposal for FY 1987 for a rate of charge of 5.92 percent, a surcharge on the rate of charge of 0.17 percent, and a reduction in the rate of remuneration of 0.17 percent, Mr. Weitz stated. Of course, the calculations were of necessity provisional until the Board concluded its review of the Fund's financial position following the end of the financial year.

In relation to the review of the remuneration coefficient, Mr. Weitz said that the proposal by the staff on page 17 of EBS/86/81 implied a suitably flexible interpretation of Rule I-10. A comprehensive review of the rate of remuneration should be conducted before November 1, 1986.

He was not ready to take a position on loan-loss provisioning at the present meeting because his authorities needed more time to form an opinion on the issue, Mr. Weitz remarked. Therefore, they reserved their position until that important subject was discussed in the Executive Board on May 19.

Finally, on the setoff in connection with a retroactive reduction of charges due by members in arrears to the Fund, Mr. Weitz said that he favored the possibility described in Attachment 4 to SM/86/90. The member should be authorized to specify the obligation it wished to discharge and, in the absence of such a specification, the setoff would apply to the earliest maturing obligation. Further, he supported the suggestion to extend from three to seven business days the period for response by the member.

Mr. Romuâldez recalled that when the Board had most recently discussed the rate of charge for the second half of FY 1986, on the occasion of its special review of the Fund's income position and the remuneration coefficient in February, there had been a general "willingness to lower the rate of charge for the last quarter or the last half of FY 1986 on the basis of excess net income evident at the end of FY 1986, and to deem part of that excess income as income for FY 1987 so as to cushion possible income shortfalls in that year." He reaffirmed his broad support for that approach, summarized in the Chairman's summing up, especially so since the Fund's income position had turned out to be even more favorable than had been expected as recently as two months previously. At the same time, however, he recognized that some Directors were not able to support a reduction in the rate of charge below 7 percent. That position had its origins in the view that the increase in the income target adopted in June 1985, from 3 percent to 5 percent of reserves, could be considered sufficient only on the understanding that, if income turned out to be in excess of the target--in light of the 7 percent rate of charge prevailing at the time--excess income would be allocated to reserves. He had shared that position and accordingly he could support a decision at the present meeting to set the rate of charge for the second half of FY 1986 at 7 percent, on the understanding that, at the appropriate time, the income in excess of the target, amounting to about SDR 25 million, would be added to reserves. On that basis, the increase in the Fund's reserves as a result of operations in FY 1986 would be about 7.4 percent, which was certainly not excessive.

It followed that, at the present stage, he did not wish part of the income in excess of target for FY 1986 to be deemed as income for FY 1987, Mr. Romuâldez continued. In any event, based on present indications, it was unlikely that the rate of charge for FY 1987 would need to be in excess of 7 percent, even if provisioning--or alternatively an increase in the reserve target--was adopted. According to his calculations, a 7 percent rate of charge for FY 1987, under present policies and with the current projections, would provide SDR 144 million of income above that resulting from the current income target of 5 percent of reserves. That amount should be sufficient to cover the possibility of provisioning or an increase in reserves in FY 1987, probably even in the absence of burden sharing.

In favoring a reduction in the rate of charge for the second half of FY 1986, rather than for the final quarter only, Mr. Romuâldez went on, and insofar as he agreed that refunds should not be made to members in arrears, he supported the adoption of setoff procedures along the lines outlined in SM/86/90. Of the four separate options presented, he preferred the option in Attachment 4, which corresponded with existing Fund policy for attributing payments received from members. He would be interested to have the staff's view on the proposal to amend the length of time within which members must indicate their choice with respect to the attribution of the offsets. His preference for the option in Attachment 4 was not an indication that the Fund's present policy on the attribution of payments was necessarily the best of the various available alternatives but rather that it would be anomalous to adopt a procedure for setoffs that differed from the Fund's general policy on attributing payments.

On burden sharing, he saw merit in the staff proposal to establish separate procedures in the form of a special surcharge on the rate of charge and perhaps a discount on remuneration, in order to safeguard the Fund's income position as a result of the need to defer income and, if provisioning was adopted, provide for doubtful repurchases or an increase in reserves, Mr. Romuâldez stated. The financial and accounting arrangements that the Fund adopted to deal with the present exceptional nature of the problem of arrears should reflect the nature of the problem; they should not become a normal part of the Fund's procedures. Another useful feature of the approach suggested by the staff was that it made the burden of arrears on other members even more transparent, thereby possibly helping to increase the sense of moral obligation on the part of members overdue in settling their obligations to the Fund to become current. In addition, he was attracted to the proposal to apply such surcharges and discounts retroactively. Clearly, there was no entirely satisfactory way in which to forecast deferred income; attempts to do so only made the rate of charge and possibly the rate of remuneration prone to unnecessary and unhelpful volatility.

As to how the burden should be shared under the mechanism suggested by the staff, Mr. Romuâldez said that he found himself in two minds, probably as a reflection of the differences among the countries in his constituency. On the one hand, creditors continued to bear a significant burden insofar as part of members' reserve tranche positions remained unremunerated, albeit a smaller part than in earlier years. In addition, the emergence of arrears had the potential of clouding the quality of members' reserve positions in the Fund, and more generally might make it more difficult for some members to support an increase in quotas to the extent that they otherwise could. In those circumstances, he did not want to push for a broadening of burden sharing to include creditors in the face of share opposition to be part of Fund creditors. Yet he sympathized with those who held the view that the burden of arrears should be borne by all members, on the basis that the Fund was a cooperative institution. Those debtors who met their obligations on time, sometimes at great sacrifice, were no more responsible for the arrears problem than were the creditors. Possibly the answer to that dilemma was to take the present underlying distribution of the cost of the Fund's operations--namely, excluding the burden arising from arrears--as given. Consideration could then be confined to methods for sharing the exceptional burden of arrears. That approach would be consistent with the view that arrears were not a normal feature in the structure of the Fund, and it might avoid opening up a whole range of much more fundamental and difficult issues, such as those raised by Mr. Dallara, Mr. Goos, and Mr. Massé. On that basis, he could go along broadly with a burden sharing proposal along the lines suggested by Mrs. Ploix.

