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Statement by Mr. Merk and Mr. Krahnke on Review of the Adequacy of the Fund's Precautionary Balances
(Preliminary)
Executive Board Meeting
October 30, 2020

We thank staff for the comprehensive updated report and the detailed risk assessment. We appreciate to discuss this important topic in the board after some time and emphasize the need to pay greater attention to ensuring adequate precautionary balances. In this regard, we offer the following comments to the proposed issues for discussion.

- *Do Directors agree with staff's assessment of the credit risks facing the Fund?*

We broadly agree with the assessment of highly augmented credit risks facing the Fund. At the same time, we would like to emphasize the mentioned uncertainty of estimates, implying that risks could be even higher than outlined (para. 32). While risks are soaring, we would like to point out that some of the described safety layers, e.g. surveillance and ex-post conditionality were weakened in the course of pandemic lending.

We appreciate the mentioning of the Fund's unique role in the international financial architecture, the unique aspects of Fund lending and the unique nature of the Fund's financing mechanism that require a different handling of credit risks by the Fund compared to other financial institutions. **We therefore consider it all the more important that the unique features defining this status are preserved and adequately safeguarded so that they can fulfil their function of preventing and mitigating risks of IMF lending.** This concerns, inter alia, the Fund's lending policies and its ability to design adequately strong programs and set appropriate program conditions in line with the level of use of its resources and, crucially, its preferred creditor status. We wonder, however, about the presentation of the Fund's multi-layered risk management framework as presented on page 7. In our view program design and conditionality, lending policies, post-program monitoring, and the Fund's de facto preferred creditor status, represent crucial preventive and corrective measures and require cooperation and adequate policies by members using Fund resources. In contrast, the cooperative arrears management strategy, and the burden sharing mechanism, and precautionary balances come only into play if the preventive framework has failed. **Thus, in our view a successful preventive framework is crucial for the Fund's financial integrity and cannot be compensated or eased by relying on arears management and precautionary balances.** Given the worrying high and increasing level of risks related to the use of Fund resources, which seems to reflect weaknesses in the preventive framework or its consistent application, the arrears and precautionary balances framework must be even stronger to ensure the continued financial integrity of the Fund.

In the current context of increasing risks and weakened safety layers, we are concerned that the built-up of precautionary balances depends on unforeseeable but possibly significant changes in income. The volatility of the Fund's annual income has increased as a result of the amended IAS 19, which renders the pace of accumulation of PB significantly more unpredictable – as evidenced by the substantial fall of PB in FY 2020. In addition, the low-interest rate environment puts income flows under pressure (e.g. Box 1). The increased income risk calls by itself already for a higher minimum as well as medium-term targets to guard against unforeseen losses. *Staff comments on this issue are welcome – including on whether there is in staff's view any flexibility in the existing accounting rules to deal with the volatility of pension-related gains and losses.*

As the risks especially due to large precautionary arrangements have increased, the coverage of commitments has declined. In view of the recent history of drawings, extraordinarily high levels of uncertainty regarding the medium-term global outlook and the recovery from the unprecedented crisis, **we would tend to question staff's assessment of a low probability of drawings under precautionary arrangements.** As rightly noted by staff, this assessment is already challenged by the recent announcement of an FCL user (ft. 38). *An elaboration of how confident staff is regarding its assessment and the reasons behind it would be appreciated.*

While we go along with the remark that credit concentration can be expected to decrease whenever additional loans are disbursed, we would like to clarify that credit concentration is only <u>one</u> measure of credit risks. The absolute amount of loans disbursed is also risk-relevant, as well as the regional concentration, and therefore, higher numbers of loans outstanding should not be misunderstood as risk-mitigating.

- *Do Directors agree that the indicative medium-term target for precautionary balance should be raised to SDR 25 billion?*
- *Do Directors agree that the target needs to be monitored closely in light of developments in credit outstanding and evolving risks within the portfolio, including the largest exposures?*

We strongly support to raise the medium-term target for precautionary balances. However, we do not agree that a new target of SDR 25 billion is sufficient and would advocate for a new medium-target of SDR 30 billion, in line with the staff's reasoning that this amount is in a reasonable range. Given that the indicative range according to the WEO baseline scenario points to required PB of SDR 23 to 35 billion, SDR 25 billion is merely above the lower bound. In the adverse scenario, the proposed target even misses the lower bound of SDR 39 billion by far. Furthermore, the current developments in lending outstanding and credit capacity against the backdrop of the announced "increased likelihood" of activation of the NAB would also speak in favor of a higher increase of the medium-term target. Generally speaking, increasing the precautionary balances should be seen – and communicated – as a cautious and prudent measure going hand in hand with the increased lending activities.

