S. Hrg. 108–939

REFORM OF THE TITLE XI MARITIME LOAN GUARANTEE PROGRAM

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

JUNE 5, 2003

Printed for the use of the Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

75–221 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

JOHN MCCAIN, Arizona, *Chairman*

TED STEVENS, Alaska
CONRAD BURNS, Montana
TRENT LOTT, Mississippi
KAY BAILEY HUTCHISON, Texas
OLYMPIA J. SNOWE, Maine
SAM BROWNBACK, Kansas
GORDON H. SMITH, Oregon
PETER G. FITZGERALD, Illinois
JOHN ENSIGN, Nevada
GEORGE ALLEN, Virginia
JOHN E. SUNUNU, New Hampshire

ERNEST F. HOLLINGS, South Carolina, *Ranking*
DANIEL K. INOUYE, Hawaii
JOHN D. ROCKEFELLER IV, West Virginia
JOHN F. KERRY, Massachusetts
JOHN B. BREAUX, Louisiana
BYRON L. DORGAN, North Dakota
RON WYDEN, Oregon
BARBARA BOXER, California
BILL NELSON, Florida
MARIA CANTWELL, Washington
FRANK R. LAUTENBERG, New Jersey

JEANNE BUMPUS, *Republican Staff Director and General Counsel*
ROBERT W. CHAMBERLIN, *Republican Chief Counsel*
KEVIN D. KAYES, *Democratic Staff Director and Chief Counsel*
GREGG ELIAS, *Democratic General Counsel*

CONTENTS

	Page
Hearing held on June 5, 2003	1
Statement of Senator Breaux	40
Statement of Senator McCain	1
Statement of Senator Stevens	38

WITNESSES

McCool, Thomas J., Managing Director, Financial Markets and Community Investment, U.S. General Accounting Office	16
Prepared statement	19
Mead, Hon. Kenneth M., Inspector General, U.S. Department of Transportation	6
Prepared statement	9
Schubert, Hon. William G., Administrator, Maritime Administration, U.S. Department of Transportation	2
Prepared statement	4

APPENDIX

American Shipbuilding Association, prepared statement	47
Letter, dated May 13, 2009, from Arthur Imperatore, Jr., President, New York Waterway, to Hon. John McCain, Chairman and Hon. Ernest F. Hollings, Ranking Member	50
Response to written questions submitted by Hon. John McCain to:	
Thomas McCool	55
Hon. Ken Mead	51
Response to written questions submitted by Hon. Ernest F. Hollings to Thomas McCool	58

REFORM OF THE TITLE XI MARITIME LOAN GUARANTEE PROGRAM

THURSDAY, JUNE 5, 2003,

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 2:30 p.m. in room SR–253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN McCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good afternoon. The Committee meets today to examine the management problems concerning the Title XI Maritime Loan Guarantee Program which have been identified by the Department of Transportation Inspector General and the General Accounting Office. Their findings make it clear that the Maritime Administration has failed to protect the interests of the American taxpayers in its administration of the program. Therefore, short of abolishing this special-interest subsidy program, which is highly unlikely given the congressional rebuke of the President's attempts to zero out program funding over the last 3 years, it's essential that we address the identified problems and institute fundamental programmatic reforms.

Title XI of the Merchant Marine Act of 1936 authorizes the Secretary of Transportation to make loan guarantees to finance the construction, reconstruction, or reconditioning of eligible vessels, and the modernization and improvement of shipyards. While the program was halted in the late 1980s after suffering billions of dollars in defaults, the program was reinstituted in 1993, following the enactment of the Federal Credit Reform Act and the National Shipbuilding and Shipyard Conversion Act.

Proponents of the Title XI program claim that the defaults that occurred in the 1980s were due to the heavy concentration of guarantees for projects supporting the offshore oil industry and the significant downturn in that industry. Even MARAD agreed that the concentration of guarantees in one sector of the economy had a significant impact on the program. Yet the agencies allowed a similar situation to occur again.

As noted in the Department of Transportation IG's report, released March 22, when American Classic Voyages filed for bankruptcy protection in October 2001, its subsidiaries held a total of six loan guarantees that accounted for over 25 percent of the value of the entire Title XI portfolio.

While the DOT IG notes that the defaults did not affect the overall solvency of the program, it did force MARAD to pay out almost $330 million, including $136 million from the U.S. Treasury, to AMCV's creditors. The report also states that this concentration of loans with AMCV was, quote, the largest amount of loan guarantees issued to an affiliated group of entities in the life of the program.

While claims have been made that the AMCV defaults were the result of a significant downturn in the cruise industry just before and after September 11, the IG reports that there was clear evidence well in advance of the industry downturn that AMCV was in financial trouble. Yet MARAD took no action to secure additional collateral to further protect the taxpayers' interest. In fact, because the guaranteed projects were owned by subsidiaries, AMCV was completely insulated from financial responsibility for the loans. And, guess what? The American taxpayer was left holding the bag.

Both the DOT IG and the GAO have found that MARAD has failed to provide effective oversight in receiving and approving loan guarantees, has failed to closely monitor the financial condition of borrowers during the term of the loan, and has failed to adequately monitor the condition of projects subject to guarantees. They also found that MARAD was flagrant in its use of authority in granting waivers to its own regulations governing the program without taking steps to better secure the taxpayer against defaults.

I want to acknowledge that MARAD is not alone in its culpability for problems with guarantee approvals. At least two of the projects received direct and indirect intervention by Congress that influenced the approval of guarantees on loans that later defaulted. This Congress knows best practice in determining which projects which receive approval must stop. If it does not, no amount of reform will work to improve the program's management and protect the taxpayers' interest.

While I've been no fan of the Title XI program, I hope we can work together in a bipartisan effort with input from the Administration to reform the Title XI program to ensure it works in a way that both promotes the U.S. maritime industry and protects the taxpayers' interest.

I welcome our witnesses, thank them for being here today and share their views on the program and recommendations for reform.

We'll begin with the Honorable William G. Schubert, Administrator, Maritime Administration, U.S. Department of Transportation, followed by the Honorable Ken Mead, Inspector General, U.S. Department of Transportation, and Thomas J. McCool, Managing Director, Financial Markets and Community Investment, U.S. General Accounting Office.

Welcome, Mr. Schubert.

STATEMENT OF HON. WILLIAM G. SCHUBERT ADMINISTRATOR, MARITIME ADMINISTRATION U.S. DEPARTMENT OF TRANSPORTATION

Mr. SCHUBERT. Good morning, Mr. Chairman. I welcome the opportunity to appear before you today to discuss the Title XI Loan Guarantee Program administered by the Maritime Administration.

I would like to request that my formal statement be accepted into the record.

As you know, MARAD administers a government program of guaranteed private sector obligations commonly referred to as the Title XI program. The President's budget for Fiscal Years 2002 and 2003 did not seek any new funding for Title XI loan guarantees. The President's budget request for Fiscal Year 2004 also does not seek funding for Title XI guarantees. However, the emergency wartime supplemental appropriations for Fiscal Year 2003 provided $25 million for the cost of new guaranteed obligations which could leverage up to $400 million in new loan guarantees.

None of the new Title XI funds may be obligated until the Department of Transportation Inspector General certifies to Congress that the recommendations contained in the recent IG report on the Title XI program have been implemented by MARAD. Further, the Bush Administration insists that any Title XI loan guarantee fully meet the eligibility requirements for economic soundness that lie at the heart of our approval process.

The Title XI program has been utilized in the construction of many types of vessels which are built throughout the country. As of March 31, 2003, MARAD's Title XI portfolio totaled approximately $4.6 billion, consisting of $3.4 billion in executed guarantees and $1.2 billion in guarantee commitments. The $3.4 billion in executed guarantees represents 102 projects for 815 vessels and four shipyard modernizations.

I believe it is critical that MARAD administer the program efficiently and effectively so as to provide the greatest value to the American taxpayer. This is a responsibility that I take seriously, and I look forward to the opportunity to improve this program.

I will summarize the information contained in my formal testimony by stating that MARAD is actively implementing needed Title XI program management improvements that were outlined in the IG's Title XI audit report. Overall, MARAD is in complete agreement with the IG's recommendations, and we are working with the Office of the Inspector General to implement these recommendations and changes.

Specifically, we are working to develop more effective program controls, such as imposing compensating measures such as liens on unencumbered collateral or requiring greater amounts of project equity as a consideration for modifying or waiving MARAD's standard financial criteria. Also, we agree with the IG that the use of outside financial advisors, in appropriate cases, would be beneficial. In MARAD's Fiscal Year 2004 authorization proposal, we seek the authority to engage such financial advisors at the expense of prospective borrowers.

Regardless of whether the program is provided additional funding by Congress, there are a number of changes that MARAD is making in the management of the outstanding portfolio. For example, we are enhancing the financial monitoring process in our current loan portfolio by transferring this responsibility to MARAD personnel that have the best financial skills and expertise. These employees now perform regular assessments of the financial health of each Title XI company. We have also instituted a credit watch report to identify those companies experiencing financial difficulties.

Last, in order to establish a formal process for monitoring the physical condition of the guaranteed assets over the term of the loan guarantee, from vessel construction to active service, MARAD is developing a reporting system to obtain relevant information from the class society during the vessel construction period and from the Coast Guard class societies and insurance companies when the assets are completed and put into service. MARAD is also reviewing its procedures for the management, maintenance, and liquidation of defaulted assets to see what improvements can be made.

The Committee has expressed interest in both the AMCV bankruptcy and the Quincy Massachusetts Heavy Industry Title XI defaults, which were also addressed in the IG's audit. The Project America and Quincy defaults and MARAD's subsequent actions are detailed in my formal testimony.

Thank you for the opportunity to talk about the Maritime Administration and the Title XI program. This concludes my prepared statement, and I will be happy to answer questions at the appropriate time.

[The prepared statement of Mr. Schubert follows:]

PREPARED STATEMENT OF HON. WILLIAM G. SCHUBERT, ADMINISTRATOR, MARITIME ADMINISTRATION, U.S. DEPARTMENT OF TRANSPORTATION

Good Afternoon, Mr. Chairman and Members of the Committee:

I welcome the opportunity to appear before you today to discuss the Title XI Loan Guarantee Program administered by the Maritime Administration (MARAD). Much has happened in this area since my confirmation as Maritime Administrator just a year and a half ago.

As you know, MARAD administers a Government program of guaranteed private sector obligations, commonly referred to as the Title XI program. Under Title XI of the Merchant Marine Act, 1936, the agency is authorized to assist private companies in obtaining financing for the U.S. construction of vessels or the modernization of U.S. shipyards. MARAD guarantees full payment to the lender of the unpaid principal and interest of an obligation in the event of default by a vessel owner or shipyard. The issuance and administration of Title XI loan guarantees are governed by regulations. Title XI loan guarantees enable vessel owners and shipyards to borrow private sector funds on more favorable terms than might otherwise be available, and thereby stimulate commercial shipbuilding in the United States.

The President's budget for Fiscal Years 2002, 2003, and 2004 did not seek new funding for Title XI loan guarantees. Instead, the Administration proposed that MARAD continue to manage the existing guarantee portfolio and associated financial activity with funds requested for the administration of the program. However, P.L. 108–11, Making Emergency Wartime Supplemental Appropriations for the Fiscal Year Ending September 30, 2003, provided $25 million for the costs of new guaranteed obligations. Utilizing a risk factor of 6.21 percent, the $25 million appropriation could leverage up to $400 million in new loan guarantees.

None of the new Title XI funds may be obligated or expended until the Department of Transportation Inspector General (DOT IG) certifies to Congress that the recommendations contained in a recent DOT IG Report on the Title XI Program have been implemented by MARAD.

MARAD is already implementing needed Title XI program management improvements, which I will describe below. It is important to note that Congress has occasionally targeted Title XI funds for specific projects. In one instance, Congress directed MARAD to relax program eligibility requirements. A small number of loans that were targeted by Congress account for a large amount of recent Title XI default obligations. Details about several of them are contained in the IG's report and testimony.

The Bush Administration has insisted that any Title XI loan guarantee fully meet the eligibility requirements for economic soundness that lie at the heart of our approval process. It is critical that MARAD administer the program efficiently and effectively so as to provide the greatest value to the American taxpayer. This is a responsibility that I take seriously and I look forward to the opportunity to improve this program.

In the past, the Title XI Program has been utilized in the construction of many types of vessels, which are built throughout the country. As of March 31, 2003, MARAD's Title XI portfolio totaled approximately $4.6 billion, consisting of $3.4 billion in executed loan guarantees and $1.2 billion in loan guarantee commitments. The $3.4 billion in executed loan guarantees represents 102 projects for 815 vessels and 4 shipyard modernizations.

The DOT IG recently issued a report on the audit of the Title XI Loan Guarantee Program. The DOT IG report made the following five recommendations, which are all based upon the assumption that Congress will continue to fund this program despite the Administration's request: (1) that MARAD require a rigorous analysis of risks from modifying any loan approval criteria and impose compensating provisions on the loan guarantee to mitigate those risks; (2) that MARAD formally establish an external review process as a check on MARAD's internal loan application review and as assistance in crafting loan conditions and covenants; (3) that MARAD establish a formal process for continuously monitoring the financial condition of borrowers, including requirements for financial reporting over the term of the guarantee as a condition of loan approval; (4) that MARAD establish a formal process to continuously monitor the physical condition of guaranteed assets over the term of the loan guarantee; and (5) that MARAD establish an improved process to monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.

MARAD has been working closely with the IG to develop more effective program controls and we are in complete agreement with the report's overall recommendations. MARAD noted that more favorable terms are offered to the Title XI loan guarantee applicants than are offered by commercial lenders as a result of the statutory full faith and credit guarantee of the United States. MARAD's response also noted that in a number of instances where defaults have occurred, it has been due to high levels of political interest and pressure brought upon the agency to overlook underwriting requirements. For example, the default of the Quincy Shipyard project is directly attributed to the specific statutory direction of Congress for MARAD to approve the guarantee without regard to economic soundness.

