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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/85

3:00 p.m., May 19, 1986

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
	H. G. Schneider
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
Huang F.	
	Jaafar A.
	H. A. Arias
	M. Foot
	H. Fugmann,
	G. D. Hodgson, Temporary
	W. K. Parmena, Temporary
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

IBRD: M. J. Gillette, Accounting Department. African Department: J. W. Kratz. External Relations Department: H. O. Hartmann. Legal Department: F. P. Gianviti, Director; P. L. Francotte, W. E. Holder, A. O. Liuksila, R. Munzberg, S. A. Silard. Middle Eastern Department: F. Drees, C. Sassanpour. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, D. H. Brown, J. Caskey, J. C. Corr, D. Gupta, B. E. Keuppens, J. A. McLaughlin, D. V. Pritchett, G. Wittich. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, M. B. Chatah, S. Ganjarerndee, L. P. Ebrill, K. Murakami, G. Nguyen, P. Péterfalvy, N. Toé, A. Vasudevan. Assistants to Executive Directors: B. Bogdanovic, J. de la Herrán, J. J. Dreizzen, S. Geadah, V. Govindarajan, G. K. Hodges, O. Isleifsson, S. King, J. K. Orleans-Lindsay, J. Reddy, L. Tornetta, E. L. Walker, B. D. White.

1. PROVISIONING AGAINST LOAN LOSSES IN FUND CONTEXT

The Executive Directors continued from the previous meeting (EBM/86/84, 5/19/86) their consideration of a staff paper on provisioning against loan losses in the context of the Fund (EBS/86/82, 4/15/86; Cor. 1, 4/23/86; and Sup. 1 4/29/86). They also had before them a staff paper entitled "Valuation of Assets in the General Resources Account - Provisioning and Write-Off - Legal Considerations" (SM/86/106, 5/16/86).

Mr. Schneider recalled that during the preliminary discussion on provisioning on April 30, 1986 he had said that overdue financial obligations to the Fund were a serious problem for the Fund's credibility and solvency. All the financial implications of that problem must be taken into account in order to protect the Fund's credit standing. At the same time, given the Fund's cooperative nature as an international institution and the fact that its members were sovereign states, the Executive Directors must be fully aware of the delicate and complex issues related to possible loan loss provisions. They must also bear in mind that the Fund's financial activities consisted mainly of purchases and repurchases of currencies regardless of the provision of the Articles under which particular transactions took place. Moreover, if it was accepted in principle that provisioning was required, it could be argued that the introduction of provisioning would imply the acceptance by the Fund of the idea that a member might default on its obligations to the Fund. That possibility could in turn easily place in doubt the quality of claims on the Fund by creditor members for which those claims were part of their official reserves.

Although the Fund was not fully protected against losses stemming from a member's inability or unwillingness to make repurchases on time, his authorities believed that it would not be appropriate to consider specific provisions, Mr. Schneider continued. Experience showed that debtor countries were well aware of the importance of the Fund's catalytic role in the international debt strategy. In addition, a decision by the Fund to classify its claims on a member as doubtful by introducing specific provisions against those claims would have serious repercussions for the member's access to international capital markets and official credit, which, in turn, would make it even more difficult for the country to implement the required adjustment measures. In all four cases of withdrawal from the Fund, the institution and the withdrawing member had agreed on the terms of settlement and the Fund had not had to sell the currencies of those members in the market.

General provisioning would involve a minor amount compared to the Fund's reserves, Mr. Schneider commented. If the Executive Board were to agree that there was a need to protect the Fund against losses, the need should be met by building up the Fund's reserves rather than by general provisioning. However, if the majority of Executive Directors favored establishing provisions against possible losses, that matter should be dealt with in parallel with the determination of the rate of charge for financial year 1987 and with consideration of possible solutions to the problem of burden sharing.

There was no need for immediate and drastic action to improve the Fund's financial situation, Mr. Schneider said. Moreover, since the Fund was not a borrower in private financial markets, there was no urgent need for specific provisioning. Finally, the staff paper on the relevant legal issues contained a number of important questions that should be considered at a later stage.

Mr. Hodgson remarked that he would focus on a few key principles in addressing the question of whether the Fund should use provisioning against loan losses. The first principle was the ongoing need for a strong and stable financial position for the Fund. The Fund must be prudent in its affairs and must be seen to be prudent by its members and by the outside world. Given the large and growing overdue financial obligations to the Fund, it was especially important that no doubt should exist about the fundamental stability of the Fund's financial position. It was for that reason that his chair had suggested during the latest review of the Fund's income position that the Fund needed to re-examine its current reserve base and to reconsider the optimal level of reserves.

The second principle was the nature of the Fund in comparison with that of other financial institutions, Mr. Hodgson continued. The Fund was not fully comparable to commercial banks or the World Bank. It was a cooperative intergovernmental institution that drew upon its entire membership for its resources rather than upon private financial markets. Even if the problem of overdue financial obligations continued to grow, the Fund's continued existence would not be in doubt, given its currency reserves, gold holdings, and, most important, the support of its membership. Accordingly, normal provisioning of the kind used by commercial banks--which was based on the probability of the institution in question not being repaid--did not fit well with the Fund's particular features. Nor did accounting practices that were generally accepted for commercial banks necessarily apply to the Fund.

A third important principle was the need for the Fund to avoid ad hoc and arbitrary measures, Mr. Hodgson commented. One of the main questions at hand was whether the Fund needed to establish a more comprehensive and structured approach to evaluate the probability that the Fund would experience a material loss. The latest staff report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86; and Sup. 1, 5/16/86) showed that there were considerable grounds for concern about the magnitude and duration of the overdue obligations, which had already had a fundamental effect on the institution's income position. The continued growth of the arrears problem was alarming, and the Fund should move quickly toward a more structured approach toward examining the impact of the arrears.

That approach should begin with an examination of the optimal level of the Fund's reserves, Mr. Hodgson went on. At the same time, work could proceed on whether a material loss was possible or probable in the light of the protracted overdue obligations to the Fund. The staff's analysis should take the following points into account. First, an evaluation was required of the liquidity and adequacy of the Fund's existing reserves.

In that connection, thought should be given to whether earmarking of different categories of reserves was useful and necessary. Second, the amount of time that obligations were overdue should influence the rate at which reserves were accumulated. Third, to the extent possible, the provisioning system should treat arrears in general and should avoid singling out specific members, although due regard must be paid to the particular circumstances of each case. Fourth, the system should not be fine-tuned in response to statements of various countries with overdue obligations; the system should give more weight to actions than to statements. Accordingly, the system should concentrate on the payments performance of members and on their policy actions rather than on their stated intentions. Fifth, the analysis should not take place in isolation of concerns about and discussions of burden sharing.

His views were preliminary, Mr. Hodgson said. He looked forward to considering the views of other Executive Directors and he hoped that the staff would give considerable thought to the issue of provisioning in coming months, so that the Executive Directors could examine a more complete range of ideas and options at a later stage.

Mrs. Ploix noted that the present discussion was a preliminary one; many of the points that had been made about the Fund's accounting structure required further study. The External Audit Committee had endorsed the Treasurer's proposal to establish a more comprehensive and structured approach to whether or not a material loss was probable with respect to members with protracted overdue obligations to the Fund. Although that endorsement did not specifically support a provisioning system, there was clearly a need to hold regular reviews of the risks of protracted arrears.

The staff had noted the number of technical problems with respect to provisioning, Mrs. Ploix remarked. The first one concerned accounting principles governing the preparation of the Fund's financial statements. The staff had suggested introducing a line on the liability side of the Fund's financial statements that would distinguish the "credits" that were to be covered. Provisioning by reducing assets was not practical, as the Fund did not extend credits like a bank. Instead, members made purchases and the Fund held the counterpart of the purchases in the national currency of the member making the purchases. Under Article V, Section 11, that counterpart was subject to periodic re-evaluation at the Fund's initiative. To reduce that "debt" denominated in SDRs would imply a reduction in its counterpart in national currency. Such a reduction could not be made, since it would involve the Fund's existing assets. That conclusion had been supported by the staff's discussion linking the idea of loss with the concepts of withdrawal and writing-off.