We would be interested to learn w*hich events or which thresholds would prompt staff to 'come back to the board' as spelled out in para. 33?*

Accordingly, we not only support a close monitoring of the target but call for a readiness to act timely when indicated by risk developments. **Against this background, we advocate to schedule the next PB review already next year.** Especially potential drawings under large precautionary arrangements would directly affect the indicative range in which the target should be placed and make a further increase necessary.

We judge the forward-looking credit measure based only on existing arrangements as not appropriately reflecting the current situation, especially given the pipeline of new arrangements presented by the Fund, e.g. in the context of the Fund's resources ("Update on Fund Resources: Near-term GRA and PRGT Outlook", October 9, 2020). Thus, we find the estimates based on the October WEO scenario more convincing than the baseline scenario, while cautioning – in line with our comments in the July meeting – that the adverse scenario seems to be based on inappropriate perceptions on the mandate of the Fund and its catalytic financing role.

Generally, from our point of view, there appears to be a striking mismatch between staff's scenarios when assessing the need for buffers (i.e. precautionary balances) on the one hand and when assessing the adequacy of Fund resources on the other. For the former, even under the most extreme scenario staff assumes that "new demand for Fund programs could reach nearly SDR 202 billion" (para. 31, last bullet). The intended message appears to be that a moderate increase in targeted precautionary balances is the appropriate response to increased risks including from higher Fund lending. For the latter, on the contrary, staff seems keen on promoting the message that demand over the near to medium term could easily exceed available resources. **While acknowledging differing assumptions in the respective approaches we would still urge staff to send a more consistent message.** With regard to the precautionary balances, this message should emphasize the strong need for a sizeable increase of their (targeted) level – and to do so quickly to mitigate the risk of substantially higher levels of Fund lending in the near to medium term. *Further comments by staff would be welcome.*

- *Do Directors agree that it would not appear necessary at this point to take additional steps to accelerate the pace of precautionary balance accumulation, but this should be kept under close review?*

Given our comments above and the fact that the PB even declined substantially during FY 2020 we are reluctant to accept that the pace of accumulation should remain unchanged. The substantial benefits of higher PB – as described in Box 3 – are not achieved by solely setting a higher target. The accumulating pace between 2018 and 2019 has already been remarkably slow, even before the onset of the crisis and the offset of operational expenses in FY 20. The coverage ratio of total credit outstanding almost halved since FY 2017 (2017: 39.4%, currently: 18.8%). While staff estimations predict a target of SDR 25 billion being reached in FY 2026 based on the desk survey scenario, we caution not to underestimate the uncertainty of such estimation. As neither re-distributions from the SCA-1-Account, nor possible drawings to cover income losses are included, the actual pace of accumulation may be significantly lower than predicted – as shown in the past.

Against this backdrop, we would like to encourage a discussion on how the pace of accumulation could be accelerated – especially on viable options and timeframes. We appreciate the additional information provided on burden sharing in Annex 3, especially the structured overview on the factors that affect the burden sharing capacity.

We would welcome a broad discussion on the role and level of the SCA-1-Account in order to strengthen precautionary balances in an environment of increased credit risks and deteriorating debt sustainability. This notwithstanding, we would welcome an authorization of an adequate SCA-1 distribution for a possible arrears clearance of Sudan. In this context, we would suggest a transfer of remaining SCA-1 balances to another account instead of re-distributing them in case all arrears are cleared.

We are somewhat surprised that the impact of a possible temporary waiver for the GRA reimbursement by the PRGT is not mentioned in the discussion on the pace of accumulation. We agree that this issue is best addressed in the context of the upcoming PRGT financing discussion, but a consideration in the current report could still have been useful and should have been included as a scenario when assessing the pace of accumulation. *A staff comment or table with projections on this issue would be welcome. How does staff assess the importance of maintaining the reimbursement from the point of view of (i) meeting the PB target and (ii), more broadly, mitigating risks to the Fund?*

- *Do Directors agree that the minimum floor for precautionary balances should be kept unchanged for now at SDR 15 billion, but revisited after the next review of the Investment Account?*

We go along with keeping the minimum floor unchanged for the time being, given the current level of PB only slightly above that floor. At the same time, we would expect a discussion on raising the minimum floor – not least given the arguments in favor of the increased medium-term PB target – in the near future together with the review of the medium-term target.

Given its role as a protection layer against unexpected rise in credit risk, we are wondering about the mechanisms that set in, whenever the minimum floor is approached or even reached? *Staff comments would be appreciated.*