

EBS/85/125

CONFIDENTIAL

May 14, 1985

To: Members of the Executive Board
From: The Secretary
Subject: Factors Bearing on the Adequacy of Fund Reserves

Attached for consideration by the Executive Directors is a paper on factors bearing on the adequacy of Fund reserves, which has been scheduled for discussion on Wednesday, June 5, 1985.

Mr. Wittich (ext. 8307) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Factors Bearing on the Adequacy of Fund Reserves

Prepared by the Treasurer's Department

Approved by W.O. Habermeier

May 13, 1985

I. Introduction

After consideration of the impact of overdue financial obligations on the Fund's financial position at Executive Board Meeting Nos. 85/40 and 85/41, the Executive Board decided that the Fund's accrued income should no longer include charges accrued or due from members that are in arrears for six months or more in meeting financial obligations to the Fund. During that discussion, the issue also arose whether it would not also be necessary or desirable, in view of the increasing level of overdue repurchases, to set aside provisions to protect the Fund's assets against the risk of ultimate failure to discharge overdue obligations. Protection against these contingencies could take the form of a charge against income for the specific purpose of meeting any ultimate default, or could be made by an increase in the annual target income and increase in reserves. In this context, a number of Executive Directors requested the staff to review the factors that have a bearing on the Fund's reserves and need to be taken into consideration in coming to a judgment on the adequacy of the reserves in present circumstances.

The present paper is intended to summarize the most important factors that would need to be taken into account in the Executive Board when considering the adequacy of the level and the growth over time of Fund reserves. Factors bearing on the adequacy of reserves are discussed in the following section, and other considerations relating to an increase in the net income target in Section III. The paper ends with a summary of conclusions (Section IV).

In the same Executive Board meeting, questions also arose regarding the sources of financing for the Fund's operations, including administrative expenditures as well as the accretion of reserves, and a number of Executive Directors requested an analysis of the cost of resources used in Fund operations both to the members providing these resources and to the members using them, and of the distribution of any burden involved in financing the Fund's operations. These issues are discussed in a memorandum to be issued as a companion paper.

II. Adequacy of the Fund's Reserves

1. Purpose of Fund reserves and factors bearing on their adequacy

The Fund's reserves presently amount to SDR 1,038 million and reflect a number of diverse factors. In part they derive from the investment in U.S. Treasury bills of the proceeds of temporary sales of gold to the United States in order to strengthen the Fund's financial position after a series of operating deficits. For the remainder, they represent earnings retained over the years which reflect an excess of income over expenditures, but were reduced to the extent that the Fund's expenditures exceeded its income, as it did during the (financial) years 1973-77 and again in 1985. Excesses of income over expenditures, in turn were the result of many factors, including the cost to the Fund of resources used in the Fund's transactions, and the charges paid on the use of these resources. In the light of these many different factors that contributed to the establishment of the Fund's reserves, they can only be considered as belonging to the membership as a whole and cannot be attributed, partially or in whole, as having been derived from any particular country or group of countries, as has occasionally been attempted. 1/

As has been discussed in the previous general review of their level and growth, the Fund's reserves serve a number of purposes. 2/ The most compelling reason for reserves is to protect the assets subscribed to the Fund against impairment through losses. Such losses could derive from a number of causes, the most obvious of which are an excess of operational and administrative expenditures over income such as now occurred in the financial year that just ended; the failure of members to discharge their financial obligations to the Fund; or exchange losses on currencies held in accounts not subject to maintenance of value obligations, such as the Special Disbursement Account or the Investment Account. In addition to the protection against possible losses, reserves also serve as a source, albeit a minor one, of additional liquidity. Lastly, as also emphasized in the recent discussion of overdue payments, the regular achievement of a net income and accretion of reserves assures creditors as well as the public at large of the sound financial management of the Fund and of its assets.

a. Reserves and excess of expenditures over income

The existence of reserves allows the Fund to avoid frequent and possibly substantial adjustments in its policies, such as, e.g., those

1/ The origin of the Fund's reserves and related factors are discussed in more detail in "Factors Relating to Burden Sharing in the Fund" (EBS/85/126, 5/14/85).

2/ See "The Level and Growth of Fund Reserves and the Determination of Fund Charges" (EBS/83/251, 11/25/83), which was discussed at EBM/83/177 (12/19/83).

relating to the rate of charge or to the rate of remuneration, that might otherwise be necessary, perhaps on occasions when this would be considered undesirable for other reasons, to prevent an excess of expenditures over income from impairing the Fund's subscribed assets. Such an excess has, in fact, occurred in the first decade of the Fund's history when, prior to the establishment of the Special Reserves through investment of part of the Fund's gold, deficits resulted in a decline in the Fund's quota resources. 1/ These continuing deficits resulted in 1956 in a decision that the Fund invest part of its gold holdings in interest-bearing assets. 2/ The proceeds of this investment program had soon reversed the decline in the Fund's assets, and investment income thereafter was used to build up the Special Reserve intended to cover any foreseeable future deficits. The existence of reserves thus allows the Fund some flexibility in its income and expenditure policy without the lack of immediate remedial action leading automatically to an impairment of its quota resources.