An important issue was how to determine a loss in the context of the Fund, Mrs. Ploix continued. If a member had clearly expressed its intention not to repay the Fund, the loss for the Fund would depend on the market value of the currencies held by the Fund. However, such a loss had never been recorded by the Fund. In order to provision against such a loss, the Fund would have to assess the possible amount of the loss--a delicate matter--and would have to assess the chances that the country would break all ties with the Fund and would freeze all the Fund's assets in the country's central bank--an even more delicate matter. Although those events were unlikely to occur, it was conceivable that a member would withdraw voluntarily or as a result of a decision by the Board of Governors under the provisions of Schedule J.

Another technical problem had to do with the financial consequences of provisioning, Mrs. Ploix remarked. As provisioning was an item of expense, provisions raised certain financing issues. The staff had mentioned on page 15 of EBS/86/82 several means of financing provisions and the costs involved. Other means were conceivable. The main issue was who should bear the cost of provisions. In her view, the cost must be borne by the entire community through a system of burden sharing. That subject was to be discussed separately in the near future. However, the suggestion to introduce provisioning stemmed from the wish to protect the Fund's financial position, and the aim of the discussion on the issue was to enable the Fund's financial structure to absorb losses. Those matters, as well as the role and the appropriate level of the Fund's reserves should be considered separately.

Provisioning would cause serious political problems in members, Mrs. Ploix noted. A system of provisioning should not run the risk of internal slippages; once a system was established, it might be tempting to provision against less obvious and less widely recognized risks. Problems with respect to the Paris Club and international financial practices would then arise, particularly if the provisions had to be tailored to individual country cases. In any event, a multi-step system for dealing with overdue financial obligations had slowly taken shape and had yielded positive results. The introduction of provisioning could reduce the pressure on members to reduce their arrears to the Fund. The question might arise whether a particular member needed the Fund or vice versa, since the Fund dealt with sovereign nations rather than with individuals and business concerns. Moreover, a creditor that introduced provisions usually did not make debtors with poor payment records aware of the creditor's provisions; that fact might well be an argument against the introduction of specific provisioning in the context of the Fund.

While she agreed with Mr. Dallara that in many areas the international financial community looked to the Fund for guidance and leadership, there was no clear evidence that the Fund had to take a leading role with respect to provisioning, Mrs. Ploix said. The Fund must not be mistaken for a credit institution for the reasons that she had mentioned during the discussion on provisioning on April 30, 1986. The nature of the Fund was unique, owing to the Fund's particular mechanisms, its non-profit status, and its relations with its members, both net borrowers and lenders. The need to maintain confidence in the Fund was a separate matter from the issue of provisioning. It was important to preserve the cooperative character of the Fund; all members should help the Fund to deal with problems facing the institution. While the Fund could use its reserves to absorb slight income deficits, solving significant problems was the responsibility of the entire membership.

The World Bank was prepared to adopt a system of provisioning in the near future, but that fact was not relevant for the Fund, as the natures of the institutions were very different, especially with respect to their accounting, lending, and borrowing practices, Mrs. Ploix remarked. While collaboration between the institutions and symmetry in their practices were desirable in general, provisioning was not a common area of interest. The issue of provisioning was closely linked to the nature of the Fund in general, and to its rules and accounting principles in particular. The issue of provisioning deserved a more thorough analysis, including an evaluation of the usefulness and suitability of increasing the Fund's reserves and of proposals on how to share the corresponding burden of that effort.

Ms. Bush remarked that, while Mr. Dallara had mentioned that the Fund had a central leadership role to play in the international community, he had not meant to imply that the Fund should play a leadership role with respect to provisioning. Given the Fund's central role in the international financial community, it must give serious consideration to appropriate and prudent steps to deal with problems facing the institution.

Mr. Goos said that his position on provisioning was based on the paramount importance that he attached to safeguarding the Fund's financial integrity. No one would disagree that the growing overdue obligations to the Fund posed a serious problem for the institution's financial position. The Executive Board had already taken a number of steps to protect that position, but serious consideration must be given to the concern that had been expressed by the external auditors about possible loan losses and the need for remedial action. The Fund should formulate a comprehensive and structured approach on the basis of which the probability and the size of a loss could be assessed with reasonable accuracy.

The staff had mentioned a number of possible criteria for establishing the probability of a loan loss, Mr. Goos noted. While those criteria appeared to be relevant for any decision on provisioning, any systematic approach to provisioning in the context of the Fund must take into account the specific and unique structure of the Fund's operations. The staff paper on the legal issues clearly suggested that, within the Fund's system of purchases and repurchases together with the existing procedures for currency valuation, overdue repurchase obligations did not necessarily result in a loss for the Fund. Indeed, the staff had made a convincing case that such a loss could occur only if a member were to withdraw from or repudiate its obligations to the Fund. Even in such cases, the maximum loss that could occur could be less than the Fund's actual holdings of the member in question and of the member's outstanding purchases. Therefore, the probability of a loan loss seemed to be remote. He agreed that the likelihood that a member would withdraw from the Fund or formally repudiate its obligations tended to increase with the duration of the member's overdue payments, but the Fund had never incurred a loss, and there was no need for the time being to take precautionary action in the form of either the introduction of provisioning or an increase in the reserve target. However, given the uncertainty about the future development of the overdue obligations to the Fund, the situation with respect to arrears and the possible need for precautionary measures should be reviewed in about one year.

The assessment of the potential loss of a loan in the context of the Fund was largely subjective in nature, Mr. Goos commented. The present discussion had brought to light a number of aspects in addition to those mentioned by the staff that warranted further careful thought. For example, further consideration should be given to the question of the extent to which the value of the Fund's currency holdings could be impaired by protracted overdue repurchases. His preliminary reaction was that the issue of the appropriate valuation of the Fund's currency holdings probably was not confined to members with protracted arrears; it probably was relevant to all members that had reserve positions that were weak--owing to inappropriate domestic policies--and would probably remain so in the foreseeable future, thereby prohibiting the Fund from using the currencies of those countries in the Fund's transactions. Pursuing that issue too far could therefore give rise to a number of serious implications for the Fund's valuation system. At the same time, he doubted whether the Fund could apply a specific criterion only to countries with overdue obligations to the Fund when that criterion would pertain to other countries as well.

A conclusion that the value of the Fund's currency holdings of members with overdue obligations would be impaired would not constitute a case for provisioning, Mr. Goos considered. Of course, with a finding that a currency could not be used the Fund would suffer a concrete loss that would have to be reflected in an immediate write-off of the value of the relevant currency holdings.

In view of the largely unanswered questions that had been raised, the Executive Board might arrive at conclusions regarding the probability of loan losses that differed from his own views, Mr. Goos remarked. In that event, he would not wish to complicate the effort to reach a consensus. However, if such a consensus would involve the adoption of precautionary measures against possible loan losses, he would have difficulty in supporting provisioning, which could undermine members' willingness to repay the Fund. Moreover, specific provisions could have a negative effect on the assessment by commercial banks and other creditors of the creditworthiness of the countries in question. If a precautionary measure were required, it should take the form of an increase in the reserve target. A default by one of the larger debtors to the Fund would probably have to be covered by the Fund's reserves. That conclusion was also applicable in the event that a global crisis triggered widespread defaults.

Consideration could be given to establishing a precautionary reserve in addition to the normal reserve, Mr. Goos continued. The targets for most reserves could be met through the Fund's annual income. While the regular charges could continue to accumulate the necessary amounts under the normal target, the precautionary reserve target could be met through burden sharing. Moreover, the amounts accumulated in the precautionary reserve could be distributed retroactively to the members that had contributed to the buildup of that reserve. Although in the essence his proposal would admittedly be identical to provisioning, his method would be called a reserve target increase, rather than provisioning. The critical difference would be that the liability side of the Fund's balance sheet would not contain a separate item for provisioning.

