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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/100

2:45 p.m., June 20, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
	H. G. Schneider
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	Jiang H.
	Jaafar A.
	J. Hospedales, Temporary
	M. Foot
	H. Fugmann
M. Massé	L. Leonard
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

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

Also Present

Exchange and Trade Relations Department: P. E. Gleason. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, R. H. Munzberg. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. H. Brown, D. Gupta, B. E. Keuppens, R. B. Hicks, P. M. Tillotson, 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: M. B. Chatah, L. P. Ebrill, G. D. Hodgson, H.-S. Lee, K. Murakami, S. Ganjarerndee, A. Ouanes, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, O. S.-M. Bethel, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrân, F. Di Mauro, W. N. Engert, R. Fox, G. K. Hodges, L. Hubloue, O. Isleifsson, A. R. Ismael, J. M. Jones, S. King, V. Govindarajan, T. Morita, J. Reddy, J. E. Rodrîguez, V. Rousset, C. A. Salinas, H. van der Burg, E. L. Walker, B. D. White.

1. INCOME POSITION FOR FY 1986 AND FY 1987 - REVIEW AND RELATED ISSUES; DISPOSITION OF NET INCOME FOR FY 1986

The Executive Directors considered a staff paper on the Fund's net income for FY 1986 and FY 1987, the disposition of net income for FY 1986, and the determination of the rate of charge for FY 1987 (EBS/86/116, 5/28/86).

Mrs. Ploix said that she wished to venture a definition of a few principles that might help guide the discussion toward a consensus. The two basic and strongly supported principles of her chair's position on burden sharing--symmetry and simultaneity--seemed to have been received favorably because they led to a simple formula. Thus, she wondered whether a third principle--simplicity--could not be adopted. Presumably, if a formula could be found through which those countries that had supported an increase in the rate of charge and a decrease in the rate of remuneration were also those that benefited from refunding upon the settlement of deferred charges, a consensus would be more easily achieved. The staff's proposal in that respect was helpful and she could support it instead of the netting out system.

To make sure that the system was temporary and exceptional, Mrs. Ploix observed, she would favor its review after one or two years. In addition, there should be an automatic review if, for instance, the rate of remuneration fell to 85 percent of the SDR rate. The choice of a floor also imposed a symmetrical ceiling, and the system could not be misused to respond to other than the temporary and exceptional situation which it had been designed to deal with.

As to the excess income, it had to be recognized that it was in part due to the recent fall in interest rates, Mrs. Ploix remarked. Therefore, she would deem the full amount of excess income for FY 1986, namely, SDR 26 million, as income for FY 1987, with the prospect of reducing the rate of charge for FY 1987. At the same time, she would like to take the opportunity of such a decision to put in place a burden sharing system in some suitable form.

As she saw it, two basic systems had been proposed, Mrs. Ploix stated. One was based on symmetry and simultaneity, and the other was based on a multiple-step approach with the debtors alone assuming the first part of the burden. By deeming all of the excess income for FY 1986, some symmetrical first step--whatever its nature--could be taken in favor of the creditors. A simple, simultaneous and symmetrical sharing of the burden of gross deferred income could then begin.

The recent discussion on provisioning had provided an opportunity for an exchange of views on that matter, Mrs. Ploix recalled. The establishment of a system for sharing the burden of deferred income was a way to strengthen the financial structure of the Fund. A temporary surcharge under a burden-sharing system would improve the Fund's cover.

However, her authorities were willing to study the matter of provisioning, which focused on the role and magnitude of reserves. In the meantime, the present target of net income for FY 1987 appeared appropriate.

Finally, she could go along also with the staff proposal in paragraph 4 of the conclusions in Section V of EBS/86/116 with respect to the review of the remuneration coefficient and the SDR rate of interest.

The Chairman remarked that if the full amount of excess income for FY 1986 were deemed as income for FY 1987, with the goal of achieving the reserve target of 5 percent in FY 1987, the outcome would be to alleviate only the problem of debtors with respect to charges.

Mrs. Ploix confirmed that that was her intention. At the same time, and as a first step in burden sharing, she envisaged the possibility of deflecting certain ideas affecting the basic rate of charge that might be put forward by some creditors. Some thought should be given to ways of achieving that objective.

Mr. Massé noted that the continuing problem of overdue obligations raised a number of complex issues related to the Fund's income position for FY 1986 and FY 1987. The final outcome for FY 1986 showed that the income target had been exceeded by some SDR 26 million. After weighing the available options, the view of his chair was that there was a good case for adding that excess income to special reserves without deeming. Given the continuing rise in overdue obligations to the Fund and the considerable uncertainty about the seriousness of that problem in the future, adding that amount to special reserves seemed to be a prudent course to follow. His inclination in that respect was based mostly upon the concern of some of his authorities that existing reserves might not be adequate to meet potential future needs arising from growing overdue obligations. That also led him to believe that consideration might need to be given to increasing the reserve target above 5 percent.

The second issue to be addressed was how the cost of deferred charges was to be shared among the membership of the Fund, Mr. Massé went on. During the discussion of the Fund's income position on April 30, 1986 (EBM/86/73 and EBM/86/74), he had suggested that thought be given to some means of spreading the impact of income shortfalls across the entire membership, in relation to quotas, if possible. The staff had examined that idea and had noted that the Articles of Agreement did not allow the Fund to impose a levy on all members. The other options mentioned in the staff paper, such as gold sales or voluntary contributions, did not seem very practical. While only a small number of members would in fact be excluded from other systems of burden sharing, including those that had been proposed so far, nonetheless he encouraged the staff to continue to think about other methods of sharing the impact of overdue obligations more equitably across the entire membership.

In the meantime, Mr. Massé added, it was necessary to find some practical means of dealing with the consequences of the failure of some members to meet their payments obligations to the Fund. He saw no obvious or inherent reason why the cost should be borne entirely or principally by borrowers or, for that matter, by any other group. Given the options available, the idea underlying Mrs. Ploix's proposal for sharing the burden of deferred costs equally between the rate of charge and the rate of remuneration was, broadly speaking, the preferable course to follow.

It had to be recognized that an element of subsidy continued to exist if the rate of remuneration was set below the prevailing SDR interest rate, Mr. Massé said. As Mr. Goos had emphasized during the discussion on April 30, it was premature to talk about equitable burden sharing in the Fund if creditors already were providing some element of subsidy, not to mention the unremunerated reserve position of members. Therefore, there appeared to be grounds for making allowance for the subsidy element prior to dividing the cost of deferred charges equally between creditors and borrowers. The view of his chair was that an increase in the rate of remuneration to 100 percent of the SDR interest rate would be the most effective means of reducing that implicit subsidy and the point of departure for making an equitable split of the burden of deferred charges.

As for the basic rate of charge for FY 1987 and the corresponding surcharge and discount, Mr. Massé observed that if the French proposal for an even split between a surcharge on the rate of charge and a reduction in the rate of remuneration was accepted, agreement would have to be reached on the starting point for that surcharge and reduction, respectively. He had already suggested that the remuneration coefficient be increased to 100 percent as a starting point. For the rate of charge, he would favor a basic rate that assumed no deferred income. The next question was whether the surcharge and the reduction in the remuneration coefficient should be set at the beginning or the end of a given period. Mrs. Ploix had suggested that the amounts be determined at the end of the period because of the uncertainties involved in projecting arrears. While recognizing those uncertainties, his authorities would prefer to set the surcharge and rate of remuneration discount at the beginning of a period, based on staff projections of overdue obligations; an adjustment would be made at the end of the period to take account of the actual results rather than waiting until the end of the period to make the entire adjustment. By using a forecast and setting the surcharge and discount at the beginning of the period, Fund members would have a better idea of the relative magnitude of the adjustments, even if they did not know the exact amounts, and could plan accordingly.

Under the Articles of Agreement, the rate of remuneration could not fall below 80 percent of the SDR interest rate, Mr. Massé noted. In recent years, the remuneration coefficient of 85 percent that had been effectively established as a floor would present a reasonable lower limit on the rate of remuneration. In the unlikely event that that lower limit was reached, provision needed to be made in the form of a review to protect the Fund's financial position, if there was a chance of the limit being reached. The margin between 80 percent and 85 percent should allow both the remuneration coefficient and the rate of charge to be adjusted further if needed.

On the settlement of deferred income, Mr. Massé said that his preference would be to provide a refund to those members that had paid the surcharge and foregone remuneration as and when the corresponding deferred charges were paid. The staff had proposed the establishment of a collateral account to keep the proceeds of surcharges and remuneration discounts separate from Fund net income for the purpose of refunding once arrears were paid. He was not certain that such a separate account was required other than for reasons of emphasis or transparency. The period for which the surcharge and discount was calculated could be semiannual.

Finally, in the transition to a new system, it would make sense, for the sake of simplicity, to apply the new system from the time that the Executive Board decided on a revision of the existing system. Furthermore, he agreed in general with the views offered by the staff relating to Rule I-10, namely, that no further review was required prior to the midyear review of the Fund's income position. Rule I-10(d) should be amended to introduce the concept of period averaging.

The position he had set out was complicated because it contained elements of more than one of the proposals that had been put forward, Mr. Massé remarked. But he had offered those ideas in the interest of reaching an effective compromise. Basically, there were two possible options. The first, as he understood Mr. Polak's proposal, was to allocate the cost of deferred charges first to an increase in the rate of charge by one half of 1 percent, to be succeeded by an equal sharing of the cost. In comparison, the option that he had described was one in which the cost of deferred income would be shared equally by the rate of charge and the rate of remuneration, without that initial allocation of one half of 1 percent, the counterpart being an increase in the remuneration rate to 100 percent. The decrease of that traditional subsidy would compensate only in part for the absence of an initial increase of one half of 1 percent in the rate of charge to debtors; the balance of the counterpart would be an increase in the reserve target from 5 percent to 8-10 percent, to deal with problems that were emerging in terms of arrears; *the third element of the compromise would be an increase in the floor on* the rate of remuneration from 80 percent to 85 percent. Preliminary calculations of the two options that he described showed that the final rate of charge would not differ greatly under one scheme or the other.

His authorities' preference was for a simultaneous solution of a number of problems that were either being faced or soon would be, Mr. Massé concluded. Fixing the rate of remuneration at 100 percent of the SDR interest rate, thereby removing the subsidy provided by creditors, would be useful to various members. His authorities were also convinced that the reserve target would have to be increased within the months ahead. If a workable consensus could be reached on the package he had described, his authorities would be ready to re-examine the disposition of the excess income of SDR 26 million. But for the time being, the compromise favored by his authorities was to share the cost of deferred charges equally between the rate of charge and the rate of remuneration, the counterpart being an increase to 100 percent in the remuneration coefficient.

The Chairman noted that the staff had made some calculations on the incidence on the rate of charge and the rate of remuneration of the proposal formulated by Mr. Massé compared with other proposals, including that of Mr. Polak. The calculations were sensitive to the amount of deferred income during a year, but on the assumption of the projected deferral for FY 1987 mentioned in Table 4 of the Appendix to EBS/86/116--SDR 132 million--under Mr. Massé's proposal, the increase in the total rate of charge would be 0.79 percent and the reduction in the rate of remuneration would be 0.34 percent--with an increase in the net income target to the maximum figure he had suggested of 10 percent--compared with 0.50 percent and 0.18 percent, respectively, under Mr. Polak's proposal. For an amount of deferred income of SDR 250 million, the increase in the rate of charge under Mr. Massé's formula would be 1.09 percent whereas it would be 0.50 percent under Mr. Polak's first formula.

Mr. Dallara remarked that he had understood Mr. Polak's proposal to incorporate also the possibility of an increase in the reserve target that would be taken into account in the basic rate of charge.

Mr. Polak noted that the suggestions he had put forward so far were entirely on burden sharing. Those suggestions could be combined with whatever reserve target was preferred. Burden sharing dealt only with deferred income and led to surcharges on the basic rate of charge and discounts from the basic rate of remuneration: how those were determined should be treated separately from the question of the reserve target, which would however be increased somewhat under his own proposal.

The Chairman remarked that if Mr. Polak's integral proposal led to an increase in the basic rate of charge, it would come much closer to Mr. Massé's proposal.

Mr. Massé commented that of course much would depend on the actual amount of deferred income. However, if no allowance was made for the effect of an increase in the reserve target, the difference between the rates of charge and rates of remuneration under his formula and that of Mr. Polak would be negligible in terms of the net burden. For instance, the difference between an increase in the rate of charge of 0.63 percent and a decrease in the rate of remuneration of 0.34 percent was 0.29 percent, compared with a difference of 0.32 percent for an increase in the rate of charge of 0.50 percent and a reduction in the rate of remuneration of 0.18 percent. Nevertheless, it had seemed to him that an increase in the rate of accumulation of Fund reserves would eventually become necessary in any event. An increase in the reserve target would have advantages, over and above those relating to burden sharing, among other things, because it would improve the Fund's financial position and credibility. The advantage of combining an increase in the reserve target with the system of burden sharing was that it would be much easier to balance the surcharge and the discount than if a further decision had to be adopted during the course of FY 1987 to change the reserve target.

Mr. Sengupta said that although it was helpful to have additional indications of the calculations relating to various proposals, in his view, the staff paper had made a major contribution to the discussion by separating the issue of the basic rates of charge and remuneration from the implications of the mechanisms for sharing the burden of deferred income along the lines proposed by Mrs. Ploix and Mr. Polak. To bring in the effect of a change in the reserve target on the basic rate of charge would call for consideration of other factors relating to net income, which should be discussed separately.

The Chairman responded that although the two issues needed to be kept separate, it was also necessary to have in mind some idea of the total incidence on the rate of charge of the various burden-sharing elements proposed, including the rate of reserve accumulation preferred by the proponents of those proposals.

Mr. Sengupta asked what Mr. Massé's position would have been, had he not proposed an increase in the reserve target.

Mr. Massé replied that he would probably have gone along with Mr. Polak's original suggestion to impose a surcharge of 0.5 percent and then to split the balance of the cost between the surcharge and the discount. But that had seemed to distribute the burden unfairly, prompting him to consider the matter in a wider context.

The Chairman remarked that the surcharge and discount resulting from Mr. Massé's proposal--if the proposed increase in the remuneration coefficient and in the reserve target, and the resulting increase in the basic rate of charge, were not taken into account--would both be set at 0.34 percent, in line with the French system of sharing the burden equally between debtors and creditors. The basic rate of charge in the formula Mr. Massé had described would increase in order to permit the reserve target to be raised up to a maximum of 10 percent and the remuneration coefficient to reach 100 percent. Under the two versions of the method proposed by Mr. Polak, the surcharge and the discount would be 0.50 or 0.59, and 0.18 or 0.09, respectively, depending on whether or not the rate of remuneration was reduced when the surcharge reached 0.33 percent or 0.50 percent. Mr. Polak's proposal would lead to equal sharing of the burden only when the total deferred income reached SDR 200 million or SDR 300 million, again depending on how much of the burden--0.33 percent or 0.50 percent--the debtors bore initially. The staff had prepared a new version of Table 4 in the Appendix to EBS/86/116 to illustrate the impact of the proposals by Mr. Massé, Mr. Polak, and Mr. Lankester, which could be circulated, if the Executive Directors concerned agreed (see EBS/86/116, Sup. 1).