The most immediate cause of an excess of expenditures over income in current circumstances is likely to be the result of changes in the cost to the Fund for the use of its resources, i.e., in the rate of remuneration, which sooner or later must find reflection in the cost the Fund levies on the use of these resources.

In addition, there are administrative expenditures the rise of which recently has given rise to increasing concern. While at present administrative expenses may not appear large in relation to the total of the Fund's operational income and expenditures, this may not always be the case. In fact, there is a certain paradoxical relation in that the very success of the Fund's work would reduce its income but not its expenditures to the same extent: significant administrative expenditures would remain even after the successful completion of adjustment programs resulted in a reduction in balance of payments problems of member countries and in a much smaller level of financial support extended by the Fund than has been the case in recent years.

In the light of the earlier experience of deficits being covered by the proceeds of an investment program, reference also has been made to the Fund's authority to make investments from its assets equal to accumulated reserves, and that therefore reserves might bear a relation to the Fund's administrative expenses. This train of thought suggested that, at one extreme, reserves might be such as to meet the Fund's normal expenditures that are unrelated to its financial activities, for instance by way of investment as provided for in Article XII, Section 6(f). To allow the Fund sufficient earnings from investment to provide for administrative expenditures of the size of the administrative budget proposed for FY 1986, or about SDR 260 million, the Fund's

1/ See "Fund Reserves - General and Special" (SM/69/140, 9/11/69).

2/ The investment of the proceeds of temporary gold sales and the importance of cost-free resources are discussed in more detail in "Factors Relating to Burden Sharing in the Fund" (EBS/85/126, 5/14/85).

reserves would need to be about SDR 3.2 billion, or about three times the level at the end of FY 1985. 1/ With a net income target of, say, 8 percent, such a level of reserves would be reached in about fifteen years. 2/

b. Failure of members to meet financial obligations to the Fund

The risk to the Fund's subscribed capital from the failure of members to meet their financial obligations to the Fund is much more difficult to assess. There has never been a case where a member has not eventually settled its obligations, 3/ and it is difficult to attach any quantitative measure to such a possibility. Nevertheless, these risks cannot be completely excluded, and the recent experience with increasing delays in members discharging obligations as they fall due would suggest that the inherent exposure of the Fund is likely to have increased.

Measures to serve as protection against the failure of debtors to discharge payments as they fall due usually differentiate between the payment of interest (in the case of the Fund, charges) and the repayment of principal (repurchases). Since the recent decision no longer to accrue as income charges from those members that are overdue six months or more in payments to the Fund (and are not current in paying charges), there would appear to be less risk that the Fund's income and reserves reported in the financial statements would include amounts that ultimately may not be collected. To the extent that the nonpayment of charges is reflected accurately in income projections, and the agreed amount of net income is achieved otherwise, the Fund's income position would appear to have achieved a certain measure of protection against the risk of delays in the payment of charges.

As regards the repayment of credit extended by the Fund (or repurchases) no similar mechanism for regular exclusion exists. Two main methods are usually employed to protect an organization against the consequences of calamities or other financial risks, including the failure of debtors to meet financial obligations. One is the retention of earnings in order to strengthen the equity base of the entity; the other is the establishment of provisions to cover likely financial losses.

The first of these methods is normally intended to provide a cushion against uncertainties or business risks and the possibility of losses that cannot be foreseen or predicted with any degree of accuracy. This

1/ Calculated at the present SDR interest rate of about 8 percent.

2/ If allowance is made for an increase in nominal expenditures of, say, 5 percent, a net income target of 14 percent would be necessary to achieve a level of reserves sufficient to finance administrative expenditures in the same time period.

3/ However, obligations of one member country--Democratic Kampuchea--have remained unpaid since 1975.

is essentially the practice that has been followed in the Fund with the establishment of general and special reserves. Should an unanticipated loss occur, it would in accordance with generally accepted accounting principles be reflected in the annual income statement as an expense, possibly leading to a deficit, and the existence of reserves would reduce the risk that such a deficit would lead to an impairment of the organization's capital or, in the Fund, of its subscribed quota resources.

