EXECUTIVE BOARD MEETING

SM/20/159
Correction 1

October 23, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Review of the Adequacy of the Fund's Precautionary Balances**

Board Action:	The attached corrections to SM/20/159 (10/8/20) have been provided by the staff:
Evident Ambiguity	**Page 7**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Page 38**
Typographical Errors	**Page 8**
Questions	Ms. Zoli, FIN (ext. 37116) Mr. Okwuokei, FIN (ext. 35816)

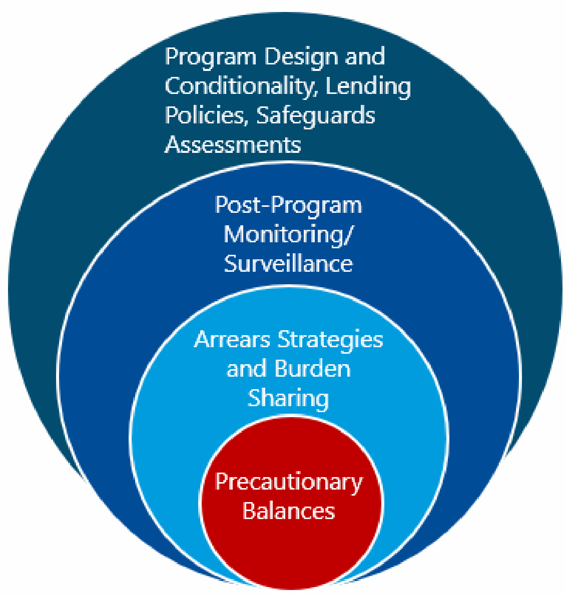
Box 1. Typology of Fund Financial Risks and Mitigation (concluded)

[4] Amounts in the Fixed Income subaccount generally correspond to the Fund's reserves that are treated as precautionary balances. Article XII, section 6(f)(ii) provides that the amounts of currency transfers from the GRA to the Investment Account shall not at the time of the decision to transfer exceed the total amount of the general and special reserves.

8. **Precautionary balances are only one element of the Fund's multilayered framework for managing credit risk.** The primary tools are Fund policies on access, program design and conditionality, all of which are critical for ensuring that Fund financial support helps members resolve their balance of payments difficulties in a timely manner:

- *Program design and conditionality*, supported by a rigorous internal review process, are tailored to the borrowing country to help members resolve their balance of payments difficulties and address other vulnerabilities while supporting growth.
- *Lending policies* (standard access criteria and limits, charges, the exceptional access and early repurchase policies) are designed to discourage long or excessive use of Fund resources; *safeguards assessments* aim to ensure that Fund resources are adequately monitored and controlled.
- *Post-Program monitoring* allows the Fund to monitor and help strengthen policies affecting the repayment capacity of members with credit outstanding beyond the program period.
- *The Fund's de facto preferred creditor* status helps support its ability to lend when others may be unwilling or unable.

Multilayered Credit Risk Management Framework



Source: IMF Finance Department.

- *The cooperative arrears management strategy, and the burden sharing mechanism* help address arrears when they arise and limit their impact.

- *Precautionary balances* are available to absorb any losses that may arise from residual credit risks, notwithstanding the above elements.[9] ~~Size, Composition and Coverage of Precautionary Balances~~

B. Size, Composition and Coverage of Precautionary Balances

9. Precautionary balances comprise the Fund's General and Special Reserves, and the Special Contingent Account (SCA-1).[10]

- *Special reserve – established as a first line to absorb administrative losses.* It was funded initially by the proceeds from a gold investment program, and later with net income allocations. Under the Fund's Articles, no distributions (dividends) can be made from the special reserve.

- *General reserve – established to absorb capital losses and meet administrative losses.*[11] It has been funded through income allocations.[12] Reserves accumulated in the general reserve may be distributed to members, in proportion to their quota, if the Board approves such decision by a 70 percent majority of the total voting power.