MARAD agreed with the DOT IG's suggestion that, as consideration for modifying or waiving financial criteria, MARAD could impose compensating measures such as liens on unencumbered collateral or requiring greater amounts of project equity. Because the program may be funded, we will continue to explore and implement these options.

MARAD also agreed with the DOT IG that the use of outside financial advisors, in appropriate cases, would be beneficial. To that end, MARAD's Fiscal Year 2004 authorization proposal seeks the authority to engage such financial advisors, at the expense of the prospective borrower. The use of financial advisors would be most appropriate for uniquely complicated projects. Based on our experience, we believe that the assessment of a new market or a new type of service, including the use of new technology, is likely to be the area where a financial advisor would be warranted. The experience of the Export-Import Bank provides a useful model for the use of financial advisors as part of a project review.

Regardless of whether the program is given additional funding by Congress, there are a number of changes MARAD will make in the management of the outstanding portfolio, as recommended by the DOT IG. For example, the financial monitoring process is being improved on those loan guarantees already in place. To that end, we have transferred the oversight responsibility to our Office of Ship Financing which now performs regular assessments of the financial health of each Title XI company. We will also institute a periodic "credit watch" report for the use of senior agency management which will identify those Title XI companies experiencing financial difficulties. In addition, MARAD will implement within 3 months a formal process for review of these statements and, in addition to the "credit watch," will look to see what outside sources may be available to assist in this area.

Lastly, in order to establish a formal process for monitoring the physical condition of guaranteed assets over the term of the loan guarantee, MARAD is developing a reporting system to obtain relevant information from the class society during the vessel construction period and from the Coast Guard, the class society and insurance companies over the term of the loan guarantee after the assets are completed and put into service. MARAD is also reviewing its procedures for maintaining defaulted assets to see where improvements can be made.

The DOT IG report specifically addressed the AMCV bankruptcy, concluding that although it significantly affected the Title XI Program, it did not threaten its solvency. The AMCV project was the result of the U.S.-Flag Cruise Ship Pilot project statute enacted by Congress in October 1997. Under this legislation, a company that entered into a construction contract to build two new cruise vessels in a U.S. shipyard was given the right to operate a foreign-built cruise ship in the Hawaiian trade for up to 2 years following delivery of the second vessel. The legislation required that the construction contracts be entered into by April 8, 1999.

In April 1999, MARAD issued a Title XI commitment for two cruise ships to be operated in Hawaii and owned by subsidiaries of Project America, Inc., which in turn was a subsidiary of AMCV. A Title XI closing was held in February 2000. Ingalls Shipbuilding, a subsidiary of Northrup Grumman Corporation, in Pascagoula, Mississippi was the shipyard. The projected cost for both vessels was approximately $1.2 billion and a Title XI approval was issued for about $1.1 billion, representing 87.5 percent of the vessel's cost. Title XI obligations were not issued with respect to the second vessel.

In October 2001, AMCV, the parent of the Project America Ship I (PASI) and Project America Ship II (PASII), the shipowners, filed for bankruptcy protection. Northrop Grumman Corporation, the parent of the shipyard, Ingalls Shipbuilding, requested approval of the issuance of an additional $915 million in Title XI indebtedness to the shipowners to complete the two vessels. MARAD declined. The shipowner defaulted on the entire Title XI debt on October 31, 2001 resulting in a demand under the Title XI guarantee. MARAD honored its guarantee and paid off $187 million on December 17, 2001.

MARAD had a security interest in the partially completed PASI vessel. In May of 2002, MARAD authorized Ingalls to sell the hull and equipment and account to MARAD for the net profits. In May of 2002, Ingalls sold both the PASI hull and PASII equipment to Norwegian Cruise Lines for $23 million. Ingalls and MARAD agreed that $14 million of the sale were attributable to the PASI assets and that $12 million of those proceeds were necessary to complete the hull sufficiently to make it floatable and towable in international waters. Thus, MARAD retained $2 million from the net sale proceeds of the PASI assets.

The Committee also previously expressed interest in Massachusetts Heavy Industries, Inc. (MHI) default on a Title XI loan for the reactivation of the Fore River Shipyard in Quincy, Massachusetts. As you recall, the Coast Guard Authorization Act of 1996 contained a provision that directed MARAD to waive the primary statutory requirement for a finding of economic soundness for this project. I would like to update you on the status of the Government's efforts to recoup its funds.

To date, MARAD has received about $35 million—a recovery of about 55 percent of the approximately $64 million paid out by the agency in connection with this project. On January 16, 2003, MARAD auctioned the shipyard real estate and personal property for an aggregate of $11.8875 million. Previously, MARAD had received approximately $23 million from an escrow account belonging to MHI, monies contributed by the Commonwealth of Massachusetts, and fees paid by MHI. In February of 2000, MARAD honored its guarantee of MHI's financial obligations and paid bondholders $59.1 million in principal and accrued interest. Subsequently, as custodian of the shipyard, MARAD expended substantial funds in the custodial upkeep and security of the property, environmental clean up and environmental studies to prevent the commission of toxic torts from materials improperly marked and maintained by MHI, payments to a bankruptcy court approved post petition senior mortgagee, and other foreclosure expenses, which are included in the $64 million total. MARAD continues to be involved in litigation regarding the sale of the property.

Thank you for the opportunity to talk about the Maritime Administration and the Title XI program. This concludes my prepared statement. I would be happy to answer any questions you may have at this time.

The CHAIRMAN. Thank you.

Mr. Mead?

STATEMENT OF HON. KENNETH M. MEAD, INSPECTOR GENERAL, U.S. DEPARTMENT OF TRANSPORTATION

Mr. MEAD. Thank you, Mr. Chairman.

Our work found that significant reforms are needed in nearly every phase of the Title XI program. I'd like to offer an overview of the four specific areas that are in need of reform and what we recommend be done.

In a program like this, there's no reform that I can recommend that's going to be a panacea against defaults, but they'll go a long way, I think, toward better protecting the interests of the taxpayers who ultimately, of course, are going to foot the bill.

I'd like to give you a quick overview of where these defaults occurred. The largest were by American Classic Voyages Company, AMCV for short. That was construction and renovation of five passenger cruise ships. Of $330 million in defaulted funds, MARAD was able to recover only $17 million. And, as you noted, the loan guarantees that went out to these people comprised about 25 percent of the total portfolio. That's a lot of eggs in one basket.

If there's a silver lining in that, though, it's that things could have been much worse. And at the time of this bankruptcy, AMCV had an additional $895 million in committed but not yet disbursed funds. So when they went bankrupt, the fact that some of the money hadn't been disbursed was a good thing.

The other ones, though, were Quincy Shipyards and Searex. And I think there are some similarities between all three of these. But Quincy Shipyard, that default was really not for construction of a boat or a ship; it was for the renovation of a shipyard in Quincy, Massachusetts. And the other one was for Searex. That was for four oil-drilling platforms. I guess these are vessels that help build the oil rigs. After the sale of assets, the combined cost to the taxpayers of both of those defaults was around $90 million.

So let me turn to the specific reforms that need to be made. As Administrator Schubert mentioned, these reforms were recently incorporated into law, but that's just for this year's appropriation. And I would caution that if you want something more long term, that'll have to be done through authorizing legislation.

So here are the reforms. First, when MARAD waives or modifies established loan criteria that are spelled right out in the Code of Federal Regulations, when they're going to waive or modify them, they need to put something in place, require some type of security in exchange for the assumption of the additional risk by the government. In every one of the nine loan guarantees that went into default since 1998, all of them were approved with waivers to one of the normal financial criteria without a sufficient compensating provision to protect the taxpayer.

What do I mean by established normal financial criteria that was waived? Things like, that working capital be at least one dollar. That was waived in a number of cases. That the long-term debt not exceed two times the company's net worth was another one that was waived.

As an example of a concrete example, of one, the guarantee for the Columbia Queen, which was an AMCV vessel, that waived the requirement for a minimum amount of equity. And MARAD did require a guarantee from the parent company, AMCV, for its shell company that it had created specifically to apply for the loan. But that guarantee wasn't backed by any unencumbered assets. So the parent was not really pledging any assets as collateral in the event of the shell company's default. And at the time of the default, the financial condition of the parent company was in a state of steady free-fall.

Second, MARAD ought to establish an external loan-review process that's independent, and it would be very similar to the one that the Export-Import Bank of the United States has in place. Why is that necessary? Well, one, MARAD needs more technical expertise. It doesn't have as much in-house technical expertise as we would like to see. And, number two, from time to time, political pressures are brought to bear on MARAD, and I think MARAD needs to have an external review process in place so you have the credibility of an outside opinion that's going to come in and say, "This is why this loan guarantee ought to be denied or approved, or here are the conditions that ought to be put in place."

And third is, we ought to proactively monitor the financial condition of both the borrowers and their parent companies over the term of the loan guarantee. We found that rather than proactive monitoring, MARAD tended to be reactive to loan problems after they occurred or while they were occurring. And yet firms rarely find themselves forced to default on loans without a lot of warning signs.

AMCV stock price is a case in point. This was on a downward spiral for nearly 2 years before its bankruptcy. It dropped from $35 a share to something in the neighborhood of 50 cents a share. And during that same two-year period, three separate loan guarantees, totaling nearly a quarter of a billion dollars, were approved. And the last guarantee was approved in June 2001, just on the heels of a year where the company reported an annual loss of about 10 million.

Also, when these warning signs start to appear, it's important that MARAD be in a position to trigger covenants in the agreements that it has with either the parent or the subsidiary to protect against—to protect the taxpayers' interest. And we refer to these as "enhanced self-help measures." They might include MARAD prohibiting the payment of cash dividends and reducing executive compensation packages.

Fourth, and finally, MARAD needs to pay close attention to the physical condition of secured assets, both during the loan guarantee and if there is a default. And that's so you can maximize the value of what is left for the taxpayers.

In the Searex case, they entered Chapter 11 bankruptcy, and the uncompleted hulls of three of the Searex ships were chopped up by the shipyard in order to make room for them to build a series of luxury cruise ships. And the value of the dismantled hulls, of course, was significantly less than if MARAD had taken possession of the hulls in their original state.

And then, finally, I would add that I do believe MARAD has been very responsive to our recommendations. It's going to take awhile to implement them, but they're moving forward. I think we have a good working relationship with them. And I only hope that they are permanent, and not just for the tenure of my colleague here, Administrator Schubert.

Thank you, sir.

[The prepared statement of Mr. Mead follows:]

PREPARED STATEMENT OF HON. KENNETH M. MEAD, INSPECTOR GENERAL, U.S. DEPARTMENT OF TRANSPORTATION

Mr. Chairman, Senator Hollings, and Members of the Committee:

Thank you for the opportunity to share our views with you today on the Maritime Administration's Title XI Loan Guarantee Program (Program). Our comments reflect the findings and recommendations of the audit report we issued this past March. We undertook the audit as a result of the Chairman's request to perform a comprehensive review of the Title XI Program and to assess the impact of the American Classic Voyages Co. (AMCV) bankruptcy filing on it.

Title XI of the Merchant Marine Act of 1936, as amended, established the Federal Ship Financing Guarantee Program to assist private companies in obtaining financing for the construction of ships or the modernization of U.S. shipyards. This Program authorizes the Federal Government to guarantee full payment to the lender of the unpaid principal and interest of a commercial debt obligation, with the Government holding a mortgage on the equipment or facilities financed.

As you are aware, the demand for this audit was driven, in part, by the recent, unsettling increase in defaulted loans in the Program that, while not as severe, seemed to echo the problems of the late 1980s. Between 1985 and 1987, 129 defaults occurred in the Program, and the Maritime Administration (MARAD) paid out approximately $2 billion in guarantees.[1] The Federal Credit Reform Act was enacted in 1990 to improve the performance of Federal credit programs. The Act required more accurate measurements of the costs of credit programs and established budgetary controls on loan programs, including requiring appropriations to cover the estimated credit costs of a project prior to the issuance of any approvals for financing. In the 5 years following implementation of this Act (1993 through 1997), only three MARAD loans defaulted, totaling approximately $12 million.

In the last 5 years (1998 to 2002), however, this improved performance has faltered. Nine MARAD loans have defaulted, six of which have occurred since December 2001, totaling approximately $490 million in payouts and $402 million in net payouts after recoveries. The biggest impact came from the bankruptcy of AMCV. Defaulted loans to AMCV represent 67 percent ($330 million) of the payouts and 78 percent ($313 million) of the net payouts after recoveries. (See Table 1.)

Table 1—Recent Payouts and Recoveries on Defaulted Loans

Date of Default	Year of Origin	Company	Project/Vessel Name	Guaranteed Amount	Paid-Out Amount[2]	Recovered Amount[3]
2/1998	1996	Surf Express, Inc.	*FastCat* Catamaran	$ 1,701,000	$ 1,788,854	$ 100,000
2/2000	1997	MHI, Inc.	Shipyard Modernization	55,000,000	59,071,658	24,108,619
3/2001	1995	SEAREX, Inc.	*Moses*-Class Vessels	77,269,000	78,099,782	25,405,708
12/2001	1999	AMCV	Project America 1 Cruise Ship	185,000,000	187,317,445	7,425,416
12/2001	2000	AMCV	*Cape Cod Light*	38,500,000	40,376,340	8,264,783
12/2001	2000	AMCV	*Cape May Light*	37,900,000	39,769,997	703,947
1/2002	1995	AMCV	*SS Independence*	33,334,000	25,185,531	0
1/2002	2001	AMCV	*Columbia Queen*	35,471,000	37,007,570	0
3/2002	1997	Friede Goldman Offshore	Shipyard Modernization	24,817,000	20,884,647	21,300,000
	Totals through January 2003:			$488,992,000	$489,501,824	$87,308,473

Source: MARAD

At the time of its bankruptcy, AMCV accounted for $1.3 billion (over one-quarter) of MARAD's total $4.9 billion Title XI loan guarantee portfolio. This $4.9 billion consisted of $3.1 billion in executed loan guarantees and $1.8 billion of loan guarantee commitments.[4] Of the $1.3 billion in loan guarantees and commitments to AMCV, $368 million (original amount) was for guarantees, which have since defaulted, and $895 million was for commitments.