His approach raised difficult issues, Mr. Goos went on. For example, further thought would have to given to the extent to which it would be possible to establish a sub-reserve within the overall reserves and whether it would be possible to distribute retroactively the accumulated amounts to the original contributors to the additional reserve. Moreover, the Fund would have to introduce criteria for establishing the size of the necessary amounts that were to be included annually in the precautionary reserve; presumably the same criteria that were used in provisioning could be used for that purpose. Finally, with regard to the general issue of burden sharing, further consideration should be given to a more balanced and fairer solution than a mere distribution of the burden between debtors and creditors in accordance with their outstanding purchases and remunerated reserve tranches, respectively. If a straight levy on quotas were not legally permissible, an approximation to the levy approach should be examined.

Mr. Sengupta said that he was opposed to provisioning against loan losses in the context of the Fund. The unique position of the Fund and the current circumstances did not warrant provisioning for losses. The increase in overdue obligations to the Fund in the recent past was a reflection of a combination of the unfavorable external environment and the difficult situation in individual members that had arrears to the Fund. Despite the difficult circumstances, several members had made their payments on time, and even members with overdue obligations to the Fund had made occasional payments. No member had even indirectly suggested that it would not discharge its financial obligations. As all members were sovereign states, there was no need to fear that there would be a default of the kind that was experienced by institutions that registered losses on loans to nongovernment enterprises. Only a few members had overdue obligations to the Fund, and they could be easily identified. Even a general provision for losses could be counterproductive, as it might adversely influence the desire of members to discharge their payments obligations. Hence, there was no reason to introduce provisioning in the Fund.

Moreover, the staff paper on the legal considerations clearly showed that provisioning in the context of the Fund was not legally permissible, since the nonfulfillment of obligations, such as a repurchase, by a member should not result in a loss for the Fund, Mr. Sengupta commented. The staff had noted that the concept of loss appeared in the Articles in connection with the liquidation of the Fund and with the withdrawal of a member. Those situations had not arisen. The Fund could experience a loss if there were an express repudiation by a member of its obligations to the Fund, but no country in arrears to the Fund had repudiated its overdue obligations to the Fund. It would therefore be difficult to estimate the probability of a loss by the Fund. As Mr. Zecchini had stressed, the probability was negligible, and provisioning against such a probability would not be feasible. He fully agreed with Mr. Abdallah that in resolving the issue of provisioning the Articles should be given precedence over accounting or auditing conventions. The Fund was not like any commercial organization, and accounting practices of commercial organizations were not applicable to the Fund.

All Executive Directors were equally interested in maintaining the financial integrity of the Fund and of ensuring the revolving nature of its resources, and all were willing to consider measures to protect the Fund's interests, Mr. Sengupta continued. That concern was reflected in Executive Board discussions on overdue financial obligations to the Fund and in the decisions that had been taken in that area. A series of measures had been introduced to safeguard the Fund's financial position; in particular, charges that had been deferred for six months or more were treated on a nonaccrual basis, the net income target had been increased by 2 percentage points, and special charges had been introduced. In addition, the Fund had reviewed the economic situation of the countries concerned on the basis of staff mission reports, and some countries had been declared ineligible to use the Fund's general resources. The introduction of mechanistic accounting practices followed by commercial banks would not help the Fund to achieve one of its main purposes, namely, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members. The Fund should examine each case carefully and consider possible methods of helping a country to meet its obligations. The value of the Fund's assets could be impaired only if the exchange value of the assets were altered. Estimating the probability of a material loss with respect to members with overdue obligations to the Fund was difficult, as any estimate of the Fund's assets would require spelling how the Fund proposed to help the countries concerned to maintain the exchange value of their currency and the countries' ability to fulfill their obligations.

The staff paper had suggested a number of criteria for determining probable loss, Mr. Sengupta observed. The criteria of duration of overdue obligations--irrespective of the particular circumstances of the member concerned--was inappropriate. In addition, he did not agree with the staff that the absence of any economic program in the face of a deteriorating economic position was an indication of a weakening of the intention by the member to discharge its obligations. The assessment of such a probability had to be made on a case-by-case basis taking into account the international environment, including assistance that was to be provided by the Fund. In that context, the procedures permitted by the Articles--including rescheduling--to deal with the problems caused by arrears should be considered.

Until such assessments were made, the Executive Board could not decide whether it was necessary to provide for any additional or ad hoc reserves over and above the current annual reserves, Mr. Sengupta went on. The staff had clearly indicated that reserves, like provisioning, served to protect the Fund from loan losses. Reserves could serve a wider purpose and could cover operational losses; they could cover all the functions of loan loss provisions if providing for such losses became necessary. On previous occasions the staff had noted that besides being a source of additional liquidity and an indicator of sound financial management, the Fund's reserves were to provide a cushion against a possible annual deficit and were to protect the Fund's capital from possible losses caused by the failure of a member to meet its financial obligations. Therefore, if the value of the Fund's assets were impaired, the problem could be solved through the normal functions of the Fund's reserves. The only case for making an extra allowance for that probable loss by having an additional element of reserves or by increasing the reserve target would be if the probability of such losses was so large that other functions of the reserves would be affected if additional or an increase in reserves were not approved. Even Mr. Nimatallah's proposal to cover 100 percent of overdue obligations that had been outstanding for more than three years would not involve a large amount. There was no reason to assume that there was a considerable probability of loss that called for changing the Fund's rules and accounting practices. As long as such estimates were not provided and the Executive Board had not judged the accuracy of the estimates, there was no reason to debate the need for additional reserves to cover probable losses.

Since 1978, the Fund's reserves had increased by about 63 percent on a cumulative basis, and about 7 percent per year on average, Mr. Sengupta noted. The reserves had already reached the sizable level of SDR 1.1 billion, which could easily cover any sudden losses that might occur. The present comfortable level of the Fund's liquidity suggested that there was no need for any further increase in reserves. In any event, Rule I-6(4)(a), under which the net income target for each year was established, ensured that a decision on the reserve target would be taken every year. Acccordingly, once it had been conclusively determined that a loss had occurred because a member had not discharged its obligations, had expressly repudiated its obligations, or had withdrawn from the Fund, a decision on the Fund's reserves could be taken. At that time, the Executive Board could examine the adequacy of the current net income target; the cost of increasing the target should be shared by creditors and debtors. If a loss were fairly large, the reserves could be increased in the subsequent period. However, he doubted whether such losses were likely to occur in the near future. Indeed, a case could be made for reducing the reserve requirement, as members in arrears to the Fund--for example, Zambia and Somalia--recognized that limitations would be placed on their access to the Fund's resources as well as to the commercial markets and were making every effort to eliminate the arrears.

Mr. Pérez said that in approaching the question of provisioning Executive Directors should consider the character of the Fund, the goals of the Fund, the record of the Fund in collecting financial obligations of members, the likely duration of the arrears problem, and the steps that had already been taken to strengthen the Fund's financial position. As the staff and most previous speakers had stressed, the Fund was a unique institution with a particular financial structure and a mode of operation that made it difficult to compare its accounting practices with those of other public and private entities. The Fund operated only with members and did not need to borrow in the market to support its normal operations. In addition, its transactions with borrowers were in the form of currency exchanges and were not strictly speaking lending operations.

The Fund was a cooperative institution, and one of its purposes was to provide financial assistance to members on a temporary basis thereby giving them an opportunity to correct imbalances in their balance of payments, Mr. Pérez continued. Fund operations represented a sovereign risk and should therefore be thought of as being essentially free of risk: countries did not go bankrupt and would not cease to exist. It was true that, because of adverse economic circumstances, a country might face a scarcity of foreign exchange that impaired its ability to remain current in its debt service, but that situation should normally be considered temporary in nature. The only risk in sovereign lending by the Fund was a repudiation of debt by a government, something that had never happened.

The Fund's financial operations were confined to its members, Mr. Pérez noted. The effectiveness of those operations in ensuring debt collectability was demonstrated by the Fund's collection experience, which had been remarkable, including members that had had serious difficulty in remaining current in servicing their debt to private and other multilateral financial institutions.