On provisioning, Mr. Romuáldez said that he conceded that arguments could be found for provisioning in the context of the Fund. Some of those arguments might include the need to take reasonably specific steps to safeguard the capital of the Fund--in addition to the general step taken to increase modestly the rate of growth in Fund reserves--in order to parallel the adoption of the method of accounting for overdue charges as deferred income. After all, both repurchases and charges were overdue, and thus both posed a risk. Provisioning would be a more transparent method of accounting for the risks implied by overdue repurchases, although much as he was usually in favor of transparency, it could in the present context be a double-edged sword. Provisioning, at least if it were tied to repurchases overdue--even if in the aggregate, which would be as specific as one could be--would be self-reversing once overdue repurchases were made. Thus, there would be little risk of provisioning becoming a permanent feature of the structure of the Fund.

Having made those points, however, he was still not able to conclude that provisioning should be adopted at the present stage, Mr. Romuáldez stated. Provisioning would represent a watershed in the Fund's history for which there was as yet no justification. He had two reasons for taking that position. First, to exclude from reported income revenues in respect of which there was some uncertainty as to the timing of their collection or even the risk of noncollection was one thing: to make provision for the probable loss of a capital asset arising from the failure of a member to make a repurchase was quite another. He was concerned that taking the latter step would have serious implications for the credibility of the Fund, not least for its catalytic role. Second, while in no way wishing to underestimate the growing seriousness of the arrears problem, it seemed to him that not all the news on arrears in the past few months had been bad. Zambia and Somalia were again current with the Fund, and significant payments had been received recently from Peru. Certainly, progress in other cases had not been so evident recently, but he wondered whether, given several favorable recent developments, it was the right time to take such an important step as provisioning. In that connection, he noted that the work program included the subject of options available to the Fund following declarations of ineligibility. Subject to the views of other Directors, the Board might be better placed to consider the need for the Fund to adopt provisioning for probable loan losses after it had considered that matter.

In the meantime, Mr. Romuáldez said that he could support a further increase in the rate of accumulation in the Fund's reserves. While acknowledging that there were important presentational differences between provisioning and reserve accumulation, it seemed to him that a more rapid reserve accumulation would go some way toward further buttressing the Fund's financial position. Indeed, it had to be concluded from the continued rapid growth in arrears since the income target was adjusted in June 1985 that the Fund's general reserves were even less adequate at present than they had been at that time. The issue was sufficiently important for him to indicate that he was prepared to consider ways of covering the cost of a more rapid buildup of reserves under burden-sharing arrangements along similar lines to those that his chair had already indicated in connection with the agreement on the method of accounting for overdue charges as deferred income.

Mr. Parmena noted that, as agreed in principle by the Board when it had reviewed the Fund's income position both in December 1985 and later in February 1986, excess income for FY 1986 was to be utilized to reduce the rate of charge retroactively to November 1, 1985. On the basis of the available data, the rate of charge should be reduced from its present high level of 7.87 percent to 6.72 percent. The suggestion in the Chairman's statement that the rate of charge be reduced retroactively to 7 percent, and that the balance of the excess income for FY 1986 be deemed as income for FY 1987, was not equitable because there was no contribution from creditors through the rate of remuneration. As the excess income had been realized solely due to the added burden borne by those borrowers who had been paying a high rate of charge during half of FY 1986, his chair considered it a matter of equity that the entire excess income should be utilized to lower the rate of charge to 6.72 percent, effective November 1, 1985. As pointed out by Mr. Salehkhou, even that rate was high in comparison with prevailing interest rates, both market rates and the SDR interest rate.

As for FY 1987, Mr. Parmena noted with satisfaction that the staff had given some thought to the concern expressed in the Board about sharing the burden of overdue obligations between debtor and creditor countries. Indeed, during the second half of FY 1986 it had become obvious that the burden of meeting the Fund's income target was falling disproportionately on the borrowing members who were struggling to remain current in their financial transactions with the Fund. Creditor members had made no contribution during that period, although they had seen the need for--and joined with others in asking the staff to look into ways of--burden sharing. There was some merit in the principle advanced by the staff for establishing a normal rate of charge at a level that would achieve the target income in the absence of deferrals. He would add that a normal remuneration coefficient should also be established. Deviations from the income target caused primarily by deferred income would be met by a surcharge on the rate of charge, with an agreed temporary upper limit to the rate of charge plus the surcharge, and a discount on the remuneration coefficient, down to a floor limit of 80 percent of the SDR interest rate. In that way, the burden of meeting potential income shortfalls would be borne by symmetrical transfers between debtor and creditor countries, and refunds should also follow symmetrically when excess income was realized. In that connection, he associated himself with the view expressed by some Directors that the staff should explore a formula under which burden sharing would cover the entire membership of the Fund.

However, he did not agree with the staff's suggestion that a surcharge would go into effect first, and only if it was inadequate to meet a shortfall would there be a discount on the remuneration coefficient, Mr. Parmena went on. He saw no logic in the argument for the staff proposal. If the argument was that the effective rate of remuneration had been lower than the nominal rate, raising the effective rate of charge would only discourage potential borrowers, thereby leaving the Fund's resources unused and leading to a further reduction in the effective rate of remuneration. On that point, he fully supported Mrs. Ploix's position on the need to ensure symmetry and hence the need to invoke surcharges and discounts at the same level at the same time.

The principle of burden sharing should be applied immediately for FY 1987, Mr. Parmena considered. Therefore, a decision in principle should be taken at the present meeting. On the basis of the most recent staff projections, a normal rate of charge for FY 1987 would be about 5.92 percent. Both the rates of surcharge and of the reduction in remuneration should be set retroactively at the time of the midyear review of the Fund's income position along the lines proposed in Mrs. Ploix's statement.

As for the remuneration coefficient, since a strict interpretation of Rule I-10 would require frequent reviews by the Board, he agreed with the staff's suggestion that some modifications in the Rule should be sought, Mr. Parmena commented. The SDR interest rate to be used for purposes of comparison with the rate of charge should be the average of the weekly SDR interest rates for the period in question. In addition, he supported the staff's proposal that the temporary discount to the remuneration coefficient in the framework of burden sharing should be considered by the Board in the major review of the remuneration coefficient in FY 1987, which was stipulated in Rule I-10 and which the staff had proposed should be concluded before November 1, 1986.

Members having overdue obligations to the Fund should not receive cash payments when deferred income was paid and a setoff to charges was refunded, Mr. Parmena noted. The reimbursement should take the form of setting off part or all of those obligations. In that connection, he supported the option in Attachment 4 under which the member would be asked to specify the order of priority of the obligations to be offset. However, three business days was too short a period for most member countries to respond, given communications problems and bottlenecks. Like Mr. Ismael, he suggested that Attachment 4 be amended to provide for one week's notice. Should the member fail to specify its preference, he could accept Mrs. Ploix's proposal that the setoff should first apply to those obligations carrying the highest rate of charge so as to minimize the cost of the member's indebtedness to the Fund.