Under the second method, provision is made when it appears that a contingent loss exists; it is variously called a loan/loss provision, or loan/loss allowance, or contingency provision. The provision or allowance is reflected in the financial statements by an offset to or a deduction from the asset in question. Such provisions are established through a charge against current income (i.e., before the determination of net income or deficit of the period) and under generally accepted accounting principles are to be made if (i) a loss is probable, and (ii) the amount of the loss can reasonably be estimated. If a loss occurs, it is charged to the contingency provision, and thus has no effect on the income of the period in which the loss is recognized.

Both these procedures of taking account of uncertainties and financial exposure thus offer a measure of protection against an impairment of the Fund's subscribed quota resources; and both would require higher revenues (or lower expenditures) than would be necessary otherwise. However, their effect on the Fund's reported income would be different, which could have an influence on the choice to be made. In addition, it would need to be decided in the light of prevailing circumstances which of the two methods would be appropriate in accordance with generally accepted accounting principles.

The practices followed by other financial institutions active in international lending to protect themselves against the risk of loss may be of interest in this context, even though they may not be directly applicable to the experience of the Fund. Perhaps best known are the practices prescribed for or customarily followed by commercial banks, which regularly make provisions against the risk of loans not being repaid. These provisions are determined in relation to the perceived quality of each bank's loan portfolio and its experience with loan repayments in the past. To determine the appropriate allocation to loan/loss provisions, financial institutions evaluate the probability of loss on the basis of historical experience which may reflect both on the characteristics or categories of outstanding loans (general provisions) and, particularly for large loans, the institution's judgment as to risk associated with a specific project or the creditworthiness of the borrower (specific provisions). According to information provided in their balance sheets, in 1983 the ten largest commercial banks in the United States had provisions ranging from 0.9 percent to 1.5 percent of their loan portfolios. ^{1/} The substantial range of allocation to

^{1/} This does not include any allocations these banks may have made to retained earnings.

loan/loss allowance reflects the differences among institutions as to the particular market sector they serve and the quality of their assets. 1/

Perhaps more directly relevant for the Fund than commercial banks, even large international banks that have substantial exposure of loans outstanding to sovereign borrowers and hence face risks that in their nature could be considered not dissimilar to the exposure of the Fund, are other international public financial institutions, such as the international and regional development banks. These institutions are similar to the Fund in that they are supported by their international membership and therefore claim a preferred creditor status; they differ from the Fund in that they rely for their financial resources mainly on borrowing in the private capital markets and accordingly are subject to the regulatory and other requirements in these markets, including the requirements of rating agencies and the preferences of underwriters and investors.

Like the Fund, these institutions have not experienced nor expect to experience losses on credit outstanding, which is owed--as in the case of the Fund--by their member countries. It therefore is not surprising that they do not have separate loan/loss provisions. Protection against possible ultimate failure of member countries to meet their financial obligations--that is, against impairment of capital subscriptions--is provided by the general reserves (or retained earnings) these institutions are accumulating. It is the policy of all of these institutions to achieve some addition to reserves each year, although net income (reserve growth) as well as the level of general reserves in relation to financial activity varies substantially from institution to institution. 2/ Notwithstanding the wide differences reflected in the table below, reserves of all of these international financial institutions are a much higher proportion of credit outstanding than they are for the Fund. 3/

1/ At the end of 1983, average loan/loss provisions of the ten largest U.S. commercial banks were reported to be 1.1 percent of total loans outstanding. At the same time "nonperforming" loans (i.e., loans the income of which was reported on a cash basis rather than accrued) were reported at 3.1 percent of outstanding loans. If these percentages would apply to the Fund, loan/loss reserves would amount to SDR 384 million, and deferred income in FY 1985 could be estimated at SDR 65 million.

2/ The IBRD, for example, aims to make annual additions to its reserves so that these reserves would not fall below 8-10 percent of disbursed loans.

3/ It may be argued that the value of assets reported in the Fund's financial statements is understated to the extent that existing gold holdings in accordance with the Articles must be valued at the price of acquisition of SDR 35 an ounce. See "Treatment and Valuation of Gold for Fund Purposes" (SM/79/40, 2/7/79).

Table 1. Ratio of Reserves to Loans Outstanding, 1975-85 1/

(In percent)

	1975	1980	1981	1982	1983	1984	1985
AsDB	14.3	22.4	26.2	29.4	31.6	n.a.	n.a.
AfDB	34.4	24.4	24.7	22.1	n.a.	n.a.	n.a.
BIS <u>2/</u>	8.7	14.4	16.1	16.9	21.9	27.1	n.a.
EIB	8.1	6.2	6.3	6.9	7.2	n.a.	n.a.
IBRD	15.6	10.8	11.0	10.7	10.1	9.8	n.a.
IADB	25.4	29.9	32.0	32.5	45.2	49.4	n.a.
IMF	10.7	8.6	8.6	6.3	4.2	3.4	3.0

1/ Financial years.