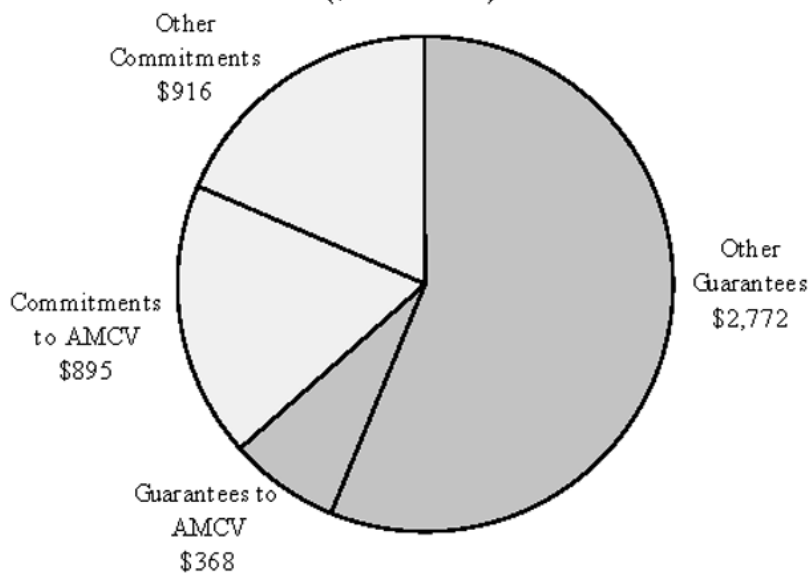
[1] Unless otherwise indicated, all years are Federal Fiscal Years.

[2] These amounts include accrued, unpaid interest as well as the outstanding principal.

[3] These amounts include recoveries from escrowed funds (as of January 2003).

[4] Executed loan guarantees are legal obligations (by MARAD) to pay off the debt if an applicant defaults on a loan. Loan guarantee commitments are legal agreements, stated in a commitment letter, stipulating that MARAD will issue a loan guarantee for the project *if the applicant fulfills agreed-upon terms and there are no material changes in circumstances.*

Figure 1 - MARAD's Title XI Portfolio
($ in millions)



These losses have generated both public and congressional concerns regarding whether the Program is adequately protecting the Government's financial interests. Concerns also exist regarding the potential for additional defaults and losses to the Government, given the uncertain financial status of some of the companies with guaranteed loans. Our audit identified a number of areas where MARAD could improve its Program practices, limit the risk of default, and reduce losses to the Government. We also identified steps that MARAD can take to significantly improve the Program, including the use of compensatory loan provisions to reduce risk, improved loan application review procedures, more rigorous financial oversight of borrowers during the term of loan guarantees, better monitoring and protection of vessels and shipyards while under a guarantee, and more effective stewardship of assets acquired through foreclosures.

MARAD should require a rigorous analysis of the risks that arise from modifying loan approval criteria and, to mitigate those risks, should impose compensating provisions on the loan guarantee such as more collateral or higher equity contributions from the borrower. MARAD routinely modifies financial requirements in order to qualify applicants for loan guarantees. Such modifications increase the risk of the loan guarantee to the Government, and MARAD should impose stricter compensating loan provisions and covenants on borrowers to mitigate those risks. All nine of the loans that have gone into default since 1998 were approved with modifications to some of the financial criteria. For example, the Project America loan guarantee included a waiver of the working capital requirement. MARAD secured a parent company guarantee from AMCV, but it was not backed by any unencumbered assets.

MARAD should establish an external review process as a check on its internal loan application review and as assistance in crafting prudent loan conditions and covenants. MARAD currently assesses loan guarantee applications primarily with its own staff, but it would benefit from the use of an additional external review using contract resources that are fully reimbursed by the borrower. Such reviews would provide additional, credible information for loan guarantee approval or denial and would assist in devising loan packages that reduce the risks to the Government. These external reviews should include at least four elements: an assessment of the borrower's business plan, an evaluation of the borrower's credit risk, an assessment of the value of collateral, and a summary analysis that includes a recommendation on whether to approve the loan guarantee and on what terms. The Export-Import Bank of the United States uses a similar approach in its loan guarantee program.

MARAD should establish a formal process for continuously monitoring the financial condition of borrowers, including requirements for financial reporting over the term of the guarantee as a condition of loan approval. MARAD does not closely monitor the financial health of its borrowers; rather, it tends to be reactive to loan problems after they occur. Yet, firms rarely find themselves forced to default on loans without many preceding quarters of financial results that indicate developing financial distress. For example, AMCV's stock price was on a downward trend for nearly 2 years before its bankruptcy, and its net income declined continuously over 4 years from 1997 to 2000, from a positive $2.4 million to a negative $10.1 million. To become more proactive, MARAD loan guarantees should include stronger financial covenants on its borrowers' required financial performance and condition, and enhanced self-help measures should those covenants be violated. Most importantly, MARAD needs to maintain rigorous financial scrutiny of its borrowers to ensure these covenants are met and vigorous enforcement of its self-help prerogatives if they are not.

MARAD should establish a formal process for continuously monitoring the physical condition of guaranteed assets over the terms of loan guarantees, and institute an improved process for monitoring the physical condition of foreclosed assets to ensure the Government recovers the maximum amount of funds from their disposal. MARAD does not closely monitor the physical condition of the vessels and property financed with guaranteed loans either during the loan period or after foreclosures. If borrowers experience financial difficulties, they may be inclined to under-maintain assets constructed with loan guarantees. MARAD staff conduct site visits on guaranteed vessels or property only on an episodic basis, usually in response to problems identified by borrowers or third parties. For example, at the time of AMCV's impending bankruptcy, MARAD officials we spoke with were not fully aware of the current condition and status of four of the five vessels whose loans ultimately defaulted. Regular, periodic inspections, particularly of those assets operated by firms in financial difficulty as identified by financial monitoring, would better ensure the value of assets to the Government.

MARAD has acknowledged that it needs to improve administration and oversight in all phases of the Title XI loan process. MARAD agreed with our five recommendations for improving oversight and is working to put these recommendations into practice. Specifically, MARAD has committed to tightening the controls over the approval and monitoring of loan guarantees and to taking more timely action to recover the maximum amount possible from foreclosed assets in the event of loan defaults.

MARAD's response to our audit report indicates that, in a number of instances where defaults have occurred, it has been due to political pressures to approve loan guarantees by overlooking underwriting requirements. Nevertheless, implementation of our recommendations regarding application review, both internal and external, should improve the credibility of MARAD's denial decisions when underwriting requirements are not met. In cases where the application is approved, our recommendations regarding protective covenants, financial monitoring, and asset monitoring should reduce the risk and size of losses to the Government.

The Office of Inspector General must certify that our recommendations have been implemented. Public Law 108–11, *Making Emergency Wartime Supplemental Appropriations for the Fiscal Year Ending September 30, 2003,* appropriated $25 million to MARAD for new loan guarantees. According to MARAD, based on average risk premiums, these funds would likely guarantee loans with a face value of about $400 million and are available for obligation until September 30, 2005. Before these funds can be obligated, the law mandates that MARAD implement the recommendations in our report and that we certify to the Congress that our recommendations have been met.

We are working with MARAD to analyze the new processes that it has proposed putting in place to meet the intent of our recommendations, and we will audit MARAD's compliance with the new processes once they are in use. We think it is important that these processes are not merely plans, but that they are in place, are being observed, and are working before we certify compliance. In this regard, some recommendations, such as those relating to compensating covenants in new guarantees, can only be verified after new loan guarantees are executed. Therefore, we may need to "certify in principle" that these recommendations have been implemented and then follow up with additional verification once the $25 million has been released.

Background

Title XI of the Merchant Marine Act of 1936, as amended, established the Federal Ship Financing Guarantee Program to assist private companies in obtaining financing for the construction of ships or the modernization of U.S. shipyards. This Program authorizes the Federal Government to guarantee full payment to the lender of the unpaid principal and interest of a mortgage in the event of default by a vessel or shipyard owner. Title XI was amended in 1972 to provide Government guarantees to commercial debt obligations, with the Government holding a mortgage on the equipment or facilities financed.

Regulations implementing the Merchant Marine Act of 1936 [Title 46 Code of Federal Regulations (CFR) Section 298] outline the application process for Title XI loan guarantees and require MARAD to assess the economic feasibility and the financial viability of an applicant's project. Upon approval of an application, MARAD agrees to guarantee these obligations with the full faith and credit of the U.S. Government through a commitment letter to the applicant. The applicant must provide at least 12.5 percent to 25 percent (depending on project use) of the project's estimated cost as equity, and a commercial financial institution issues obligations for the remainder.[5]

Applicants generally receive more favorable loan terms than are available in the commercial market without a guarantee. The Program has contributed to preserving a U.S. commercial fleet and modernizing U.S. shipyards. Vessels financed using loan guarantees include double-hull oil tankers, passenger ferries, cruise ships, and offshore drilling rigs. Shipyard modernizations have included capital improvement projects at shipyards located on the east, gulf, and west coasts.

As of December 31, 2002, MARAD's Title XI portfolio totaled approximately $4.3 billion, consisting of $3.4 billion in executed loan guarantees (formal agreements to issue obligations) and $849 million of loan guarantee commitments (formal offers for guarantees). The $3.4 billion in executed loan guarantees represents 103 projects for 818 vessels and 4 shipyard modernizations. Included in the Title XI portfolio are eight projects totaling about $226 million in commitments that MARAD approved in 2002. As of December 31, 2002, MARAD had 26 pending applications that requested about $5.7 billion of Title XI financing.

MARAD Could Reduce the Risk of Losses Through Compensatory Loan Provisions Such as More Collateral and Higher Equity Contributions

MARAD currently assesses loan guarantee applications primarily with its own staff using financial criteria in regulations adopted from the Merchant Marine Act of 1936, as amended.[6] Routinely, however, MARAD modifies these financial requirements to allow applicants to qualify for loan guarantees, and these modifications lead to increased risk of loss. All nine of the loans that have gone into default since 1998 were approved with modifications to some of the financial criteria. For example, the Project America loan guarantee included a waiver of the working capital requirement.[7] Other applicants had long-term debt-to-equity ratios of more than the 2 to 1 permitted in the regulations. In fact, one active project, approved for a loan guarantee of over $15 million, had a debt-to-equity ratio of more than 4 to 1.

Although MARAD's regulations permit modifications and they may be appropriate in some cases, MARAD should impose compensating conditions on the borrower to offset the increased risk to the Government. This is particularly true because vessels under construction may have little or no value if the vessel is incomplete at the time of default. For example, the hull and materials for a vessel being built for Project America, Inc., a subsidiary of AMCV, and guaranteed by MARAD for $185 million, were recently sold by the shipyard, with MARAD recovering only $2 million. This subsidiary had no assets beyond the guaranteed vessel, as in all six of the loans to AMCV subsidiaries.

MARAD often accepts parent company guarantees of loan repayment for a subsidiary that either cannot qualify for a loan guarantee on its own or cannot qualify without modifications to the loan criteria. In 50 percent of the projects we examined (21 of 42), the applicants could not independently qualify for a loan guarantee, had few or no assets to offer as collateral, and provided a parent company guarantee as the sole form of security. When these parent company guarantees are general

[5] These are bonds, notes, debentures or other evidence of indebtedness.

[6] 46 CFR 298.13

[7] Working capital is the difference between a company's short-term assets (such as cash, marketable securities, accounts receivable, and inventories of raw materials and finished goods) and liabilities (accounts payable, short-term loans, and the current portion of long-term debt). Working capital roughly measures a company's potential reservoir of cash to maintain its solvency if unforeseen circumstances arise.

pledges by the company to honor the loan commitment and do not specifically pledge unencumbered assets as collateral, these guarantees provide no real security if the parent company itself is not creditworthy or has few unencumbered assets, as was the case in six of nine recent defaults.

MARAD can prevent this problem by requiring parent company pledges to be backed by liens on other unencumbered assets, requiring greater amounts of project equity from the applicants, or having a greater portion of the risk assumed by the applicant's lender. This approach should be feasible because many Title XI applicants are subsidiaries of parent companies that have other assets and financial resources. For example, MARAD approved a loan guarantee for over $150 million to a company for an oil-drilling unit without requiring a lien on other assets, yet the company had a number of other unencumbered assets it could have used to secure the guarantee.

MARAD Would Benefit From External Review of Applications

MARAD primarily conducts in-house reviews of applications and does not routinely obtain independent assessments of proposed projects to determine if they are economically and financially sound. MARAD officials have acknowledged a lack of in-house expertise to review projects that employ new technologies, are financially complex, or are high-cost. Independent assessments of such projects would assist MARAD in its internal analysis and reduce the risk of default and loss to the Government. MARAD officials noted that a current application for about $750 million in loan guarantees for two high-speed container vessels is being reviewed by an outside firm due to the ships' cost, the use of new technology, and the start-up nature of the company.

Independent external reviews should be paid for by borrowers and should encompass four elements: an assessment of the borrower's business plan; an evaluation of its credit risk; an independent assessor's analysis of the current market value of collateral and any encumbrances; and an independent summary analysis of the loan guarantee application that includes a recommendation on whether to approve the loan and on what terms.