Finally, with respect to the staff paper on provisioning against loan losses in the context of the Fund, his chair was not ready to discuss the matter as no guidance had been received from the constituency. However, his chair should be in a position to do so on the date scheduled for Board discussion of the issue.

Mr. Fugmann said that he agreed that the Board should apply the present rules and practices as closely as possible in setting the rate of charge at the present meeting. Nevertheless, if any improvement in those rules and practices was possible, an effort should be made to improve them in the near future. According to Rule I-6(4)(a), the rate of charge was to be determined at the beginning of each financial year. Should the Fund's financial position diverge from the projections, the rate of charge could be adjusted subsequently, as had been done in FY 1986. Against that background, he had a preference for the maximum possible reduction of the rate of charge for the second half of FY 1986, to 6.72 percent, as well as for FY 1987, to 6.35 percent. He could also go along with a maximum reduction of the rate of charge for FY 1986, together with a continuation of the resulting rate into FY 1987. The fact that accounting procedures appeared to have resulted in an overestimate of the outcome for FY 1987 might provide an opportunity to review the rate. Should a smaller reduction in the rate of charge be a prerequisite for obtaining a consensus, he would not withhold his support. But in that case, the resulting excess income should be transferred to FY 1987 in order to keep the rate of charge at a stable level. At any rate, it seemed appropriate, as proposed, to set only a preliminary rate of charge for FY 1987 pending the outcome of the Board's discussion, toward the end of May, on provisioning against loan losses and burden sharing in general.

With respect to the setoff in connection with a retroactive reduction of charges due by members in arrears to the Fund, Mr. Fugmann said that he preferred the first option presented in the staff paper. The order of the setoff should be determined by analogy with rules commonly accepted in most legal systems. That option would have the benefit, among other things, of reducing outstanding charges under Article V, Section 8(a) and (b) in the proper order of priority; those charges were of the type that could become deferred and thereby affect the Fund's income. He could also go along with the option in Attachment 3, specifically, to start by attributing the setoff to the obligations carrying the lowest rate of charge (or none at all). In his view, the other options treated members that were in arrears to the Fund too favorably. However, he did not want to stand in the way of a solution, and he could go along therefore with some of those options as a last resort, should that be necessary to obtain a consensus.

To change the sharing by Fund members of the burden of its income shortfall implied a difficult balancing exercise, Mr. Fugmann stated, particularly as the main reason for the shortfall--arrears to the Fund--was caused by one part of the membership. A higher rate of charge, even though it had a concessional element, could undermine the incentive for countries to seek Fund support for adjustment programs; yet low rates of remuneration could reduce member countries' interest in supplying resources to the Fund. He could not venture a more precise judgment of the proposals by the staff or Mrs. Ploix regarding burden sharing in the Fund because his authorities had not had time to evaluate the implications in sufficient depth; they would welcome further elaboration of the various modalities by the staff.

His chair had been opposed to retroactivity in setting the rate of charge, Mr. Fugmann recalled, but in light of experience, he had acquired a certain understanding from a general point of view of the considerations arguing for a retroactive system of determining the rate of charge. Probably, such a system would imply increased stability in the rate of charge and reduce the need for ad hoc decisions. With respect to uncoupling the rate of charge from the SDR rate--as implied in Mrs. Ploix's proposal--he was uncertain about the implications, which should be studied further.

Referring to the issue of provisioning against loan losses in the context of the Fund, Mr. Fugmann observed that the Nordic countries had tried as far as possible to regard the lack of timely discharge of financial obligations to the Fund as a temporary aberration. Thus, those countries had preferred to underline the need to eliminate the arrears to the Fund rather than, for instance, to adopt accounting measures that implied some kind of recognition of the long-term nature of the problem. Given the increase in arrears to the Fund, both in terms of amount and the time periods involved, his chair had over time had to accept the introduction of measures designed to protect the Fund's financial position.

Provisioning against loan losses would be one further step in that direction, Mr. Fugmann said. In addition, if that major step were taken, it would be in recognition of the fact that there was a not negligible probability of incurring loss. In general, it could be considered that the unique character of the Fund as a financial institution was an argument against the introduction of provisions against loan loss. Certain considerations had been brought forward, however, that made a case for some form of provisioning against loan loss in the context of the Fund. Generally speaking, a clearer picture of the Fund's actual financial position would emerge. The question that he would like to ponder further was whether such a clearer picture was really necessary at the present time. One advantage of provisioning, however, would be that losses would eventually be distributed more evenly over time, leading in the long term to increased stability in the rate of charge and in the rate of remuneration.

To make use of general allowances, for instance, by writing off a certain proportion of overdue obligations, was likely to present difficulties, Mr. Fugmann added. Use of the Fund's resources covered a broad range, from small amounts to very large ones, and purchases of the largest amount--and by the largest countries--played a dominant role. The law of large numbers was not immediately applicable. Neither had the Fund any experience with previous loan losses to indicate the size of the general allowances.

Classifying claims on individual member countries as bad debts would imply marked effects on the general creditworthiness of those countries, Mr. Fugmann went on. While such effects could provide a strong incentive for the particular country to avoid falling seriously into arrears, it was doubtful whether a measure with such a forceful influence would be applied in practice, especially as decisions would be made to a certain extent on the basis of judgments in each separate case. Perhaps a purely automatic rule, providing for instance for obligations overdue for more than three years to be classified as bad debts, and corresponding allowance made, would be the best approach.

One alternative to loan-loss provisioning could be to raise the income target, although the two measures were not exact substitutes, Mr. Fugmann stated. Yet increased reserves could have approximately the same effect as general allowances with respect to the Fund's actual financial position, and the outside world's judgment of that position.

His remarks on provisioning against loan loss should be seen in the light of the preliminary character of the present discussion on the subject, Mr. Fugmann concluded. All in all, he was skeptical at present about the practical applicability of the method. However, he did not exclude a study of some form of provisioning, should the Fund experience further major problems in respect of overdue obligations in the future.

Mr. Finaish said that he supported a retroactive reduction in the rate of charge to 6.72 percent as of November 1, 1985. As to the setoff procedure, he could support the option in Attachment 4 to SM/86/90. With respect to the rate of charge for FY 1987, it would not be useful to prejudge at the present stage the rate to be set for the coming fiscal year; the Board would have a chance to reach a decision in that respect within a few weeks.