Mr. Foot commented that he too hoped that a constructive dialogue on a package of changes to the existing rules would generate a consensus or at least point the way toward that consensus without much further delay. To begin by recalling the discussion at EBM/86/73 and EBM/86/74 (4/30/86), he noted that those who had opposed the staff scheme--whereby burden sharing would begin once the rate of charge exceeded the five-year SDR rate plus one half percent--had made two observations: first, that the starting point for burden sharing was too high; and second, that the five-year SDR rate was an unacceptable base. His authorities were prepared to accept both those arguments. However, they retained the strong view that burden sharing could not begin at a rate as low as the short-term SDR rate or a fortiori the basic rate, and they remained of the view that any arrangement should in the first instance run for no longer than FY 1987. Nevertheless, his authorities would be prepared to base a scheme of burden sharing upon either the short-term SDR rate or the basic rate, with the first tranche of deferred income to be met solely by the borrowers and thereafter with the burden to be shared equally by borrowers and creditors.

To illustrate, and using the statistics in the staff paper, Mr. Foot went on, if the basic rate of charge was taken to be 6.01 percent, which supposed no change in the current SDR coefficient or in the reserve target, he could support a scheme in which, if the rate of charge were to go above 6.51 percent, then borrowers and creditors would share the burden equally thereafter. The only caveat would be that the SDR remuneration coefficient should not fall below 85 percent under any circumstances. Therefore, it would be best if a review were held well before that point, say, when the SDR coefficient seemed likely to fall below 90 percent.

It should be noted that, from the figures in the staff paper, the original staff proposal would have brought burden sharing into operation only when the rate of charge exceeded 7.38 percent, namely, the five-year SDR rate plus one half percent, Mr. Foot continued. The scheme he had outlined would begin burden sharing immediately, and at a rate of charge below that projected under the current rules.

To avoid complicating the issue with additional figures, Mr. Foot offered some general observations. First, his chair, like a number of others, was looking for a rate of remuneration that would rise to and stay at 100 percent of the SDR interest rate. A consensus that that would be the case would put his chair in a position to take account of that benefit to creditors in what was an acceptable package. Equally, some Directors were keen, as previous discussions in the Board had shown, to consider an early rise in the reserve target. The U.K. authorities were concerned to give full and serious consideration to the adequacy of Fund reserves; in an ideal world, the Executive Board would be discussing a staff paper on the adequacy of Fund reserves at the present meeting. Even in the absence of that paper, he would support an immediate increase in the reserve target although he would not press for it, because it would, other things being equal, increase the basic rate of charge. Again, as in respect of the SDR coefficient, he would be prepared to look favorably at some corresponding change in the burden-sharing arrangement; to cite Mrs. Ploix's principles, to achieve symmetry in practice if not quite in presentation.

His strong preference was to put the excess income from FY 1986 of SDR 26 million to reserves, in line with the agreement reached when the target had been raised in 1985 from 3 percent to 5 percent of reserves, Mr. Foot stated. But he recognized that the overall shape of the package to be agreed would have a bearing on the outcome in that respect and therefore he would be prepared to agree that the excess income be placed immediately to reserves on the clear understanding that the Executive Board could subsequently agree to deem the excess as income for FY 1987, in the context of an overall burden sharing package, if that were the general consensus. He asked whether that course of action was possible and would enable the accounts of the Fund for FY 1986 to be closed, the only key operational decision that had to be settled immediately, as had been pointed out at the previous meeting.

With respect to the modalities, within a burden sharing arrangement, for returning to borrowers and creditors future payments of deferred income, the strong preference of his authorities was for a scheme in which payments were returned to those who had borne the burden rather than one in which the payments were netted out against the current charges, Mr. Foot stated. Thus, he favored the refund approach rather than the netting out approach.

He agreed with Mr. Massé that it would be better to set surcharges and discounts in advance and make the necessary adjustment at the end of the period, Mr. Foot went on. He also agreed with Mr. Massé that there seemed to be no prima facie need to have a separate account for recording the proceeds of the surcharge and the amounts equivalent to the savings on a remuneration.

Whatever the shape of the package that was finally agreed, the existing rules, specifically those relating to the midyear review of the Fund's income position, and the requisite action with respect to the rate of charge if no agreement was reached, in the absence of a 70 percent majority, should remain unchanged, Mr. Foot considered. The rules that would operate once a package was put into effect would have to be examined with great care.

He hoped that his remarks would serve as a useful contribution to the debate, the main purpose of which he saw as being to bring into effect for FY 1987 a viable and fair system of burden sharing, Mr. Foot stated. He took it as axiomatic that the agreement reached would in no way lessen the resolve of all members to go on facing up to arrears problems along the broad lines that the Executive Board had agreed so painstakingly over the past two years.

Mr. Salehkhou recalled that recent meetings on the Fund's income position had dealt with specific developments in FY 1986 and the need to correct the rate of charge in order to ensure attainment of the income target. At the present meeting, however, it was necessary to address the wider issue of Fund policies with respect to income and how to strike a balance between the various objectives of those policies. Earlier discussions had indicated clearly that there were conflicts between the decision to enhance the attractiveness of members' reserve tranche positions with the Fund, and, on the other hand, the maintenance of a rate of charge that was stable and compatible with both market interest rates and the cooperative nature of the institution. Since the Board's decision on the treatment of deferred income, those conflicts had been compounded by the issue of overdue financial obligations and the wisdom of financing them through imposing a high surcharge on borrowing members despite their severe difficulties.

Concern in that regard stemmed not only from the obvious inequity of the present system, Mr. Salehkhou continued, but also from the impact that a rate of charge close to commercial interest rates would have on debtor members' incentive to seek either the Fund's assistance at an early stage of their difficulties or to respect the Fund's priority in settling their external financial obligations. In addition to the recent tightening of conditionality and of nominal and actual access, the rising cost of the Fund's ordinary resources had certainly contributed both to increasing overdue obligations and to the declining number of stand-by or extended arrangements. Members with balance of payments difficulties might be tempted by solutions other than cooperation with the Fund, including the accumulation of arrears, or, for those with access to capital markets, recourse to commercial borrowing.

The need for a balance among the various objectives of the Fund's income policies was further underlined by the pronounced shift toward a significantly lower level of use of Fund resources and a more active Fund both in its surveillance function over members' policies and as a catalyst for foreign assistance to developing countries, Mr. Salehkhou observed. It should be noted in that regard that any reduction in members' purchases translated into a reduction in net income because, as indicated in an earlier staff paper on the Fund's income, "charges foregone--both service and periodic charges--exceed at present the concomitant reduction in operational expense--in the form of remuneration, interest expense on borrowed resources, and interest on SDR holdings." Obviously, that excess in the Fund's operational costs would increase to more significant proportions should the current trends on the use of Fund resources and on surveillance continue.

In those circumstances, a consensus finally appeared to be developing in the Executive Board on the need to review the method of calculation of the rate of charge in order to introduce some form of burden sharing to deal with the issue of overdue obligations to the Fund, Mr. Salehkhou noted. Such consensus was welcome, even though none of the proposals before the Board addressed burden sharing in the financing of the Fund's overall activities; yet the Fund's additional operational costs, which were increasingly due to activities unrelated to the use of Fund resources, would continue to lead to higher rates of charge and to a further erosion of concessionality. Furthermore, it was evident that some of the various proposals for burden sharing would be activated only under extreme conditions or would not relieve significantly the pressure on the rate of charge.

The latter point was true of the staff's proposal, which referred to medium-term market interest rates represented by the SDR five-year interest rate as the adequate instrument for measuring Fund concessionality and the level at which any system of burden sharing would be triggered, up to which the staff would add an arbitrary half percentage point, Mr. Salehkhou went on. Notwithstanding the maturity of Fund credit, reference to the five-year interest rate of the SDR was unsatisfactory, not only in view of the cooperative nature of the institution but equally because of the top quality and the liquidity of Fund-related assets. That was all the more so as it was not sufficient to measure concessionality in terms of the differential between market rates for maturities similar to those of the Fund and the rate of charge or remuneration in the absence of an estimate of the benefits associated with large Fund reserve tranches, including influence over Fund policies and high voting power.

An equitable system of burden sharing should not be triggered only under extreme conditions, Mr. Salehkhou considered, particularly when the problem was one of overdue obligations to the Fund in which debtor members in good standing with the institution played absolutely no part. Overdue financial obligations to the Fund were a major concern to the membership at large. As such, there was no justifiable reason why a limited number of members--and the neediest at that--should have to bear the burden of overdues. True burden sharing required that the system of surcharge and discount devised by the staff be triggered each time the estimated regular rate of charge was not sufficient to yield the FY income target, with charges and remuneration contributing simultaneously to filling the gap. A system that would distribute the burden of overdue obligations among Fund members on the basis of their respective quotas, irrespective of their debtor or creditor position, was of course superior to all others. However, there were practical as well as legal obstacles to such a system that could necessitate major and complex changes to deal with an issue which, it was universally hoped, was temporary.

In view of the considerations he had mentioned, Mr. Salehkhou said, the system proposed by Mrs. Ploix appeared to be at the same time the most simple, the most equitable, and the one that would preserve the temporary character of the issue of overdues. Her proposal could also function in harmony with current procedures under Rule I-6(4) and Rule I-10, which would continue to determine the regular rate of charge and the regular remuneration coefficient.

Having addressed the issue of burden sharing, which was central to the present discussion, Mr. Salehkhou took up some of the specific questions raised in the concluding section of the staff report. Referring first to the net income for FY 1986, he noted that the excess of

SDR 26 million above the income target reflected largely the maintenance for the second half of the year of an unduly high rate of charge. Although Rule I-6(4) provided for various ways to dispose of such an excess, the pertinent elements of FY 1986 income all pointed to the need to use the excess for the benefit of debtor countries, preferably in the form of a retroactive reimbursement of charges for the second half of the year. That position was strengthened by the recognition that so far only debtor members had contributed to financing overdue obligations.

Moreover, an increase in the rate of remuneration would obviously run counter to the accepted need for more equitable burden sharing, Mr. Salehkhou added, while any addition to reserves above the target would be unacceptable for at least two reasons. On the one hand, the rate of charge would remain excessive, compared not only to market and World Bank interest rates, but also to the SDR interest rate; on the other hand, additions to reserves had been consistently above the target, which had already been significantly increased at the beginning of the financial year. He recalled that deeming FY 1986 income for FY 1987 had been part of the Chairman's suggested compromise at the last discussion of Fund income, and he believed that such a compromise could have been adopted formally at that time.

Either retroactive reimbursement of charges or deeming would result in rates of charge below the current rate of 7 percent, which would raise no problem as far as the objective of a stable rate of charge was concerned. Such an objective could not be called for only when a reduction in the rate of charge was justified. And it was evident that the movement of market and comparable interest rates as well as the preservation of an adequate degree of concessionality were more important factors.

As for FY 1987, the rates of charge shown in the staff paper as resulting from decisions with respect to the excess income for FY 1986 were clearly only indicative, as the actual rate was linked to the decision on burden sharing in financing deferred income, Mr. Salehkhou stated.

In supporting the French proposal for a simultaneous and equal contribution from charges and remuneration, he wished to indicate his position on some of its details, Mr. Salehkhou went on.

First, the contribution to come from the rate of remuneration was limited by the provision under the Articles that such rates should not be less than four fifths of the SDR interest rate, Mr. Salehkhou noted. While that could be considered the normal floor for the rate of remuneration, it also raised the issue of a ceiling on the rate of charge, even though the proposed system provided for a large margin before the floor on the rate of remuneration was reached. With or without such a ceiling, a review that would be triggered by the reduction of remuneration to the limit provided for in the Articles appeared appropriate.

Second, on the issue raised by the settlement of deferred income, it was important to agree first on the principle of refunding related proceeds to the members or at least to the group of members that could be considered to have paid them, Mr. Salehkhou stated. In that respect, any procedures that were adopted should ensure that proceeds from the settlement of income deferred in FY 1986 should benefit exclusively debtor members in good standing with the Fund. With that proviso, he could go along with either a system of netting out or the establishment of a collateral account as described in the staff paper.

Third, on the remaining issues, his preference was for minimizing the uncertainties associated with the projection of deferred income by setting the surcharge and discount at the end of the period rather than at the beginning, Mr. Salehkhou concluded. That approach could be extended to the whole exercise, of course, by adopting a system of setting the rate of charge retroactively. That system would eliminate uncertainties associated with the staff's projections as well as the asymmetry of Rule I-6(4), which provided for an automatic increase in the rate of charge to cover any projected income shortfall but allowed for no automatic reduction to offset income above the target. The alternative to retroactive rates of charge that was mentioned in the staff paper did not appear to be satisfactory as more frequent adjustments in the rate of charge would not tackle the major weakness of the current system, namely, the payment of charges on the basis of necessarily uncertain projections.

Mr. Dallara said that the Executive Board had to take action in the near future on a number of the issues under discussion, including the disposition of excess income from FY 1986 and setting the rate of charge for FY 1987. In addition, the Board had for consideration various proposals that had been put forward to share the impact of overdue charges on Fund income.

An important related issue, mentioned by a number of other Directors, was the need to strengthen the Fund's financial position, possibly through provisioning, Mr. Dallara noted. Two discussions had taken place on that issue, and while a majority of the Board did not seem to favor establishing loan-loss provisions at the time of those discussions, it had been recognized that a number of important aspects of the issue of provisioning required further study, and that the need for a more structured approach to the matter raised, in any case, an important question. A number of Directors also had favored consideration of an increase in the level of reserves, either the general reserves or some sort of special reserve. The Chairman had noted in his summing up of the last discussion of the issue that the subject would be brought back to the agenda, noting that although a number of Directors had asked for the matter to be placed on the agenda in July, a precise date could not be determined at that time. In light of the need to reach decisions on certain issues within the few weeks ahead, he hoped that such a discussion could be scheduled, perhaps by mid-July, since he believed that it would be necessary to view those issues collectively before final decisions could be reached on individual matters. For example, before the rate of charge for FY 1987 was set, it would be necessary to decide whether there would be provisioning or at least what the level of reserves should be. Many of the burden-sharing proposals incorporated reserve increases. He would welcome any information that the Treasurer might have on the status of efforts to bring the issue of provisioning back to the Board as well as any relevant information that could be appropriately provided on the discussion of that issue with the External Auditors, although he understood that such information might not be available until the discussion was concluded.

He recognized that a decision needed to be taken shortly on the disposition of excess net income for FY 1986, Mr. Dallara continued. Of the four options outlined in the staff paper, the first--a retroactive reduction in the rate of charge for FY 1986--was not appropriate. The second option, an increase in the rate of remuneration, was interesting but out of the question. His first preference would be for the third option of adding the excess income to reserves without deeming. However, he would be willing to listen to other views on the issue. In current circumstances, the best approach might be that suggested by Mr. Foot, namely, to take a decision at the present meeting to add the net income to reserves without reaching a definitive view on whether it would be deemed until decisions were reached on all of the related matters.

With respect to possible approaches to burden sharing, Mr. Dallara offered some further preliminary thoughts. His authorities were guided in their thinking on the issue by a number of principles. First, there was a basic case for sharing the costs of the arrears problems between debtors and creditors as long as all members of the Fund, including those not in arrears, were making their best effort to help resolve the arrears problem. Second, given the current level of charges and the effective rate of remuneration--both of which his authorities continued to believe were quite concessional--the initial costs associated with deferred charges should first be covered by a temporary surcharge. Third, after such an initial approach, his authorities would be able to consider supporting some pari passu sharing of the costs between debtors and creditors, as incorporated in a number of the proposals put forward. He hoped in that connection that those members not in either category could consider making voluntary contributions, as mentioned in the staff paper. Such an approach was of interest to his authorities, although he did not know how feasible it would be. Fourth, while the basic remuneration coefficient was being moved toward 100 percent, creditor participation in burden sharing should take the form of a temporary discount from the coefficient since the surcharge would also be temporary. However, his authorities would not be prepared to support an approach that would involve an excessive temporary discount.