2/ Reserves as percent of time deposits, advances and securities with maturity in excess of 3 months.

This may in part be explained by differences in character and, particularly, in the financial structure, as between them. The development banks derive most of their resources by borrowing from member countries or in the private markets, and therefore have to pay much closer attention to the effect on the capital markets of the perception of their financial strength; to the extent that private investors are used to and normally expect certain balance sheet ratios to be observed, it may be difficult for development banks to disregard them even though the inherent risk to which they are subject may be much lower than that of private financial institutions for which the ratios had originally been developed. Nevertheless, these comparisons clearly indicate that the reserves of the Fund are much lower, relative to the scope of its financial activities, than that of other institutions which face similar risks, if not similar tasks.

While in contrast to private financial institutions the Fund has no experience by which to evaluate the risk to which it may be exposed, there are of course a number of statistics that relate the Fund's reserves to its financial activity. These have been summarized in earlier staff memoranda dealing with the Fund's reserves and with overdue payments, 1/ and they are updated in the Appendix tables.

1/ See, e.g., "The Level and Growth of Fund Reserves and the Determination of Fund Charges" (EBS/83/251, 11/25/83), and "Overdue Financial Obligations to the Fund--Supplementary Information" (EBS/85/32, 2/5/85).

They point to various aspects in which the Fund's reserves provide less assurance against an impairment of its subscribed quota resources (though not of its ability to meet its financial obligations to its creditors as they fall due) than was the case in the past. Reserves have declined in relation to outstanding purchases from 7-8 percent at the time the Supplementary Financing Facility became effective in 1979 to less than 3 percent, and from about 15 percent of outstanding borrowing at the same time to about 7.4 percent. 1/ The total of overdue payments has increased over the same period from SDR 15 million (2 percent of reserves) to SDR 197 million (19 percent of reserves), and Fund credit to members that were overdue for six months or more at the end of the last financial year amounted to 70 percent of the present level of reserves. 2/ These aggregates change over time, of course, and an income target related to them should be reviewed at regular intervals and adjusted upward or downward as appropriate, as discussed further below.

c. Reserves and Fund liquidity

Reserves increase the total of the Fund's assets and thereby provide a contribution, albeit a minor one, to its liquidity. As a cooperative institution, the Fund's resources are primarily provided by the subscriptions from its member countries, although the Fund's ability to assist its members has over time been importantly supplemented by borrowed resources, and this may in particular situations be expected to continue to be the case. Nevertheless, the Fund is not an institution that constitutionally is likely to or conceived to rely on self-finance, and the contribution reserves make to its liquidity, though helpful, would not seem to provide an indication as regards the level of reserves the Fund may find appropriate to hold or to achieve. Moreover, the general contribution to liquidity made by the Fund's reserves must be distinguished from the Fund's liquidity at any point in time which depends primarily on its holdings of currencies of members judged of a sufficiently strong balance of payments and reserve position that their currencies are usable in Fund transactions, and on its creditworthiness which allows it to draw upon borrowed resources. Although the media in which reserves have originally been paid may clearly be identifiable (as in the case of the investment program mentioned earlier), it is not possible to attribute any particular asset to the Fund's reserves, as the composition of the Fund's assets at any particular point in time will much more importantly reflect the use of these assets since that time. The contribution of the Fund's reserves to liquidity thus is, at least in present circumstances, not likely to provide any guidance as regards the adequacy of reserves.

d. Reserves and Fund credibility

There can be little doubt that the Fund's holdings of reserves strengthen the public perception of it as an institution, both as

1/ See Appendix Table 1.

2/ See Appendix Table 2.

regards its role as an agency with a supervisory role at the center of the international monetary system, and its standing in the eyes of those that make resources available to it, whether these resources reflect the Fund's use of its currency holdings (resulting in the establishment of reserve positions in the Fund) or lending to the Fund. ^{1/}

e. Factors relevant for the size and growth of reserves

While it is generally agreed that it is desirable, for the reasons discussed earlier, for the Fund to be able to show reserves in its financial statements, it is much more difficult to be certain on the level of reserves it should have, or on annual additions to them.

One of the possible considerations discussed--i.e., an endowment the returns on which might suffice to finance the Fund's administrative expenditures--would call for substantially larger reserves than the Fund presently holds; the rate of growth necessary to achieve such a level of reserves would depend on the time period deemed reasonable to achieve it.