As to the question of burden sharing, Mr. Finaish said that he welcomed the emerging consensus that some form of burden sharing was necessary. The idea of separating the normal rate of charge from the increment associated with overdue obligations was useful. The exact form of burden sharing would need to be worked out in detail. His preliminary view of the surcharge and discount mechanism proposed by the staff was that, although it had some positive aspects, it seemed to place a disproportionate burden on charges. Mrs. Ploix's proposal attempted to deal with that problem, and he would be interested in its additional analysis by the staff.

On provisioning, Mr. Finaish said that he was not in a position to make any comments at the present time, for reasons similar to those advanced by Mr. Salehkhou and Mr. Sengupta.

Mr. Polak said that, in welcoming the proposal made by Mrs. Ploix on burden sharing, he had not commented on the staff's proposal, which he welcomed at least conditionally. However, the proposal by Mrs. Ploix was greatly to be preferred because it was simultaneous and symmetrical. The substantive aspect of the staff proposal that he did not like was that it had the effect of placing the first and largest part of the burden on the debtor. The technical aspect that he failed to understand was why the five-year SDR interest rate had suddenly been invoked as a consideration on the grounds that use of the Fund's resources was usually medium term. If that were a relevant consideration, it should be applied at all times in setting the Fund interest rate, and not invoked suddenly when the question of arrears had to be dealt with. If the Fund's basic approach was to cover its costs, which were themselves based on a short-term interest rate--namely, the SDR interest rate multiplied by the relevant coefficient of remuneration--he saw no reason to move away from that approach in situations of arrears to the Fund. Indeed, Chart 1 in EBS/86/81 indicated that there were strong reasons for not moving in that direction. While there was some general parallelism between the five-year and the three-month SDR interest rates, the difference between the two rates could be very large and fluctuating. Over the past year, the SDR interest rate had hovered around 7.75 percent or 7.50 percent until it had declined very recently; during that period, the spread between the three-month rate and the five-year rate had moved from 1.5 percent or close to 2 percent to as little as 0.25 percent recently. It would be most unfortunate if fluctuations in the term structure of interest rates were to determine what proportion of arrears would be borne by the debtor and what proportion by the creditor. Therefore, no arrangement for burden sharing should be based on the five-year interest rate.

Mr. Dallara said that he had noted with interest the comments and views of a number of Directors on the subject of provisioning. In particular, he had noted that Mr. Massé and Mr. Romuáldez were not convinced that there was a need for provisioning at the present time. It would be helpful to know whether any particular criteria were readily available for making such a judgment, either implicit or explicit, so as to assist in the preparations for the Board's further discussions. One of the difficulties with which his authorities were grappling was not just the question whether provisioning was needed at the present time but what the proper criteria were for reaching that judgment.

More generally, Mr. Dallara asked whether the Treasurer could explain the references in the staff paper on provisioning to the proposal of the staff to establish a more comprehensive and structured approach to the process of evaluating whether or not a material loss was probable. He had taken the references to that proposal, which had been endorsed by the External Audit Committee, and the response of the staff in EBS/86/82 as an implicit request for further guidance from the Board on the possible content of a more comprehensive and structured approach. If his understanding was correct, it seemed incumbent on the Board to respond to that request and to provide the necessary guidance at some stage in the near future. Whether or not Directors agreed or disagreed on the need for provisioning at the present time, it seemed to him to be imperative to reach an understanding on the need to develop a comprehensive and structured approach for evaluating the probability of a loss and reaching a judgment on that basis.

The Treasurer remarked that the staff would do its best in the coming weeks, as it prepared for the forthcoming discussions, to take into account the many points made by Executive Directors.

Responding to the questions raised during the discussion, the Treasurer referred first to the proposal for setting off payments to a member in connection with a retroactive reduction in the rate of charge against charges or repurchases overdue by that member in the General Resources Account, in lieu of a cash payment to that member. If the Executive Board adopted the option in Attachment 4 to the staff paper, there seemed to be no reason, on operational grounds, not to give the member seven business days rather than three business days within which to make a choice as to which overdue obligations the setoff should be applied.

As had been observed by Mr. Sengupta, the offset, which was intended to reduce arrears, might also affect the income deferral coefficient and therefore the prospects for the subsequent financial year, the Treasurer added. The staff had not made an adjustment for that factor, for two reasons. First, until the rate of charge for the second half of FY 1986 was decided, the maximum amount of the offset could not be calculated. Second, the staff needed to know which of the four options for a setoff would be adopted by the Board. Under the fourth option, which had garnered considerable support, the member could select the obligation against which the offset should be attributed, and it might not necessarily choose an overdue obligation to pay charges. In practice, few members were likely to be in a position to receive the offset, and the amounts involved in offsetting would also probably be small, in the neighborhood of SDR 1 million, depending on the rate of charge. Moreover, the coefficient to be applied in FY 1987 was unlikely to change, except in the second decimal place, with a visible but minimal effect. At present, deferred income for FY 1987 was projected at SDR 67 million, or marginally lower.

As for whether it might not be possible for the Fund's actual income to be brought closer in line with the targeted amount of net income, the Treasurer noted that the problem of matching income with the target had been with the staff and the Board ever since a target had been set. He was not suggesting that the target was unnecessary; it was an essential element of the Fund's policies. During the discussion two basic ideas had been suggested relating to the possibility of refining the projections further, and of finding different ways of setting the rate of charge. As to the refinement of projections, Mr. Dallara, supported by one or two other Directors, had asked whether it would be possible to supplement the deferral coefficient with a certain element of judgment, or alternatively, as Mr. Fujino had mentioned, with a safety margin. The staff had on occasion ventured the view that the projections resulting from the application of agreed formulas might be open to question, and be either too high or too low. However, judgments could differ, depending on the amount of information available; and even when the staff had the fullest possible information at its disposal, on which it reached reasonably firm views for what seemed to it to be good reasons, it had too often been proved wrong. Therefore, he was highly skeptical that, by refining the projections on the basis of judgmental adjustments, the conduct of the Fund's business would be facilitated. If ad hoc adjustments were made to the coefficient, for what the staff considered to be good reasons, its judgments were likely to lead to considerable debate. There would no longer be a standard coefficient.

In the past, before a firm target amount of net income had been adopted, the staff had on occasion put forward a range of figures, the Treasurer recalled. However, in current circumstances, it was necessary to make a firm projection of income so that the rate of charge could be determined. That was particularly true of the half-yearly review when the safeguard clause would operate automatically if the Board did not agree by the necessary majority on a rate of charge.