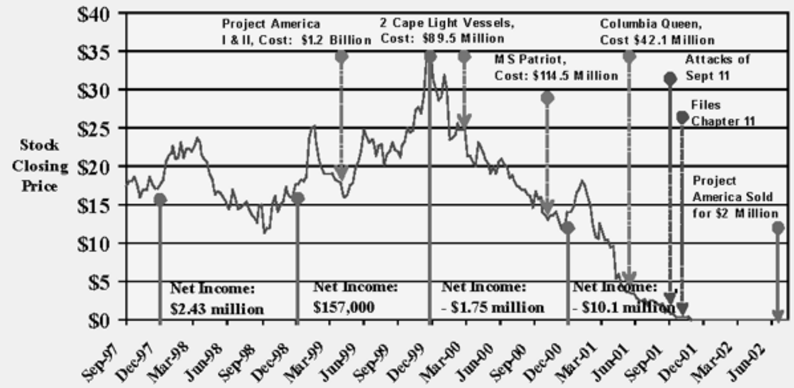
The Export-Import Bank of the United States (Bank), which operates a loan guarantee program, uses such external review. For projects with financial transactions that exceed $30 million, the Bank hires outside independent financial, legal, and technical advisors. After the Bank selects the advisor, the applicant is required to pay an evaluation fee and execute a contract with the advisor. The Bank uses the advisor's report as part of the evaluation package to determine if a loan guarantee will be made.

MARAD Could Better Protect Its Interests Through Improved Oversight of Borrowers Over the Duration of Their Loans

MARAD does not closely monitor the financial health of its borrowers over the term of its loan guarantees. Currently, borrowers submit annual audited financial statements to MARAD as well as selected financial information on a semi-annual basis. Although MARAD has the authority to require additional financial information, examine and audit the books and records pertaining to a project, and assess vessels, MARAD typically does not take these additional steps. MARAD does record loan payments, obtain documentation of insurance coverage, and monitor the portfolio for delinquent accounts. Although MARAD maintains communications with lenders, insurance companies, and loan guarantee recipients, MARAD has no established procedures or policies to perform periodic reviews of a company's financial well-being once a loan guarantee is approved.

Firms rarely enter into bankruptcy or default on guaranteed loans without many preceding quarters or years of financial results that indicate developing financial distress. For example, AMCV's stock price fell from $35.00 a share in December 1999 to less than $0.50 before its bankruptcy filing in October 2001, as shown in Figure 2.

Figure 2 - AMCV Financial Events



Source: MARAD & Securities and Exchange Commission Filings

Furthermore, AMCV's filings with the Securities and Exchange Commission show a marked decrease in net income from December 1997 to December 2000. In spite of AMCV's declining net income and stock valuation, MARAD continued to approve loan guarantees to AMCV for $76 million for the two Cape Light ships, and over $35 million for the *Columbia Queen*. Just prior to AMCV's bankruptcy filing, MARAD was considering a disbursement from AMCV's Project America I escrow account to fund further construction of this vessel.

Increased financial monitoring is only useful if MARAD also includes stronger financial covenants in its loan guarantee commitments. These covenants should prescribe the required financial performance and condition of its borrowers as well as enhanced self-help measures to which MARAD is entitled should those provisions be violated. Performance targets could include higher minimum working capital levels, cash-flow requirements, minimum financial ratios, future capital spending constraints, and timely financial reporting. Self-help measures might include the ability to require additional reserves or collateral, declare defaults, take possession of existing collateral, and repossess the guaranteed asset. By having the right to invoke these measures earlier, when firms begin to experience financial distress, MARAD may be able to limit its losses by avoiding additional commitments and acquiring existing assets before they are dissipated by a failing firm.

MARAD Could Improve Its Return on Foreclosed Assets Through Better Tracking of the Vessels and Property Constructed With Loan Guarantees

MARAD does not closely monitor the physical condition of the assets produced with the guaranteed loans over the term of its loan guarantees. MARAD relies on annual Coast Guard inspections and third-party notices such as those from insurance underwriters. MARAD's field offices conducted site visits on guaranteed vessels or property only in response to problems or notices of potential problems from third parties or from borrowers. Third-party notices do not necessarily ensure that the value of the asset is maintained at a level commensurate with the remaining loan balance.

MARAD also does not adequately monitor and protect assets after loan defaults occur. At the time of AMCV's impending bankruptcy, MARAD officials we spoke with were not fully aware of the current condition and status of several vessels whose loans ultimately defaulted (totaling about $330 million). Furthermore, MARAD does not adequately manage assets acquired from foreclosure. There are no set timeframes or procedures to maximize recovery of funds from defaulted loans. Thus, vessels and equipment may deteriorate due to exposure, vandalism, and neglect, diminishing their value and potential return.

For example, in 1998, MARAD paid out approximately $1.8 million for a default on a vessel owned by Surf Express. The initial appraisal valued the 3-year-old vessel at only $793,000, and MARAD advertised it for sale several times, but rejected the bids in an attempt to recover more money. Meanwhile, MARAD stored the vessel in a wet-berth where it was exposed to the elements, including Hurricane Georges. When MARAD finally found a prospective buyer, the bidder rejected the vessel because of seized up engines and general deterioration due to exposure to tropical weather and the hurricane. As a result, MARAD recovered only $100,000 from the sale.

To better protect the Government's interest in the assets that are collateral for its loan guarantees, MARAD needs to periodically inspect such assets, particularly those operated by firms that MARAD's financial monitoring identifies as experiencing financial difficulties. Likewise, when MARAD forecloses on assets after loan default, it could increase the return to the Government on them by better managing these assets to ensure they are maintained in good condition.

AMCV's Bankruptcy Significantly Affected the Title XI Program but Does Not Threaten Its Solvency

AMCV's bankruptcy affected over one-quarter of the value of MARAD's Title XI portfolio. With MARAD's approval of the last (sixth) guarantee application in May 2001, for the vessel *Columbia Queen,* AMCV had received loan commitments of about $1.3 billion covering seven vessels—potentially the largest amount of loan guarantees issued to an affiliated group of entities in the history of the Program. However, only $391 million in guarantees had actually been signed when AMCV filed for bankruptcy protection and ceased operations on October 19, 2001. AMCV defaulted on five loans and cost the Government almost $330 million in guaranteed payouts. See Table 2 for a description of the AMCV loan guarantees.

Table 2—MARAD's Liability for AMCV Vessels as of December 2002

Date of Origin	Date of Default	Applicant	Parent Company[8]	Project or Vessel Name	Cost of Vessel to Owner	Guaranteed Amount	Paid-Out Amount	Disposition/ Recovery[9]
May 2001	January 2002	Great Pacific NW Cruise Line, L.L.C.	Delta Queen Steamboat Co.	*Columbia Queen*	$ 42,140,568	$ 35,471,000	$ 37,007,570	Maintained by MARAD
March 2000	December 2001	Coastal Queen West, L.L.C.	Delta Queen Coastal Voyages, L.L.C.	*Cape May Light*	44,950,728	37,900,000	39,769,997	Maintained by MARAD
March 2000	December 2001	Coastal Queen East, L.L.C.	Delta Queen Coastal Voyages, L.L.C.	*Cape Cod Light*	44,582,720	38,500,000	40,376,340	Maintained by MARAD
April 1999	December 2001	Project America Ship I, Inc.	Project America, Inc.	Project America Vessel I	610,797,578	185,000,000	187,317,445	Recovered $2 million
April 1999	n/a	Project America Ship II, Inc.	Project America, Inc.	Project America Vessel II	622,946,837	0	0	Part of the $2 million recovery above
November 1995	January 2002	Great Independence Ship Co.	Great Hawaiian Cruise Lines, Inc.	*S.S. Independence*	44,774,271	33,334,000	25,185,531	Maintained by MARAD
July 1995	n/a	Great American Queen Steamboat, L.L.C.	Delta Queen Steamboat Co.	*American Queen*	69,424,647	60,746,000	0	Full recovery-refinanced to new owner
					Totals:	*$390,951,000*	*$329,656,883*	

Source: MARAD

The circumstances surrounding AMCV's loan approvals and defaults illustrate the problems identified above. Specifically, modifications to loan approval criteria were made without compensating collateral, and parent company guarantees were accepted without liens on specific assets of the parent companies. Close financial monitoring of AMCV did not occur over the terms of the loans before default, and neither did close monitoring of the foreclosed assets. Had our recommended Program revi-

[8] AMCV is the parent company to Delta Queen Steamboat Co. and AMCV Holdings, Inc. Delta Queen Steamboat Co., in turn, is the parent company of Delta Queen Coastal Voyages, L.L.C. AMCV Holdings, Inc., is the parent company of Project America, Inc., and Great Hawaiian Cruise Lines, Inc. Applicants are subsidiaries of Delta Queen Steamboat Co.; Delta Queen Coastal Voyages, L.L.C.; Project America, Inc.; and Great Hawaiian Cruise Lines, Inc.

[9] These amounts do not include recoveries from escrowed funds.

sions and protections been in place at the time of AMCV's loan application, the losses to the Government would likely have been much less.

For each of the six loan approvals, MARAD cited the Secretary of Transportation's authority to waive or modify the financial terms or requirements otherwise applicable, upon determining that there was adequate security for the Title XI guarantees. However, prudent financial analysis of AMCV as a whole would have highlighted the great risk of default and should have prompted MARAD to require more collateral or stricter covenants to protect the Government's interest. Of the 10 vessels owned and operated by, or under construction by, the AMCV group, 7 vessels were supported by loan guarantees. The other three vessels were encumbered with debt from commercial banking facilities. Thus the only collateral available to secure each vessel was the first mortgage from AMCV's subsidiary on the vessel itself.

On their own, only one of the AMCV subsidiaries would have met all of the qualification requirements for a loan guarantee. By modifying the financial requirements for each of AMCV's consecutive loans, MARAD approved guarantees beyond AMCV's ability to service the debts, thereby creating a potential default situation—one that could not be cured with collateral. One practice that MARAD did employ effectively to limit losses was the use of incremental payments to control the disbursement of loan proceeds. This allowed MARAD to release funds to the borrower incrementally as construction on the project progressed, rather than releasing the entire loan proceeds up front.

Better monitoring of the shipbuilding and financial operations of the AMCV subsidiaries would likely have alerted MARAD to AMCV's growing financial problems, allowing it to take action prior to the defaults. With the guarantee approval for the Columbia Queen, MARAD allowed AMCV's annual debt service to increase by $3 million even though the company's financial statements indicated a net loss for the previous year of over $10 million. AMCV's cumulative debt service was estimated to be $12 million every 6 months, yet no part of the approval package indicates MARAD reviewed the impact of this growing debt service on AMCV's ability to guarantee or pay its subsidiaries' debts.

MARAD's loan guarantees with the AMCV subsidiaries had no established agreements, protocols, or requirements on how to secure and maintain the vessels after default. The loan guarantees did not specify which party in the guarantee security agreement was responsible for specific actions and the timeframes in which protective actions needed to be taken. Security of the onboard inventory from theft and pilferage was minimal for all the vessels MARAD acquired through the AMCV default. It was only after our audit inquiries that MARAD took action to ensure the security and the manner of laying-up the vessels.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you.

Mr. McCool, welcome.

STATEMENT OF THOMAS J. McCOOL, MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Mr. McCOOL. Thank you, Mr. Chairman, Members of the Committee. I'm pleased to be here today to discuss the results of our review of the Maritime Administration's Title XI Loan Guarantee Program.

Mr. Chairman, because of concerns about the scale of recent defaults experienced by MARAD, you asked us to conduct a study of the Title XI Loan Guarantee Program. Specifically, you asked us to determine whether MARAD complied with key Title XI program requirements, describe how MARAD's practices for managing financial risks compare to those of the private-sector maritime lenders, and also to assess MARAD's implementation of credit reform as it relates to the Title XI program.

I'm not going to spend too much time on the first objective, because our results parallel very closely the IG's testimony, and our written statement talks about the compliance issues in some detail.

But I did want to spend some time talking about this issue of comparing MARAD's approach to monitoring loans to the private sector.

First, I wanted to make a point that when we make this comparison, we're not saying that we think MARAD should be—we're not trying to equate MARAD's responsibilities with those of a private-sector lender. We realize that MARAD is not in the business of making money. But what we think it needs to do is to do a very careful tradeoff between its policy goal of promoting the maritime industry, but also its alternative policy goal of protecting the government's financial interest, and we think that that tradeoff can be improved by some of the things that both the IG and we recommend for MARAD.

One basic point that we did learn from private-sector lenders was that they manage financial risk by establishing a separation of duties to provide a system of checks and balances for important lending functions, such as approving loans, monitoring projects, and disposing of assets. In contrast, we found that the same office that promotes and markets the Title XI program at MARAD also has influence and authority over the office that approves and monitors the loans. It's also true that they're primarily responsible for underwriting and approving loan guarantees, as well as for program management, and they're also involved in the disposition of assets.

Private-sector lenders told us that they rarely grant waivers or exceptions to underwriting requirements, or approve applications when borrowers do not meet key minimum requirements. Whereas, MARAD, as we just heard, often permits waivers or modifications of key financial requirements, often without a transparent or independent deliberative process.

Private-sector lenders minimize financial risk by establishing loan monitoring and control mechanisms, such as periodically reviewing financial statements and assigning risk ratings on the basis of the current financial condition of the borrower. At MARAD, we found no evidence that staff routinely analyzed or evaluated financial statements or have changed risk categories after a loan was approved, even when a borrower's financial condition had changed.

MARAD has guidance governing the disposition of defaulted assets, and we found that MARAD does not always adhere to it. MARAD officials cite the uniqueness of the vessels and projects as the reason for using guidelines instead of requirements for handling defaulted assets. However, certain practices for handling defaulted assets can be helpful regardless of the uniqueness of the project. Without a definitive strategy and clear requirements, defaulted assets may not always be secured, assessed, and disposed of in a manner that maximizes MARAD's recoveries, resulting in unnecessary costs and losses to the government.

According to MARAD officials, the chief reason for the difference between private-sector and MARAD techniques for approving loans, monitoring project progress, and disposing of assets is the public purpose of the Title XI program. That is, MARAD's program purposely provides for greater flexibility in underwriting in order to meet the financing needs of shipowners and shipyards that otherwise might not be able to obtain financing.

While program flexibility and financial and economic-soundness standards may be necessary to help MARAD meet its mission objectives, the strict use of internal controls and management processes are also important. By not employing the limited internal controls it does possess and not taking advantage of basic internal controls like those private-sectors lenders employ, MARAD cannot ensure it is effectively utilizing its limited administrative resources or the government's limited financial resources.