- *Special Contingent Account (SCA-1)* – holds contributions by members that are explicitly targeted to protect the Fund against potential credit losses resulting from the ultimate failure of a member to repay its overdue charges and repurchases in the GRA. It was funded during the period 1987–2006 mainly through the burden sharing mechanism by equal contributions from borrowing and creditor member countries via adjustments to the rates of charge and remuneration, respectively. Under existing decisions, the balances in the SCA-1 would be distributed to contributing members when there are no outstanding overdue charges or repurchases.[13] As discussed in *Provisioning for Impairment Losses in the Context of the Fund*, the

[9] Precautionary balances address credit risks arising from the Fund's non-concessional lending operations, which are managed through the General Resources Account (GRA). The Fund's concessional lending operations are trust-based, so the associated credit and liquidity risks cannot impact the GRA's balance sheet.

[10] Precautionary balances do not include the portion of special reserves attributed to the gold profits and invested in the endowment as, in setting up the endowment, the Board recognized that its sole purpose would be to generate income. On the asset side, the Fund's reserves treated as precautionary balances are either invested in the Fixed-Income subaccount or held in SDRs and currencies.

[11] Established in 1958 to absorb capital losses and to meet administrative losses, it was decided that the reserve contemplated in Article XII, Section 6(a) of the Articles, prior to the Second Amendment, would be referred to as the general reserve to distinguish it from the special reserve.

[12] Net operational income was placed in this reserve in FY 1958–72. Further placements of resources included net operational income generated under the Supplemental Reserve Facility (SRF), after meeting the cost of administering the PRGF Trust (FY 1998–2001); and surcharges on purchases under the SRF, credit tranches and EFF (FY 2002–2006). After a period of Fund income shortfall in FY 2007-08, the Board agreed to resume the practice of placing surcharge income in the General Reserve in FY 2011. Since FY 2016, net income has been allocated equally to the special and general reserves. The income shortfall in FY 2020 was placed to the special reserve.

[13] See Executive Board Decision No. 3780-(88/12), adopted on January 29, 1988. The Board has broad discretion to decide, with a 70 percent majority, on the timing and magnitude of any SCA-1 distribution. The Board authorized such distributions in 2007 and 2019 in the context of Liberia's and Somalia's arrears clearance, respectively.

3. The potential call on Fund resources would be high consistent with a severe economic fallout from the COVID-19 Pandemic. Access is calculated using the average size of Fund programs (excluding precautionary arrangements as they are not part of the forward-looking credit measure for the indicative target range) in the past ten years of about 5 percent of GDP, and in each identified case adjusting for outstanding Fund credit, projected disbursements and repurchases consistent with applicable exceptional access limits. On this basis, aggregate new demand for IMF financing under 29 disbursing arrangements could reach about SDR 138 billion over FY 2021-2022.

4. Under this WEO model-based scenario, the outstanding stock of Fund credit is projected to increase over the stock resulting from existing arrangements by about SDR 76 ~~98~~ billion at the peak in FY 2024. A combination of 10 Stand–By Arrangements (SBAs) and 19 Extended Fund Facilities (EFFs) is assumed, with even phasing over three years for SBAs and four years for EFFs. The average outstanding stock of Fund credit is projected to rise from about SDR 67 billion in FY 2020 to a peak of SDR 164.8 billion in FY 2024 (Figure 1), including existing arrangements and prospective arrangements under this baseline scenario. This compares with a peak of SDR 88.5 billion if only existing arrangement are taken into account.

5. As a result of projected new arrangements, precautionary balance would surpass the indicative target by FY 2023, and reach nearly SDR 32 billion over the medium term. This is higher than projections based only on existing arrangements, where precautionary balances would reach the indicative target by FY 2023, and remain close to the target level over the medium term.

6. Additional demand for Fund resources over this baseline could materialize in a more adverse scenario. Given the uncertain global economic outlook in the wake of the pandemic, staff considered an adverse scenario where the projected growth for 2020–21 for a country is assumed to fall by ½ standard deviation of its historical values relative to the October 2020 WEO baseline. The growth shock is combined with a high financial market shock (VIX level of 40). In addition, it is assumed that (1) average access per arrangement is significantly higher than under the baseline, about 7 percent of GDP (excluding precautionary arrangements) and that (2) all current FCL arrangements are drawn simultaneously. As a result, the outstanding stock of Fund credit is projected to increase by about SDR 137 billion above the peak under the WEO model-based scenario. The impact on Fund credit could thus be illustrative of a second wave of the pandemic. In this scenario, precautionary balances would increase to SDR 46 billion over the medium term.