Given the character of the Fund's financial operations and the Fund's record in collecting members' obligations, the only potential for the nonfulfillment of a repurchase obligation was repudiation by the member or termination of membership, Mr. Pérez remarked. Hence, there was no need for provisioning in the context of the Fund beyond the particular cases that he had mentioned. The adoption of a decision on general provisioning could send the wrong signal and could have far-reaching implications for a large portion of the membership. The introduction of general provisioning could convey the impression that the Fund was no longer confident that it could collect payments from members and that default by a group of members was feasible. The use of general provisioning would therefore be tantamount to saying that the debt problem could not be solved and that the Fund foresaw a financial crisis.

Some Executive Directors seemed to believe that specific provisions offered a more promising way in which to tailor provisioning to the particular circumstances of each case, Mr. Pérez continued. However, he had difficulty in going along with that approach except in the event of withdrawal by a member that failed to settle all its obligations to the Fund or in the event of a repudiation by a member of its obligations to the Fund.

In any institution general or specific provisioning together with reserves gave confidence to potential lenders to the institution in the real value of the assets of the institution, Mr. Pérez remarked. That confidence was crucial both for the ability of the institution to raise money in the market and for the price that that institution paid for the money. A deterioration in confidence was immediately reflected in the institution's difficulty in borrowing and in the need for it to pay higher interest rates. However, the Fund was not a financial institution that needed to borrow in the market in order to carry on its activities. Of course, the Fund had responsibilities to its members as shareholders, but those providing resources to the Fund were informed punctually and completely of financial events that affected the Fund. The Fund was not experiencing any fundamental weakening of its financial position. Although there had been a growing risk in recent years that the Fund would not be repaid by a few members, the Fund had adequate reserves to meet that risk. The Executive Board had improved the Fund's financial position by increasing the reserve target from 3 percent to 5 percent, and further movement in that direction could be taken, if necessary. Moreover, his authorities were confident of the ability of the Executive Board and management to deal effectively with the present transitory problem of arrears.

Specific provisioning to deal with members in arrears could be counterproductive, Mr. Pérez said. It could give the impression that the Fund was already compensating for the financial implications of a member's failure to repay the Fund and was accordingly eliminating the negative effect of the arrears on other members that needed the Fund's financial support. As discussions on individual cases of arrears had clearly shown, the damage that arrears inflicted on other members was an important factor in encouraging members with arrears to become current in the Fund.

The Fund did not lend money to a member, Mr. Pérez noted. Instead, it exchanged currencies with members that were using its resources. The Fund had the equivalent in the borrower's domestic currency of the amount of resources that were available to the member. Although the liquidation of the currency of a member using the Fund's resources could entail a loss for the Fund in some cases, the loss would be merely partial; that fact reduced the potential risk facing the Fund in comparison with the risk facing private and other financial entities.

The Executive Board had already taken a number of steps to strengthen the Fund's financial position, Mr. Pérez commented. In 1985, the Executive Board had increased the reserve target from 3 percent to 5 percent in response to the risk stemming from the arrears problem. In view of the arguments that had been made in behalf of that step, the amount of reserves resulting from the increase in the reserve target could be considered as a kind of special reserve that should be used to meet losses arising from overdue payments. He had an open mind on increasing the general reserves or establishing a special reserve, provided that fair consideration was given to adequate formulas for burden sharing.

Mr. Foot said that the preliminary nature of the present discussion should be stressed. Executive Directors' comments had already revealed a number of difficult problems with respect to provisioning. There should be a comprehensive and structured approach to the estimation of a possible material loss. The present discussion was the first step in establishing that structured approach.

Common sense suggested that, in addition to the cases outlined in SM/86/106, the Executive Board could decide when the Fund was likely to suffer an effective reduction in the value of its assets and should take precautionary steps, Mr. Foot continued. There would of course be room for argument in applying such an approach, but there had been a number of cases of debt repudiation outside the Fund. While an examination of individual cases was difficult, the example of Kampuchea underscored the real likelihood of having to write off a loss. The kind of precautions that he had in mind need not resemble general provisions. Instead, the Fund should look at specific cases and exercise judgment, albeit judgment that was strongly guided by objective criteria, such as the length of time that a member's overdue obligations had been outstanding. There was no need at the present stage to take such precautionary steps, but that possibility should be considered in future years if current trends were to persist.

Whatever steps might be taken in the future, the signals that they might send should be carefully considered, Mr. Foot went on. Some previous speakers had correctly underscored the inappropriate signals that provisioning adopted at the present stage might send to the banking community. However, he doubted whether provisioning by the Fund would be taken as a sort of credit rating trigger by a commercial bank; the banks were probably farther along on the road to provisioning than the Fund. However, provisioning in the context of the Fund could be taken to mean that the Fund had accepted that in certain cases it could no longer deal with the problems that it had been designed to deal with. Provisioning to deal with large debtors could have an adverse impact upon banks' confidence in the overall debt strategy. The introduction of provisioning could destroy any remaining chances of repayment by a member with overdue obligations. In addition, provisioning would eliminate any idea that the Fund would subsequently be prepared to settle an overdue obligation by writing down the value of the overdue amount. Such problems could be addressed and need not preclude some precautionary action where necessary.

The United Kingdom supported the adoption of specific provisioning in the World Bank, Mr. Foot remarked. His authorities agreed with the President of the World Bank that provisioning was required to ensure the preservation of the World Bank's standing in the markets in which it borrowed. The relation between the World Bank and the financial markets justified a different conclusion regarding provisioning from that which he had arrived at in respect to the Fund.

He agreed with the staff that reserves and provisions were not interchangeable, Mr. Foot said. However, an adequate level of reserves was important for the Fund. In addition, developments in the size and pattern of overdue obligations, together with a decline in the Fund's reserves as a proportion of credit outstanding over the previous several years, justified a renewed examination of the target for reserves and of the nature of the precautionary steps that the Fund might take to provide for future losses.

Mr. Wijnholds noted that several speakers had referred to the adequacy and the size of the Fund's reserves in the context of provisioning. The staff should update its examination of the adequacy of reserves. The staff's discussion should include the adequacy of reserves in the light of a possible system of provisioning.

Mr. Fujino recalled that during the previous discussion on provisioning he had raised several questions about the legal aspects of provisioning in the context of the Fund, the unique character of the Fund as an institution, and incentives for members with arrears to discharge overdue obligations to the Fund. Because of those complicated and difficult questions and given the Fund's limited experience regarding overdue payments, his authorities believed that it was premature to conclude that the Fund should introduce a provisioning mechanism at the present stage.

The 1985 External Audit Committee's report had specifically referred to and endorsed the Treasurer's proposal to establish a more structured approach to the evaluation of whether or not a material loss was probable in the Fund, Mr. Fujino said. Sufficient consideration should be given to establishing a comprehensive and structured approach; the staff's work on the matter should be continued. The tasks involved were complex, and quick results should not be expected. Excluding the ultimate possibility of a write-off except in the case of a member's withdrawal from the Fund, it would be difficult to apply provisioning in the Fund in the narrow terms of generally accepted accounting principles, and further study on the application of provisioning in the context of the Fund was required. The Executive Board should return to that matter on another occasion.

In addition, serious consideration should be given to raising the reserve target further in view of the increasing volume of arrears to the Fund, Mr. Fujino remarked. Since June 1985, when the reserve target had been increased from 3 percent to 5 percent, the overall situation concerning overdue obligations to the Fund had further deteriorated. The total amount of those obligations was SDR 654 million on May 14, 1986, which was the equivalent of some 60 percent of the Fund's reserves. The total obligations of members with protracted arrears would amount to almost SDR 1 billion by the end of 1987. In those circumstances, the need to protect the Fund's financial position and integrity had become even more pressing than in 1985. He hoped that the Executive Board could reach an agreement on increase in reserve target during the coming discussion on the Fund's income position for financial year 1987.

Mr. Nebbia said that he agreed with the staff that steps should be taken to preserve the soundness of the Fund's financial position and to respond to the recommendation of the External Audit Committee concerning the growing problem of arrears to the Fund.

The Executive Board had already taken a number of decisions to strengthen the Fund's financial position, Mr. Nebbia noted. The increase in the reserve target from 3 percent to 5 percent in June 1985 had been adopted on the basis of the assumption that it would not affect the rate of charge in financial year 1985 and, even more important, that it would protect the Fund from the adverse effects of the growing arrears problem. The first assumption had proved to be wrong, and the second one seemed to be likely to be proven incorrect.