It should be noted in that connection that U.S. legislation mandated his chair to work to increase the rate of remuneration and the Fund lending rate to market rates, Mr. Dallara added. In implementing that legislation, emphasis had been placed on the remuneration side rather than the lending side, and although an upward movement in the underlying or basic rate of remuneration would obviously be helpful, an excessive discount, even a temporary one, could create problems for his authorities.

The case for burden sharing rested on a common effort by all Fund members to resolve the arrears problem, Mr. Dallara reiterated. While members might have their own views on the form burden sharing could take, his authorities felt strongly that that case had been undermined by recent efforts on the part of some member countries to push for consideration of either rescheduling of repurchases to the Fund or payment of charges in local currency. His authorities considered those approaches to be inimical to the cooperative pursuit through other avenues of a solution to the arrears problem. As long as certain member countries continued to pursue such efforts actively, his authorities did not believe that they would be in a position to agree to a burden-sharing arrangement. He wondered whether those Directors who had asked in a recent discussion (EBM/86/94, 6/9/86) for staff papers to be prepared on the relevant provisions of the Articles of Agreement would reconsider the need for those papers or at least the need for the Executive Board to consider them.

On the assumption that it might be possible to overcome that impediment, Mr. Dallara offered some preliminary thoughts on the proposals put forward for burden sharing, bearing in mind the principles he had outlined. First, he did not believe that either Mrs. Ploix's proposal, as initially outlined, or Mr. Zecchini's proposal would provide a particularly appropriate basis on which to proceed. However, the modifications of the French proposal put forward by Mrs. Ploix, including a floor on the remuneration coefficient, the reserve increase, and the prospect that deeming could be interpreted as a first contribution to creditors, added some interesting possibilities. After further examination, it might be possible to blend certain aspects of the approaches of Mr. Massé and Mrs. Ploix. As he had stated at a previous Board meeting, he had some sympathy for the staff approach, particularly the use of the five-year SDR interest rate, plus 50 basis points. However, he recognized the concerns of others about using that rate and would be willing to consider the use of the short-term SDR interest rate. But as he had indicated at the last discussion in the Board, that approach had one serious deficiency because his authorities would be unable to agree to a floor of as low as 80 percent for the remuneration coefficient. Certain elements of the arrangement set forth by Mr. Polak were also attractive, particularly if associated with an increase in reserves. He would have difficulty with an initial surcharge of 33 basis points rather than 50 at the first stage, and he might have difficulty with the surcharge at the third stage, depending on the floor set for the rate of remuneration. If that floor were high enough, there might be room for a modest surcharge in the third phase.

Mr. Schneider stated first that the target amount of income for FY 1986 of SDR 52 million should be added to special reserve. On the use of the SDR 26 million in excess of the income target--and in line with the proposals he had made at the previous discussion at EBM/86/73 and EBM/86/74--he had found no compelling reason for using that excess income either to increase retroactively the rate of remuneration or to further decrease retroactively the rate of charge for the second half of the financial year. As he had argued during the Board's earlier discussion, the great uncertainty surrounding the future course of overdue obligations to the Fund and income projections for FY 1987 called for a cautious approach, and it therefore seemed preferable to add the excess income of FY 1986 to special reserve and to deem the amount as income for FY 1987 to provide some additional room for maneuver in the coming months.

Comparison of the latest income projections with those made in April, and other indicators of the possible behavior of deferred charges, confirmed that the Fund's income prospects were quite volatile and that it would not be very wise at the present stage to release the excess income realized as a result of favorable developments in the last quarter of FY 1986, Mr. Schneider added. The argument that the rate of charge for the last half of FY 1986 should be further reduced to match the behavior of market interest rates during that period was not very convincing, given the real risk that in a few months the Fund might be forced again to abandon that relationship by sharply raising the rate of charge to cope with an income shortfall. Consequently, he maintained his preference for adding the excess income for FY 1986 to special reserve and deeming it as income for FY 1987.

Any burden-sharing solution should be of a temporary nature, Mr. Schneider considered. Therefore, a basic review should be held after, say, one year. His authorities had examined the various proposals submitted recently with great interest and welcomed the broad support that had emerged for a more general and balanced sharing among the membership of the cost of overdue charges to the Fund. His authorities were of the view that the French proposal met those concerns in the most appropriate way because they preferred the impact of deferred income on the Fund's net income to be shared equally among the Fund's debtors and creditors by means of simultaneous adjustments of the rates of charge and remuneration. In addition, the proposal was not encumbered by the legal problems and complexities of formulas aimed at extending the sharing of income shortfalls to members that had neither a debtor nor a creditor position with the Fund. Nor did it run up against any of the principal objections that could be made to setting a ceiling on fluctuations in the rate of charge. As to the legal limitations on fluctuations on the rate of remuneration, provision should be made for a special review in case that rate should reach 85 percent of the SDR rate; equally important, a formula should be devised to enable creditors to be reimbursed, without limitation, for past remuneration shortfalls in case large amounts of deferred charges were settled in a short period of time. Any indications from the staff as to how those issues might be resolved would be helpful.

He shared the view expressed by Mr. Goos during the Board's earlier discussion that the rate of remuneration was already at a discount from the SDR interest rate and that care should be taken not to abandon the objective of raising the basic rate of remuneration to the level of the SDR interest rate, Mr. Schneider continued. However, it appeared from the calculations summarized in Table 4 of the staff paper that the principle of burden sharing would be greatly weakened if the basic remuneration rate were first to be raised to match the SDR interest rate. Therefore, the objective of a preferential remuneration of the Fund's creditors would continue, under present circumstances, to be best served by progressively increasing the remuneration coefficient in accordance with the current rules.

On the technical aspects, it seemed preferable to implement the principle of burden sharing by using the basic rate of charge and remuneration that would prevail in the absence of deferrals and that would be adjusted retroactively by a surcharge and a discount to take into account the existence or increase of deferred charges, Mr. Schneider said. That approach would permit the Fund to avoid setting its rates initially at levels that might prove after some months to be totally out of line with actual income. It had the further advantage that, by clearly isolating the impact of deferrals from the other determinants of income, it could provide an additional incentive to countries facing arrears situations to decide on an early settlement of their overdue charges.

The accounting procedures to be established for the implementation of that method should preferably be organized in such a way that the impact on the Fund's annual net income was neutral at any given moment, Mr. Schneider considered. Accordingly, the surcharge should be collected and the discount should be made for the period during which the charges were deferred, and the proceeds of the operation would be added to income to offset the shortfall arising from the deferrals.

As for the handling of the late settlement of deferred charges that had originally given rise to the levy of a surcharge or the reduction of remuneration, Mr. Schneider said that he preferred the refunding method outlined by the staff, under which the amounts discharged would be refunded to those members that had initially paid the surcharge, and those members whose remuneration payments had been reduced would receive additional remuneration. Although that method might appear somewhat cumbersome, it seemed preferable, on grounds of equity, to the netting out method.

He would prefer to delay the introduction of the new system to the second half of FY 1987 instead of implementing it retroactively from the beginning of that financial year, Mr. Schneider stated. The delay would provide time to solve the impending technical issues and ensure a clean start. The system could be introduced with effect from November 1, 1986, without retroactivity, meaning that the proceeds from the settlement of deferred charges outstanding at that time would be refunded to the members that had paid them, or alternatively added to the Fund's regular income in order to permit a reduction of the basic rate of charge.

Taking all those elements together, Mr. Schneider said that he proposed that the rate of charge for the first half of FY 1987 be set at 6.56 percent, that all of the excess income from FY 1986 be deemed as income for FY 1987, and that the rate of remuneration continue to be set according to current practice until a major review took place prior to the midyear review of the Fund's income position.

Mr. Zecchini observed that the review of the Fund's income position for FY 1986 and FY 1987 raised some unprecedented issues that made a decision more difficult to reach because of the need to deal with a fairly large number of rather conflicting needs. Those issues were related to a phenomenon--overdue obligations--that although it was not new had recently achieved intolerable dimensions in terms of both the size and the duration of arrears. It was quite striking to note from Table 7 of EBS/86/16 that in FY 1986 overdue payments amounted to more than half of the Fund's reserves, and that the financial exposure of the Fund vis-à-vis members in arrears for more than six months was very close to the Fund's entire reserve base. From those eloquent data, and without repeating the considerations he had mentioned during the Board's discussion on loan-loss provisioning, he had drawn the conclusion that the income review had to be framed in a wider context, including two additional aspects that also constituted important objectives of financial management.

First, ways should be considered of adjusting the Fund's income in order to strengthen its reserve base at a quicker pace than in the past financial year, Mr. Zecchini stated. That would help to enhance the financial viability of the institution, improve the liquidity of its resources, and better shelter the Fund from the rising risks associated with its credit activities. Second, it was not only the users of Fund resources that should be encumbered with the financial burden stemming from such action to strengthen the Fund's financial position. Countries using the Fund's resources were in the worst position to bear that burden, to begin with, and would be discouraged from entering into adjustment programs supported by the Fund. Therefore, it was advisable to adjust the rules to ensure an equitable and effective distribution of the costs of overdue obligations among all members or, if that was not feasible on a voluntary basis, given existing legal restrictions, among debtor and creditor countries.

An important qualification needed to be made in that connection, Mr. Zecchini added. In the opinion of this chair, burden sharing should not be related exclusively to the deferral of charges and the consequent income shortfall but should deal with the overall financial implications of arrears for the finances of the Fund. The rising trend in overdue payments had an impact on the adequacy of existing reserves and on the desired pace of their accretion; it also affected the realization of the annual income target and might lead to raising the rate of charge in the course of the financial year. Thus, he saw no strong argument for limiting burden sharing to the implications of the nonpayment of charges. As a consequence, the solution to the issue of how to distribute the burden could encompass all the main elements of the present income review, namely, the use of excess income for FY 1986; the rate of reserve accumulation and the rate of charge for FY 1987; the review of the remuneration coefficient; and the specific method of burden sharing. He had already expressed his preference for a purely temporary solution for the time being, instead of a permanent system that would alter the recently established rules on the remuneration of creditor positions.

In the light of all the considerations he had mentioned, he was in favor of a decision which would include three main elements, Mr. Zecchini stated. First, all the excess income realized in FY 1986 should be transferred to reserves without deeming. Second, the rate of charge for FY 1987 should be reduced from 7 percent to 6.69 percent in line with an income target of SDR 56 million, calculated on the basis of a 5 percent rate of reserve accumulation and the projection of deferred charges. That reduction would be consistent with the idea of making the rate of charge reflect, to some extent, movements in the SDR rate. However, all excess income deriving from the application of that rate of charge should be transferred to reserves without deeming. Third, the remuneration coefficient should not be allowed to increase for FY 1987 with respect to the level reached in FY 1986. According to the staff's estimates, that would reduce remuneration expenses by about SDR 68 million, which should be transferred entirely to reserves.

The decision he had outlined would involve a contribution from both debtor and creditor countries for the purpose of sharply accelerating the buildup of reserves, which would grow by at least SDR 150 million in one calendar year, Mr. Zecchini observed. The rate of reserve accumulation would double in one year, reaching its highest level for the past 15 years. As a consequence, it would be possible either to lower the income target and the rate of charge in subsequent years, if the volume of arrears did not keep on increasing, or to avoid raising the present 5 percent rate of reserve accumulation and consequently the rate of charge in the opposite case. In such a way, the intertwined implications of deferred charges and overdue payments of principle would be dealt with simultaneously.

Though he preferred such a solution, Mr. Zecchini added that he stood ready to consider a permanent system of sharing the cost of deferred charges, should a clear majority in its favor emerge in the Board. Such a system would have longer-term effects than his preferred solution but would lead to a less rapid increase of reserves in the initial years. That was so because it would seem inconsistent with the aim of alleviating the burden of debtor countries to share the cost of unpaid charges but at the same time to raise the reserve accumulation target, which would automatically increase the rate of charge.

In considering a system different from the one that he favored, he would attach importance to its implications for the realignment of the remuneration rate up to the level of the SDR rate, Mr. Zecchini commented. It seemed unacceptable to his chair to establish a system that would pave the way for a permanent and significant negative gap between the rate of remuneration and the SDR rate. Furthermore, in the context of a permanent system, it would be appropriate to create a temporary collateral account in order to emphasize the peculiar function of the resources collected under the new scheme.

Finally, Mr. Zecchini reiterated his support for an amendment of Rule I-10(d) to base the required comparison on the quarterly average of the SDR interest rate. In that connection, he saw no need to change the present method of calculating the SDR rate.

Mr. Goos said that he approached the issues under discussion from the angle of the rate of charge to be set for FY 1987, and he came to a similar solution to the one which Mr. Massé apparently had in mind. The relevant calculations in that respect were based on the projection of deferred charges in the amount of SDR 132 million, a figure that could reach SDR 222 million in the current financial year under certain assumptions, as a brief look at Table 2 in the Appendix indicated. Hence, there was little doubt that the projections underlying the Fund's income for FY 1987 were subject to a substantial degree of uncertainty. That uncertainty, of course, had an immediate bearing on the rate of charge to be set for FY 1987 and on the appropriate disposition of excess net income for FY 1986 but also on considerations relating to the adequacy of the Fund's reserves. The problem became even more complex when account was taken of the uncertainties that had been revealed during the Board's discussion on the possible introduction of provisioning.

Those issues appeared to be so closely interlinked that he joined those Directors who felt that they should be resolved in the framework of a comprehensive package, Mr. Goos continued, a package that would have as an integral part the method of burden sharing with respect to deferred charges. To his mind, such a comprehensive package solution should preferably include several elements. First, like Mr. Massé, he believed that a significant increase in the reserve target was needed in order to meet the growing uncertainty affecting the Fund's financial position as a result of the alarming increase in overdue charges and overdue repurchase obligations. Second, and for the same reason, he would prefer to add the excess net income of FY 1986 to reserves. But he could also consider deeming at least part of that addition to reserves as income for FY 1987 or using it for the temporary financing of deferred charges, if such solutions would help to reach an acceptable compromise. Another possibility acceptable to him would be to use the excess income to finance the adjustment of the remuneration coefficient to the level of the SDR interest rate, a proposal that he understood to have been made by Mrs. Ploix and Mr. Dallara. In that context, he would be interested in the staff's view on the possibility of adding the excess income to reserves with the proviso that a decision would be reached later on the specific use of the addition to reserves; that approach would probably be helpful because it was unlikely that a timely conclusion would be reached on the whole package.