As mentioned in the staff paper, an effort had been made to find ways of improving the standard formula for determining the amount of deferred income, in order especially to reduce the elements of volatility in the coefficient, the Treasurer said. It had not proved possible to find a better formula than the one approved by the Executive Board, which was a composite of two types of formula, with the higher of the two resulting amounts being taken as the projection of deferred income. As he understood the suggestion for a safety margin, a certain percentage of the obligations of all members in arrears, for an agreed future period, would be added to the projected amount of deferred income. It should be noted, first, that the amount of those obligations fluctuated; second, while the accuracy of the projections would not necessarily be improved, the total amount of income deferred would certainly increase. As some Directors had observed, such an additional safety margin might suggest that the Fund had more doubts than necessary about the willingness of members to settle their obligations, especially as it was the future obligations of those members that would have to be estimated. However, the issue was one of policy on which the staff would ask for guidance.

As for the idea of improving the technique for setting the rate of charge, the Treasurer remarked that, if the Executive Board was willing to accept the system suggested by the staff, under which the effects of deferred income would be isolated from the other factors affecting the Fund's income, with burden sharing being applied retroactively to the amount so isolated, one of the major uncertainties with respect to charges would be resolved, as Mr. Polak had observed. One way of avoiding the necessity for making frequent corrections to charges would be to set the rate of charge retroactively, namely, on the basis of known facts. However, little support had been expressed for that idea, and the staff itself in the past had adhered to the principle that it was better to have certainty in an uncertain world than to add to uncertainty. As he understood the system suggested by Mr. Polak, once the actual amount of deferred income became known, it would be financed, but when the charges were paid and the deferred income became actual income, the financing would be reversed through the burden sharing system suggested by Mrs. Ploix. The objective was to adjust the rate of charge--and thus the Fund's income--more promptly to market rates or, in other words, to the SDR interest rate and the rate of remuneration, which was linked to that rate. The result would be greater certainty and the magnitude of corrections to the rate of charge would be reduced but not eliminated. A number of questions would also have to be resolved, including that of the frequency with which the rate of charge would be adjusted; thus, the period of certainty might be for one day, one week, or one quarter. The longer the period, the less certainty there would be. A balance would have to be reached between certainty at the beginning and at the end of the year.

One element of uncertainty that had not been greatly in evidence in the past 6-12 months, and that was not captured in the mixed sort of system proposed by Mr. Polak, the Treasurer observed, was the impact on the Fund's expenses of drawings by members in the unremunerated reserve tranche. Such drawings usually involved the payment of remuneration to other members unless the currency used to finance the drawing also came from an unremunerated reserve tranche, in which case there would be no cost to the Fund. It was important to note that the effect of remunerated reserve tranche drawings of, say, from SDR 300-500 million--depending on whether they were financed by currency or SDR holdings--would be similar to the impact of a change in the SDR interest rate. As he had mentioned at the beginning of the previous meeting, a change of 0.1 percent in the SDR interest rate would increase the Fund's operational expenditure, and reduce the Fund's income, by about SDR 20 million. If a few members with a small quota, or one member with a larger one, used the reserve tranche, the projections of the Fund's income might be affected significantly, and subsequent corrections to the rate of charge would have to be made.

The important issue for the staff was to know whether it should try to prepare a workable system along the lines of its own proposal or that of Mrs. Ploix--the two systems being basically the same because they isolated a certain element of income and provided certainty--or whether the staff should--or could afford to--take the time to think about possible refinements in its methods of projection or of setting the rate of charge, the Treasurer said.

The staff would look into all the suggestions made by Directors with respect to the various proposals for burden sharing, the Treasurer commented. One specific point that had been raised concerned the use of the five-year SDR interest rate as the relevant market interest rate for determining the maximum combined surcharge and rate of charge under burden sharing. According to Mr. Polak, the use of that rate would suddenly introduce an alien element--the term structure of SDR interest rates--into the setting of the rate of charge. There were logical and economic reasons for setting a limit on the rate of charge; it was not the cost to the Fund that was relevant but what it was reasonable for the Fund, in accordance with its purposes, to charge its members for the use of its resources. The Articles of Agreement did not include provision for placing a limit on the rate of charge, and none had been introduced by the Fund so far. However, in accordance with the principles of concessionality and cooperation, the five-year SDR interest rate plus a modest margin had been taken by the staff as representing the point at which concessionality might be considered to cease to apply. Views differed on the appropriate element of concessionality; he recalled that Mr. Dallara had stated in the past that the Fund's rate of charge was too low compared with market rates. The issue of the term structure and of the margin with respect to market interest rates did not of course arise if the element of cost to the Fund was not taken into account. The argument of the staff was a technical one with respect to the element of concessionality; whether the result would be a higher or lower cap on the rate of charge would depend on the fluctuations in market rates. The same would also be true with respect to fluctuations in the SDR interest rate, which was normally slightly lower than longer-term rates, although it might at times be higher than the five-year SDR interest rate. It was up to the Executive Board to decide whether it preferred the three-month SDR interest rate as the limit.

Mr. Sengupta remarked that, although he did not like the concept of a cap, because he preferred Mrs. Ploix's proposal, he agreed with Mr. Polak that, to take the five-year interest rate instead of the SDR interest rate would introduce a new element into the Fund's system that was hard to justify. If a ceiling or cap was to be placed on the current rate of charge, it should be the current rate of interest on the SDR, which was related to the cost of resources to the Fund. Another minor point that he had made in his statement was that, when interest rates rose, the differential between the short-term SDR interest rate and the medium-term SDR rate tended to be wider than when interest rates were declining.

Mr. Polak commented that he had not proposed putting a cap on the SDR interest rate.

Mr. Zecchini remarked that, as the Treasurer had commented, short-term interest rates could be higher than long-term interest rates. In addition, short-term rates fluctuated much more than long-term rates. Therefore, in terms of certainty, there was a technical advantage in using the five-year SDR interest rate.

The Treasurer reiterated that it was the technical issue of stability and at what point concessionality would be regarded as having been eliminated--where that point was could be debated--that had motivated the staff, not considerations of cost to the Fund.

Another specific point that had been made with respect to burden sharing concerned members making use of their unremunerated reserve tranche position, the Treasurer said. Since such members were not contributing to the Fund's income, the question had been raised whether they should be expected to participate in the burden-sharing effort, possibly through a levy proportionate to quota. So far, no legal way had been found to introduce such a levy.