According to normal accounting procedures provisioning was applicable when there was a probability of a loss and the extent of the loss could be assessed, Mr. Nebbia continued. The discussion at the present meeting and the staff paper on legal considerations concerning provisioning showed that the Fund could incur a loss only in connection with a withdrawal of a member or the even more remote possibility of the liquidation of the Fund. As a result, the probability of a loss was directly linked to the probability of withdrawal by a member that had overdue obligations to the Fund; therefore, the probability of loss in the context of the Fund was nearly impossible to determine.

The staff had emphasized that it was difficult to compare the Fund's accounting practices with the practices of other public or private organizations because the Fund's structure and operations were unique, Mr. Nebbia remarked. The Fund dealt with members and did not have to obtain resources in the market.

The staff had explained that general provisioning was based on past experience and that the amount of provisioning was usually determined by establishing a ratio between past losses on loans and total outstanding credit, Mr. Nebbia said. Such a provision would be arbitrary, since the Fund had had no loan losses in its history. In addition, introducing general provisioning would send the wrong signal to members and the international financial community, namely, that the Fund was no longer confident that it could collect its financial obligations. Sending such a signal would place the soundness of the Fund's financial position in doubt.

The implications for members of specific provisions must be carefully considered, Mr. Nebbia commented. Presumably the problem of overdue obligations to the Fund was not the result of the unwillingness of members to settle those obligations; instead they resulted from a combination of unfavorable internal and external factors. Using specific provisions would send the market signals that might undermine the ability of individual members to eliminate their overdue obligations to the Fund. Specific provisioning against potential losses owing to a particular country would make it almost impossible for that member to obtain credit in private markets with which to repay its overdue obligations to the Fund. Specific provisioning would result in a further deterioration of the creditworthiness of members with overdue obligations. For the membership as a whole specific provisioning would increase the instability in the rate of charge and in the remuneration coefficient.

He shared other Executive Directors' doubts about the application of the concepts of losses and writing-off of assets with respect to members that had not withdrawn from the Fund, Mr. Nebbia remarked. The Fund clearly did not make loans to members; it exchanged currencies with countries. As a result, the Fund held among its assets the currency of each country that had made a purchase from the Fund. Those currency holdings must have some value; accordingly, even if the Fund were fully certain that a member would not become current in the institution, there would be assets that the Fund held that could be used to cover the losses.

The Fund was a cooperative institution that consisted of sovereign member countries, Mr. Nebbia commented. The objective of accumulating substantial reserves each year was to enable the Fund to deal with transitory or permanent losses, including those arising from overdue obligations to the Fund. An increase in reserves was more appropriate than provisioning as a way in which to deal with the problem of the arrears to the Fund. An increase in reserves should be considered in the context of the coming comprehensive discussion on burden sharing.

Mr. Polak remarked that it was clear that the risk had increased in recent years that even in the long run a few countries might not make required repurchases. As a result, serious consideration must be given to the possibility that losses would be incurred by the Fund. Since the Fund's reserves were relatively low, it was necessary to pay serious attention to the question of provisioning. Even if the Executive Board were to conclude that conditions were not yet sufficiently serious to warrant the introduction of provisioning at present, clear conclusions should be reached on how provisioning by the Fund should be designed and on the conditions in which it would be introduced.

Commenting on issues raised in the staff paper on legal considerations, Mr. Polak said that the issues of the probability of loss and of the maintenance of value as prescribed by Article V, Section 11 were essentially unrelated. The Fund had an unusual structure: its claim on a member--the member's obligation to repurchase--was expressed in the member's currency. At first sight, it might seem that the member could unilaterally reduce its liability by depreciating its currency. Article V, Section 11 ensured that that outcome would not occur: the member must maintain the SDR value of the Fund's holdings of its currency. Even if the member failed to do so, the Fund had a claim, expressed in SDRs, for the amount of currency that was lacking. That claim extended beyond membership, as Schedule J provided that a withdrawing member must compensate the Fund for any loss resulting from the difference between the value of its currency in terms of the SDR on the date of withdrawal and the value realized in terms of the SDR by the Fund on disposal under paragraphs 4 and 5 of Schedule J.

Under the provisions of Article V, Section 11, the Fund was in as favorable a position with respect to its claim as it would be if the member had signed a loan obligation denominated in SDRs, Mr. Polak continued. The oddity of having the Fund's assets in local currency had been counteracted by the provisions of Article V, Section 11. However, a claim in SDRs or in dollars was not necessarily a good claim, and losses could be incurred.

The word "loss" appeared in the Articles--specifically in Schedule J--but the Articles did not refer specifically to a loss suffered by the Fund because a member or ex-member failed to maintain the value of the Fund's holdings of the member's currency, Mr. Polak went on. That outcome was unsurprising, as the Articles presumed that members would observe their obligations. However, the absence of a reference to a possible loss was not sufficient reason for the Fund to be unconcerned about such a possibility--especially as losses seemed likely--and to fail to provision against losses.

Commenting on the design of provisioning in the Fund, Mr. Polak said that a good case could not be made for general provisioning. Such provisioning was too close in terms of its effects to additions to the Fund's reserves. The exceptional nature of a failure by a member to repurchase would make it impossible for the Executive Board to design a clear basis on which general provisioning could be applied. Thus, any provisioning that might be agreed must be specific provisioning. However, even specific provisioning could not be based on a quantitative judgment of probable loss using such criteria as the staff had described on pages 10-13. The special character of the claims of the Fund precluded the making of the kind of quantitative judgments on overdue debt that commercial banks could make. Accordingly, specific provisioning by the Fund would have to be based on the presumption that repurchases that had been overdue for a certain period presented a probability of loss and that the magnitude of the likely loss would increase over time. In other words, provisioning in the Fund would have to be based on a formula, such as the one that Mr. Dallara had proposed or the one that was being examined in the World Bank. The five-year period in the World Bank formula and the similar period in Mr. Dallara's formula seemed to be sufficiently short to be usable even in cases in which a member or an ex-member had taken the extreme step of repudiating its liabilities to the Fund.

Provisioning would be made at the expense of the Fund's income, Mr. Polak noted. The present discussion underscored the urgent need to seek agreement on how to allocate among members the cost of the income deferral practice and of provisioning. The Executive Directors had held a constructive discussion on provisioning on April 30, 1986, and a further discussion was scheduled for June 16, 1986. He had been struck during the discussion on April 30 by the unanimous support for the concept of burden sharing. Many Executive Directors had shown a strong interest in the French proposal, and his authorities could accept that proposal, which was characterized by simultaneity and symmetry. However, it was his impression that to reach a general agreement on burden sharing the French proposal might have to be broadened to include the following three ideas. First, the initial portion of the cost of deferred charges and provisioning should be borne by the debtors alone, although the proportion should not be as large or as variable as the staff had suggested during the discussion on April 30. Second, an additional portion should be shared equally by debtors and creditors, and a third portion should be absorbed by creditors alone, as the U.K. chair had suggested. Third, there should be a limit on the amount that could be distributed under burden sharing in order to avoid rates of charge that were sufficiently high to discourage the use of Fund credit and rates of remuneration that were so low as to undermine the willingness of creditors to make the necessary resources available to the Fund. If that limit were reached, it would be necessary to reconsider the question of burden sharing and to decide how the unusually heavy burden--which might well last for just one year--could be borne. The maximum burden might have to be set at about 1 percent or 1 1/2 percent per year, which would imply a maximum surcharge on the rate of charge of 1/2 percent to 3/4 percent per year and a maximum discount on the rate of remuneration of the same magnitude. At present, a maximum burden of 1 percent would yield about SDR 200 million per year and a maximum burden of 1 1/2 percent about SDR 100 million, compared with the staff's estimate of net deferred charges of SDR 67 million for financial year 1987.