On the basis of the two elements that he had mentioned, he could go along with burden sharing, Mr. Goos said. Like Mr. Massé, he continued to believe that a system of burden sharing that included all members would offer the fairest solution. Therefore, he encouraged the staff to look for such a solution even though he recognized that, at least for the time being, it felt that that was not possible. In considering the proposals for burden sharing, his first preference of course was for the German proposal, as outlined in detail in the staff paper. The remuneration coefficient would be raised to 100 percent, and the cost of deferred charges distributed symmetrically between debtor and credit countries by means of temporary surcharges and discounts on the basic rates of charge and remuneration. The rationale for that proposal to establish equality between the rate of remuneration and the SDR interest rate was clearly described in the staff paper: in short, any kind of burden-sharing formula had to take into account that the Fund's creditor countries already carried part of the burden inasmuch as they accepted a rate of remuneration considerably below market rates, thereby enabling the Fund to set its rate of charge at concessional levels. Table 6 in the staff paper appeared quite telling in that respect, demonstrating in particular that even the SDR interest rate would only partially capture the grant element in the present rate of remuneration. Therefore, he had considerable sympathy for those who favored an asymmetrical formula of burden sharing, which provided for the initial absorption of deferred income by debtor countries. In any event, he would have to support such an asymmetrical formula, along the lines proposed by Mr. Foot, if no agreement were reached on a prior adjustment of the rate of remuneration.

Stating his position on the remaining questions raised in the staff paper, Mr. Goos noted, first, that he favored limiting the reduction of the actual rate of remuneration to 85 percent of the SDR interest rate. Such a limit or floor would also place an effective ceiling on the actual rate of charge. Once those limits were reached, there should be a review of the system. Second, surcharges and discounts should preferably be set retroactively at the end of six-month periods on the basis of charges actually deferred; however, he could also go along with setting them at the beginning of the period and then to have retroactive adjustments, for the reasons explained by Mr. Massé.

Third, he had an open mind with respect to the treatment of charges deferred prior to the introduction of a burden-sharing system, Mr. Goos continued. Fourth, surcharges and discounts should be accumulated on a gross basis and refunded to those members that had compensated for the deferred income once the corresponding overdue charges were setttled. Moreover, he would prefer to see the proceeds of the surcharge, and the savings of remuneration expenses, recorded as Fund income in the year they were collected to ensure that net income and reserves remained as close to target as possible.

Any new system of burden sharing with respect to deferred charges should be introduced only for a limited time, say, for one year, Mr. Goos considered, subject to possible renewal toward the end of such a period. In addition, the existing system of reviewing and setting the basic rate of charge and a reserve target, including the safeguard clause of Rule I-6(4)(b) should continue to apply. Finally, he could go along with the understanding mentioned in paragraph 4 of the conclusions in EBS/86/116 concerning the review of the remuneration coefficient and the SDR interest rate.

Mr. Sengupta observed that with a 7 percent rate of charge, the net income realized for FY 1986 was SDR 78 million, or SDR 26 million in excess of the net income target amount. In his view, that excess should be used straightaway to reduce the rate of charge retroactively for the second half of FY 1986. The Board had had two choices when it had last discussed the disposition of that excess income: using it to reduce the rate of charge or deeming it as part of income for FY 1987. The decision had been postponed in order to obtain the final figures, and to have an idea of the projected rate of charge for 1987 and the movement of the SDR interest rate so that the 1986 rate remained in line. With the SDR rate at 6.3 percent and a projected rate of charge of 6.69 percent in FY 1987, it was only logical to bring down the rate of charge to 6.73 percent retroactively for the last half of FY 1986 by using the excess income of SDR 26 million. That would also be in line with the general fall in interest rates in the world; otherwise, only the IMF would be applying a sticky high rate of interest when everybody else was reducing interest rates.

Users of the Fund's resources had already had to bear two burdens, Mr. Sengupta recalled. First, on account of raising the net income target from 3 percent to 5 percent of reserves at the end of the previous financial year, and second, on account of the change effected in placing charges overdue for six months or more in nonaccrual status. Besides, the users also bore a disproportionate share of the burden. As everyone was aware, the rules relating to the rate of remuneration were so devised that when the SDR interest rate declined, the remuneration coefficient went up, with the result that the fall in the rate of remuneration was less than would otherwise have been the case.

One of the arguments for maintaining the rate of charge at 7 percent and for adding the excess income of SDR 26 million to reserves with deeming, Mr. Sengupta noted from the staff paper, was that it would "contribute to greater stability in the rate of charge." That argument had been heard when the Board had last discussed the Fund's income position; it had not been regarded as relevant when the rate of charge had been raised in December 1985 from 7 percent to 7.87 percent retroactively from November 1, 1985 by applying the existing rules.

The staff projections for FY 1987 were based on a larger amount of deferred charges--SDR 132 million--than would have been the case had the agreed method used so far for calculating those charges been applied, Mr. Sengupta thought. The net deferral coefficient method would have shown only SDR 97 million as deferred charges for FY 1987 on the basis of current projections. Deferred charges for the 12 months ending May 31, 1986 were SDR 103 million. The agreed method had been to take the higher of those two figures for deferred charges. Instead, the staff had adopted the unusual procedure, which it had described as an informal formula, whereby the net deferral coefficient of the preceding 12 months was applied to the remaining 11 months of FY 1987 and the amount so derived was added on to the actual deferrals of May 1986. That meant singling out Peru's overdue charges, which fell due on May 6, and including them in the projection of deferred charges for FY 1987 even though the Peruvian authorities had indicated their intention to discharge all their arrears to the Fund by mid-August 1986.

There was no reason for discarding the agreed method in favor of the indicator formula that had been employed, Mr. Sengupta considered. Uncertainty about FY 1987 was not a defensible reason; if it were, what would be relevant would be to consider deferred income separately from other income, as the staff itself had pointed out on page 7 of its paper. He had suggested in the Board's last discussion on the subject that actual deferrals in the preceding period could be used in the current period and then adjusted for the actual figures that emerged at the end of the current period.

A rate of charge of 6.69 percent for FY 1987--determined after excluding the projected deferred income of SDR 132 million income from periodic charges--would still provide net income of 5 percent of reserves at the end of FY 1986, Mr. Sengupta noted. Thus, the rules and procedures being followed at present in determining the rate of charge showed that the reasons for raising the reserve target in 1985--from 3 percent to 5 percent--had become irrelevant. It was useful in that context to recall the purposes that the Fund's reserves served and that had been pointed out in a staff paper on factors bearing on the adequacy of Fund reserves (EBS/85/125, 5/14/85). The most compelling purpose was "to protect the assets subscribed to the Fund against impairment through losses," as when there was an excess of operational and administrative expenditures over income, or when some members were in arrears to the Fund, or when there were exchange losses.

That purpose served by the reserves had been largely taken care of, since overdue charges did not form part of income and an amount corresponding to the overdue charges had been obtained by increasing the rate of charge, Mr. Sengupta added. The Fund's general and administrative expenditures were currently being well contained. Therefore, the possibility of impairment of the Fund's assets had become remote, and with it the necessity for reserve increases. However, if the SDR interest rate went up sharply, and remuneration payments increased as a consequence, a possible need to draw down reserves might arise in current circumstances. But that was not the expectation. Therefore, he saw no reason why the targeted net income for FY 1987 could not be brought down back to the previous level of 3 percent of reserves at the end of FY 1986. For an income target of 3 percent, the rate of charge for FY 1987, based on current projections, would be only 6.58 percent as against the suggested 6.69 percent needed for meeting a 5 percent net income target.

On burden sharing, he had noted the summaries in the staff paper of the various proposals and of the cost implications of overdue charges, Mr. Sengupta continued. But the concept of burden sharing underlying those proposals and the staff paper was confined to charges overdue for six months or more. His chair had been advocating burden sharing in a broader manner so as to encompass not merely overdue charges as defined but also increases, if any, in administrative expenditures and in reserves. He wished to reiterate that view: as he had already suggested, the net income target should be returned to its former level of 3 percent; and since administrative expenditures were under control, deferred income should be considered separately from other income.

As for the impact of deferred income, Mr. Sengupta remarked that just as there was a floor to the rate of remuneration, so should there be a ceiling to the basic rate of charge. Likewise, if the reserve target was to be increased, the effect should be shared equally by the basic rate of charge and the rate of remuneration. He asked the staff what implications the decision to increase reserves by more than 3 percent would have on the basic rate of charge and the rate of remuneration.

Based on the logic of international cooperation, the burden of deferred income would be shared by all members in proportion to quotas, Mr. Sengupta continued. That would be the most equitable principle because members' ability to pay differed, as reflected in their relative economic strength in the world economy and thus in their Fund quotas. Besides, it was a principle that was consistent with the traditional way of linking most of the Fund's activities to quotas. For example, all purchases were related to quotas; SDR allocations were made on the basis of quotas; and voting power was linked to quotas. The users of Fund resources would pay to the Fund their share of the amount of overdue charges in accordance with their quotas, while the Fund would make reduced payments to the members receiving remuneration, again in accordance with their quotas, Mr. Sengupta stated. The terms used by the staff--surcharges and discounts--left the impression of a burden being imposed from outside. The burden should be shared willingly by all members in a spirit of international cooperation. He would like the staff to give fuller treatment to that issue than in its rather cursory reference in paragraph 1(e) of its summary of proposals. In his view, schemes could be worked out to give effect to that principle under the Articles of Agreement.

In case that route was not chosen--and because of implementational problems rather than on logical grounds--the only acceptable principle on grounds of fairness, equity, and the principle of international cooperation was the one espoused by Mrs. Ploix, Mr. Sengupta considered. All other formulas made the rate of charge bear a highly disproportionate burden relative to the rate of remuneration, at least until the rate of deferred income went beyond SDR 250 million. It was highly unlikely that deferred income would reach that figure in the near future, so that the debtor countries would in effect pay for most of the deferred income, especially those debtor countries that were fulfilling their obligations.

The question was why, Mr. Sengupta commented. It was said that creditors were providing concessional money. He did not accept that claim and he had requested the staff to look into the effective rates of charge as well as referring to the effective rate of remuneration because several debtor countries also had unremunerated positions in the Fund. In any event, the totally different issue of whether or not concessionality was a factor should be considered when the nature of the Fund was discussed; the issue was not relevant to a discussion on deferred income where it should be taken as given. In sum, burden sharing should be equitable. There was no logic in asking developing countries to bear a greater share of the burden, especially those countries that did not default and that made regular payments.

Mr. Fujino said that before addressing the difficult and interrelated issues before the Board, he wished to make his position clear on two important matters. First, he was greatly concerned about the recent increase in overdue obligations to the Fund, which had seriously eroded its financial health. The rise in arrears might prove to be a temporary phenomenon, but the recent trend seemed to suggest that precautionary steps to safeguard the Fund's financial position needed to be taken as a matter of priority, perhaps even before the matter of burden sharing was taken up. Therefore, he believed that there was urgent need to agree on a new reserve target or on some sort of provisioning before, or at least at the same time, a decision on burden sharing was reached.

Second, Mr. Fujino considered that it was very important to put into proper perspective what was called sharing the burden of increased arrears. That would require a thorough examination of the overall financial structure of the institution. The Fund had provided use of its own resources for members in need of balance of payments financing at a favorable rate, favorable not only in comparison with the market rate for medium-term borrowing but also in comparison even with the SDR rate. Such concessional lending had been facilitated by the provision made for nonremunerated reserve positions and for a lower than market rate of remuneration, with the result that creditor members had to a considerable extent borne the burden of creating that concessionality. Before deciding on a way to deal with increases in costs arising from the problem of arrears, and more specifically, before asking creditor members to make further sacrifices, the present practice of setting the rate of charge at a concessional level should be looked into.

One of the main objectives of the Fund was to make resources temporarily available to members thereby promoting balance of payments adjustment, Mr. Fujino continued. It perhaps followed that in order for the Fund to play an important role in the balance of payments adjustment process, the rate of charge should not be too high compared with the rate of alternative financing provided by the market. However, it did not follow that the rate of charge should always be set below the SDR rate. At the same time, it was very important to provide sufficient incentive to creditors to ensure the smooth financing by the Fund. Thus, he had been led to conclude that there was scope for debtor members to bear the additional cost to the Fund of overdue charges and that any burden-sharing scheme should be based on a debtor first principle.

Among the substantive issues for discussion, Mr. Fujino referred first to the disposition of FY 1986 income. He favored adding the excess income over the target amount--SDR 26 million--to reserves without deeming so as to strengthen the Fund's financial position for the reasons he had already described. More generally, he believed that a substantial increase in the reserve target was needed, for instance, to 10 percent from the present 5 percent level. That issue would have to be addressed before deciding upon the rate of charge for FY 1987. However, he could be flexible with respect to the final treatment of the amount of excess income, depending on the agreement reached on the broad issue of burden sharing, and he would be interested in the staff's response to the question raised by Mr. Goos in that respect.

Burden sharing should be subject to two general conditions, Mr. Fujino remarked. First, a new burden-sharing scheme should be strictly temporary and be applied only for FY 1987; at the end of the year, in the absence of a new agreement in the Board, the scheme would have to be replaced by the existing mechanism. Second, while the rate of remuneration would be lowered automatically under the burden-sharing formula, he proposed setting a floor for the remuneration coefficient at 90 percent, with provision for a review by the Board if a further reduction was necessary.

He could endorse the staff proposals for the establishment of separate accounting in a temporary collateral account to reflect the Fund's obligation to refund amounts upon settlement of deferred charges, Mr. Fujino noted. The net increase in the collateral account over a financial year would have to be regarded as income for the purpose of meeting a reserve target; otherwise, an additional source of income would have to be sought at a time of increasing deferrals.

On such details as the timing for setting the surcharge or discount and the periods to be covered, it would seem to be most practical to determine the surcharge and discount semiannually and at the end of the semester, for retroactive application, Mr. Fujino commented. He was open to any other practical suggestions.

As to the actual modality of burden sharing, which might be the essence of the discussion, he recalled that he had expressed his preference in the previous discussion for the original staff proposal to set the ceiling for the rate of charge at the level of the five-year SDR rate, plus a margin, Mr. Fujino said. However, if the two principles that he had elaborated at the beginning of his statement--the need to reinforce the Fund's financial position and the debtor-first principle--could be agreed upon, he would be prepared to discuss other methods of burden sharing that might emerge from the present discussion. For the time being, the proposal by Mr. Massé, among others, seemed to deserve further elaboration from the viewpoint of his two basic principles.

Mr. Fugmann remarked that it was clear from the data in Table 6 of the staff paper that the concessional element in the rate of charge on the Fund's ordinary resources had shrunk gradually over the past few years while the rate of remuneration had drawn nearer to the market rate. It should be kept in mind, however, that the rate of charge still lay considerably below debtor countries' alternative borrowing costs, whereas creditor countries made large interest-free resources available to the Fund. A broader analysis should also take into account the benefits accruing to Fund member countries in other than financial areas. He had in mind the broader concept of burden sharing which had been discussed by the Board in 1985 on the basis of a staff paper (EBS/85/126, 5/14/85) with which his chair was in general agreement.

In sum, the conclusion was that it was not possible at present to make an objective assessment of whether or not burden sharing in the Fund was equitable, Mr. Fugmann stated. Therefore, there was not much of a basis for judging what would be an equitable sharing of the costs of deferred charges. What had been agreed, however, was that the impact on the Fund's income of those costs should be treated separately, and that creditors should share that impact to a greater extent than under the present rules. When it came to deciding what that extent should be, different factors should be considered, including the risk of borrowing costs becoming too high, which might make prospective borrowers less interested in entering into Fund-supported adjustment programs. At the same time, it was important to take account of the effect of the rate of remuneration on creditor countries' willingness to make capital resources available to the Fund.