Now let me turn to the credit-subsidy estimates, this notion of credit reform. We think it's important—in fact, the Congress thinks it's important—to do credit-subsidy calculations in the correct way. We believe that without properly calculated credit-subsidy estimates and re-estimates, it's not possible to understand the cost of the Title XI program; and, therefore, the decisions relating benefits to cost, whether by Congress or the agency, will not be well informed.

We think that MARAD uses a relatively simplistic cash-flow model, which contains five assumptions regarding the default amount, default timing, the recovery amount, recovery timing, and fees, to estimate the cost of the Title XI Loan Guarantee Program. Because MARAD has not evaluated its default and recovery-rate assumption since they were developed in 1995, the agency does not know whether its cash-flow model is reasonably predicting borrower behavior and whether its estimates of loan-program costs are reasonable.

The nature and characteristics of the Title XI program make it difficult to estimate subsidy costs. MARAD approves a small number of guarantees each year, leaving it with relatively little experience in which to base estimates for the future. In addition, each guarantee is for a large dollar amount. The projects have unique characteristics and cover several sectors of the market. Further, when defaults occur, they're usually for large amounts and may not take place during easily predicted timeframes. Recoveries may be equally difficult to predict and may be affected by the condition of the underlying collateral.

We believe that an analysis of the past 5 years of actual default and recovery experience is meaningful and can provide management with valuable insight into how well its cash-flow models are predicting borrower behavior and how well its estimates are predicting the loan-guarantee program costs. We further believe that, while difficult, an analysis of its risk-category system is meaningful for MARAD to ensure that it appropriately classified loan-guarantee projects into risk-category subdivisions that are relatively homogeneous in cost.

Further, MARAD's risk-category system is flawed because it does not consider concentrations of credit risk. For loans originated since 1996, we found that five of the eight defaults that occurred, totally 330 million, involved loan guarantees that had been made to one borrower, AMCV. Assessing concentration of credit risk is a standard practice in private-sector lending.

MARAD's ability to calculate reasonable re-estimates is seriously impacted by the same outdated assumptions it uses to calculate cost estimates, as well as by the fact it has not compared these estimates with actual default and recovery experience.

Last, based on our analysis, we believe that OMB provided little review and oversight of MARAD's estimates and re-estimates. OMB has final authority for approving estimates, in consultation with the agencies, and OMB approved each MARAD estimate and re-estimate, explaining to us that they defer to the expertise of MARAD program officials. However, MARAD has little expertise in the credit-reform area and has not devoted sufficient resources for developing this expertise.

The Credit Reform Act of 1990 assigns responsibility to OMB for coordinating credit-subsidy estimates, developing estimation guidelines and regulations, and improving cost estimates, including coordinating the development of more accurate historical data and annually reviewing the performance of loan programs to improve cost estimates. Had OMB provided greater review and oversight of MARAD's estimates and re-estimates, they would have realized the assumptions were outdated and did not track with actual recent experience.

In conclusion, Mr. Chairman, MARAD does not operate the Title XI Loan Guarantee Program in a businesslike fashion. MARAD does not fully comply with its own requirements, does not have clear separation of duties for handling loan approval and fund disbursement functions, does not exercise sufficient diligence in considering and approving modifications and waivers, does not adequately secure and assess the value of defaulted assets, and does not know what its program costs. Because of these shortcomings, MARAD lacks assurance that it is effectively promoting growth and modernization of the U.S. Merchant Marine and U.S. shipyards or minimizing the risk of financial loss to the Federal Government.

Finally, MARAD's questionable subsidy-cost estimates do not provide Congress a basis for knowing the true cost of the Title XI program, and Congress cannot make well-informed policy decisions when providing budget authority.

Again, we have a report that is currently at the agency for comment which contains a number of recommendations and matters for Congressional consideration. In the area of recommendations, most of the recommendations follow from our findings to have MARAD improve its internal processes, both from the standpoint of approving and monitoring loans, as well as disposing of defaulted assets. In addition, we have recommendations to improve its credit-subsidy calculations. We have some potential recommendations for Congress, which I'll be glad to discuss, if you wish.

That concludes my statement.

[The prepared statement of Mr. McCool follows:]

PREPARED STATEMENT OF THOMAS J. MCCOOL, MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the results of our review of the Maritime Administration's (MARAD) Title XI loan guarantee program. Title XI was created to help promote growth and modernization of the U.S. merchant marine and U.S. shipyards by enabling owners of eligible vessels and shipyards to obtain long-term financing on terms and conditions that might not otherwise be available. Under the program, MARAD guarantees the payment of principal and interest to purchasers of bonds issued by vessel and shipyard owners. These owners may obtain guaranteed financing for up to 87.5 percent of the total cost of buying or constructing a vessel or buying or modernizing a shipyard.

Under Title XI, MARAD committed to guarantee more than $5.6 billion in shipyard modernization and ship construction projects over the last 10 years. During this period, MARAD experienced nine defaults on these loan guarantee commitments totaling over $1.3 billion. The defaulted amounts associated with these nine loan guarantee commitments totaled $489 million.[1] Five of these defaults were by subsidiaries of American Classic Voyages Company (AMCV), a shipowner. AMCV defaults represented 67 percent of all defaulted amounts experienced by MARAD during this period, with this borrower having defaulted on guaranteed loan projects in amounts totaling $330 million. The largest loan guarantee ever approved by MARAD, for over $1.1 billion, was for Project America, Inc., a subsidiary of AMCV. Project America, Inc., had entered into a contract in March 1999 with Northrup Grumman Corporation (formerly Litton Ingalls Shipbuilding) in Pascagoula, Mississippi, for the construction of two cruise ships. In October 2001, AMCV filed for bankruptcy, defaulting on $187 million in loan guarantees associated with Project America.

As of December 31, 2002, MARAD's portfolio included approximately $3.4 billion in executed loan guarantees, representing 103 projects for 818 vessels and four shipyard modernizations.[2] At the end of Fiscal Year 2002, MARAD had approximately $20 million in unexpended, unobligated budget authority that had been appropriated in prior years. In its 2004 budget, the administration requested no new funds for the Title XI program.

While Title XI of the Merchant Marine Act of 1936, as amended, established the requirements of the loan guarantee program, the loan guarantees are also subject to the Federal Credit Reform Act of 1990 (FCRA). Under the FCRA, Federal agencies must account for the estimated costs of direct and guaranteed loans on a net present value basis, over the full term of the credit, and agencies must receive appropriations for these costs before they disburse a loan or enter into loan guarantee commitments.

Because of concerns about the scale of recent defaults experienced by MARAD, particularly those associated with AMCV, you asked us to conduct a study of the Title XI loan guarantee program. Specifically, you asked us to: (1) determine whether MARAD complied with key Title XI program requirements in approving initial and subsequent agreements, monitoring and controlling funds, and handling defaults; (2) describe how MARAD's practices for managing financial risk compare to those of selected private-sector maritime lenders; and (3) assess MARAD's implementation of credit reform as it relates to the Title XI program.

To determine whether MARAD complied with key Title XI program requirements, we identified key program requirements and reviewed how these were applied to the management of five loan guarantee projects. To determine how MARAD's practices for managing financial risk compare to those of selected private-sector maritime lenders, we interviewed three maritime lenders to learn about lending practices, and compared these practices to MARAD's. To assess MARAD's implementation of credit reform, we analyzed MARAD's subsidy cost estimation and reestimation processes and examined how the assumptions MARAD uses to calculate subsidy cost estimates compare to MARAD's actual program experience. We conducted our work in Washington, D.C., and New York, N.Y., between September 2002 and April 2003 in accordance with generally accepted government auditing standards.

In summary:

- MARAD has not fully complied with some key Title XI program requirements. We found that MARAD generally complied with requirements to assess an applicant's economic soundness before issuing loan guarantees. However, MARAD used waivers or modifications, which, although permitted by MARAD regulations, allowed MARAD to approve some applications even though borrowers had not met all financial requirements. MARAD did not fully comply with regulations and established practices pertaining to project monitoring and fund disbursement. Finally, while MARAD has guidance governing the disposition of defaulted assets, adherence to this guidance is not mandatory, and MARAD did not always follow it in the defaulted cases we reviewed.
- Private-sector maritime lenders we interviewed told us that to manage financial risk, they among other things: (1) establish a clear separation of duties for carrying out different lending functions; (2) adhere to key lending standards with

[1] Defaulted amounts may include disbursed loan guarantee funds, interest accrued, and other costs.

[2] Loan guarantees are legal obligations to pay off debt if an applicant defaults on a loan.

few, if any, exceptions; (3) use a systematic approach to monitoring the progress of projects; and (4) primarily employ independent parties to survey and appraise defaulted projects. They try to be very selective when originating loans for the shipping industry. MARAD could benefit from considering the internal control practices employed by the private sector to more effectively utilize its limited resources while maximizing its ability to accomplish its mission.

- MARAD uses a relatively simplistic cash-flow model that is based on outdated assumptions, which lack supporting documentation, to prepare its estimates of defaults and recoveries. While the nature and characteristics of the Title XI program make it difficult to estimate subsidy costs, MARAD has not performed the basic analyses necessary to assess and improve its estimates, which differ significantly from recent actual experience. Specifically, we found that in comparison with recent actual experience, MARAD's default estimates have significantly understated defaults, and its recovery estimates have significantly overstated recoveries. Agencies should use sufficient reliable historical data to estimate credit subsidies and update—reestimate—these estimates annually based on an analysis of actual program experience. However, MARAD has never evaluated the performance of its loan guarantee projects to determine if its subsidy cost reestimates were comparable to actual costs. Finally, the Office of Management and Budget (OMB) has provided little oversight of MARAD's subsidy cost estimate and reestimate calculations.

Because MARAD does not operate the Title XI loan guarantee program in a businesslike fashion, it lacks assurance that it is effectively promoting growth and modernization of the U.S. merchant marine and U.S. shipyards or minimizing the risk of financial loss to the Federal Government. Consequently, the Title XI program could be vulnerable to waste, fraud, abuse, and mismanagement. Also, MARAD's questionable subsidy cost estimates do not provide Congress a basis for knowing the true costs of the Title XI program and Congress cannot make well-informed policy decisions when providing budget authority. If the pattern of recent experiences were to continue, MARAD would have significantly underestimated the costs of the program.

To review our findings in more detail, let me start by describing MARAD's management of the Title XI program.

MARAD Has Not Fully Complied with Some Key Title XI Program Requirements

MARAD has not fully complied with some key Title XI program requirements. We found that MARAD generally complied with requirements to assess an applicant's economic soundness before issuing loan guarantees. However, MARAD used waivers or modifications, which, although permitted by MARAD regulations, allowed MARAD to approve some applications even though borrowers had not met all financial requirements. Additionally, MARAD did not fully comply with regulations and established practices pertaining to project monitoring and fund disbursement. Finally, while MARAD has guidance governing the disposition of defaulted assets, adherence to this guidance is not mandatory, and MARAD did not always follow it in the defaulted cases we reviewed. We looked at five MARAD-financed projects (see table 1).

Table 1.—Projects Included in Our Review

Project	Year loan committed	Original amount (millions)	Risk category	Status
(AMCV) Project America, Inc.	1999	$1,079.5	2A	Default
Searex	1996	$77.3	2B	Default
Massachusetts Heavy Industries (MHI)	1997	$55.0	3	Default
Hvide Van Ommeran Tankers (HVIDE)	1996	$43.2	2C	Active
Global Industries	1996	$20.3	1C	Active

Source: MARAD data.

Note: MARAD places projects into one of seven risk categories that, from lowest to highest, are 1A, 1 B, 1 C, 2A, 2B, 2C, and 3.

MARAD Used Waivers and Modifications to Approve Loans That Would Otherwise Not Be Approved

MARAD regulations do not permit MARAD to guarantee a loan unless the project is determined to be economically sound.[3] MARAD generally complied with requirements to assess an applicant's economic soundness before approving loan guarantees, and we were able to find documentation addressing economic soundness criteria for the projects included in our review. Specifically, we were able to find documentation addressing supply and demand projections and other economic soundness criteria for the projects included in our review.[4] In 2002, MARAD's Office of Statistical and Economic Analysis found a lack of a standardized approach for conducting market analyses. Because of this concern, in November 2002, it issued guidance for conducting market research on marine transportation services. However, adherence to these guidelines is not required. Finally, while MARAD may not waive economic soundness criteria, officials from the Office of Statistics and Economic Analysis expressed concern that their findings regarding economic soundness might not always be fully considered when MARAD approved loan guarantees.[5] They cited a recent instance where they questioned the economic soundness of a project that was later approved without their concerns being addressed. According to the Associate Administrator for Shipbuilding, all concerns, including economic soundness concerns, are considered by the MARAD Administrator.

Shipowners and shipyard owners are also required to meet certain financial requirements during the loan approval process. However, MARAD used waivers or modifications, which, although permitted by Title XI regulations, allowed MARAD to approve some applications even though borrowers had not met all financial requirements that pertained to working capital, long-term debt, net worth, and owner-invested equity[6] For example, AMCV's Project America, Inc., did not meet the qualifying requirements for working capital, among other things. Although MARAD typically requires companies to have positive working capital, an excess of current assets over current liabilities, the accounting requirements for unterminated passenger payments significantly affect this calculation because this deferred revenue is treated as a liability until earned.[7] Because a cruise operator would maintain large balances of current liabilities, MARAD believed it would be virtually impossible for AMCV to meet a positive working capital requirement if sound cash management practices were followed.[8] Subsequently, MARAD used cash-flow tests for Project America, Inc., in lieu of working capital requirements for purposes of liquidity testing.