Mr. Fugmann recalled that during the discussion on April 30, 1986 he had expressed some skepticism about the applicability of provisioning in the context of the Fund. Since then, he had grown even more skeptical about the proposal. No compelling reason to introduce provisioning rather than some other means of protecting the Fund's financial position had been provided. A compelling reason would be the belief by the Fund that a loss or the uncollectability of repurchase obligations had become probable. The Fund's income position had already been safeguarded against the adverse effects of overdue charges through the introduction in March 1985 of the deferral mechanism that excluded from current income charges that were overdue for six months or more.

In implementing provisioning the Fund would have to find that the principal of a loan--in other words, repurchase obligations--probably was uncollectable, Mr. Fugmann continued. To reach that conclusion the Fund would have to make a judgment that the borrowing member concerned was unwilling or unable to implement adjustment policies in the foreseeable future and that special safeguards to secure the servicing of debt to the Fund would not be introduced in the coming period. Those judgments would be difficult to make. While a judgment on the willingness of a member to pay the Fund could be linked to the duration of overdue payments in the form of a more or less automatic trigger involving a period of more than, say, three years, the situation was totally different with respect to a country's ability to implement economic policies needed to ensure that the country could service its debt to the Fund.

As to the extreme case of Kampuchea, given the duration of its overdue obligations, prudence called for the introduction of some measures regarding the principal owed by Kampuchea to the Fund, Mr. Fugmann remarked. However, the Fund's exposure in Kampuchea was limited, and the amount of overdue obligations was marginal. Accordingly, Kampuchea alone did not warrant the introduction of provisioning against loan losses.

The political risk of repudiation of debt could not be ignored, although no member with overdue obligations to the Fund had indicated either a formal repudiation of its debt to the Fund or an unwillingness to discharge those obligations, Mr. Fugmann remarked. A negative statement by a member on its intention to service its financial obligations to the Fund would of course have to be taken at face value. At its meeting on May 20, 1986 the World Bank's Executive Board was expected to agree in principle to introduce provisioning. The different positions of the Fund and the World Bank with respect to provisioning should be stressed: the World Bank was a borrower in the international capital markets and had to protect its credibility and credit rating; the Fund's lending activities were markedly different from the World Bank's, and given its intergovernmental and cooperative nature the Fund had to pay due regard to a number of factors. In that connection, it was important to remember that Fund credit was extended in the context of an adjustment program that was negotiated with the borrowing country, and that the extension of credit by the Fund took the form of an exchange of currencies. The present discussion on the legal considerations raised in SM/86/106 and on other issues strengthened his doubt about the usefulness of loan loss provisioning in the context of the Fund.

For the time being, he could not accept the introduction of loan loss provisioning in the Fund, Mr. Fugmann stated. There was some risk that the Fund could incur losses, and the Executive Board should review on a regular basis--preferably in connection with its discussion of each six-monthly report on overdue obligations--the risk with a view to determining the probability of loss in individual cases. Such a determination should be based on established criteria. Experience suggested that particular weight should be given to the duration of overdue payments, e.g., three years or more. A review by the Executive Board of each such case would be required; accordingly, conclusions concerning probable loss would not be made entirely on an automatic basis. If the application of the agreed criteria suggested that action was needed, the Executive Board should consider protective measures to counter the detrimental effects of a loss on the Fund's financial position. In that context, the basic alternatives seemed to be provisioning and reserve accumulation. Those two actions were not direct substitutes for one another, but both would have to be examined in order to give the Executive Board alternative possible avenues. Those alternatives should be examined in the context of burden sharing. At present, his first preference was reserve accumulation, but provisioning should not be ruled out, and some form of specific provisioning should be further studied by the staff, not least because of the considerations that had been mentioned by the External Audit Committee. The Fund must adhere to the highest accounting standards so that its financial position would always remain above suspicion.

Mr. Salehkhou said that after considering the discussion in the staff report and the recommendations of the External Audit Committee he believed that the proposal to establish loan loss provisioning was fully inconsistent with the nature of the Fund, which was a cooperative and intergovernmental institution. The proposal was unjustifiable--given the factors responsible for the problem of overdue obligations to the Fund--and it was offensive to a large portion of the membership. The legality of any loan loss provisioning mechanism was questionable given the Fund's system of currency purchases and repurchases in comparison with the usual form of borrowing. Moreover, he was not convinced that provisioning would be adequate either as a means of solving the problems caused by overdue financial obligations to the Fund or as a signal to both debtor members and the international financial community.

Loan loss provisioning was a normal and necessary tool of responsible management of any profit-oriented enterprise and of institutions that depended mainly on capital markets for their financial resources, Mr. Salehkhou continued. Provisioning was needed to assure creditors and shareholders of the profit-oriented institution that the institution's income would be stable and that its assets would be protected. The Fund did not fit any of those descriptions, although responsible and cautious management as well as the confidence of the membership were of crucial importance to the Fund's effectiveness. The cooperative nature of the Fund, the quality of its membership, and the unique character of its financial activities precluded the applicability to the Fund of the concept of loans, profits, and shareholding to which some Executive Directors had referred. While the Fund had depended on its members and their economic performance for its resources, a financial yield was not the objective of the members' investment in the Fund; rather, members wished to ensure a stable international monetary environment, and the major countries wished to maintain a significant influence within the Fund. The proposed provisioning would significantly alter the Fund's image, making the institution merely another creditor, and it would bring the Fund's procedures closer to the practices of commercial banks. Any decision by the World Bank should not affect the Fund's decision; after all, the World Bank relied heavily on market borrowing.

As to the adverse effect of members' difficulty in meeting their financial obligations to the Fund, the Executive Board had already increased the reserve target from 3 percent to 5 percent, Mr. Salehkhou commented. Moreover, the present procedures with respect to the Fund's income were clearly adequate safeguards against significant losses. In any event, under the established procedures there had consistently been a larger accumulation of reserves than that required under Rule I-6(4). Although most of the measures that had been recently adopted to protect the Fund's financial position had dealt mainly with income, they had also increased the cover for the remote risk that purchases would not be made.

Even in traditional financial institutions provisioning was required only when a judgment was made that a loan loss was probable and when that loss could be estimated, Mr. Salehkhou remarked. The External Audit

Committee had noted the difficulty in making such judgments and in evaluating possible losses in the Fund. Moreover, in its paper on the legal considerations the staff had concluded that there would be serious difficulty with the very concept of loan loss in the context of the Fund in view of the Fund's system of drawings and currency purchases. There was no basis for considering that any member in arrears to the Fund would not ultimately settle its overdue obligations. Repeated reviews of the situation concerning overdue obligations had shown that the major factor in the accumulation of arrears to the Fund was the virtual depletion of the reserves of the members concerned owing to the adverse international economic and financial environment. Moreover, all the members concerned, including those that had been declared ineligible to use the Fund's resources, had maintained close contacts with the staff and the Executive Board and many had adopted or were negotiating arrangements with the Fund. Neither past experience nor the current behavior of debtor members pointed to the probability of nonpayment or repudiation of obligations to the Fund.

Many of the criteria that the staff had mentioned as possible indicators of a probable loss were unconvincing, Mr. Salehkhou stated. The heavy burden of external debt and the severely constrained financial circumstances of debtor members were a reflection mainly of prolonged adverse exogenous conditions, including high real international interest rates, and, even more important, of the sharp deterioration in developing countries' terms of trade. The absence of an economic program with the Fund could not be regarded as an indication of a weakening of a member's intention to discharge its obligations, especially in view of the recent considerable tightening of the Fund's conditionality, the sharp reduction in actual access, the continued erosion of the concessionality of the Fund's resources, and the failure of programs to address effectively the difficulties facing the members concerned.

He agreed with other Executive Directors who had stressed the signals that the establishment of provisioning in the Fund would send to members and the international community, Mr. Salehkhou said. Loan loss provisioning was hardly a step in the right direction in terms of encouraging members to discharge their obligations and donors and creditors to assist members in solving the problems facing their economies. Moreover, at a time when the Interim Committee had expressed confidence in an improvement in the world economic outlook, including developing countries' prospects, and when the Fund had significantly reduced its financial assistance as a result of that expected improvement, the establishment of a provisioning system in the Fund would clearly indicate that overdue financial obligations to the Fund were far from being a country-specific problem. Introducing provisioning would raise serious questions about the effectiveness of the Fund's assistance to members in difficulty and about the Fund's overall role in the international monetary system. Efforts to encourage private and official creditors to maintain and increase their exposure in developing countries would be impaired by the introduction of provisioning in the context of the Fund.