The Fund's cooperative character suggested that costs arising from overdue obligations should be distributed explicitly among different categories of member countries, Mr. Fugmann continued. Although he agreed with those who believed that ideally all member countries should participate in the burden sharing that might appear to be difficult to implement, according to the staff. The burden-sharing mechanism that he preferred was along the lines of the solution suggested by Mr. Polak. An appropriate cap for the rate of charge, plus the surcharge, could be the five-year SDR rate, which was closer than the short-term SDR rate to the borrowing countries' alternative borrowing costs. The floor for the rate of remuneration should be set at 85 percent of the SDR rate. He was also favorably disposed toward the German proposal; in particular, it would be desirable to increase the rate of remuneration to 100 percent of the SDR rate prior to implementing burden sharing.

With respect to the possibility of raising the income target, he was not opposed to such an idea but because it had been attached at such short notice as a rider to the burden-sharing discussion, Mr. Fugmann commented, it was difficult to take a firm position on it at the present meeting. However, he was prepared to consider it in light of the wish to reach a compromise. Thus, within the preferences he had outlined, he was prepared to support any compromise that met with broad support.

He preferred the surcharge and discount to be determined and applied in retrospect on a semiannual basis, among other things, for administrative simplicity, Mr. Fugmann noted. On the question of how to deal with the proceeds of the discharge of previously deferred charges, refunding would be a more just system, in principle, although it would be too complicated to implement. For that reason, he would opt for netting out rather than refunding. He had no strong feelings on the establishment of a collateral account, although the need for such an account did not seem to be strong enough to warrant the inherent complications.

The excess income for FY 1986 of SDR 26 million could suitably be considered as a buffer in a system of burden sharing, Mr. Fugmann considered. For instance, the first SDR 26 million of deferred charges could be balanced against that excess income before the surcharge and the discount were calculated, which would amount in practical terms to treating the excess income as deemed income for FY 1987. If no decision was taken on burden sharing at the present meeting, he was prepared to add the excess income to reserves as a substitute--albeit a limited one--for loan-loss provisioning.

His chair placed emphasis on the need to keep Rule I-6(4)(b) as a safeguarding clause, Mr. Fugmann stated, particularly as the proposed burden-sharing system could not absorb deferred charges in excess of a specific limit. He agreed that Rule I-10(d) should be amended, to base comparisons on quarterly averages, for instance. No further review under that rule should be necessary until the regular review scheduled to take place before the midyear review of the Fund's income position. Finally, the present discussion should constitute the reviews of the rate of remuneration and the SDR rate.

Mr. Hospedales noted that over the past 18 months the Board had been grappling with a number of questions relating to the impact on the Fund's income of the incidence of overdue financial obligations. While a number of measures had been taken aimed at assisting members to meet their financial obligations to the Fund, and at safeguarding the Fund's financial position, it had not been possible to resolve, in an equitable manner, the issue relating to the financing of the cost of the impact on income of deferred overdue obligations. In the meantime, the Fund's income position had been safeguarded and protected by variations in the rate of charge, the high level of which had been inconsistent not only with trends in market interest rates but also with the important traditional element of concessionality in the use of Fund resources, stemming from the cooperative nature of the institution. An undue burden was being imposed on the users of the Fund's resources, the bulk of them being punctual in their repayment obligations, a point emphasized by Mr. Sengupta.

His chair had therefore been encouraged by the emerging consensus in the Board's discussions of April 30 on the introduction of a burden-sharing mechanism, which was to be regarded, in the words of the summing up "as an exceptional device to deal with a temporary situation," Mr. Hospedales remarked. While he could agree with some other Directors that it would be equitable for all members to make a contribution to bearing temporary costs, he remained convinced that the only way to determine those individual responsibilities was in proportion to quotas, the basic reference point for all Fund transactions. But in view of the operational difficulties associated with such a proposal, he continued to support Mrs. Ploix's proposal, which had the distinct objective of financing deferred charges separately from the financing of other arrangements affecting the Fund's income. In that sense, the symmetry and simultaneity of Mrs. Ploix's system for sharing the burden of financing deferred charges charges, not to mention its simplicity and importance for improved international economic relationships, were a great attraction.

The aim of the mechanism would be to ensure that the margin of error contained in the Fund's calculation of the rate of charge to generate a specific net income target was considerably minimized, Mr. Hospedales continued. The process would also avoid the increasing instability in that rate in recent times, while keeping it in line with trends in international interest rates. In that connection, he agreed with Mr. Sengupta that the Fund should adhere to established procedures for calculating net deferrals on the basis of its customary net deferral coefficient. In the same vein, the rate of remuneration should be calculated in accordance with well established procedures under the Articles of Agreement. The logical consequence of that reasoning--namely, that the rate of charge bear a closer relationship to market rates--suggested however that the net income in excess of target for FY 1986 should be utilized to reduce the rate of charge for the second half of FY 1986.

Following the same line of reasoning and bearing in mind the emerging consensus on a burden-sharing mechanism, Mr. Hospedales said that his chair could support a proposal to set the rate of charge for the second half of FY 1986 and subsequently for 1987, semiannually, and on the basis of an equal sharing of the projected level of deferrals through variations in charges and remuneration payments, to take the form of an additional surcharge on the rate of charge and a discount on the rate of remuneration within the limits imposed by existing procedures. It would be clearly understood that a review would take place once the floor for the rate of remuneration was reached, namely, 80 percent of the SDR interest rate. Within that general approach, he was of the view that in the first half year of the arrangement, the calculations should be based on gross deferred charges since debtor countries, which bore the cost of deferred charges, should benefit from their settlement. However, subsequently, the surcharge and discount should be based on net deferred income, determined at the end of each six months and collected for the same period.

Finally, on the question of the review of the remuneration coefficient and the SDR rate of interest, Mr. Hospedales said that his chair supported the position outlined in paragraph 4 of the summary and conclusions in EBS/86/116.

Mr. Suraisry stated that the choice between the various options presented by the staff with respect to income in excess of the target amount should be determined by an assessment of the underlying financial trends. It was clear from the Board's recent discussion of the six-monthly report on overdue obligations that the situation with respect to arrears and ways to deal with it had yet to show a substantive improvement. In fact, the projected amount of deferred charges for FY 1987 had had to be increased. Accordingly, it was prudent to apply the excess net income to general reserves. Alternatively, he could go along with setting the excess income of SDR 26 million aside and determining its disposition at a later stage in the light of developments.

In principle, his authorities were in favor of burden sharing, Mr. Suraisry added. However, whatever mechanism could be applied should meet the potential financial demands associated with the problem of overdue financial obligations. More specifically, the issue of burden sharing was not limited to recovering deferred charges but went beyond it, as had been made clear by Mr. Zecchini. At some time in the future, agreement might have to be reached on a special reserve or some form of provisioning, should repurchases continue to be postponed for too long. Unfortunately, none of the proposed methods in the staff paper appeared to be adequate for that purpose. Therefore, it would make more sense not to take any decision on burden sharing until it was clearer where the Board stood on provisioning. At that time, the magnitude of the problem would be better known so that it could be addressed comprehensively. In fact, depending on the magnitude of the problem, methods other than those before the Board might be needed. He was aware that a review could be held once the limits of any method had been reached. But since the issues were complex and their discussion not always easy, it would be preferable to minimize the number of reviews to the extent possible.

However, if there was a sufficient majority to reach a decision on burden sharing at the present meeting, Mr. Suraisry concluded, he had an open mind with respect to the specific method, particularly the method presented by Mr. Massé, which allowed for an increase in the reserve target. Whatever the method chosen, it should not increase the rate of charge to a level that drove members in need of the Fund's financial assistance away from the Fund.

Mr. Polak observed that the disposition of the surplus income of FY 1986 of SDR 26 million had been discussed by the staff to a large extent in terms of the stability of the rate of charge. Like Mr. Sengupta, he did not think that the issue could be resolved on that basis; he would prefer to draw into the discussion the outcome of the debate on provisioning. While that debate had shown broad support for provisioning, many Directors had discerned the need to increase the annual addition to reserves. However, the questions under discussion at the present meeting could not wait until agreement was reached on provisioning, which would no doubt take months. Therefore, he favored taking action on the reserve target as part and parcel of the present package; specifically, he suggested that the income target be raised from 5 percent to 7.5 percent of reserves, which would add 14 basis points to the basic rate of charge. If agreement could be reached later on provisioning--and he assumed that the burden of provisioning would be shared on the same basis as the burden of income deferrals--that agreement could take the place of any increase in the reserve target that might be decided upon. To mitigate the impact of the increase in the reserve target, he suggested that the surplus of SDR 26 million be used for the benefit of the debtors. He had very little preference for using the surplus to lower charges for FY 1986 or, through deeming, the charges for FY 1987. However it was done, the net effect would be to offset the increase in the reserve target for one year since SDR 26 million was about 2 1/2 percent of the Fund's current reserves.

In setting the rate of charge for FY 1987, he assumed that some system of burden sharing could be agreed, Mr. Polak continued, based on a basic rate of charge and a basic rate of remuneration. The latter rate was determined for FY 1987 by the formula of the December 1983 decision relating to Rule I-10. Under that Rule the rate of remuneration had to be reviewed before May 1, 1987. He was quite prepared to proceed to that review at an early date, if some Directors would find that helpful. But such a review should be undertaken on the clear understanding that any conclusions drawn from it would apply only to FY 1988 and beyond and not to the current financial year. According to the staff paper, on the basis of the rate of remuneration at the start of FY 1987, and assuming no deeming of any part of income for FY 1986 to income for FY 1987, the basic rate of charge would be 6.01 percent, which he hoped would be rounded off to 6.00 percent.

He had listened with great interest to what other Directors had had to say on burden sharing, Mr. Polak went on. His own position remained as he had stated it to be on May 19 when he had expressed the hope that a sufficient majority could be found for the French proposal, all the more so if that proposal was combined with some increase in the reserve target, as he had suggested. If he was not mistaken, a number of Directors had been veering in that direction, a movement that he would encourage. Only if agreement on burden sharing on that basis could not be reached would he be willing to fall back on his compromise proposal, which had been well described in footnote 2 to the continuation of Table 4; it was therefore no longer necessary for him to describe that proposal in detail, except to note that the maximum reduction in the rate of remuneration implied in the calculations of the first and second choice methods illustrated were 90 percent and 85 percent, respectively.

On the technique of any burden-sharing scheme, Mr. Polak joined the staff and Mrs. Ploix in their view that estimating deferrals in advance had proved to be an impossible task. Therefore, he would favor calculating the surcharge and the discount retroactively at the end of each half-yearly period. He could also accept Mr. Massé's proposal which, as he understood it, was to start out on the basis of an estimate in order to give members some idea of what they might have to pay and correct it retroactively for the same half year.

He agreed with the idea underlying the staff's approach to accounting for surcharges and discounts and for their eventual return to the individual members that had made such contributions when deferred charges were finally paid, Mr. Polak observed. It was an approach that aimed at channeling the amounts ultimately received by the Fund on account of deferred charges back to the members that had in the meantime compensated the Fund for its loss in income. But it seemed to him that a logically simpler technique than that proposed by the staff would be preferable. The staff did not count the contributions in surcharges and discounts as income but proposed to channel them into a collateral account. The consequence would be that the income shortfall due to unpaid charges would remain as an income shortfall, which would have to be ignored for some purposes, in order to avoid an ever-escalating process of plugging the continuing shortfall. He suggested that it would be much simpler to count the contributions as income but to keep a record, which would not have to find its way into the Fund's balance sheet, of each member's contribution, notionally distributed over the specific charge payments that other members had failed to make at a specific moment of time. Whenever a deferred payment was made to the Fund, the Fund would immediately pass on the amount received to the corresponding contributing members in the amounts that each could be construed to have contributed. Such a system might sound complicated but it was not; it could also be applied without difficulty to the amounts contributed so far by members to cover deferred charges as the latter were ultimately discharged; the extra charges levied on "paying" members had enabled the Fund to meet its reserve target. Therefore, if the deferred charges were paid, the amount could promptly be channeled back to the debtor countries that had made all of the contributions so far. Again, the required statistical record for that purpose could readily be established retroactively.

Mr. Jiang considered that burden sharing was the issue to be tackled first since the other issues under discussion depended on the decision taken on the distribution of the cost of deferred charges. During the discussion in April, his chair, along with a majority of Executive Directors having more than 60 percent of the voting power, had been in favor of Mrs. Ploix's proposal. His position remained unchanged. The normal rate of charge should be decided at the beginning of each financial year, as was the standard practice, and the impact of deferred charges must be shared more widely among Fund members. The cost of deferred charges needed to be divided evenly between creditor and debtor members: a surcharge and a reduction of the remuneration coefficient should be set at the end of each six months of the financial year depending on the actual net income position of the Fund, the surcharge and discount being retroactive to the beginning of the same half of the financial year.

In case of settlement of the deferred income, the netting out system seemed preferable because it was less complicated, Mr. Jiang considered. If and when the cost of the deferred charges increased to such an enormous amount that the surcharge would exceed a certain percentage of the average interest rate of the SDR over the same period, and the remuneration coefficient was reduced at the same time to less than a certain percentage, the matter would need to be brought to the Board for a thorough discussion. He had an open mind on the appropriate percentages.

He could go along with the staff's proposals to add to the special reserve the targeted amount of net income for FY 1986 of SDR 52 million; to deem the excess of net income over that target amount as income for FY 1987; to set the rate of charge for FY 1987 at 6.56 percent; and to amend Rule I-10 in order to introduce the concept of period averaging for the SDR interest rate, Mr. Jiang continued. However, since the issues before the Board were complicated and interrelated, he would be prepared to accept any compromise of the various options raised by others during the discussion at a later stage of the discussion.

Mr. Jaafar said that he had no difficulty in supporting the proposal to add target income of SDR 52 million to the special reserve. That proposal was fully consistent with the objective of strengthening the Fund's financial position at a time when the problem of overdue obligations remained unresolved. He found it unnecessary at the present time to speed up somewhat the target for reserve accumulation, as suggested by some Executive Directors. The Fund's reserves were at present in excess of SDR 1 billion, or about twice the amount of overdue obligations. Therefore, in respect of the SDR 26 million in excess of the target, his preference was for reducing retroactively the rate of charge for the second half of FY 1986 to 6.73 percent, the rate calculated by the staff. In his opinion, that was a more attractive option than deeming the full SDR 26 million as income for FY 1987. While the latter option would reduce signficantly the rate of charge in FY 1987, and therefore reflect the market trend, it seemed more appropriate to reduce the charge retroactively to FY 1986 for income realized in that fiscal year. In fact, that possibility had already been taken into consideration in the Board's earlier deliberations. Besides, on the basis of the projections in Table 1 of EBS/86/116, the rate of charge for FY 1987 would be 6.69 percent. He recognized that the projections in that table might be subject to an extraordinary degree of uncertainty; but the projection of deferred charges for FY 1987 of SDR 132 million had not taken account--perhaps rightly--of the promise by Peru to settle in full by mid-August 1986 its overdue obligations to the Fund, as mentioned by Mr. Sengupta. Therefore, the projection was a conservative one and if payments were received, other things being equal, a better income position could be expected in FY 1987.