According to MARAD officials, waivers or modifications help them meet the congressional intent of the Title XI program, which is to promote the growth and modernization of the U.S. merchant marine industry. Further, they told us that the uniqueness of the Title XI projects and marine financing lends itself to the use of waivers and modifications. However, by waiving or modifying financial requirements, MARAD officials may be taking on greater risk in the loans they are guaranteeing. Consequently, the use of waivers or modifications could contribute to the number or severity of loan guarantee defaults and subsequent Federal payouts. In a recent review, the Department of Transportation Inspector General (IG) noted that the use of modifications increases the risk of the loan guarantee to the government and expressed concern about MARAD undertaking such modifications without

[3] All projects must be determined to be economically sound, and borrowers must have sufficient operating experience and the ability to operate the vessels or employ the technology on an economically sound basis. Particularly, MARAD regulations contain language stating that: (1) long-term demand must exceed supply; (2) documentation must be provided on the projections of supply and demand; (3) outside cash-flow should be shown, if in the short-term the borrower is unable to service indebtedness; and (4) operating cash-flow ratio must be greater than one (sufficient cash-flow to service the debt).

[4] Economic soundness analyses are prepared by the Office of Subsidy and Insurance and the Office of Statistical and Economic Analysis. It should be noted that we did not assess the substance of these economic analyses.

[5] In another case, Congress statutorily waived economic soundness criteria. Specifically, the Coast Guard Authorization Act of 1996 contained a provision waiving the economic soundness requirement for reactivation and modernization of certain closed shipyards in the United States. Previously, MARAD had questioned the economic soundness of the MHI proposal and rejected the application.

[6] MARAD may waive or modify financial terms or requirements upon determining that there is adequate security for the guarantees.

[7] Unterminated passengers are individuals who pay for a cruise, but do not actually take the cruise, and the payment is not refunded. However, the passenger may take the trip at a later date.

[8] Cash management is a financial management technique used to accelerate the collection of debt, control payments to creditors, and efficiently manage cash.

taking steps to mitigate those risks.[9] The IG recommended that MARAD require a rigorous analysis of the risks from modifying any loan approval criteria and impose compensating requirements on borrowers to mitigate these risks.

MARAD Did Not Follow Requirements for Monitoring the Financial Condition of Projects and for Controlling the Disbursement of Loan Funds

MARAD did not fully comply with requirements and its own established practices pertaining to project monitoring and fund disbursement. Program requirements specify periodic financial reporting, controls over the disbursement of loan funds, and documentation of amendments to loan agreements. MARAD could not always demonstrate that it had complied with financial reporting requirements. In addition, MARAD could not always demonstrate that it had determined that projects had made progress prior to disbursing loan funds. Also, MARAD broke with its own established practices for determining the amount of equity a shipowner must invest prior to MARAD making disbursements from the escrow fund.[10] MARAD did so without documenting this change in the loan agreement. Ultimately, weaknesses in MARAD's monitoring practices could increase the risk of loss to the Federal Government.

MARAD regulations specify that the financial statements of a company in receipt of a loan guarantee shall be audited at least annually by an independent certified public accountant. In addition, MARAD regulations require companies to provide semiannual financial statements. However, MARAD could not demonstrate that it had received required annual and semiannual statements. For example, MARAD could not locate several annual or semiannual financial statements for the Massachusetts Heavy Industries (MHI) project. Also, MARAD could not find the 1999 and 2000 semiannual financial reports for AMCV. The AMCV financial statements were later restated, as a result of a Securities and Exchange Commission (SEC) finding that AMCV had not complied with generally accepted accounting principles in preparing its financial statements.[11] In addition, several financial statements were missing from MARAD records for Hvide Van Ommeran Tankers (HVIDE) and Global Industries Ltd. When MARAD could provide records of financial statements, it was unclear how the information was used. Further, the Department of Transportation IG in its review of the Title XI program found that MARAD had no established procedures or policies incorporating periodic reviews of a company's financial well-being once a loan guarantee was approved.

An analysis of financial statements may have alerted MARAD to financial problems with companies and possibly given it a better chance to minimize losses from defaults. For example, between 1993 and 2000, AMCV had net income in only 3 years and lost a total of $33.3 million. Our analysis showed a significant decline in financial performance since 1997. Specifically, AMCV showed a net income of $2.4 million in 1997, with losses for the next 3 years, and losses reaching $10.1 million in 2000. Although AMCV's revenue increased steadily during this period by a total of 25 percent, or nearly $44 million, expenses far outpaced revenue during this period. For example, the cost of operations increased 29 percent, or $32.3 million, while sales and general and administrative costs increased over 82 percent or $33.7 million. During this same period, AMCV's debt also increased over 300 percent. This scenario combined with the decline in tourism after September 11, 2001, caused AMCV to file for bankruptcy. On May 22, 2001, Ingalls notified AMCV that it was in default of its contract due to nonpayment. Between May 22 and August 23, 2001, MARAD received at least four letters from Ingalls, the shipbuilder, citing its concern about the shipowner's ability to pay construction costs. However, it was not until August 23 that MARAD prepared a financial analysis to help determine the likelihood of AMCV or its subsidiaries facing bankruptcy or another catastrophic event.

MARAD could not always demonstrate that it had linked disbursement of funds to progress in ship construction, as MARAD requires. We were not always able to determine from available documents the extent of progress made on the projects included in our review. For example, a number of Project America, Inc.'s, disbursement requests did not include documentation that identified the extent of progress made on the project. Also, while MARAD requires periodic on-site visits to verify the progress on ship construction or shipyard refurbishment, we did not find evidence of systematic site visits and inspections. For Project America, Inc., MARAD

[9] U.S. Department of Transportation, Office of Inspector General, *Maritime Administration Title XI Loan Guarantee Program* (Washington, D.C.: Mar. 27, 2003).

[10] An escrow fund is an account in which the proceeds from sales of MARAD-guaranteed obligations are held until requested by the borrower to pay for activities related to the construction of a vessel or shipyard project or to pay interest on obligations.

[11] On June 25, 2001, AMCV restated losses from $6.1 million to $9.1 million for the first quarter of 1999.

did not have a construction representative committed onsite at Ingalls Shipyard, Inc., until May 2001, 2 months after the MARAD's Office of Ship Design and Engineering Services recommended a MARAD representative be located on-site. For the Searex Title XI loan guarantee, site visits were infrequent until MARAD became aware that Ingalls had cut the vessels into pieces to make room for other projects. For two projects rated low-risk, Hvide Van Ommeran Tankers and Global Industries, Ltd., we found MARAD conducted site visits semiannually and annually, respectively. We reviewed MHI's shipyard modernization project, which was assigned the highest risk rating, and found evidence that construction representatives conducted monthly site visits. However, in most instances, we found that a project's risk was not linked to the extent of project monitoring. Further, MARAD relied on the shipowner's certification of money spent in making decisions to approve disbursements from the escrow fund.

We also found that, in a break with its own established practice, MARAD permitted a shipowner to define total costs in a way that permitted earlier disbursement of loan funds from the escrow fund. MARAD regulations require that shipowners expend from their own funds at least 12.5 percent or 25 percent, depending on the type of vessel or technology, of the actual cost of a vessel or shipyard project prior to receiving MARAD-guaranteed loan funds. In practice, MARAD has used the estimated total cost of the project to determine how much equity the shipowner should provide. In the case of Project America, Inc., the single largest loan guarantee in the history of the program, we found that MARAD permitted the shipowner to exclude certain costs in determining the estimated total costs of the ship at various points in time, thereby deferring owner-provided funding while receiving MARAD-guaranteed loan funds. This was the first time MARAD used this method of determining equity payments, and MARAD did not document this agreement with the shipowner as required by its policy. In September 2001, MARAD amended the loan commitment for this project, permitting the owner to further delay the payment of equity. By then, MARAD had disbursed $179 million in loan funds. Had MARAD followed its established practice for determining equity payments, the shipowner would have been required to provide an additional $18 million. Because MARAD had not documented its agreements with AMCV, the amount of equity the owner should have provided was not apparent during this period. Further, MARAD systems do not flag when the shipowner has provided the required equity payment for any of the projects it finances.

MARAD officials cited several reasons for its limited monitoring of Title XI projects, including insufficient staff resources and travel budget restrictions. For example, officials of MARAD's Office of Ship Construction, which is responsible for inspection of vessels and shipyards, told us that they had only two persons available to conduct inspections, and that the office's travel budget was limited. The MARAD official with overall responsibility for the Title XI program told us that, at a minimum, the Title XI program needs three additional staff. The Office of Ship Financing needs two additional persons to enable a more through review of company financial statements and more comprehensive preparation of credit reform materials. Also, the official said that the Office of the Chief Counsel needs to fill a long-standing vacancy to enable more timely legal review. With regard to documenting the analysis of financial statements, MARAD officials said that, while they do require shipowners and shipyard owners to provide financial statements, they do not require MARAD staff to prepare a written analysis of the financial condition of the Title XI borrower.

Inconsistent monitoring of a borrower's financial condition limits MARAD's ability to protect the Federal Government's financial interests. For example, MARAD would not know if a borrower's financial condition had changed so that it could take needed action to possibly avoid defaults or minimize losses. Further, MARAD's practices for assessing project progress limit its ability to link disbursement of funds to progress made by shipowners or shipyard owners. This could result in MARAD disbursing funds without a vessel or shipyard owner making sufficient progress in completing projects. Likewise, permitting project owners to minimize their investment in MARAD-financed projects increases the risk of loss to the Federal Government.

MARAD Does Not Have Requirements in Place to Govern the Handling of Defaulted Assets

MARAD has guidance governing the disposition of defaulted assets. However, MARAD is not required to follow this guidance, and we found that MARAD does not always adhere to it. MARAD guidelines state that an independent, competent marine surveyor or MARAD surveyor shall survey all vessels, except barges, as soon as practicable, after the assets are taken into custody. In the case of filed or expected bankruptcy, an independent marine surveyor should be used. In the case of

Searex, MARAD conducted on-site inspections after the default. However, these inspections were not conducted in time to properly assess the condition of the assets. With funds no longer coming in from the project, Ingalls cut the vessels into pieces to make it easier to move the vessels from active work-in-process areas to other storage areas within the property. The Searex lift boat and hulls were cut before MARAD inspections were made. According to a MARAD official, the cutting of one Searex vessel and parts of the other two Searex vessels under construction reduced the value of the defaulted assets. The IG report on the Title XI program released in March 2003 noted that site visits were conducted on guaranteed vessels or property only in response to problems or notices of potential problems from third parties or from borrowers.

The guidelines also state that sales and custodial activities shall be conducted in such a fashion as to maximize MARAD's overall recovery with respect to the asset and debtor. Market appraisals (valuations) of the assets shall be performed by an independent appraiser, as deemed appropriate, to assist in the marketing of the asset. Relying on an interested party in determining the value of defaulted assets may not have maximized MARAD's financial recovery. In the case of Project America I and II, MARAD relied on the shipbuilder, Ingalls, to provide an estimate of the cost of making the Project America I vessel seaworthy. According to MARAD officials, their only option was to rely on Ingalls to provide this estimate. Ingalls' initial estimate in April 2002 was $16 million. Based on this estimate, MARAD rejected two bids to purchase the unfinished hull of Project America I ($2 million and $12 million respectively).[12] Subsequently, on May 17, 2002, MARAD advised Ingalls that it should dispose of the assets of Project America I and remit the net savings, if any, to MARAD. In a June 28, 2002, agreement between Northrup Grumman Ship Systems, Inc. (formerly Litton Ingalls Shipbuilding), Northrup Grumman advised that it would cost between $9 and $12 million to preserve and make Project America I seaworthy for delivery to the prospective purchaser. Had the $9 to $12 million estimate been made earlier in April 2002, MARAD would have accepted the $12 million dollar bid and would have disposed of the Project America I asset. By accepting Ingalls' original estimate of $16 million to make the ship seaworthy, MARAD may have incurred several months of unnecessary preservation expenses and possibly lowered its recovery amount. According to MARAD officials, as of March 2003, MARAD had received $2 million from the sale of the Project America I and II vessels.

Rather than obtaining a market appraisal to assist in marketing the asset, MARAD hired the Defense Contract Audit Agency (DCAA) to verify the costs incurred by Northrop Grumman Ship Systems, Inc., since January 1, 2002, for preparing and delivering Project America I in a weather-tight condition suitable for ocean towing in international waters. A MARAD official said that the DCAA audit would allow MARAD to identify any unsupported costs and recover these amounts from the shipyard. The DCAA review was used to verify costs incurred, but not to make a judgment as to the reasonableness of the costs. DCAA verified costs of approximately $17 million.

MARAD officials cite the uniqueness of the vessels and projects as the reason for using guidelines instead of requirements for handling defaulted assets. However, certain practices for handling defaulted assets can be helpful regardless of the uniqueness of a project. Among these are steps to immediately assess the value of the defaulted asset. Without a definitive strategy and clear requirements, defaulted assets may not always be secured, assessed, and disposed of in a manner that maximizes MARAD's recoveries—resulting in unnecessary costs and financial losses to the Federal Government.

MARAD Techniques to Manage Financial Risk Contrast to Techniques of Selected Private-sector Maritime Lenders

Private-sector maritime lenders we interviewed told us that it is imperative for lenders to manage the financial risk of maritime lending portfolios. In contrast to MARAD, they indicated that to manage financial risk, among other things, they: (1) establish a clear separation of duties for carrying out different lending functions; (2) adhere to key lending standards with few, if any, exceptions; (3) use a more systematic approach to monitoring the progress of projects; and (4) primarily employ independent parties to survey and appraise defaulted projects. The lenders try to be very selective when originating loans for the shipping industry. While realizing that MARAD does not operate for profit, it could benefit from the internal control practices employed by the private sector to more effectively utilize its limited resources

[12] The bids were for the purchase of the unfinished hull for Project America I in seaworthy condition.

and to enhance its ability to accomplish its mission. Table 2 describes the key differences in private-sector and MARAD maritime lending practices used during the application, monitoring, and default and disposition phases.