In response to some of the more specific questions raised by Mr. Dallara on the question of provisioning, the Treasurer noted that the relationship between ineligibility and provisioning had not been covered in detail in the staff paper. Ineligibility was, of course, one of the crucial criteria that might impel the Executive Board, in the absence of other factors, to make provision against a probable loss. A declaration of ineligibility indicated that the member had not had access to the Fund's resources for some time and would continue to be deprived of access until the Board lifted the declaration. Even if the member settled all its overdue obligations, it would not automatically gain access to the Fund's resources. As a result, the creditworthiness of the member in the Fund, and possibly also with other creditors, would be diminished. The member might also find it difficult, or it might be less willing, to service its debt. However, it could not necessarily be concluded that the member did not have the resources to satisfy the Fund that it would discharge its obligations, therefore leading to a judgment of probable loss and the need for provisioning. In discussing the issue, the staff had given thought to including a declaration of ineligibility as one element preceding a judgment that a loan loss was probable, but not as a trigger for such a judgment. If ineligibility were used as a trigger for provisioning, the question would arise whether there would be any provisioning as long as a member was not declared ineligible. For that reason, the staff would prefer a more objective and less judgmental element as a main presumption leading to a decision on provisioning, such as a given period of time during which the member's obligations had been outstanding.

On a broader question raised by Mr. Dallara, the staff was indeed seeking guidance from the Executive Board on establishing a more structured approach to the assessment of probable loss, the Treasurer said. The External Audit Committee for FY 1985 had conveyed the view to the Treasurer's Department and to the Managing Director that generally accepted accounting principles would make it necessary for the Fund, in light of the increase in overdue obligations, to reach a judgment as to whether loan loss was probable. He had explained to the External Audit Committee that the Fund had already taken certain steps--as outlined also in the staff paper on provisioning--to safeguard its financial position, and that it had had some success under the system developed in reducing the extent of overdue obligations. Nevertheless, the External Audit Committee had maintained the position that, even though it was not yet essential for the Fund to introduce provisioning, it was essential for the Fund to make a judgment that provisioning in respect of overdue obligations was not in fact necessary at the present stage. For that purpose, the Committee felt that the Fund should, as a first step, have an agreed system for arriving at a judgment on whether or not a loss was probable. The response of the management had been to inform the External Audit Committee that the Treasurer's Department would make proposals for introducing a more structured approach. The staff of the Treasurer's Department had been working on the matter with area departments, but guidance was needed from the Executive Board on how to proceed further. The Board did not have to come to a conclusion that provisioning was necessary but simply to advise the staff on the institution of a structural process enabling the Treasurer to make an assessment as to whether or not provisioning was needed. In most financial institutions, evaluation committees took on the task of making the assessment. In the Fund, the final judgment would presumably be made by the Executive Board.

Mr. Fugmann remarked that, although the issue would be taken up later, it seemed necesssary to have some idea of the effect on the relationship between the Fund and a member of a decision to write off overdue obligations. He agreed with the Treasurer that it would be logical for a declaration of ineligibility to precede the final step of loan-loss provisioning. At present, the Fund maintained as normal relations as possible with a member that had been declared ineligible to use its general resources, including the continuation of Article IV consultations and whatever other contacts were needed to assist the member in settling its obligations. The question for consideration was what relationship the member would have with the Fund after a loan-loss provision had been made in respect of its obligations to the Fund.

The Director of the Legal Department noted that a staff paper on the treatment of members that had been declared ineligible was to be discussed at a later stage. He would take up Mr. Fugmann's other point when he responded to Directors' questions on provisioning.

The Treasurer reiterated that he did not see a necessary relationship between ineligibility and provisioning nor did he foresee any adverse effect on the relationship between the Fund and the member, which in fact was likely to become a more active one if experience so far was a guide, and if the member continued to be willing to cooperate after a decision on provisioning. If the member was not willing to cooperate, other issues would be raised that would have to be dealt with.

Provisioning did not entail writing off, the Treasurer stated. The Fund's holdings of a member's currency would not be reduced in value. If a loss was considered probable, a special, temporary allowance would be made on the liability side of the Fund's financial balance sheets. As he understood the legal situation, writing off could occur only after a member had withdrawn from the Fund.

Mr. Dallara remarked that his authorities viewed ineligibility and provisioning as very different stages in the Fund's relationship with a member. They did not necessarily see provisioning as having any more adverse effects on the Fund's relations with members than would ineligibility. Although ineligibility might be one key criterion for provisioning, his authorities were not convinced that it was the appropriate criterion at the present stage; certainly, they did not wish it to be the sole criterion. The longevity of overdue obligations seemed to be a first consideration in developing criteria for provisioning.

He had indicated in his statement that his authorities would continue to study the proposal by the staff for financing the costs of various prudential measures, Mr. Dallara added. Therefore, he had not commented on that proposal in his statement, although he could indicate at the present stage that his authorities did not consider the use of the five-year SDR interest rate to be inappropriate. A number of Executive Directors had questioned the propriety of using that rate. If it was necessary to reflect a medium-term rate, he suggested as other possibilities the medium-term interbank rate, together with an average market spread for an average basket of Fund members' currencies. It was important to recognize--as a matter of fact and not of criticism--that many members using the Fund's resources were not creditworthy in the eyes of the marketplace. Indeed, the World Bank had restricted the access of some countries to certain of its windows, for reasons of creditworthiness.

The Director of the Legal Department, noting that the draft decision in Attachment 4 to SM/86/90 seemed to have the preference of the Executive Board, said that there was no legal objection to giving the member seven instead of three business days to respond. However, it should be noted that, under Rule B-4, the Fund used the concept of business days--Monday through Friday--rather than calendar days, so that, in practice, amending the decision to provide for seven business days might extend the period to at least nine calendar days.

As a financial institution, the Fund had paid-up capital, which it had the power to invest for purposes of earning interest, the Director continued. The Fund also engaged in operations that brought in income in the form of charges. Therefore, unlike other international organizations, such as the United Nations and UNESCO, the Fund did not have the power under its Articles of Agreement to levy assessments on its members on the basis of quotas. The Fund had been organized as a self-sufficient institution that was to find ways and means of meeting its financial obligations or dealing with overdue obligations of members out of its income. Consequently, it would not be possible under the Articles of Agreement to bring all members into the system of burden sharing on the basis of quotas.

Some of the questions that had been raised with respect to provisioning could be clarified if a distinction was made between charges and repurchases, the Director of the Legal Department commented. With respect to charges, the Fund was a creditor and had a claim on its members similar to that of any creditor, including banks. With respect to repurchases, the Fund held assets in the form of members' currencies, and it could not write off those assets. Under a specific provision in the Articles of Agreement, the valuation of the Fund's holdings of a member's currency must be made on the basis of the SDR value of that currency. Although the Fund was bound by that provision, and could not reduce the value of its holdings of currencies, it could look for other techniques of provisioning.