Alternatively, the desirable level of reserves may be related to some of the aggregate measures discussed above. The most obvious ones would be the outstanding level of Fund credit, and perhaps the recent experience with the timely discharge of obligations as they mature as an indicator of the Fund's exposure to the risk of obligations to it being met. It is noteworthy that the Fund's reserves are a much smaller proportion of outstanding credit than those of the international financial institutions surveyed. While the Fund's financial structure differs from most of these institutions--i.e., it has not relied on the private markets for its resources and holds large amounts of gold, and its credit activities are even more closely linked to adjustment programs than are the balance of payments credits extended by other institutions--the differences in financial structure should not be overdrawn.

It would appear likely that the Fund's exposure to risk has risen in recent years in view of the increase in balance of payments support made available since the early 1970s and the expansion of outstanding purchases. This exposure to risk seems likely to remain for some years to come, although net credit expansion is beginning to slow down and is expected to stabilize in the near future, mainly as a result of large repurchases falling due. ^{2/} Much will depend on the progress which members make in improving their external positions and on the ability of the Fund and its members to contain and reduce the incidence of overdues to the Fund. It would thus appear reasonable that the growth of the Fund's reserves reflect these uncertainties and also be increased.

^{1/} It ought to be emphasized, however, that for the reasons discussed in the previous paragraph, the Fund's ability to meet its liabilities as they fall due is much more closely connected to its holdings of usable currencies than to the level of its reserves.

^{2/} See "The Fund's Liquidity and Financing Needs," (EBS/85/56, 3/7/85).

However, in view of its functions, the credit extended by the Fund to its member countries is likely to fluctuate over time much more than that of other international financial institutions. It would appear to follow that any target growth of reserves that might be agreed should be reviewed at periodic intervals. The need for increasing reserves might accordingly be reduced when the credit extended by the Fund would have declined in relation to quotas. 1/

Less obvious perhaps as an indication of risk exposure of the Fund is the proportion of reserves to Fund quotas. Nevertheless, quotas as a scale factor may have an advantage over outstanding credit in avoiding the destabilizing effect of reserve accretion on the rate of charge that results from wide variations over time of outstanding purchases. Notwithstanding the Fund's ability to supplement its resources by borrowing and thus increase the assistance it is able to extend to members in balance of payments difficulties, on average and in the longer run, it may well be expected that use of Fund credit would be related to the overall size of Fund quotas.

In the light of these uncertainties, it would not appear possible to draw any firm conclusion about a numerical relation between the Fund's reserves and outstanding credit, or credit to members in arrears in payments to the Fund, or between reserves and Fund quotas. However, the Fund's reserves clearly are very low in relation to any of these magnitudes if compared to data available for other international financial institutions. Although the Fund is not directly subject to the same constraints, such as evaluation by investors in the capital markets that may play an important role in these institutions, it does not follow that the same considerations do not also have applicability to the Fund's policy choices, particularly in the context of the Fund's borrowing programs. In this context, an increase in the Fund's net income target from the present 3 percent of reserves to a higher level would appear consistent with what market considerations appear to imply for other international financial institutions.

III. Considerations Relating to an Increase of the Net Income Target

The developments in the diverse indicators reflecting both the Fund's transactions and the increasing exposure to risk it has experi-

1/ Given that the amount of "interest-free" or "costless" resources available to the Fund is narrowly circumscribed, an expansion of credit extended by the Fund magnifies the effect of the reserve target on the Fund's income, and vice versa. After the successful completion of adjustment programs presently in effect under enlarged access and with much lower levels of Fund credit that may then be outstanding, Fund reserves may be judged adequate in the light of the credit risks then faced, with a correspondingly lower net income target. The impact of cost-free resources on Fund income is discussed in more detail in "Factors Relating to Burden Sharing" (EBS/85/126, 5/14/85).

enced in recent years have led a number of Executive Directors to suggest the desirability of an increase in the net income target, which forms one of the bases for the annual determination of the rate of charge on the use of Fund resources. In view of the difficulty of determining a clear and well-defined relationship between the exposure to the risk of nonpayment and the extent of the use of Fund resources, there does not appear to be any one cogent automatic formula to determine a target for reserve growth in aggregate or individually, and a more judgmental approach would appear warranted, involving a decision to increase the reserve target to an agreed higher rate in combination with a decision to review the need for the higher rate after a stated interval.