The divergence in the Fund's rate of charge from interest rates in the market had become prominent lately and somewhat difficult to rationalize, Mr. Jaafar continued. For example, between 1982 and 1985, the market rate as measured by the SDR interest rate had dropped by more than 420 basis points while the rate of charge in the same period had advanced by 75 basis points. Similarly, the IBRD lending rate had moved downward by more than 130 basis points during that period, despite similar experience with arrears by the Fund and the World Bank. His supposition was that that divergence had in part influenced members' decisions to approach the Fund for support of their economic adjustment programs. However, it was difficult to gauge the significance of that factor from the drastic reduction in the use of Fund resources from a high of SDR 12.6 billion in 1983 to a mere SDR 4 billion by the end of 1985.

On the question of burden sharing, it was not easy to accept the approach outlined by the staff in EBS/86/81 of meeting the income shortfall arising from deferred charges first through a surcharge to be levied on the users of ordinary resources and only later by the creditors of the Fund, Mr. Jaafar stated. Such a procedure was not equitable because in practice the cost burden would fall mainly on the debtors. The ideal solution would be to spread the burden over the whole membership; on the other hand, such an approach could prove difficult to administer because a levy would be required on members that were neither creditors nor users of Fund resources.

The proposals by Germany and Mr. Zecchini were interesting, and were certainly an improvement over the staff's model, Mr. Jaafar considered. The German proposal had the important quality of preserving symmetry between debtors and creditors, both parties sharing the deferred income burden but with an important qualification--the rate of remuneration would be increased immediately to the SDR interest rate. In a sense, that would mean that as long as the rate of remuneration was below the SDR interest rate, the burden on debtors would be larger. For instance, for FY 1987 the rate of charge would be higher by as much as 50 basis points, compared with a reduction of only 18 basis points in the rate of remuneration. The same was true of the proposal put forward by Mr. Zecchini. A rate of deferred income in excess of SDR 132 million would increase disproportionately the burden to the debtors but be less onerous to them with respect to deferred income below that amount. Since neither of those two proposals preserved symmetrical treatment of both parties, he would prefer not to consider them until the rate of remuneration caught up with the SDR rate. He was not prepared at the moment to comment on either of the three additional options suggested by Mr. Massé, Mr. Polak, and Mr. Foot until he had had time to reflect on them. In principle, some of the criteria mentioned earlier by Mrs. Ploix would be difficult for his chair to accept.

The proposal by Mrs. Ploix was technically similar to that of Germany, with one important exception, namely, that the current rate of remuneration was taken as the basis for working out the burden-sharing formula, Mr. Jaafar noted. That exception was constructive because the principle of symmetry was preserved. The proposed scheme not only satisfied the original objective of enhancing cooperation but also introduced some elements of simplicity; in fact, it would be quite straightforward to apply. Furthermore, it would not be necessary to set up a complicated collateral account and a cumbersome refunding procedure if overdue charges were determined at the end of every six-month period rather than at the beginning. He had noted, for example, that for FY 1987 the scheme would set a basic rate of charge of 6.01 percent for FY 1987 and a surcharge of only 0.34 percent, compared with a rate of charge of 6.69 percent under the conventional calculations if the income target for FY 1987 was to be realized. However, as the remuneration coefficient could not fall below four fifths of the SDR rate, the floor of that coefficient would then automatically indicate the ceiling to the surcharge. Under that arrangement the outer limits of the surcharge and discount could cover deferred charges of as much as SDR 428 million, a figure that was more than three times the amount of deferred charges projected for FY 1987 of SDR 132 million. Therefore, the proposal would provide, at least for the time being, sufficient room for maneuver for the Fund. In any case, it was desirable to provide for a review of the arrangement should overdue obligations accelerate at a faster rate than at present. It was notable that the outcome of all three options would come closer as the rate of remuneration approached the SDR rate.

Nevertheless, Mr. Jaafar reaffirmed his support for the 5 percent income target for FY 1987 and the use of the safeguard clause, if necessary. Finally, on the review of the remuneration coefficient and the SDR rate of interest, he was in favor of the suggestion that Rule I-10 needed to be amended to allow for the concept of period averaging. Therefore, a further review under Rule I-10(d) before that review took place would not be necessary.

Mr. Ortiz observed that it had been confirmed that a rate of charge of 7 percent for the whole of FY 1986 had led to net income of SDR 26 million in excess of the income target set for the year. As his chair had stated during the previous discussion of the Fund's income position, total income in excess of the target should be applied to a retroactive reduction of the rate of charge for the second half of FY 1986. The result would be a rate of charge only slightly higher than the one that would be required for FY 1987, consistent with the attainment of the net income target. Thus, the stability of the rate of charge from FY 1986 to FY 1987 would be preserved. His preferred solution would therefore seem to be a better course of action than deeming income in excess of target as income for FY 1987.

With respect to the projections for FY 1987, he agreed with the staff's figures, with the caveats noted earlier by some Directors, Mr. Ortiz added. The indications provided by the Peruvian authorities of their intention to discharge all their obligations suggested that the projections were on the conservative side. Given that income projections were naturally subject to a great deal of uncertainty, there was a case to be made for erring on the side of prudence.

On burden sharing, Mr. Ortiz reiterated his interest in establishing a mechanism that would result in an equitable, symmetrical, and simultaneous distribution of shortfalls or losses in the Fund's income among debtor and creditor countries. In that respect, he continued to support the proposal of Mrs. Ploix and thus endorsed the formula on which that proposal was based. He was also of the view that the proceeds stemming from the settlement of arrears should be refunded to those members that had actually borne the cost of either a surcharge or a reduction in the remuneration coefficient. However, he was aware that the type of majority required to pass a decision on burden sharing called for some flexibility on the part of members of the Executive Board in order to make possible an agreement on a concrete formula or set of principles. In that respect, his chair was open to consideration of some modifications to the French formula that could contribute to gathering the necessary majority.

Under the agreed formula, surcharges and discounts should be set at the end of a six-month period rather than at the beginning, Mr. Ortiz considered. Deviations between projections and actual deferred charges would thus be prevented from leading to undesirable fluctuations in the rates of surcharge and discount. Such a procedure also had the advantage of simplicity.

As to the adjustment of the basic rate of charge, Mr. Ortiz said that he had found quite helpful the suggestion to adjust that rate at the beginning of each quarter to provide a better way of monitoring that variable more precisely and to obtain a closer approximation to the net income target. The periods covered by the surcharge and discount should be semiannual. Finally, with respect to the transition to the new system, it would be preferable to introduce the system after approval by the Board and without any retroactive application with respect to the discharge of deferred income.

Mr. Mawakani stated that he had been pleased to note that the final figures showed a substantial surplus at the end of FY 1986. He had no objection to adding the target income of SDR 52 million to the reserves. But his preference with respect to the attribution of excess income of SDR 26 million was to use that amount to reduce the rate of charge retroactively to November 1, 1985. As his chair had stated in the past, the general decline in interest rates in financial markets and the financial difficulties being experienced by many countries warranted a further retroactive reduction in the rate of charge in order to preserve the concessionality of Fund assistance. The Fund should contribute to alleviating the burden placed on many members by the servicing of their external debt. A reduction in the rate of charge would be a step in that direction. However, in light of the reasons given by the staff--the need to avoid wide fluctuations in the rate of charge and the uncertainties surrounding the projections for funding for FY 1987--he could support the proposal to deem net income in excess of the target for FY 1986 as income for FY 1987, should there be a majority in favor of that proposal.

All the arguments for, and consequences of, the various proposals for sharing the costs of deferred income had been comprehensively analyzed in the staff paper, Mr. Mawakani noted. Therefore, he could be brief and state his preference for the method proposed by Mrs. Ploix. Table 4 showed that that method was more in line with the cooperative spirit of the Fund in that it distributed the burden of the additional costs equally and simultaneously among debtors and creditors, irrespective of the amount of deferred income. He had always found it to be unfair for debtor members to carry the full burden of overdue obligations; if accepted by the Board, the French proposal would remove that element of unfairness.

On more specific issues, Mr. Mawakani added, he favored setting a cap on the rate of charge so as to avoid placing an excessive burden on members making use of the Fund's resources as a result of the deferral of income, with a provision for a periodic review to avoid weakening the financial position of the Fund. Consistent with the French proposal, he would prefer a procedure for retroactively collecting surcharges and discounts; as an added advantage, it would remove the uncertainties associated with the projections of deferred income.

On the issue of the rate of charge for FY 1987, Mr. Mawakani noted that under the French proposal, surcharges and discounts would be applied retroactively. Thus, at the time of the midyear review of the Fund's income position, the rate of charge and remuneration would be recalculated to take effect as of May 1, 1986. In the meantime, the rate of charge to be set for FY 1987 should be calculated in the absence of a projection for deferred income. Finally, he could go along with the proposal that a quarterly average be used for calculating the rate of remuneration under Rule I-10(d).

Mr. Alhaimus recalled that as his chair had stated during the Board's discussion on April 30, his chair's position was that the rate of charge should not exceed that necessary to yield the income target. On the basis of the actual results for FY 1986, the excess net income for that year could therefore be used to reduce the rate of charge retroactively for the second half of FY 1986 to 6.73 percent, the rate needed to achieve the income target. The rate of charge for the current financial year would obviously depend on whether agreement could be reached on any method to share the impact of overdue charges on Fund income. In case no such method were agreed the rate of charge for the second half of FY 1986, which would have been reduced to 6.73 percent, would apply for FY 1987. As the staff projections had shown, that rate was more than sufficient to achieve the income target for FY 1987.

On the more complex problem of burden sharing, he subscribed to certain principles, Mr. Alhaimus observed. First, the impact on deferred charges needed to be shared more widely among members. That would entail a clearly defined share to be borne by members receiving remuneration and members paying charges. It was not a matter of any perception that creditor members' share in the overall burdens of the Fund had been inadequate. The previous work done by the staff and the Board's discussion on burden sharing should have made that issue clear. The rate of remuneration, in fact, remained below average market rates and the effective rate of remuneration was even much lower, as shown in Table 6 of EBS/86/116. The rationale for a specific burden-sharing formula was based on the need to address a particularly serious and unique problem affecting the financial position of the Fund, that of overdue payments, a problem that was not a normal feature of the Fund's finances and the cost of which could not be borne, if present procedures for determining the rate of charge continued to apply, except by imposing undue hardships on members paying charges.

The second principle on which the new approach should be based rested on the assumption that the overdue payments problem facing the Fund was basically a temporary phenomenon, Mr. Alhaimus added. The figures for deferred charges might rise sharply at times, but it was assumed that overdue payments would be discharged eventually through the efforts of the members concerned, the Fund, and the international financial community. The specific features of any approach adopted would need to reflect that assumption.

Third, the mechanism that would be most in line with those concepts would separate the impact of the Fund's income from deferred charges from the position that might prevail in the absence of such deferred charges, Mr. Alhaimus stated. That effect could be achieved by establishing a basic rate of charge that could generate the target income in the absence of an assumption about the existence of deferred charges. The burden of any deferred charges in any agreed period--semiannual, as currently envisaged--would be borne, as the French proposal suggested, by a surcharge on the basic rate and a discount from the rate of remuneration.

Finally, equitable compensation should be made for members that actually incurred surcharges and discounts broadly along the lines of the staff's suggestion, Mr. Alhaimus considered. Accordingly, the proceeds of surcharges and amounts equivalent to the savings on remuneration expenditures could be recorded separately, with the proceeds of any discharge of deferred income being refunded to members that had intially paid the surcharge, and with additional remuneration payments being made to the members that had received discounted remuneration payments.

With respect to the review of the remuneration coefficient and the interest rate on the SDR, Mr. Alhaimus remarked that he could go along with the staff's understanding in paragraph 4 of its summary and conclusions.

Mr. Mtei said that he too had been glad to note that FY 1986 had closed with a net income of SDR 78 million, representing an excess of SDR 26 million over the annual target. As his chair had pointed out in previous discussions on the matter, the entire surplus earned in FY 1986 was earned as a result of the burden borne by borrowers whose rate of charge was effectively 7 percent throughout that financial year. It followed therefore that all of that excess income should be applied to lowering the rate of charge retroactively to November 1, 1985, giving those borrowers relief in the form of a charge equivalent to 6.73 percent. That rate of charge would be more in line with the recent decline in international interest rates, and would make the Fund's behavior more like that of other financial institutions in the current improved interest rate environment.

As for financial year 1987, Mr. Mtei recalled the consensus of the Board on April 30, 1986 on sharing the burden of the cost of deferred income caused by overdue obligations. As the Chairman had put it in his summing up, the consensus was for a general approach of "setting a 'normal' rate of charge determined in the absence of deferrals....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." His chair had long pointed to the unfair situation in which debtor members, in many cases low income countries struggling to remain current in their financial obligations to the Fund, were bearing the entire burden occasioned by overdue obligations, and through no fault of their own. Therefore, he urged the Board to implement an equitable burden-sharing formula in the context of FY 1987.

With the income target of SDR 56 million for FY 1987, the "basic" rate of charge would be 6.01 percent, in the absence of deferrals, Mr. Mtei continued. In order to share the burden of financing the cost of deferrals equally and symmetrically between debtors and creditors, he would support the formula supported by Mrs. Ploix. Of course, the fairest way would be for the whole membership to share the burden but he had taken note of the difficulties of implementation explained by the staff. From the illustrations of that proposal in Table 4, he had noted that with estimated deferrals for FY 1987 of SDR 132 million, the surcharge on top of the "basic" rate would be equivalent to 0.34 percent and the reduction in the rate of remuneration would also be equal to 0.34 percent. It should be borne in mind that a formula already existed to bring the remuneration coefficient to 100 percent and that formula should be allowed to work as had been agreed two years previously.

In order to avoid unnecessary and frequent revisions of rates of charge and remuneration, Mr. Mtei continued, he endorsed the proposal that the surcharge and discount be fixed retroactively at the end of each six-month period on the occasion of the semiannual review of the Fund's income position. Therefore, while accepting that the basic rate of charge for FY 1987 should be fixed at 6.01 percent on the basis of the current reserve target, the question of the surcharge and discount should be re-examined at the midyear review in December 1986 with a view to achieving an equal and symmetrical sharing of the burden of the costs of deferrals. He noted in particular in that connection that the increase in the reserve target to 5 percent had been accepted only because of the arrears problem; that target had been more than adequately met, in spite of deferrals in FY 1986, and it should be given a little longer time to operate.

He recommended that the ceiling on the surcharge be related to the current SDR interest rate rather than to the five-year SDR interest rate, Mr. Mtei stated. Indeed, it was implied in Rule I-10(d) that the rate of charge on the Fund's ordinary resources should not exceed the SDR rate of interest, and the Board was required to undertake a review if it did so. The floor to the remuneration coefficient should remain at 80 percent of the SDR interest rate as required by the Articles of Agreement. As indicated by the staff, the application of Mrs. Ploix's formula within that band could accommodate deferrals of up to SDR 428 million, an estimate that was well above the present estimate of deferrals of SDR 132 million for FY 1987.

Mr. Nebbia observed that in line with the latest calculations, and based on a rate of charge of 7.0 percent for the whole year, net income for FY 1986 amounted to SDR 78 million, a figure that exceeded by SDR 26 million the newly agreed income target of 5 percent of reserves. The outcome in the Fund's income position for the past financial year was quite interesting, first because it had allowed the prevailing rate of charge of 7.0 percent to be restored; and second, because beyond that it had provided the opportunity not only to add to the Fund's special reserve but also to reduce further the rate of charge or increase the rate of remuneration, either retroactively or in a future exercise.