He did not favor establishing what had been called a more comprehensive and structured approach to the evaluation process as to whether a material loss was probable, Mr. Salehkhou said. Such an approach was the necessary first step to the introduction of a provisioning system. The six-monthly report on overdue obligations to the Fund was an adequate way in which to deal with all the issues that were raised by such obligations. The External Audit Committee should be informed that the Executive Board had reviewed the probability of loss and had concluded that in the light of the measures that had already been implemented as well as of the existing safeguards no further action was required at the present stage. The alternative to provisioning that had been mentioned by the staff and that had been supported by some Executive Directors would for all practical purposes have many of the negative effects of provisioning and would be unfair to members that were attempting to remain current in the Fund. Even if an equitable system of burden sharing were adopted, a further increase in the reserve target would complicate members' adjustment efforts and could be counterproductive in the effort to deal with the problem of overdue obligations to the Fund.

Mr. Huang remarked that, although the amount of overdue financial obligations to the Fund had been increasing for some time, the situation had recently improved. He agreed with Executive Directors who had stressed that the problem of the overdue financial obligations might well be temporary. The problem was not attributable solely to mismanagement by members; exogenous factors, most of which were beyond the control of the authorities concerned, had played an important role. In most cases, members had simply been unable to remain current in the Fund. All members--creditors, debtors, industrial countries and developing countries--should work together to find ways in which to solve the problem of the arrears to the Fund. The introduction of the structural adjustment facility, the emphasis on growth-oriented adjustment, and the strengthening of multilateral surveillance over the macroeconomic policies of the major industrial countries were steps in the right direction, and additional constructive measures were required.

The Fund was an international governmental institution that had always been able to rely on the cooperative spirit of its members, Mr. Huang continued. It extended loans only to sovereign governments and then only in the form of sales of currencies or SDRs for the equivalent amount of the purchasing member's currency. While there had been cases of overdue financial obligations in the past, there had been no loan losses in the history of the Fund. Moreover, the Fund was not governed by any national or international accounting principle under which provision must be made against any probable loan loss. The probability of a loss owing to a member's failure to make a repurchase was a matter of judgment; indeed, the judgment would be particularly difficult to make. Specific provisioning would increase the instability in the rate of charge and in the remuneration coefficient and would adversely affect the reputation of the member against which the provisioning was made. The issue of provisioning was a practical one rather than a theoretical one. If an increase in reserves could perform the same function as provisioning, there was no urgent need to establish provisioning at the present stage.

He did not wish to consider provisioning at the present stage, Mr. Huang stated. The Fund could introduce provisioning only in connection with the withdrawal of a member and when the member had expressly repudiated all its obligations to the Fund.

Mr. Jaafar said that he was not yet convinced that there was a need to move in the direction of provisioning in the coming period. The overdue obligations to the Fund were a cause for concern, but the time was not yet ripe for the Executive Board to adopt a special procedure similar to the procedures practiced by financial and other business enterprises to make provision against possible loan losses. There were two reasons not to introduce provisioning in the near future, Mr. Jaafar continued. First, the Fund was a unique institution: it made loans only to sovereign countries, and although there had been considerable discussion inside and outside the Fund regarding sovereign risks when the debt crisis had emerged several years earlier, sovereign obligations--including those to the Fund--had never been repudiated. Second, provisioning in substance had already been made in a general fashion that did not highlight unnecessarily a probable risk that for the moment was not large and could be contained; that form of provisioning was the accumulation of reserves in the Fund. In that connection, the Executive Board had recently increased the reserve target to 5 percent. That decision had been based significantly on the wish of Executive Directors to provide for a contingent loan loss in response to the increasing overdue obligations to the Fund. Whether or not the target was appropriate was not the main issue at hand. The main issue was whether or not accumulation of reserves served the same function as provisioning. In his view, because of the unique nature of the Fund, it was more appropriate to increase reserves than to introduce provisioning.

In the early 1980s, there had been a severe world economic recession, during which commodity prices had fallen to record low levels and interest rates had reached unprecedented high levels, Mr. Jaafar commented. The problem of overdue obligations to the Fund had occurred because of the adverse international economic environment that presumably was temporary in nature. All the countries that had arrears to the Fund had indicated that they would honor their obligations as soon as their economic conditions improved. No member had declared its intention not to live up to its obligations to the Fund.

The Fund would have further flexibility in provisioning if it provided for an increase in reserves rather than for normal provisioning, Mr. Jaafar considered. For example, reserves could be used not only to offset a possible loan loss but also to provide financial assistance to members. Provisioning would be more specific: the sum set aside for provisioning could not be used for any other purpose. The amount of reserves that were to be used for provisioning should be considered in the context of burden sharing.

He was not yet certain which procedure was best for assessing a probable loan loss, Mr. Jaafar said. Mr. Zecchini's proposal to provide for an automatic increase in reserves within a certain period after the declaration of ineligibility was attractive. In addition, there was merit in Mr. Nimatallah's proposal to consider that a loan loss was probable in the case of obligations that had been overdue for more than three years. An important aspect of Mr. Nimatallah's proposal was that the assessment of probable loss would be made after account had been taken of the effort by the member concerned to settle its overdue obligations to the Fund. That approach would give the member the maximum latitude to settle its obligations to the Fund; after that latitude had been fully used, appropriate action should be taken by the Fund.

In SM/86/106 the staff had discussed the concept of a loss in the value of the Fund's holdings of a member's currency, Mr. Jaafar noted. The staff had concluded that the nonfulfillment by a member of certain obligations did not necessarily result in a loss for the Fund, and that a loss could occur only in connection with the liquidation of the Fund or the withdrawal of a member. In the latter event, the loss would occur if the member, after withdrawing from the Fund, did not repurchase the Fund's excess holdings of the member's currency and did not cover any loss incurred by the Fund when the institution sold its holdings of the member's currency in the market. Those conclusions made it difficult for him to support provisioning at the present stage.

Mr. Rye recalled that during the discussion on April 30, 1986 his chair had stated that the introduction of provisioning would represent a watershed in the Fund's history. Provisioning should not be introduced unless it was clear that no sensible alternative existed. That point had not yet been reached. Provisioning would represent a substantial change in the nature of the Fund in general and in the relationship between the Fund and members in particular. That conclusion must not be lost sight of during the examination of possible provisioning.

It would not be possible to achieve through a judicious use of the reserve and income targets all or nearly all that could be achieved through provisioning, Mr. Rye considered. The reasons for drawing that conclusion had been mentioned by previous speakers, especially Mr. Zecchini. However, the Executive Directors did not have sufficient knowledge to draw final conclusions about provisioning at the present stage. Mr. Dallara had raised a number of thought-provoking questions. Much depended on the answer to whether the determination of a probable loss necessarily hinged on a determination that a member was likely to withdraw from the Fund. If so, there would be few if any cases involving arrears that had accumulated for more than, say, two years, about which it could be confidently concluded that there was an actual probability--in other words, a statistical probability in excess of 0.5 percent--of a withdrawal and therefore of a loss. However, if in any particular case the Fund were able to draw such a conclusion, it would seem to follow--especially as the member concerned would already have substantial arrears--that provisioning should cover 100 percent, or nearly 100 percent, of the outstanding obligations of that member. Mr. Dallara had posed a significant question in noting that the Fund had a class of assets--relating to arrears that had existed over a certain period--each of which had no probability of loss but did have a small possibility of loss that in the aggregate might be thought of as a probability of loss for the whole group of assets. He wondered whether provisioning on the basis of that logic was legally permissible. Even if there were no legal obstacles to it, the objective of introducing such a general provision could be met just as well by strengthening the Fund's reserves.

His views were personal in nature, Mr. Rye said. His Australian authorities were more favorably disposed than other members of his constituency toward provisioning, which they believed was consistent with sound accounting principles and would lend a desirable transparency to the Fund's accounts. However, his Australian authorities would not object to using the reserve mechanism to cover the problem of possible losses in the Fund.