In his statement for the Executive Board discussion of the effects of overdue payments on the Fund's income position at EBM/85/40, the Managing Director indicated that a minimum increase of the targeted reserve growth from 3 percent to an order of, say, 6 percent would be broadly consistent with the results of several of the formulas illustrated in the staff paper and would seem to be indicated in present circumstances with continued inclusion in reported income of charges due from members with protracted overdue payments. Alternatively, if unpaid charges from these members were no longer included in accrued income, a somewhat smaller increase of the reserve target, in light of overdue repurchases, might be considered. 1/ Such a somewhat lower target might be set, for example, at 5 percent of reserves. This would meet the objective of a somewhat faster growth of the Fund's reserves even if not as fully as some Executive Directors considered desirable, and thus might alleviate a perception that could otherwise arise of an impairment of the Fund's financial strength with the attendant dangers to its standing at the center of the international monetary system, as well as to its liquidity because of the possibility of a perceived risk to the liquidity of reserve positions in the Fund. 2/

One of the difficulties in establishing a reserve new target is likely to be related to the great sensitivity of the Fund's net income, to extraneous developments and the uncertainty whether the target would in fact be achieved. 3/ For example, the possibility that even slight movements in market rates of interest would lead to a surplus or deficit that could easily be a multiple of the net income target sets up incentives both to provide for a higher target amount than might be judged adequate or acceptable in the absence of such uncertainty in order to increase the likelihood that it would be achieved, as well as the opposite (a lower than desired target) in order to avoid an increase

1/ See Buff 85/47 (3/8/85). See also "Overdue Financial Obligations to the Fund--Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84) and "Overdue Financial Obligations to the Fund--Supplementary Notes" (EBS/85/32, 2/5/85).

2/ See EBM/85/40 and EBM/85/41 (3/13/85).

3/ See, e.g., "Review of the Fund's Income Positions for the FYs 1985 and 1986" (EBS/85/104, 4/25/85), pp. 13-14.

in the rate of charge that in retrospect appeared excessive. 1/

There are a number of ways in which these concerns could be taken into account in a revised net income target, depending on the level of the target. If, for example, there were a general consensus for the Fund's reserves to increase, on average over time, by, say, at least 5 percent, that net income target could be combined, in order to meet the concern of Executive Directors who held that a higher rate of increase would be necessary in present circumstances, with the presumption that any excess of net income above the target would be used to accelerate reserve growth, at least as long as the combined planned and unanticipated addition to reserves did not exceed an agreed higher figure on average, say over the last three to five years. Income in excess of the target deriving from interest rate developments and from net payment of deferred charges exceeding the amounts included in income projections would in this case first accrue to reserves, rather than lead to a reduction in the rate of charge. Similarly, if the Executive Board decided to adopt special charges on overdue obligations, the proceeds from such charges (which are unpredictable and therefore not taken into account in the income projections) would, to the extent that they raised net income beyond the target amount, lead to an increase in reserves. The presumption of reserve growth in excess of the target might take the form that an action that differed from addition to reserves of the surplus--say the use of the excess for deemed, or for a retroactive reduction in the rate of charge--would require a qualified majority. Such an approach would differ from present procedures embodied in Rule I-6(4) in effectively setting a range of net income in which the use of income in excess of the target would be predetermined, unless the Board decided otherwise, which would provide some assurance of faster accretion of reserves should the income position turn out more favorable than projected.

Alternatively, if a higher net income target as proposed by some Executive Directors were agreed, it could be accompanied by the presumption that any excess of income above the target would be used first to reduce the rate of charge, either retroactively or through deemed the excess income for the subsequent financial year for the purpose of setting charges and only secondly--e.g., after the rate of charge had been reduced by a certain amount--consideration would also be given to a retroactive (or prospective) increase in the remuneration coefficient

1/ The desirability of accepting an increase in reserves in excess of the net income target in lieu of an increase in the target was discussed during the last review of the Fund's reserve policy. See "The Level and Growth of Fund Reserves and the Growth of Fund Charges" (EBS/83/251, 11/25/83) and EBM/83/177 (12/19/83). Conversely, the practice of deemed income in excess of the target to meet the target for the subsequent year (or the possibility of a retroactive adjustment in the rate of charge or the remuneration coefficient) provides the possibility of corrective action if it is considered preferable to use income above target otherwise than adding it to reserves.

or to further additions to the reserves. A reduction in the SDR rate of interest below the projected level, for example, would then in the first place tend to be reflected in a reduction (or reduced increase) in the rate of charge and thus directly benefit the Fund's debtors. A similar unanticipated (that is, not projected) effect on income would result from the discharge of deferred charges, at least to the extent that it exceeded unanticipated new deferrals, and similarly from the proceeds of any special charges on overdue payments if such charges were adopted.

An alternative approach to assist in more exactly achieving an agreed net income target that might be considered would be a retroactive determination of the rate of charge. To the extent that the Executive Board agreed on a net income target that was generally considered acceptable in the light of the Fund's present financial situation, Executive Directors might wish to reconsider whether there would be advantage in setting the rate of charge retroactively at the end of a period, similar to the determination of the rate of charge on borrowed resources. Doing so would have the disadvantage of a greater fluctuation in the rate of charge parallel to (though below) interest rate movements in the market. It would, however, provide an assurance that the rate of charge would not exceed the level which is necessary to achieve the agreed target amount of net income.