The achievement of a net income larger than required for purposes of reserve accumulation had taken place in spite of reductions in income associated with deferred charges reflecting overdue payments to the Fund, Mr. Nebbia remarked. In other words, the actual reserve accumulation was SDR 112 million, of which SDR 52 million had been effectively earned while the remaining SDR 60 million reflected, to a certain extent, future income earned in the current period. Beyond those amounts, there was the additional SDR 26 million of income in excess of 5 percent of reserves, the reserve target that had been agreed upon in light of the prevailing trend in overdue payments to the Fund, and a target that in his view remained adequate.

The disposition of the excess net income would certainly be affected by several factors, Mr. Nebbia continued, among which the most relevant were linked to ways to share the impact of overdue charges on Fund income, the need to keep a stable rate of charge below the SDR interest rate, and also the need to ensure a reasonable rate of remuneration. Yet the determination of both the rate of charge and the rate of remuneration for FY 1987 also depended on how the excess of income of FY 1986 was finally allocated. Thus, the Board was faced with a simultaneous set of equations whose outcomes, in terms of the value of each variable, would depend heavily on the method that it might decide to implement for sharing the burden of deferred income. Unless that issue was addressed first, the discussion on whether to reduce the rate of charge, increase the rate of remuneration, or add to special reserves would be meaningless; it was essential to begin by ensuring a stable mechanism for an appropriate distribution of a relevant part of the costs associated with maintaining a sound income position for the institution.

As for the selection of one specific mechanism to distribute such costs, Mr. Nebbia said that his first preference would be for sharing them in proportion to the quota of each member country. That approach had the merit of fully reflecting the cooperative character of the Fund while ensuring the most equitable distribution of financing needed to deal with the overdue payments situation. However, and as a compromise position, he could support the view that the impact of deferred income should be shared equally by both debtors and creditors of the Fund, through simultaneous movements in the rate of charge and in the rate of remuneration, in line with what had been proposed by Mrs. Ploix.

A basic rate of charge needed to be set at the beginning of each financial year, and such rate should be calculated without including the amount of income that was expected to be deferred as well as being in line with the achievement of the reserve target, Mr. Nebbia considered. In addition, it was necessary to ensure that the rate of remuneration was calculated in line with the coefficients envisaged in Rule I-10(b)(i) and (ii) and that it remained, as a maximum, at the level of the SDR interest rate. A surcharge on the rate of charge and a discount from the rate of remuneration would be required as a means of financing deferred income for each financial year; conversely, a reduction in the former or an increase in the latter could be contemplated in those periods when discharges of previously deferred charges exceeded new deferrals.

As with the quota approach, that mechanism would take the whole problem of overdue payments out of the picture of the Fund's income position, Mr. Nebbia commented, and would therefore allow the basic rates of charge and remuneration to be set within the scope of the current rules and regulations. In addition, it would also permit an equitable distribution of the costs associated with overdue payments while providing the grounds for compensating debtors and creditors when such payments were effectively settled.

On the more specific issue of how to allocate the excess income generated in FY 1986, Mr. Nebbia said that he was inclined to favor a reduction in the rate of charge within the vicinity of the 6.73 percent calculated by the staff in its paper, which in turn was more consistent with the prevailing rate of the SDR, retroactive to November 1, 1985. As for FY 1987, and once deferred income began to be treated and financed by either of the previously described methods, actual net income projected for the whole year would be a somewhat smaller total amount than the SDR 249 million that would result from a rate of charge of 7 percent, allowing for SDR 132 million of deferred income and net income of SDR 117 million, of which SDR 52 million would be the amount needed to meet the reserve target.

It would be useful to learn from the staff what rate of charge would ensure the achievement of net income in line with the reserve target, Mr. Nebbia added. In other words, what rate of charge--in the absence of deferred income--would permit the achievement of net income in the order of SDR 52 million. Once that basic rate was obtained, a surcharge equivalent to the financing of half of the projected deferred income should be added with a simultaneous application of a discount on the side of the remuneration rate.

Finally, Mr. Nebbia remarked that he looked forward to the staff's response to the question raised by Mr. Sengupta about the calculation of deferred income in EBS/86/116 for FY 1987, and in particular to the possibility of an ad hoc system having been used.

Mr. Romuáldez said that he had no difficulty in agreeing that the target amount of income for FY 1986 of SDR 52 million should be added to the special reserve. The remaining income of SDR 26 million should also be added to the special reserve, at least pending prudential action in relation to overdue repurchases. In suggesting that course, he would be prepared to take that addition to reserves into account when such prudential action was considered.

Burden sharing should be introduced, in principle, Mr. Romuáldez agreed. The Fund was a cooperative organization and it was appropriate for the whole membership to share the costs arising from the behavior of a few members that were not as cooperative as they should be. Putting the point another way, it was difficult to accept that the financial burden arising from arrears should be concentrated only on those members who were in effect the good debtors, or for that matter on debtors and creditors alone. The ideal solution should involve some kind of levy to be charged each member according to quota size. But, as the staff paper had shown, there were no feasible options available in that respect. However, he supported Mr. Massé's suggestion that a further effort be exerted by the staff to find a solution along those lines.

The preferences of his chair with respect to the more practicable options for burden sharing were based on two principles--the order in which the burden would be shared, and in what proportion, Mr. Romuáldez continued. The staff had set out one possible arrangement under which the debtors would bear the burden up to the point when the rate of charge reached the five-year SDR interest rate plus 50 basis points, and then by creditors. Mrs. Ploix had proposed an alternative approach under which the burden would be shared equally and simultaneously from the outset. During the Board's discussion of provisioning on May 19, 1985 Mr. Polak had mentioned a compromise approach that would combine elements of the two other approaches, with the debtors bearing the burden initially and then sharing it with creditors in equal proportions, before finally the creditors alone assumed it.

The proposal by Mrs. Ploix had considerable appeal because it reflected and perhaps would even strengthen the cooperative character of the Fund, Mr. Romuáldez remarked. Yet it was a fact that creditors were already accepting less than a market rate of remuneration, albeit to a lesser extent than in earlier years. Weighing both considerations suggested two possible approaches. The one that his authorities found particularly attractive was basically the French proposal with the additional stipulation that the remuneration coefficient be raised to 100 percent. In that connection, although his chair had often in the past indicated the need to re-examine reserve targets, the issue should preferably be separated from that of burden sharing related to overdue charges. Barring a consensus on that modified French approach, his authorities would be willing to consider a compromise solution along the lines outlined by Mr. Polak; they were prepared to be flexible, within certain limits, on the apportionment of the burden over the three phases of such a system. Burden-sharing arrangements that in effect left all, or virtually all, of the burden as it was presently envisaged to be carried by users of Fund credit would be unacceptable.

It would not be unreasonable, under the staff's pessimistic, if not worst-case scenario--no charges received from members currently overdue by 30 days or more throughout the remainder of FY 1987--for the burden to be shared fairly evenly between debtors and creditors, Mr. Romuâldez commented. Under such a scenario, and on the basis that the current 7 percent rate of charge would remain in effect, deferred income in FY 1987 would amount to about SDR 222 million, or, according to his calculations, to about SDR 200 million if the "basic" rate of charge was reduced to about 6 percent. Interestingly, the latter amount of deferred income was about the same as would be generated by a combined surcharge on the rate of charge and discount to the rate of remuneration of 1 percentage point. Equal distribution of the burden between debtors and creditors under the compromise approach to burden sharing would apply a need for the 1 percentage point (100 basis points) to be attributed in equal proportions to the three elements of that approach, corresponding to the outcome of Mr. Polak's proposal. Applying that structure to the perhaps more likely situation of deferred income in FY 1987 amounting to SDR 132 million--the amount projected by the formula--would result in debtors bearing about three quarters of the burden and creditors bearing about one quarter, proportions that he could accept.

In passing, Mr. Romuâldez noted that the burden-sharing arrangement suggested by the staff, which he did not support, would result in debtors taking up all of the burden envisaged to arise in FY 1987, on the basis of the current relevant interest rate levels. If the Board preferred an approach along the lines suggested by the staff, a different ceiling for the surcharge should be found than the five-year SDR interest rate plus 50 basis points. The SDR interest rate, rather than its five-year counterpart, might be a better base rate. Even then, however, adoption of the SDR interest rate plus 50 basis points would be likely to result in most, if not all, of the burden of deferred income in FY 1987 being carried by users of Fund credit. As indicated on page 13 of EBS/86/116, those members would still have to absorb the effect of the first SDR 146 million of deferred charges compared with the current estimate of deferred charges in FY 1987 of SDR 132 million; that amount would be roughly doubled, under the maximum ceiling proposed by the staff, based on the five-year SDR interest rate.

The important principle underlying his attitude on the treatment of the proceeds of the settlement of deferred income was that those taking up the burden of deferred income should be reimbursed as precisely as possible upon settlement, Mr. Romuâldez went on. In that respect, it should be recalled that the burden of the first SDR 40 million of deferred income that had accumulated had in effect been absorbed by the Fund's reserves. Mainly as a result of the need to defer income, net income and thus reserve growth had fallen short of the target for FY 1985 by that amount. Accordingly, in his view, reserves should have a prior claim on the first SDR 40 million of settlements of deferred income. The burden of the remaining balance of deferred income of SDR 132 million could be considered as having been borne by debtors, insofar as the rate of charge for FY 1986 was set and maintained at a level that ensured achievement of the FY 1986 income target. Therefore, that balance should be the amount considered available for reimbursement to FY 1985 and FY 1986 debtors when the proceeds of deferred income were received. Ideally, reimbursements should correspond to the burden borne by each debtor at the time of income deferral.

For the future, he was attracted to the method of a collateral account suggested in the staff paper, Mr. Romuâldez remarked. In addition to conforming with the principle that when undeferred income was eventually settled, members should have returned to them the contributions that they had made in the meantime in taking up the burden, that method would also highlight the extraordinary nature of the problem and the arrangements established to cope with it. His only concern with respect to the establishment of collateral accounts pertained to the apparent adverse effect on the Fund's reported income and reserves.

In favoring the compromise approach to burden sharing, it followed that he accepted that there should be limits to the surcharge to be added to the rate of charge and the discount to be applied to the rate of remuneration, Mr. Romuâldez observed. The limits implied by assigning 33 basis points to each element of such a scheme would seem appropriate for the time being. If the problem of deferred income grew to such an extent that those limits became a constraint, it would be time to reconsider the whole issue.

He had not attempted to explore how the cost of any measures that might be taken in the near future to cover the risks involved in overdue repurchases should be integrated with burden-sharing arrangements relating to deferred income, Mr. Romuâldez stated. However, he believed that an integrated approach would be desirable to ensure that overall equity was established, not to mention keeping an extremely complex matter as simple as possible. In the event that provisions for loan losses or perhaps for an additional special reserve were introduced to cover the risks of loan losses, he would want to review the above-mentioned limits to the surcharge on the rate of charge and discount to the rate of remuneration. In the context of such a review, he would be willing to consider the related but separate issue of increasing the reserve target, an issue that his authorities believed involved factors beyond the problem of arrears.

On the question of how frequently the surcharge and discount should be determined, the suggestion in the staff paper of a semiannual basis would be in line with the provisions of Rule I-6(4)(a), Mr. Romuâldez noted. However, it had been suggested that determination of the rate of charge should be moved to a quarterly basis so as to lessen the uncertainty in the Fund's income position arising from the floating nature of the SDR interest rate and thus of remuneration expense. The latter suggestion seemed to have considerable merit; if it was adopted, it would probably make sense to determine the rates of surcharge and discount quarterly as well.

Within the framework that he had outlined with respect to burden sharing, he could support in principle a basic rate of charge for FY 1987 of 6 percent, Mr. Romuáldez stated. But he would find it necessary to put in place the arrangements for burden sharing before a formal decision to that effect could be taken. Until that time, he could agree to the rate of charge being set at 6.69 percent, the result of applying existing Rule I-6(4)(a). He hoped that it would be possible to finalize the burden-sharing arrangements to permit the basic rate of charge to be reduced to 6 percent before the first quarterly charges for FY 1987 were payable.

Finally, concerning the review of the remuneration coefficient, Mr. Romuáldez said that he could agree that for the purposes of Rule I-10(d) it should be understood that the concept of a quarterly average SDR interest rate should be adopted when comparing the SDR interest rate with the rate of charge. The Rule itself could be amended to that effect along with any other amendments that might be required, in the context of the review of Rule I-10, which was scheduled to take place soon after the 1986 Annual Meetings. He could also agree that the present discussion fulfilled the requirement pursuant to Rules I-10(c) and T-1(d) to review the SDR interest rate.

The Treasurer said that as he understood it, a decision could be taken to place net income, including the amount in excess of target, to special reserve, pending a decision on the rate of charge--including possibly a surcharge--for FY 1987, which had already begun.

As to the availability of the staff papers that had been requested at EBM/86/85 when the question of provisioning against loan losses had been discussed, the Treasurer said that it would take at least four weeks, if not longer, to issue the paper on provisioning. That paper would also deal with the question of whether and to what extent an increase in reserves could take the place of provisioning and, further, whether there should be any later refunding of a special increase in reserves. It would be recalled that the Chairman had stated in his summing up that the timing of the further discussion could not be fixed, and that he had added that although the issue was important, it was not one of immediate urgency. It was therefore a matter of attaching the appropriate priority to the various papers that the staff had been asked to prepare, including its further examination of issues related to provisioning and five other papers on issues related to overdue obligations.

In response to Mr. Dallara's related point about the external audit, the Treasurer confirmed that he was unable to provide any detailed information until the auditors had completed their work and expressed an opinion on the issue of provisioning.

The principles underlying the method for estimating income deferrals had not been changed, the Treasurer explained. The deferral coefficient was calculated for the preceding 12-month period, as shown in Table 2 of EBS/86/116, and was applied to the amount of charges due in the remaining months in the current financial year; the result was added to actual deferrals of the current financial year. The same method had been used in connection with the midyear review of the Fund's income position, when the ratio had been calculated over the twelve months to the end of October 1985, and deferred charges projected for the subsequent and final six months of the financial year. In response to the wishes of Executive Directors, the estimates in Table 2 of charges due had been updated to the end of May 1986, and the coefficient had then been applied to the remaining eleven months of the current financial year. He recalled that one reason for the request by Executive Directors for an update had been the treatment under the decision of accrual of charges overdue from one member that had settled some overdue obligations and thus for a time was not overdue in its payments for more than six months. An amount of about SDR 40 million of charges due from that member had reverted to accrued income although most of it remained overdue. In those circumstances, the staff had been asked to update its projections and to write a paper reviewing the relevant Executive Board decision. In the meantime, a full explanation had been provided of the projections in EBS/86/116 to permit Executive Directors to judge for themselves whether or not those projections of deferred income were reasonable. If Peru discharged its overdue obligations, the estimate of SDR 132 million for deferred income might be on the high side; at the same time, the estimated deferred charges for FY 1987 of members overdue in payments to the Fund for more than 30 days, which were shown in Table 2 of the appendix to EBS/86/116 at SDR 222 million would, if the estimates were updated, be SDR 275 million. Moreover, those calculations and estimates had to be based on the facts and not on expectations of settlement.