Table 2.—Comparison of Private-sector and MARAD Maritime Lending Practices

Phases of the lending process	
Private-sector practices	MARAD practices
Application	
• Permit few exceptions to key financial underwriting requirements for maritime loans	• Permit waivers of key financial requirements
• Seek approval of exceptions or waivers from Audit Committee	• Have no committee oversight regarding the approval of exceptions or waivers of program requirements
• Perform an in-depth analysis of a business plan for applications received for start-up businesses or first-in-class shipyard vessels	• Employ little variation in the depth of review of business plans based on type of vessel, size of loan guarantee, or history of borrower
Monitoring	
• Set an initial risk rating at the time of approval and review rating annually to determine risk rating of the loan	• Assign one risk rating during the application phase. No subsequent ratings assigned during the life of the loan
• Use industry expertise for conducting periodic on-site inspections to monitor progress on projects and potential defaults	• Use in-house staff to conduct periodic on-site inspections to monitor progress of projects
• Perform monitoring that is dependent on financial and technical risk, familiarity with the shipyard, and uniqueness of the project	• Perform monitoring based on technical risk, familiarity with shipyard, uniqueness of project, and availability of travel funds
• Analyze the borrower's financial statements to identify significant changes in borrower's financial condition and to determine appropriate level and frequency of continued monitoring at least annually	• Have no documentation of analyses of borrowers' financial statements
Default and disposition	
• Contract with an independent appraiser to prepare a valuation of a defaulted project	• Permit an interested party or MARAD official to value assets
• Enlist a technical manager to review the ship after default to assist in determining structural integrity and percentage of completion	• Permit an interested party or MARAD official to perform technical review of Title XI assets

Sources: GAO analysis of MARAD and private-sector data.

Private-sector Lenders Separate Key Lending Functions

Private-sector lenders manage financial risk by establishing a separation of duties to provide a system of checks and balances for important maritime lending functions. Two private-sector lenders indicated that there is a separation of duties for approving loans, monitoring projects financed, and disposing of assets in the event of default. For example, marketing executives from two private-sector maritime lending institutions stated that they do not have lending authority. Also, separate individuals are responsible for accepting applications and processing transactions for loan underwriting.

In contrast, we found that the same office that promotes and markets the MARAD Title XI program also has influence and authority over the office that approves and monitors Title XI loans. In February 1998, MARAD created the Office of Statistical and Economic Analysis in an attempt to obtain independent market analyses and initial recommendations on the impact of market factors on the economic soundness of projects. This office reports to the Associate Administrator for Policy and International Trade rather than the Associate Administrator for Shipbuilding. However, the Associate Administrator for Shipbuilding also is primarily responsible for overseeing the underwriting and approving of loan guarantees. Title XI program management is primarily handled by offices that report to the Associate Administrator for Shipbuilding. In addition, the same Associate Administrator controls, in collaboration with the Chief of the Division of Ship Financing Contracts within the Office of the Chief Counsel, the disposition of assets after a loan has defaulted. Most recently, MARAD has taken steps to consolidate responsibilities related to loan disbursements. In August 2002, the Maritime Administrator gave the Associate Administrator for Shipbuilding sole responsibility for reviewing and approving the disbursement of escrow funds. According to a senior official, prior to August 2002 this responsibility was shared with the Office of Financial and Rate Approvals under the supervision of the Associate Administrator for Financial Approvals and Cargo Preference. As a result of the consolidation, the same Associate Administrator who is responsible for underwriting and approving loan guarantees and disposing of defaulted assets is also responsible for approval of loan disbursements and monitoring financial condition. MARAD undertook this consolidation in an effort to improve performance of analyses related to the calculation of shipowner's equity contributions and monitoring of changes in financial condition. However, as mentioned earlier, MARAD does not have controls for clearly identifying the shipowner's required equity contribution. The consolidation of responsibilities for approval of loan disbursements does not address these weaknesses and precludes any potential benefit from separation of duties.

Private-sector Practices Employ Less Flexible Lending Standards

The private-sector lenders we interviewed said they apply rigorous financial tests for underwriting maritime loans. They analyze financial statements such as balance sheets, income statements, and cash-flow statements, and use certain financial ratios such as liquidity and leverage ratios that indicate the borrower's ability to repay. Private-sector maritime lenders told us they rarely grant waivers, or exceptions, to underwriting requirements or approve applications when borrowers do not meet key minimum requirements. Each lender we interviewed said any approved applicants were expected to demonstrate stability in terms of cash on hand, financial strength, and collateral. One lender told us that on the rare occasions when exceptions to the underwriting standards were granted, an audit committee had to approve any exception or waiver to the standards after reviewing the applicant's circumstances. In contrast, we found in the cases we reviewed that MARAD often permits waivers or modifications of key financial requirements, often without a deliberative process, according to a MARAD official. For example, MARAD waived the equity and working capital financial requirements at the time of the loan guarantee closing for MHI's shipyard modernization project. Also, a recent IG report found that MARAD routinely modifies financial requirements in order to qualify applicants for loan guarantees. Further, the IG noted that MARAD reviewed applications for loan guarantees primarily with in-house staff and recommended that MARAD formally establish an external review process as a check on MARAD's internal loan application review.[13] A MARAD official told us that MARAD is currently developing the procedures for an external review process.

These private-sector lenders also indicated that preparing an economic analysis or an independent feasibility study assists in determining whether or not to approve funding based on review and discussion of the marketplace, competition, and project costs. Each private-sector lender we interviewed agreed that performance in the shipping industry was cyclical and timing of projects was important. In addition, reviewing historical data provided information on future prospects for a project. For example, one lender uses these economic analyses to evaluate how important the project will be to the overall growth of the shipping industry. Another lender uses the economic analyses and historical data to facilitate the sale of a financed vessel. In the area of economic soundness analysis, MARAD requirements appear closer to those of the private-sector lenders, in that external market studies are also used to help determine the overall economic soundness of a project. However, assessments of economic soundness prepared by the Office of Statistical and Economic Analysis may not be fully considered when MARAD approves loan guarantees.

Private-sector Lenders Use a More Systematic Approach to Loan Monitoring

Private-sector lenders minimized financial risk by establishing loan monitoring and control mechanisms such as analyzing financial statements and assigning risk ratings. Each private-sector lender we interviewed said that conducting periodic reviews of a borrower's financial statements helped to identify adverse changes in the financial condition of the borrower. For example, two lenders stated that they annually analyzed financial statements such as income statements and balance sheets. The third lender evaluated financial statements quarterly. Based on the results of these financial statement reviews, private-sector lenders then reviewed and evaluated the risk ratings that had been assigned at the time of approval. Two lenders commented that higher risk ratings indicated a need for closer supervision, and they then might require the borrower to submit monthly or quarterly financial statements. In addition, a borrower might be required to increase cash reserves or collat-

[13] The IG also recommended that MARAD impose compensating factors for loan guarantees to mitigate risks.

eral to mitigate the risk of a loan. Further, the lender might accelerate the maturity date of the loan. Private-sector lenders used risk ratings in monitoring overall risk, which in turn helped to maintain a balanced maritime portfolio.

At MARAD, we found no evidence that staff routinely analyzed or evaluated financial statements or changed risk categories after a loan was approved. For example, we found in our review that for at least two financial statement reporting periods, MARAD was unable to provide financial statements for the borrower, and, in one case, one financial statement was submitted after the commitment to guarantee funds. Our review of the selected Title XI projects indicated that risk categories were primarily assigned for purposes of estimating credit subsidy costs at the time of application, not for use in monitoring the project. Further, we found no evidence that MARAD changed a borrower's risk category when its financial condition changed. In addition, neither the support office that was initially responsible for reviewing and analyzing financial statements nor the office currently responsible maintained a centralized record of the financial statements they had received. Further, while one MARAD official stated that financial analyses were performed by staff and communicated verbally to top-level agency officials, MARAD did not prepare and maintain a record of these analyses.

Private-sector lenders also manage financial risk by linking the disbursement of loan funds to the progress of the project. All the lenders we interviewed varied project monitoring based on financial and technical risk, familiarity with the shipyard, and uniqueness of the project. Two lenders thought that on-site monitoring was very important in determining the status of projects. Specifically, one lender hires an independent marine surveyor to visit the shipyard to monitor construction progress. This lender also requires signatures on loan disbursement requests from the shipowner, shipbuilder, and loan officer before disbursing any loan funds. This lender also relies on technical managers and classification society representatives who frequently visit the shipyard to monitor progress.[14] Shipping executives of this lender make weekly, and many times daily, calls to shipowners to further monitor the project based on project size and complexity. This lender also requires shipowners to provide monthly progress reports so the progress of the project could be monitored.

MARAD also relied onsite visits to verify construction progress. However, the linkage between the progress of the project and the disbursement of loan funds was not always clear. MARAD tried to adjust the number of site visits based on the amount of the loan guarantee, the uniqueness of project (for example, whether the ship is the first of its kind for the shipowner), the degree of technical and engineering risk, and familiarity with the shipyard. However, the frequency of site visits was often dependent upon the availability of travel funds, according to a MARAD official.

Private-sector Lenders Use Industry Expertise to Value Defaulted Assets

Private-sector maritime lenders said they regularly use independent marine surveyors and technical managers to appraise and conduct technical inspections of defaulted assets. For example, two lenders hire independent marine surveyors who are knowledgeable about the shipbuilding industry and have commercial lending expertise to inspect the visible details of all accessible areas of the vessel, as well as its marine and electrical systems. In contrast, we found that MARAD did not always use independent surveyors. For example, we found that for Project America, the shipbuilder was allowed to survey and oversee the disposition of the defaulted asset. As mentioned earlier, MARAD hired DCAA to verify the costs incurred by the shipbuilder to make the defaulted asset ready for sale; however, MARAD did not verify whether the costs incurred were reasonable or necessary. For Searex, construction representatives and officials from the Offices of the Associate Administrator of Shipbuilding and the Chief of the Division of Ship Financing Contracts were actively involved in the disposition of the assets.

MARAD Cites Mission as the Difference in Management of Financial Risk Compared to Private-sector Lenders

According to top-level MARAD officials, the chief reason for the difference between private-sector and MARAD techniques for approving loans, monitoring project progress, and disposing of assets is the public purpose of the Title XI program, which is to promote growth and modernization of the U.S. merchant marine and U.S. shipyards. That is, MARAD's program purposefully provides for greater flexibility in underwriting in order to meet the financing needs of shipowners and ship-

[14] Classification society representatives are individuals who inspect the structural and mechanical fitness of ships and other marine vessels for their intended purpose.

yards that otherwise might not be able to obtain financing. MARAD is also more likely to work with borrowers that are experiencing financial difficulties once a project is under way. MARAD officials also cited limited resources in explaining the limited nature of project monitoring.

While program flexibility in financial and economic soundness standards may be necessary to help MARAD meet its mission objectives, the strict use of internal controls and management processes is also important. Otherwise, resources that could have been used to further the program might be wasted. To aid agencies in improving internal controls, we have recommended that agencies identify the risks that could impede their ability to efficiently and effectively meet agency goals and objectives.[15] Private-sector lenders employ internal controls such as a systematic review of waivers during the application phase and risk ratings of projects during the monitoring phase. However, MARAD does neither. Without a more systematic review of underwriting waivers, MARAD might not be giving sufficient consideration to the additional risk such decisions represent. Likewise, without a systematic process for assessing changes in payment risk, MARAD cannot use its limited monitoring resources most efficiently. Further, by relying on interested parties to estimate the value of defaulted loan assets, MARAD might not maximize the recovery on those assets. Overall, by not employing the limited internal controls it does possess, and not taking advantage of basic internal controls such as those private-sector lenders employ, MARAD cannot ensure it is effectively utilizing its limited administrative resources or the government's limited financial resources.

MARAD's Credit Subsidy Estimates and Reestimates Are Questionable

MARAD uses a relatively simplistic cash-flow model that is based on outdated assumptions, which lack supporting documentation, to prepare its estimates of defaults and recoveries. These estimates differ significantly from recent actual experience. Specifically, we found that in comparison with recent actual experience, MARAD's default estimates have significantly understated defaults, and its recovery estimates have significantly overstated recoveries. If the pattern of recent experience were to continue, MARAD would have significantly underestimated the costs of the program. Agencies should use sufficient reliable historical data to estimate credit subsidies and update—reestimate—these estimates annually based on an analysis of actual program experience. While the nature and characteristics of the Title XI program make it difficult to estimate subsidy costs, MARAD has never performed the basic analyses necessary to determine if its default and recovery assumptions are reasonable. Finally, OMB has provided little oversight of MARAD's subsidy cost estimate and reestimate calculations.

MARAD's Credit Subsidy Estimates Are Questionable

The Federal Credit Reform Act of 1990 (FCRA) was enacted, in part, to require that the Federal budget reflect a more accurate measurement of the government's subsidy costs for loan guarantees.[16] To determine the expected cost of a credit program, agencies are required to predict or estimate the future performance of the program. For loan guarantees, this cost, known as the subsidy cost, is the present value of estimated cash-flows from the government, primarily to pay for loan defaults, minus estimated loan guarantee fees paid and recoveries to the government. Agency management is responsible for accumulating relevant, sufficient, and reliable data on which to base the estimate and for establishing and using reliable records of historical credit performance. In addition, agencies are supposed to use a systematic methodology to project expected cash-flows into the future. To accomplish this task, agencies are instructed to develop a cash-flow model, using historical information and various assumptions including defaults, prepayments, recoveries, and the timing of these events, to estimate future loan performance.

MARAD uses a relatively simplistic cash-flow model, which contains five assumptions—default amount, timing of defaults, recovery amount, timing of recoveries, and fees—to estimate the cost of the Title XI loan guarantee program. We found that relatively minor changes in these assumptions can significantly affect the estimated cost of the program and that, thus far, three of the five assumptions, default and recovery amounts and the timing of defaults, differed significantly from recent

[15] U.S. General Accounting Office, *Standards for Internal Control in the Federal Government,* GAO/AIMD–00–21.3.1 (Washington, D.C.: November 1999) and *Internal Control Management and Evaluation Tool,* GAO–01–1008G (Washington, D.C.: August 2001).