IV. Summary of Conclusions

1. The Fund's reserves serve essentially three purposes: (i) to provide protection against the impairment of the assets subscribed to the Fund while at the same time allowing it some flexibility in adjusting its policies, including the policy on the rate of charge on the use of the Fund's resources, in the face of adverse developments in its income position; (ii) to provide some, albeit a minor, addition to the Fund's liquidity and its cost-free resources; and (iii) to demonstrate to the Fund's creditors and the public at large, through the regular achievement of a net income and accretion of reserves, that the financial affairs of the institution are soundly managed.
2. Total reserves at the end of FY 1985 presently are projected at SDR 1,038 million, taking into account the deficit experienced in that year projected at SDR 36 million. There have been regular additions to the Fund's reserves since in 1978, when a six-year period of annual deficits ended, the Fund adopted a policy of aiming at a small surplus each year in its income position. From the end of FY 1977 to the end of FY 1985, the Fund's reserves have increased at a compound rate of 5.3 percent or almost twice the net income target incorporated in Rule I-6(4). However, in relation to other criteria such as quotas, outstanding Fund credit, or borrowing by the Fund, reserves have declined notably since access to the Fund's resources was expanded under the Supplementary Financing Policy and the Policy on Enlarged Access. It is also noteworthy that the Fund's reserves are a considerably smaller portion of outstanding credit than is the case for other international financial institutions which would appear to face credit risks not very dissimilar from those faced by the Fund.
3. There has also been a sharp rise in overdue financial obligations to the Fund in the last few years, with an apparent corresponding rise in the Fund's exposure to financial risks. At the end of FY 1985, total overdue obligations to the General Department amounted to SDR 197 million or almost one-fifth of the Fund's reserves, and obligations overdue for more than six months to SDR 78 million (8 percent of reserves). Purchases outstanding from members overdue to the Fund (SDR 1,721 million) exceeded the Fund's reserves by two thirds, and credit to members overdue for more than six months in meeting financial obligations to the Fund (SDR 718 million) amounted to 70 percent of reserves.
4. The Fund's reserves may appear adequate to meet, under normal conditions, the need for flexibility in the Fund's policies relating to its financial position; it is at any rate unavoidable that adverse developments in that position will in due time need to be reflected in the structure of either its cost or its revenues. In contrast, questions have been raised whether the level of reserves remains adequate in light of the sharp expansion of credit extended by the Fund to its member countries and the rising incidence of overdue payments. In addition, the increase in liabilities of the Fund to its members could

be thought to argue for an enhanced level of reserves, even though the Fund's ability to meet its obligations on time is not in question and does not depend on the Fund's reserves.

5. An element not present when the Executive Board last considered the Fund's reserves is the increasing amount of obligations members find themselves unable to discharge as they fall due. Apart from the impact overdue obligations have on the level of reserves, it would appear likely that a rate of reserve accretion considered adequate, or perhaps even modest, in the absence of overdue obligations would be judged too low in the face of increased financial exposure. To the extent that the loss is not judged probable, it would appear appropriate to provide for an increase in financial exposure through an increase in the target increase in the Fund's reserves. This, however, would not prevent the need for the establishment of provisions against the possibility of losses on outstanding credit in the event such a loss is judged probable and is considered quantifiable. The level and rate of growth of reserves that would provide appropriate protection in the light of the increased risks to which the Fund is exposed to would be a matter for judgment that is difficult to quantify in any exact manner. At the recent consideration of the effect of overdue payments on the Fund's financial position, the Managing Director proposed that consideration be given to a minimum increase of the targeted reserve growth from the present 3 percent to on the order of, say, 6 percent while overdue obligations having a duration of six months or more remained outstanding, if unpaid charges continued to be accrued as income, and a somewhat smaller increase of the reserve target if unpaid charges from these members would no longer be included in accrued income and recorded as current income only when actually received. Some Executive Directors considered a somewhat larger increase in the net income target would be appropriate under present circumstances, while other Directors were not convinced of the need for an increase at all.

