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Joint Statement by Mr. Bevilaqua, Mr. Buisse, and Ms. Riach on Review of the Adequacy of the Fund's Precautionary Balances
(Preliminary)
Executive Board Meeting
October 30, 2020

We thank staff for this informative report and welcome the analysis on the adequacy of the Fund's precautionary balances, even more warranted in the context of the outbreak of Covid-19 and the related surge in lending. Together with the broader Fund's credit risk management framework and the burden sharing mechanism, precautionary balances play a critical role in mitigating and absorbing financial risks. They nevertheless represent the third available line of defense in risk coverage, after considering the Fund's policies on access, program design and conditionality and its *de facto* preferred creditor status, as rightly pointed out in the report.

The report provides a good rational for raising the indicative medium-term target for precautionary balances to SDR 25 billion, while keeping the evolution of expected demand for Fund lending and increased credit risks under close monitoring. Under the current rules-based framework for assessing precautionary balances adopted in 2020, the reserve coverage ratio and credit measure remain adequate elements. In the context of the Covid-19 crisis, additional demand scenarios for non-precautionary arrangements will lead to an increase of the indicative range and mid-point for both FY2021 and FY 2022, with the current target moving below or slightly above the lower bound (20% of the forward-looking measure of credit outstanding). The Covid-19 pandemic outbreak has led to a rapid surge in emergency financing and to a significant increase in the projected credit path in line with the need to support members during the stabilization and recovery phases. The risk of a second wave of the pandemic also looms over this transition, posing an additional drag on countries' economic recovery. Against this backdrop, we agree that the Fund's financial risks have

broadly amplified along with a deterioration of portfolio credit quality. And even if new financing is expected to increase lending income in the baseline scenario, it will be partly offset by lower investment income in the medium term and subject to higher credit concentration and rising uncertainty over lending and non-lending income projections. *Could staff confirm what the trigger would be to move from heightened monitoring to expediting the next full review?*

Since March 2020, the Covid-19 crisis has exacerbated some of the risks linked to credit portfolio concentration but, to our point of view, the balance of risks has not deteriorated further and hysteresis effect in the Fund's balance sheet should be avoided once the peak of the crisis is passed. The loan portfolio concentration remains high, but not higher, resulting mainly from the exposure to one large borrower and large repurchases from the latter in SDR terms are scheduled in FY 2023-2024. We also recall that regional concentration in periods of high demand for Fund resources is not uncommon historically and should be dealt with by the multi-layered risk management framework. Albeit associated to low or no conditionality, a large volume of RFIs repurchases should come in FY 2024-25 bringing mechanically down the amount of credit outstanding and the level of the indicative range. Likewise, key risks to Fund income position remain approximately even compared to the March 2020 report. We should continue to monitor closely the evolution of commitments and outstanding credits as well as of repurchases to maintain precautionary balances at an adequate level, and lower if need be when crisis conditions abate.

We believe that in considering concentration risk, care should be taken to differentiate between credit outstanding – particularly Argentina's large repurchases falling due in FY2023-24 – and committed but undrawn resources. We remain of the view that in most circumstances the use of precautionary arrangements reduces the probability that a country needs to draw on Fund resources and this should be considered when exercising judgement under the framework. We continue to advocate for the 2022 review of precautionary facilities to more thoroughly consider the scope for flexibility in scoring of precautionary arrangements in the FCC.

We agree with the projected pace of accumulation of precautionary balances (in line with lending income) and do not think additional steps are needed to accelerate this pace. Yet, growing downside risks at the global level, mainly the rapid deterioration in market confidence and the resulting surge in yields, could lead to debt sustainability issues. Though very unlikely, it could potentially lead to difficulties in redeeming the Fund. We note that staff's baseline projections abstract from changes in the balances of the SCA-1 related to possible arrears clearance. In this respect, we would like to highlight the specific nature of the SCA-1 and its paramount role in ensuring that the Fund's comply with international

financial reporting standards. In line with the recent adoption of IFRS 9 and the compulsory recognition of credit impairment losses for the whole portfolio under the revised impairment model, the Fund needs to ensure that, given the existence of large exposures, its corresponding reserves cover for an unlikely event of credit impairment. We would appreciate an explicit discussion of the role and level of balances in the SCA-1 in view of preparing the review of the Fund's Concessional financing. Additionally, as underscored by staff, the Fund's burden sharing capacity is expected to remain low and even decline in the coming years.

We finally agree to keep the **minimum floor at SDR 15 billion** until the next Investment Account review given the current level of risks and the role played by such floor as a source of income in a lower for longer interest rate environment.