Reference had been made to the need, which had been mentioned on page 15 of the staff paper, to safeguard the Fund's financial position in case deferred charges were greater than expected and the surcharge and the discount on the rate of remuneration reached the respective ceilings and floors set in any burden-sharing mechanism, the Treasurer noted. Some of the proposals for burden sharing covered in the updated Table 4 envisaged a ceiling on the rate of surcharge and provided that the creditors should assume--in varying degrees--the burden of additional deferred income once that ceiling had been reached. The question then became one of the extent to which the creditors could be expected to accept a reduction in the rate of remuneration, given the existence of the legal floor to the remuneration coefficient of 80 percent of the SDR interest rate. Some Directors had suggested that the burden sharing by creditors should not lead to a reduction in the remuneration coefficient below 85 percent or 90 percent. If there were a significant increase in deferred income, the floor could be reached fairly quickly under some of the proposals covered in Table 4, especially if it were set at 90 percent.

Many Directors had expressed their agreement with the staff's suggestion that provision should be made for a review, should the floor be reached, the Treasurer continued. In response to Mr. Schneider's question about what would happen if the review did not lead to agreement on a course of action, the staff view was that, consistent with past practice, a safeguard clause should be brought into play. Such a clause was included in Rule I-6(4) and it should be retained or appropriately reformulated. It would also be necesssary to take into account that the application of the current safeguard clause would lead to an increase in the rate of charge. The necessary decisions would have to be taken in advance to enable the Fund to handle a situation in which the floor to the rate of remuneration was reached and in order to safeguard the Fund's income position; otherwise the reserve target might not be reached or a deficit might even be recorded.

On the question of refunding the amounts received in settlement of deferred charges, the Treasurer explained that six-monthly payments proposed by the staff rather than immediate payment, as mentioned by Mr. Polak, had been found to be more practical. The payments to be made to many creditors and debtors would be so small that a system of immediate payment would be administratively cumbersome, suggesting that payments should be accumulated in some way. A similar problem had arisen with respect to special charges, which had had to be levied in a way that did not take small amounts into account.

The reasons for the staff's proposal to set up collateral accounts were those that had been mentioned by Mr. Massé and Mr. Schneider, the Treasurer noted. Accounts would have to be kept of the surcharges and discounts in any event, and they might just as well be open and clear accounts. An additional advantage would be that members would have an incentive to give serious consideration to the need to settle their overdue obligations because the fact that the rest of the membership was bearing the cost of financing deferred income would be brought out into the open. However, although the staff would prefer such a system of collateral accounts, he would not press the point.

Mr. Sengupta remarked that the deferral coefficient had to be applied on the basis of two distinct 12-month periods covering actual deferred income and charges due, respectively, if the averages were not to be distorted, for instance, by an unexpectedly large actual deferral in one month. He had compared the results of applying to total projected charges for FY 1987 the deferral coefficient given in EBS/86/81 (4/14/86) for the year ended April 30, 1986 of 3.96. On that basis the estimated amount of deferred income was SDR 103 million, rather than the estimate of SDR 132 million given in EBS/86/116. The difference of SDR 30 million was due to the fact that projected deferrals for May 1986 would have been lower than the actual deferrals that the staff had included for that one month out of the eleven months remaining in the financial year.

The Treasurer said that he had limited his response to explaining that the formula that the Executive Board had agreed should be used had been applied consistently. He agreed with Mr. Sengupta that the application of that formula could lead to divergences from averages as a result of large changes in deferred income due to payments by members with overdue obligations. An averaging process might diminish the incidence of those divergences to some extent, although the staff had examined many averaging methods without arriving at a better solution than the one currently being used. The amounts of income deferred on account of even the relatively few members that had overdue obligations could increase or decrease quickly. The staff had supplemented the projections with additional explanations in its paper that would assist in judging the reasonableness of the projections. However, if the Executive Board wished, the staff could use an approach along the lines suggested by Mr. Sengupta.

Mr. Polak said that he recognized the need for refunds upon settlement of deferred charges to be made in reasonable amounts or from time to time. At the same time, it seemed essential to change the rule on accounting for deferred and accrued income in order to overcome the sort of problem that had arisen in Peru's case and that might arise in other cases. Once charges had been deferred, they should not subsequently be counted as accrued income until payment had actually been made.

The Treasurer commented that a number of Directors had requested that the rule be changed. The staff was examining the issue and would submit a paper as soon as it could.

Mr. Zecchini mentioned that the need for transparency in burden sharing, coupled with the need for a system that would induce debtors to pay charges, suggested to him that thought should be given to ways of encouraging debtor countries to pay charges on the same basis as principal. If he understood the practice correctly, the debtor member could decide whether a payment was to be considered in settlement of principal or charges. The continuation of such a system seemed to him to run the risk of extending the period of a burden sharing which was limited to charges if debtor countries imputed payments to principal instead of to overdue charges.

The Treasurer confirmed that under the present rules a member was free to attribute its payments to any of its obligations, except in the SDR department, where special rules applied. However, if consideration was given to specifying the proportions in which payments of members with overdue obligations were allocated to principal and charges, the different maturity of Trust Fund loans and interest outstanding would have to be taken into account. In addition, it should be borne in mind that if a member systematically attributed any payment it made to principal, it would not accrue further overdue charges. Thought would have to be given to the balance of the advantages and disadvantages, and of the incentives and disincentives, of such a change in the rules.

The Director of the Legal Department said that it would be possible for the Executive Board, after deciding by a 50 percent majority to place the entire net income for FY 1986 to special reserve, subsequently to deem the excess net income for FY 1986 as net income for FY 1987, by a majority of 70 percent of the total voting power. According to Rule I-6(4)(d), the Executive Board had the power to deem any part of income in excess of the target amount as income for the subsequent financial year. The Rule required the Executive Board to take that decision at the end of the financial year for which the excess income had been received, namely, the deeming would have to be decided at the end of FY 1986 for FY 1987. Thus, it would not be consistent with Rule I-6(4)(d) to take a later decision to deem income for FY 1986 as income for FY 1987. But the Executive Board could either amend the rule or make an exception to it, as long as that exception was consistent with the Articles of Agreement, the Board being bound only by the Articles.

Under the Articles of Agreement, the Director continued, the Fund had the duty, at the end of each financial year, to determine the amount of its net income and how much of that income was to be placed to special reserve or general reserve, and what amounts would be distributed. When the Executive Board took a decision to deem part of its income for a particular financial year as income for the subsequent financial year, that excess income was placed permanently to reserves. Therefore, the only meaning of a decision taken during the subsequent financial year to deem part of the net income for the preceding financial year as income for the current financial year would be to lower the income target for the current year. In determining the majority required to change the income target, account had to be taken of the fact that the income target for a particular year would determine the rate of charge for the second half of the financial year, in the absence of an agreement in the Executive Board on a rate of charge. Thus, indirectly, the determination of the income target determined the rate of charge, and since 70 percent of the total voting power was required to determine the rate of charge, a decision in FY 1987 to deem income for FY 1986 would also require 70 percent of the total voting power.

The question of burden sharing on the basis of quotas had been raised before, and the position of the staff was that that would require an amendment of the Articles, the Director of the Legal Department noted. For the time being, proposals for burden sharing would be based on the rate of remuneration and charges, neither of which were determined on the basis of quotas. Remuneration was determined on the basis of the net use of each member's currency by the Fund, and no other formula could be adopted without an amendment of the Articles. Likewise, charges were determined on the basis of net use of the Fund's resources by each member, and no other formula could be adopted without an amendment of the Articles.

The Chairman observed that the Executive Board had to decide on the disposition of net income for FY 1986 before the External Auditors closed the accounts for the past financial year at the end of the following week. Directors had the choice of continuing the present discussion before that time or of taking an immediate decision and returning later to the matter of deeming excess income for that year as income for FY 1987, together with the other issues calling for decision, including the rate of charge and a system of burden sharing. In the meantime, the rate of charge would remain at 7.0 percent. A decision to lower the rate of charge, which seemed warranted by the circumstances and also by the discussion, would have to be taken before the end of July when the first charges for FY 1987 would fall due.

The understanding reached in the Executive Board with respect to the staff paper on provisioning was that it should be a sound, well-prepared paper, which would take a good two months, the Chairman added. The Executive Board would then need time to consider the matter. His discussion with the External Auditors had not led him to understand that the paper should be issued with great urgency, although they had drawn attention to their concern about the overdue obligations.

The Executive Directors agreed to take a decision at the present meeting on the disposition of the net income for FY 1986, and to take up other matters outstanding separately, as outlined in EBS/86/116.

The Chairman made the following concluding remarks:

> I understand that most Directors would prefer to have a little more time to consider the global aspects of the proposals, and to settle at the present meeting the question of the disposition of the net income for FY 1986 of SDR 78 million. Ten Executive Directors, who represent something like 29 percent of the voting power, favor or can accept a retroactive reduction of the rate of charge; four Directors are in favor of placing the income in excess of target, amounting to SDR 26 million, to reserves and immediately deeming it as income for FY 1987, and some others could accept that as a compromise. The eight Directors remaining, who have by themselves a majority of the voting power, would place the excess income to reserves, and most of them would be willing to re-examine the matter of deeming part or all of the income exceeding the target for FY 1986 as income for 1987 as part of the overall package, which I understand can be done from a legal point of view. At this stage, we draw the conclusion that the net income in excess of target of SDR 26 million will be put in the special reserve, along with the target amount of income of SDR 52 million. The possibility of deeming all or part of the excess income remains open and could be part of the overall package on the rate of charge for FY 1987 and burden sharing, which I hope can be agreed in the coming weeks. The question of provisioning is the object of further studies and is under review.
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> As far as the increase in the reserve target is concerned--and this, of course, has a bearing on the rate of charge for FY 1987--I have noted that six Directors, representing some

40 percent of the voting power, would like to raise the reserve target from the present 5 percent as an integral element of an overall package on burden sharing. Some other Directors also favor an increase in the reserve target but have not suggested that it be an integral part of an overall package.

On burden sharing, I think it is fair to say that 16 Directors, who have some 54 percent of the voting power, favor Mrs. Ploix's proposal in some form. But we have counted among those 16 Directors Mr. Massé, Mr. Suraisry, and Mr. Polak, who either advocate or can accept an increase in the reserve target; Mr. Massé would also want an increase in the remuneration coefficient as a basic starting point. Without the support of those three Executive Directors the French proposal would gather some 42 percent of the voting power. Mrs. Ploix made two suggestions which were favorably noted by some Directors who have not been counted as supporting her proposal, and thus there might be an element of compromise here. One of her suggestions was to have an automatic review if the rate of remuneration fell to 85 percent, which should help those who attached some importance to not letting the rate of remuneration fall to the statutory limit of 80 percent without a warning mechanism of some kind. As I understand it, the second suggestion was to deem the full amount of excess income for FY 1986 as income for FY 1987, making it possible to help both debtors and creditors temporarily: for FY 1987, the basic charge could be reduced and the reserve target raised. There was a certain support for a solution along the lines suggested by Mrs. Ploix and it should be considered very carefully during the coming weeks so that we understand exactly what we are to discuss. Thus, I note that the French proposal is attracting widespread interest and support, although some modifications may be necessary if the proposal is to receive the necessary 70 percent majority.

I was interested to hear a number of Directors express the view that the burden-sharing mechanism did not have to be limited to compensating for charges that have not been paid. If the Fund had to make provision or establish a special increase in reserves to tackle the problem of overdue principal, the same logic that led the Board to give its consent to the notion of burden sharing should also, in their view, govern the measures to cope with the problem of principal. Mr. Zecchini made a very logical point in that respect, followed by some other Directors who said that they could not consider any provisioning scheme that would not lead also to some form of burden sharing. Directors should keep that point in mind in looking at the question of provisioning and possible procedures for implementing it.

On more detailed aspects, the discussion showed that most Directors would prefer refunds as a method of dealing with the settlement of deferred charges rather than a netting out approach.

As for the timing and the procedure for setting the surcharge and the discount, most Directors prefer to take stock of actual experience and set them retroactively at the end of a six-month period, rather than in advance on the basis of uncertain forecasts.

The Executive Board then took the following decision:

The net income of the Fund for the financial year ending April 30, 1986 shall be placed to Special Reserve.

Decision No. 8310-(86/100), adopted
June 20, 1986

Mr. Sengupta said that it would be helpful in arriving at a compromise to have additional calculations on the impact of applying the concept of burden sharing to other costs than those deriving from deferred income, including special increases in reserves.

Mr. Polak remarked that as he understood it, the agreement on burden sharing was related to the temporary problem of arrears or deferred income.

The Chairman, in response to a comment by Mr. Zecchini, said that he did not foresee a further staff paper before the Board took up the overall package. The problem of a more permanent provisioning procedure was not part of the package to be discussed before the end of July. Moreover, there were various ideas that had been put forward by individual Executive Directors that would have to be taken into account in arriving at a final agreement. He agreed with Mr. Zecchini that it would be most useful to attempt to reach a consensus before the Board returned to the overall package.

Mr. Fujino considered that an agreement would be possible only if the burden-sharing scheme was to be a temporary solution for the current financial year. That was how he had understood Mrs. Ploix's proposal.

The Chairman responded that one of the issues on which a decision would have to be reached was whether a burden-sharing method should be introduced for one year, followed by a return to the present system, or whether the methods adopted should be introduced with provision for reviews. The structure of Mrs. Ploix's proposal was based on willingness to accept a review after one or two years, which was not the same as making an exception from the present system for one year unless a decision was taken to prolong that exception.

In response to a question by Mr. Dallara, the Chairman said that it would be advisable for the proponents of the various methods of burden sharing--especially those of a more permanent nature--to look carefully into what would happen if the ceiling on the surcharge and/or the floor to the rate of remuneration were reached. The current rules had made it possible so far for the Fund automatically to avoid an unfinanced gap.

Mr. Dallara said that, in light of the apparent interest in the Board in moving within the coming weeks toward an agreement on the broader issues under discussion, he wished to revert briefly to a point that he had made in his statement and that was of some importance to his authorities. Some Executive Directors had requested, during the Board's recent six-month review of overdue obligations, that the staff prepare papers--presumably but not explicitly for discussion in the Board--on the use of local currency in the payment of charges and on the rescheduling of repurchases as possible elements of an approach to the problem of arrears. As he had already mentioned, such proposals undermined the existing basis for agreement on a burden-sharing mechanism, and it would be helpful to him to have some indication of the preliminary thoughts of other Directors on the matter before the debate resumed.

Mr. Nebbia commented that he would not preclude the possibility of a request to the Executive Board to discuss any such paper that might be produced, even though the Chairman in his summing up at EBM/86/94 had said that the paper would not be of an operational nature.

Mr. Dallara said that he recognized that papers on the issues in question could be brought to the Executive Board for discussion. But if those issues were actively pursued, his authorities would not be able to join in an agreement on burden sharing.

Mr. Sengupta remarked that it did not seem possible to preclude consideration of any aspect of the Fund's operations for which provision was made in the Articles of Agreement.

The Chairman explained that the reference in his summing up to the paper as covering technical and legal rather than operational aspects had been intended to reflect the fact that a majority had been opposed to the preparation of the papers.

Mr. Dallara confirmed that he did not dispute the agreement reached at EBM/86/94. It was simply that his authorities felt that the issue of burden sharing could be considered most constructively within a framework of mutually cooperative efforts to address the arrears problem. Although views on the most effective way to do that might differ, it would be counterproductive and inconsistent with the spirit in which the need for burden sharing had been approached so far to pursue certain ideas that were to be dealt with in the requested papers.

The Executive Directors concluded for the time being their consideration of the Fund's income position for FY 1986 and FY 1987.

APPROVED: March 4, 1987

LEO VAN HOUTVEN
Secretary