The Treasurer observed that there was only one situation in which members could be asked to make a contribution in proportion to quota, namely, a situation in which the Fund was having continuous operating deficits. The staff had not found a way to isolate the Fund's reserves from its capital in order to make it possible for all members to share the burden.

Mr. Goos noted that the support for the option in Attachment 4 with respect to the setoff had been based on reasons of conformity with the rules governing the attribution of other payments to the Fund. That argument would no longer hold if the period of three business days was extended to seven business days. He himself had supported the option in Attachment 1 because it would be in the interest of all members if overdue charges were settled first so that the Fund's income position would be improved and the problem of overdue obligations alleviated.

The Treasurer said that the Fund's income position would benefit from the prior discharge of overdue charges, but only to the extent that those charges had been overdue for six months or longer. In addition, although it was the general commercial practice of bankers to apply payments first to interest, to lengthen the period during which credit was outstanding and to maximize interest earnings, the Fund was, on the contrary, a cooperative institution created for the purpose of providing balance of payments assistance for the shortest period possible so that its capital resources resolved, and at the lowest rate of charge that it could afford to levy rather than the highest possible rate of charge.

Mr. Fugmann requested that the clear explanation by the staff of the different nature of provisioning for the Fund and the exclusion of the possibility of writing off members' assets should be included and expanded in future staff papers on the subject.

The Chairman stated that, with respect to the rate of charge to be set retroactively for the second half of FY 1986, 13 Directors having 40.5 percent of the voting power were in favor of a rate of 6.72 percent, and 9 Directors having 57.9 percent of the voting power were in favor of the rate of 7.00 percent. Even if account was taken of the willingness of 2 among those 13 Directors to accept a rate of charge of 7 percent if the rate of 6.72 percent did not obtain sufficient support, the majority in favor of a rate of 7 percent, at 65.5 percent of total votes would remain below the 70 percent majority required. In order to reach an agreement and avoid the necessity of retaining the current rate of charge of 7.87 percent, he asked those Directors who were in favor of a rate of charge of 6.72 percent to accept a rate of 7 percent, on the understanding that, when the outcome of the Fund's financial position for FY 1986 was known, the excess income that would result from the higher charge would be deemed as income for FY 1987 and not added to reserves at the present time.

Mr. Sengupta said that he had understood previously that the disposition of the excess net income for FY 1986 would be discussed at the time of the review of the Fund's financial position, thereby keeping open the possibility of a further reduction in the rate of charge for FY 1986.

Mr. Pérez remarked that, on the understanding expressed by Mr. Sengupta, he could go along with a rate of charge of 7 percent for FY 1986 as an interim measure.

The Chairman observed that, if no indication was given of how the excess income for FY 1986, about SDR 25 million, was to be used, a decision might be reached following the end of the financial year to place that amount to reserves.

Mr. Suraisry said that, in approaching the issues under discussion, he had had two concerns. First, he was concerned by a rate of charge above or close to market interest rates. Such a rate was likely to lead some members to delay the required adjustment, to say the least. Obviously, as experience had shown, such adjustment would become very costly for those countries. The cost of adjustment was not the immediate concern of the Executive Board; but the broader issue was that delayed adjustment could weaken countries' ability to meet their financial obligations to the Fund. As a result, the problem of overdue obligations to the Fund in the future might be aggravated.

Until recently, many countries had not taken timely adjustment measures, Mr. Suraisry added, but had delayed them until they had no alternative. During that period of delay, the productive base in many countries had been weakened, confidence in their economies had been undermined, and the problems confronting them had become tremendous. The Fund had provided active assistance through its enlarged access and other policies, thereby permitting substantial progress to be made. He did not want to see those gains undermined. Moreover, it was his belief that delayed adjustment was one of the main reasons for the Fund's problem of overdue obligations. Therefore, he was not in favor of a rate of charge that might lead to further adjustment delays or, in other words, a rate of charge that might be attractive at present but that in the future might create a serious problem for member countries and for the Fund's income position.

Yet he was equally concerned about the uncertainties surrounding the Fund's income position, Mr. Suraisry said. He did not need to enumerate those uncertainties, which had been reported by the staff and mentioned by some other Directors; suffice it to say that the Fund had to remain strong if it was to continue performing the role assigned to it by its Articles.

The rate of charge adopted by the Executive Board at the present meeting should strike a balance between those two concerns, Mr. Suraisry concluded. He admitted that he did not know what rate would achieve that objective. Based on the projections in Table 2 of Supplement 1 to

EBS/86/81--of average daily balances and rates of periodic charges, SDR interest, remuneration, and interest on borrowing for FY 1986 and FY 1987--and taking into consideration that the SDR rate was, in a way, a subsidized rate, he could go along with the Chairman's proposal for a rate of charge of 7 percent for the second half of FY 1986--and provisionally for the first half of FY 1987. He agreed that any surplus income from FY 1986 should be transferred to FY 1987.

Mr. Ganjarerndee stated that his chair's first preference was for a rate of charge of 6.72 percent, to be effective November 1, 1985. However, in order to achieve a compromise solution, his chair was willing to be flexible and could accept the recommendation for the rate of charge to be set at 7 percent, retroactive to November 1, 1985. He also associated himself with Mr. Sengupta's views on how to deal with excess income at a later stage.

Mr. Arias said that, in order to achieve a compromise, he could go along with the Chairman's proposal for a rate of charge of 7 percent. On the disposition of any excess income, he associated himself with Mr. Sengupta's view that the decision should be left open.

Mr. Sengupta remarked that, on reflection, it seemed preferable to accept the Chairman's proposal and to deem the excess income for FY 1986 as income for FY 1987, making it possible to determine the rate of charge for the subsequent fiscal year in the light of that decision when the review of the Fund's financial position took place.

Mr. Polak said that he would greatly prefer to take an unqualified decision to set the rate of charge at 7 percent, a sufficient majority having been attained to do so. The merits of applying the excess income toward a further reduction in charges could be debated at length, and probably without a clear resolution of the issue. The disposition of the excess income should be left for consideration at the time of the review of the Fund's financial position.

Mr. Jiang said that he could go along with the majority in favor of reducing the rate of charge to 7 percent. Income in excess of the target for FY 1986 should be deemed as income for FY 1987.

Mr. Foot said that he agreed with Mr. Polak that it would be premature to decide on anything at the present meeting other than the rate of charge of 7 percent, and without any commitment with respect to the disposition of excess income.