Mr. Alfidja remarked that the request to examine the issue of provisioning had been made by Executive Directors who felt that steps to safeguard the Fund's financial integrity were needed in response to the effects of overdue obligations on the Fund's financial position. Despite the difference of views on the appropriate approach to deal with the problem of overdue financial obligations, Executive Directors agreed on the need to preserve and, when necessary, to enhance the Fund's financial strength.

The staff papers adequately emphasized the particular features of the Fund, Mr. Alfidja said. In the light of the discussion in those papers and of the comments by previous speakers he was not convinced that the time was ripe to establish provisions against loan losses in the Fund. In arriving at that conclusion he had taken into account the uniqueness of the Fund and its operations, the existence of mechanisms that were designed to strengthen the Fund's financial position in response to overdue obligations, and the wrong signals that the introduction of provisioning might send to the international financial community. Before firm conclusions on provisioning were reached further study would be needed, including a more detailed presentation by the staff of a possible comprehensive and structured approach to the evaluation of whether or not a material loss was probable with respect to members with protracted overdue obligations to the Fund.

Provisions against loan losses should not be established at the present stage, Mr. Alfidja considered. He shared other Executive Directors' concern about the financial strength of the Fund, but the problem of overdue financial obligations was temporary and would be solved as the international economic environment improved. On page 13 the staff had noted that the increased incidence of overdue obligations had occurred against a background of difficult economic and financial conditions for many members--including in particular the poorer debtor countries--that might be temporary as economic recovery became more widespread. Moreover, the possible gains from establishing loan loss provisions were uncertain while the drawbacks were clearly significant.

Mr. Alhaimus said that he wished to associate himself with previous speakers who had said that there was no need to introduce provisioning in the context of the Fund. The cooperative nature of the Fund, the elaborate procedures that it had developed to deal with the problem of overdue payments, and the fact that a probability of loss had to be based essentially on a judgment that a withdrawal from the Fund was likely meant that the probability of loss was too small to warrant provisioning.

The Treasurer noted that a number of Executive Directors had mentioned the authority of the Fund to sell the Fund's holdings of the currency of a member that had withdrawn from the Fund and had not met its repurchase obligations. It was important to note that conceivably the Fund would hold only a claim on a member's currency if the member had not, after devaluing its currency, made a payment to the Fund to maintain the SDR value of the Fund's holdings of the currency. As Mr. Polak had noted, even if the Fund's claim on the member were valued in SDRs, the Fund still faced the possibility of incurring a loss. Moreover, even after a member had withdrawn from the Fund, it was not obvious that the Fund could sell its holdings of the member's currency; such sales would be the only way in which the Fund could offset any loss resulting from the member's inability or unwillingness to meet its obligations to the Fund. The Fund did not hold its currency balances in a private account or in some other account that was not controlled by the member. The holdings were kept in the depository of the member, and if the member had defaulted on its obligations to the Fund, there was no guarantee that that member would permit the Fund to sell its currency, thereby enabling the Fund to cover any loss. Such an outcome was of course unlikely to occur in practice, but the possibility could not be ruled out altogether.

Judgments on whether a loss was probable were difficult to make, the Treasurer remarked. However, the auditors could be expected to ask whether management or the Executive Board considered that such a loss was probable, and a judgment would have to be made. Presumably Executive Directors felt that the time was not yet ripe to make such a judgment.

The Director of the Legal Department noted that a possible loss could be covered by reserves while a probable loss could be covered by a loan loss provision. The same losses could not be covered by both reserves and provisioning; they would be covered by one or the other.

The question had been raised about the basis on which the Executive Board would conclude that there was a statistically relevant risk with respect to particular assets, the Director of the Legal Department commented. The Fund dealt with individual countries. Each member had its own economic and political structure and could be analyzed separately as a potential risk with respect to repayment to the Fund. A commercial bank could deal with categories of customers or all its customers as a group in making a statistical estimate of risk. It would not be appropriate to use statistical analysis to assess risk in the Fund.

Mr. Goos said that he had meant to suggest that the Fund could introduce greater precision into its balance sheet that would more or less fulfill the same function as provisioning. In addition, the amounts accumulated in a special reserve could be redistributed after the problem that had caused the build-up in reserves had been eliminated. As he understood it, a distribution of the general reserves had to be made to all members; it could not be limited to certain members.

Mr. Rye commented that presumably a statistical assessment of risk would have to be made under the scheme that Mr. Dallara had suggested, and particularly in connection with the 15 percent threshhold under that scheme.

The Treasurer remarked that the general reserve was meant to cover income deficits. Any distribution of the general reserve had to be in proportion to quota. If the Executive Board decided to establish a "reserve" to safeguard the Fund's financial position against a possible loss, a refund liability could also be established so that the "reserve" would be distributed to members that had paid a surcharge or received a smaller rate of remuneration as a result of the establishment of the "reserve." In fact, however, that amount of resources would actually be a liability of the Fund, rather than a reserve, and should not be called a reserve.

Mr. Zecchini commented that conceivably a certain amount of reserves financed by a particular group of members--say, debtor countries--could be set aside. If the overdue obligations against which the reserve had been established were eliminated, the reserve could become part of the Fund's current income, and could therefore have a positive effect on the rate of charge for the current or subsequent year. Accordingly, although the specific countries that had contributed to the build-up of the reserve might not benefit directly from the distribution of the reserve, they could benefit indirectly.

The Treasurer remarked that it would be possible to establish a system under which any amount remaining after the Fund had paid itself could be distributed to the members that had financed the original amount. For example, if it were decided that it was no longer necessary to maintain a particular safeguard, even the members that had originally contributed to the safeguard could conceivably be reimbursed in proportion to their contribution.

The Director of the Legal Department added that it would be legally possible for the Fund to undertake to repay a surcharge that had been paid by debtors over a certain period.

The Chairman made the following summing up:

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

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

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

At the same time, many Directors, constituting a significant proportion of the voting power, stressed the need for the Fund to maintain high standards in its accounting practices and to provide adequate protection aginst the risk of erosion of its financial assets. A number of Directors questioned in this regard the adequacy of the level of the Fund's reserves. Those Directors also stressed the need for the Fund to assess periodically and carefully, on a country-by-country basis, the adequacy of the level of reserves. Those speakers felt that if this examination should lead to the conclusion that additional "safeguard measures," as some speakers called them, were needed to cope with financial risks to the Fund, the measures should take the form of special reserves. Most Directors who mentioned the possible need for safeguard measures also said that their views on the question of burden sharing they had expressed on previous occasions should be taken into account in the formulation of the safeguard measures. We will be studying carefully the various suggestions that were made concerning the possible development of a structured method or approach to handling financial risks, be it the provisioning route or special reserves. A number of questions have been raised to which we will have to come back--for example, the link between provisioning and the notion of a write off. What are the practical differences between the technique of provisioning and the technique of increasing reserves? Are some of the objectives of provisioning not reachable within the framework of an increase in reserves, or could an increase in reserves accomplish what provisioning is supposed to accomplish? The question has been raised of a possible refunding of special increases in reserves to members that contributed to that increment if the extra reserves should prove to be unnecessary.

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

Mr. Nimatallah commented that specific and general provisioning were not mutually exclusive. They could conceivably be combined.

The Chairman said that he agreed with Mr. Nimatallah. There could be a case-by-case examination of possible risks that could lead to, say, an increase in reserves, in which event there would be no need to disclose the analysis of individual cases that had led to the reserve increase.

Mr. Dallara commented that there were several possible variations of provisioning on the basis of the approach that he suggested and the suggestions that had been made by Mr. Zecchini and Mr. Goos. The staff should analyze the full range of possible options.

The Executive Directors concluded for the time being their discussion on provisioning in the context of the Fund.

2. SCHEDULE OF MEETINGS

After a brief discussion the Executive Directors agreed that the Board's consideration of the six-monthly report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86; and Sup. 1, 5/16/86) should be rescheduled from May 19 to June 6, 1986.

APPROVED: February 5, 1987

LEO VAN HOUTVEN
Secretary