6. In view of uncertainties as to the appropriate size of the net income target and of actually achieving an agreed target, the exact modalities of an increase in the net income target of the Fund might be influenced by the target itself. A lower target, say of 5 percent, might be combined with emphasis on factors that facilitate further reserve growth. There could, for example, be a presumption that any excess income would first be used to accelerate the rate of reserve accretion, at least until the combined planned and unanticipated addition to reserves reached an agreed higher rate of reserve growth. Conversely, a higher reserve target such as mentioned by some Executive Directors might be combined with a presumption that any income in excess of target would first be used retroactively or prospectively to reduce the rate of charge, unless the Executive Board decided otherwise with a qualified majority. With either of these methods, the risk of not meeting the target, say because of adverse interest rate developments, would rest on the Fund and any necessary catching up would need to be considered by the Executive Board in the context of the income projections for subsequent financial years. Alternatively, if a reserve

target were widely agreed to be appropriate, the Executive Board might wish to consider whether there would be advantage in adopting a formula that sets the rate of charge and possibly the rate of remuneration retroactively and automatically. This would shift the risk of adverse market development to the Fund's debtors and creditors but would create certainty that the net income target would be achieved, albeit with the disadvantage of possibly much wider fluctuations in the rate of charge than has been the case so far. An increase in the reserve target from the present 3 percent under each of the three methods described above would involve a change in Rule I-6(4) that requires a 70 percent majority of voting power.

Table 1. The Fund's Reserves and Other Financial Variables 1974-85

(In millions of SDR)

Year Ending April 30	Net Income (Deficit)	Opera- tional Income	Total Reserves	Percent Increase (Decrease) Over Pre- vious Year	Total Reserves as a Percentage of						Total Overdue Payments As a Percentage of Reserves	Fund Credit to Members Late by Six Months or More
					Quotas	Out- standing Purchases	Repur- chases	Opera- tional Income	Outstanding Borrowing	Assets		
1974	(37.2)	38.5	717.3	(4.9)	2.5	20.7	106.7	1,863.1	--	2.4	--	--
1975	(9.7)	166.5	707.6	(1.4)	2.4	10.7	136.4	425.0	28.3	2.2	--	--
1976	(2.9)	455.9	704.7	(0.4)	2.4	5.8	73.4	154.6	10.9	1.9	1.5	1.8
1977	(18.2)	774.6	686.5	(2.6)	2.3	4.3	79.1	88.6	8.9	1.8	2.0	1.8
1978	27.5	839.6	714.0	4.0	2.2	5.1	15.9	85.0	8.9	1.5	2.0	1.8
1979	46.1	753.3	760.1	6.5	1.9	7.4	15.6	100.8	15.1	1.7	2.0	1.6
1980	3.1	614.2	763.2	0.4	2.0	8.6	20.2	124.3	20.3	1.7	2.1	1.6
1981	80.1	882.3	843.3	10.5	1.4	8.6	29.8	95.6	19.3	1.3	2.8	1.5
1982	92.0	1,788.9	935.3	10.9	1.4	6.2	46.5	52.3	13.8	1.3	3.5	1.3
1983	65.4	2,045.0	1,000.7	7.0	1.6	4.2	64.4	48.9	9.1	1.3	3.6	1.2
1984	73.1	2,792.0	1,073.8	7.3	1.2	3.4	53.2	38.5	7.8	1.0	6.3	9.3
1985 1/	(36)	3,480.0	(1,038)	(3.3)	1.2	3.0	37.5	29.8	7.4	1.0	21.6	69.2

1/ Some of the data for FY 1985 are projections. See "Review of the Fund's Income Position for the Financial Years 1985 and 1986" (EBS/85/104, 4/25/85).

Table 2. Overdue Payments from Members in the General Department
at the end of FY 1985 and Purchases Outstanding

(In millions of SDR)

	Charges and Repurchases Overdue	Days Overdue <u>1/</u>	Of Which Overdue for					Purchases Outstanding
			0-2 Weeks	2 Weeks- 1 Month	1-3 Months	3-7 Months	Over 6 Months	
Guinea-Bissau	0.2	42	--	--	0.2	--	--	3.5
Guyana	17.1	348	--	--	1.5	3.9	11.7	71.7
Kampuchea, Democratic	25.7	2,960	--	--	0.2	0.2	25.3	12.5
Liberia	18.3	86	--	2.3	6.2	9.9	--	211.2
St. Lucia	0.4	52	--	--	0.4	--	--	1.6
Sierra Leone	3.4	58	0.3	1.3	1.8	--	--	72.8
Sudan	98.5	149	--	11.6	8.2	50.3	28.4	605.3
Tanzania	5.0	34	--	3.1	1.9	--	--	21.1
Viet Nam	20.2	224	--	3.6	0.5	4.0	12.1	28.4
Obligations overdue for less than one month	<u>8.6</u>	<u>2</u>	<u>8.6</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>693.3</u>
Total <u>2/</u>	197.4	485	8.9	21.9	20.9	68.3	77.5	1,721.4

1/ Weighted average of number of days for which obligations to the Fund are overdue.

2/ Obligations overdue amounted to SDR 20.9 million in the Trust Fund and to SDR 5.4 million in the SDR Department.