Mr. Parmena said that he supported the position taken by Mr. Polak.

Mr. Mawakani remarked that, in the spirit of cooperation, he could accept the majority view.

The Secretary confirmed that, with the support of those Directors who had agreed to accept a rate of charge of 7 percent for the second half of FY 1986, without taking a decision at the same time with respect to the disposition of the excess income for FY 1986, the required 70 percent majority had been more than reached.

The Chairman made the following summing up:

The Board has agreed today that no cash refunds should be made to members in arrears as a result of a retroactive reduction in the rate of charge; any amounts due to such members as a result of this reduction will be set off against overdue obligations. I think it is also clear that the Board wishes to follow the Fund practice with respect to the attribution of payments according to which the member would specify the obligation it wishes to discharge by responding within seven business days--rather than three, as proposed--to the Fund's request. In the absence of a specification by the member, the Fund would follow the order of setoff prescribed in the adopted decision (Attachment 4 to SM/86/90).

In line with the consensus reached in December 1985 and confirmed in February 1986, the Board has decided to reduce retroactively the rate of charge from 7.87 to 7 percent, effective November 1, 1985. The attribution of the excess income that will accrue from the adoption of a rate of charge of 7 percent for the second half of FY 1986--instead of a rate of charge of 6.72 percent, which on the basis of current projections would have been sufficient to meet the income target of 5 percent--will be decided in the first part of June when the income position of the Fund for FY 1986 is reviewed after the closing of the accounts. The rate of charge for FY 1987 will also be decided at that time, in the light of all the relevant factors, namely, updated estimates for FY 1987, the decision on the attribution of the excess income for FY 1986, and other questions, including burden-sharing mechanisms.

The discussion on burden-sharing mechanisms was interesting although not decisive. For that reason, I shall not draw any conclusions at this stage; this is a matter for June. But I note the consensus that there is a case for some form of burden sharing and that on the whole there was broad interest in the general approach--but not necessarily the detailed mechanism--suggested by the staff in Section V of EBS/86/81. By general approach, I mean setting a "normal" rate of charge determined in the absence of deferrals of income stemming from overdue obligations. To take deferrals into account, an adjustment could be made on a retroactive and semiannual basis through the use of a temporary surcharge on the rate of charge and, if needed, a discount from the remuneration coefficient.

It is also fair to say that a number of Directors did not wish to go along with certain modalities suggested in the staff paper. Mrs. Ploix made a proposal that was supported or considered worth examining further by 17 other Directors who did not, however, all agree on the entire proposal. Including Mrs. Ploix, those Directors represent some 64 percent of the voting power of the Board. The proposal was judged by those Directors as superior to the staff proposal, essentially because it was more symmetric and more simultaneous. Other Directors felt that the staff proposal had the drawback of introducing a medium-term SDR yardstick--medium-term interest rate plus a margin--for the sole purpose of calculating the surcharge, a feature that was not accepted by all. One Director had some doubts on the idea of placing a cap on the rate of charge for systemic reasons. Other Directors stressed the importance of preserving the fundamental principle of moving toward a rate of remuneration equal to the SDR interest rate. One Director asked that, in examining possible burden-sharing mechanisms, a limit be placed on the rate of remuneration at 85 percent instead of 80 percent of the SDR interest rate. Three Directors expressed the explicit wish to limit the period during which the mechanism was applied to a sort of test period of, say, one year. But a number of other Directors--I would say a large number--thought that the whole burden-sharing mechanism was to be regarded as an exceptional device to deal with a temporary situation. Several Directors asked whether the membership as a whole could be asked to participate in the burden-sharing mechanism; the staff will pursue the matter further.

On the matter of provisioning, the discussion was very preliminary and incomplete. Indeed, a large number of Directors had not had the time to consider the subject, and thus were not in a position to offer any substantive views. I hope that we will have a fuller discussion on May 19 on that difficult and very complex matter.

Mr. Dallara asked whether the Fund was not bound to take up the issue of a more structured and comprehensive approach to the question whether some of the credit extended by the Fund was not subject to probable loss. To venture a personal remark, I would say that, even if we were to take such a structured approach, this would not necessarily mean that we would have to set up a provisioning mechanism at this point in time. I heard little guidance today on the subject of provisioning; indeed, I heard more questions than guidance. For instance, is provisioning appropriate for the Fund, which is a unique institution; might the use of reserve accumulation not be more useful? On general versus specific provisioning, what would be the effect of specific provisioning on the attitudes of the interested countries in terms of their willingness to repay? Again, would the use of general reserve accumulation be an alternative to specific or general provisioning? Mention was made of the consequences for the techniques of provisioning of the notion that the Fund does not extend loans but exchanges currencies with countries that use its resources, and many other questions were raised that we will take careful note of and will come back to. I do not think we can prepare a further paper on the basis of today's discussion for May 19. We have not heard the reactions of all Directors on the paper on provisioning against loan losses in the context of the Fund. We will take stock of your views when we have had a chance to have a full tour de table on May 19, and will then consider whether and how the matter would need to be further pursued.

The Executive Board then took the following decisions:

a. Rate of Charge as of November 1, 1985

The Fund has reviewed the rate of charge on the Fund's holdings of currency acquired as a result of the purchases referred to in Rule I-6(4) and decides that the rate shall be reduced to 7 percent per annum, effective November 1, 1985.

Decision No. 8270-(86/74), adopted
April 30, 1986

b. Setoff in Connection with Retroactive Reduction of Charges Due by Members in Arrears

1. When the Fund decides upon a retroactive reduction in the rate of charge specified in Rule I-6(4), the amount to be paid to a member that has charges or repurchases overdue, in the General Resources Account, on the effective date of the payment by the Fund, shall be set off pro tanto, as of that date, against such overdue obligations in the following manner: the member shall be requested to specify which overdue obligations, among the categories listed in paragraph 2, it wishes to discharge by the setoff; in the absence of a response by the member within seven business days after the request, the setoff shall apply to the member's overdue obligations, within the categories listed in paragraph 2, in the descending order of maturities.

2. The setoff under paragraph 1 shall apply to:

(a) special charges due on the amount of overdue charges under Executive Board Decision No. 8165-(85/189) G/TR, December 30, 1985;

(b) special charges due on the amount of overdue repurchases under Article V, Section 8(c);

(c) charges due under Article V, Section 8(a) or (b);

(d) overdue repurchase obligations.

Decision No. 8271-(86/74), adopted April 30, 1986

APPROVED: January 22, 1987

LEO VAN HOUTVEN
Secretary