[16] The Federal Accounting Standards Advisory Board developed the accounting standard for credit programs, Statement of Federal Financial Accounting Standards No. 2, "Accounting for Direct Loans and Loan Guarantees," which generally mirrors FCRA and which established guidance for estimating the cost of guaranteed loan programs.

actual historical experience.[17] According to MARAD officials, these assumptions were developed in 1995 based on actual loan guarantee experience of the previous 10 years and have not been evaluated or updated. MARAD could not provide us with supporting documentation to validate its estimates, and we found no evidence of any basis to support the assumptions used to calculate these estimates. MARAD also uses separate default and recovery assumptions for each of seven risk categories to differentiate between levels of risk and costs for different loan guarantee projects.

We attempted to analyze the reliability of the data supporting MARAD's key assumptions, but we were unable to do so because MARAD could not provide us with any supporting documentation for how the default and recovery assumptions were developed. Therefore, we believe MARAD's subsidy cost estimates to be questionable. Because MARAD has not evaluated its default and recovery rate assumptions since they were developed in 1995, the agency does not know whether its cash-flow model is reasonably predicting borrower behavior and whether its estimates of loan program costs are reasonable.

The nature and characteristics of the Title XI program make it difficult to estimate subsidy costs. Specifically, MARAD approves a small number of guarantees each year, leaving it with relatively little experience on which to base estimates for the future. In addition, each guarantee is for a large dollar amount, and projects have unique characteristics and cover several sectors of the market. Further, when defaults occur, they are usually for large dollar amounts and may not take place during easily predicted timeframes. Recoveries may be equally difficult to predict and may be affected by the condition of the underlying collateral. This leaves MARAD with relatively limited information upon which to base its credit subsidy estimates. Also, MARAD may not have the resources to properly implement credit reform. MARAD officials expressed frustration that they do not have and, therefore, cannot devote, the necessary time and resources to adequately carry out their credit reform responsibilities.

Notwithstanding these challenges, MARAD has not performed the basic analyses necessary to assess and improve its estimates. According to MARAD officials, they have not analyzed the default and recovery rates because most of their loan guarantees are in about year 7 out of the 25-year term of the guarantee, and it is too early to assess the reasonableness of the estimates. We disagree with this assessment and believe that an analysis of the past 5 years of actual default and recovery experience is meaningful and could provide management with valuable insight into how well its cash-flow models are predicting borrower behavior and how well its estimates are predicting the loan guarantee program's costs. We further believe that, while difficult, an analysis of its risk category system is meaningful for MARAD to ensure that it appropriately classified loan guarantee projects into risk category subdivisions that are relatively homogenous in cost.

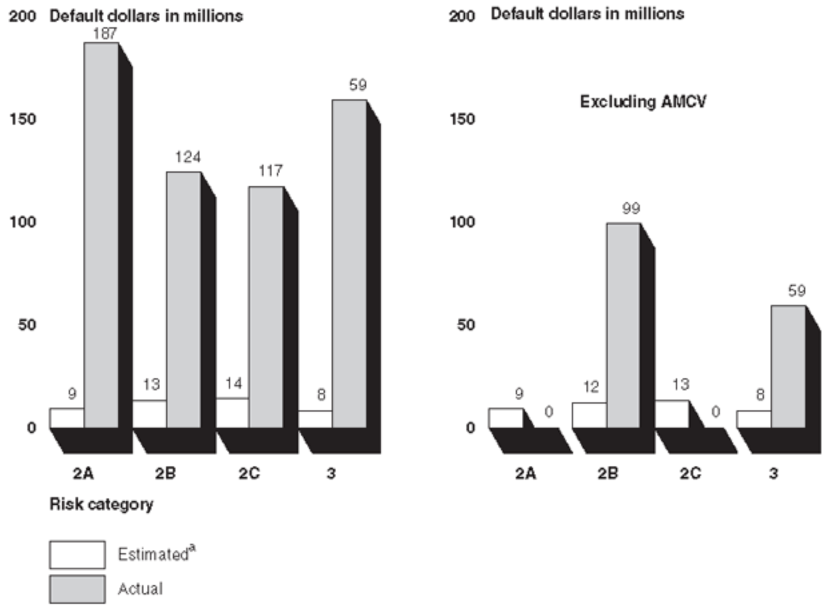
Of loans originated in the past 10 years, nine have defaulted, totaling $489.5 million in defaulted amounts. Eight of these nine defaults, totaling $487.7 million, occurred since MARAD implemented its risk category system in 1996. Because these eight defaults represent the vast majority (99.6 percent) of MARAD's default experience, we compared the performance of all loans guaranteed between 1996–2002 with MARAD's estimates of loan performance for this period.[18] We found that actual loan performance has differed significantly from agency estimates. For example, when defaults occurred, they took place much sooner than estimated. On average, defaults occurred 4 years after loan origination, while MARAD had estimated that, depending on the risk category, peak defaults would occur between years 10–18. Also, actual default costs thus far have been much greater than estimated. We estimated, based on MARAD data, that MARAD would experience $45.5 million in defaults to date on loans originated since 1996. However, as illustrated by figure 1, MARAD has consistently underestimated the amount of defaults the Title XI program would experience. In total, $487.7 million has actually defaulted during this period—more than 10 times greater than estimated. Even when we excluded AMCV, which represents about 68 percent of the defaulted amounts, from our analysis, we found that

[17] MARAD's recovery assumption assumes a 50 percent recovery rate within 2 years of default. However, 2 years have not yet elapsed for several of the defaults and so we could not yet determine how the estimated timing of recoveries compares to the actual timing of recoveries.

[18] Our analysis focused on loans beginning in 1996 because: (1) this was the first year in which MARAD implemented its risk category system, and (2) MARAD could not provide us with any supporting data for its default and recovery assumptions for loans originating before 1996. Further, only one default occurred between 1993–1996, representing less than 1 percent of MARAD's total defaults between 1993–2002.

the amount of defaults MARAD experienced greatly exceeded what MARAD estimated it would experience by $114.6 million (or over 260 percent).

Figure 1: Estimated and Actual Defaults of Title XI Loan Guarantees (1996–2002)

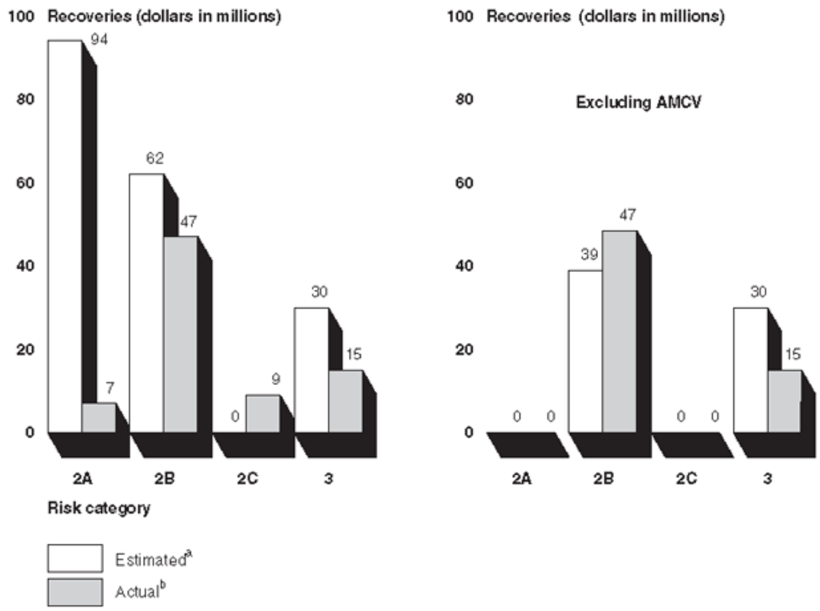


Sources: MARAD (data); GAO (presentation).

[a] We excluded estimates for risk categories 1A, 1B, and 1C, because estimated defaults for these categories totaled only $1.5 million or 3.4 percent of total estimated defaults.

In addition, MARAD's estimated recovery rate of 50 percent of defaulted amounts within 2 years of default is greater than the actual recovery rate experienced since 1996, as can be seen in figure 2. Although actual recoveries on defaulted amounts since 1996 have taken place within 1–3 years of default, most of these recoveries were substantially less than estimated, and two defaulted loans have had no recoveries to date. For the actual defaults that have taken place since 1996, MARAD would have estimated, using the 50 percent recovery rate assumption, that it would recover approximately $185.3 million dollars. However, MARAD has only recovered $78.2 million or about 42 percent of its estimated recovery amount. Even when we excluded AMCV, which represents about 68 percent of the defaulted amounts, from our analysis, we still found that MARAD has overestimated the amount it would recover on defaulted loans by $6.8 million (or about 10 percent). If this pattern of recent default and recovery experiences were to continue, MARAD would have significantly underestimated the costs of the program.

Figure 2: Estimated and Actual Recoveries on Title XI Loan Defaults (1996–2002)



Sources: MARAD (data); GAO (presentation).

[a] Estimated recoveries are based on applying MARAD's 50 percent recovery rate within 2 years to the actual default amounts. Our analysis of recovery estimates includes estimated recovery amounts for two of the five defaulted AMCV loans, even though 2 years have not elapsed, because, according to MARAD officials, no additional recoveries are expected on these two loans. Thus, our recovery calculation was based on $370.6 of the $487.7 million in defaulted loans, which includes defaults for which 2 years have elapsed, as well as the two AMCV defaults for which no additional recoveries are expected. With its 50 percent recovery assumption, MARAD would have estimated that, at this point, it should have recovered $185.3 million of these defaulted loans.

[b] We calculated the actual recovery rate by comparing the total actual recoveries to the $370.6 million in relevant actual defaulted amounts. At the time of our review, MARAD had recovered $78.2 out of this $370.6 million.

We also attempted to analyze the process MARAD uses to designate risk categories for projects, but were unable to do so because the agency could not provide us with any documentation about how the risk categories and MARAD's related numerical weighting system originally were developed.[19] According to OMB guidance, risk categories are subdivisions of a group of loans that are relatively homogeneous in cost, given the facts known at the time of designation. Risk categories combine all loan guarantees within these groups that share characteristics that are statistically predictive of defaults and other costs. OMB guidance states that agencies should develop statistical evidence based on historical analysis concerning the likely costs of expected defaults for loans in a given risk category. MARAD has not done any analysis of the risk category system since it was implemented in 1996 to determine whether loans in a given risk category share characteristics that are predictive of defaults and other costs and thereby comply with guidance. In addition, according to a MARAD official, MARAD's risk category system is partially based on outdated MARAD regulations and has not been updated to reflect changes to these regulations.

Further, MARAD's risk category system is flawed because it does not consider concentrations of credit risk. To assess the impact of concentration risk on MARAD's loss experience, we analyzed the defaults for loans originated since 1996 and found

[19] MARAD's risk category system incorporates ten factors that are set out in Title XI, which specifies that MARAD is to establish a system of risk categories based on these factors. How MARAD weighs and interprets these factors is described in program guidance.

that five of the eight defaults, totaling $330 million or 68 percent of total defaults, involved loan guarantees that had been made to one particular borrower, AMCV. Assessing concentration of credit risk is a standard practice in private-sector lending. According to the Federal Reserve Board's Commercial Bank Examination Manual, limitations imposed by various state and Federal legal lending limits are intended to prevent an individual or a relatively small group from borrowing an undue amount of a bank's resources and to safeguard the bank's depositors by spreading loans among a relatively large number of people engaged in different businesses. Had MARAD factored concentration of credit into its risk category system, it would likely have produced higher estimated losses for these loans.

MARAD's Credit Subsidy Reestimates Are Also Questionable

After the end of each Fiscal Year, OMB generally requires agencies to update or "reestimate" loan program costs for differences among estimated loan performance and related cost, the actual program costs recorded in accounting records, and expected changes in future economic performance. The reestimates are to include all aspects of the original cost estimate such as prepayments, defaults, delinquencies, recoveries, and interest. Reestimates allow agency management to compare original budget estimates with actual costs to identify variances from the original estimates, assess the reasonableness of the original estimates, and adjust future program estimates, as appropriate. When significant differences between estimated and actual costs are identified, the agency should investigate to determine the reasons behind the differences, and adjust its assumptions, as necessary, for future estimates and reestimates.

We attempted to analyze MARAD's reestimate process, but we were unable to do so because the agency could not provide us with any supporting data on how it determined whether a loan should have an upward or downward reestimate. According to agency management, each loan guarantee is reestimated separately based on several factors including the borrower's financial condition, a market analysis, and the remaining balance of the outstanding loans. However, without conducting our own independent analysis of these and other factors, we were unable to determine whether any of MARAD's reestimates were reasonable. Further, MARAD has reestimated the loans that were disbursed in Fiscal Years 1993, 1994, and 1995 downward so that they now have negative subsidy costs, indicating that MARAD expects these loans to be profitable. However, according to the default assumptions MARAD uses to calculate its subsidy cost estimates, these loans have not been through the period of peak default, which would occur in years 10–18 depending on the risk category. MARAD officials told us that several of these loans were paid off early, and the risk of loss in the remaining loans is less than the estimated fees paid by the borrowers. However, MARAD officials were unable to provide us with any supporting information for its assessment of the borrowers' financial condition and how it determined the estimated default and recovery amounts to assess the reasonableness of these reestimates. Our analysis of MARAD's defaults and recoveries demonstrates that, when defaults occur, they occur sooner and are for far greater amounts than estimated, and that recoveries are smaller than estimated. As a result, we question the reasonableness of the negative subsidies for the loans that were disbursed in Fiscal Years 1993, 1994, and 1995.

MARAD's ability to calculate reasonable reestimates is seriously impacted by the same outdated assumptions it uses to calculate cost estimates as well as by the fact that it has not compared these estimates with the actual default and recovery experience. As discussed earlier, our analysis shows that, since 1996, MARAD has significantly underestimated defaults and overestimated recoveries to date. Without performing this basic analysis, MARAD cannot determine whether its reestimates are reasonable and it is unable to improve these reestimate calculations over time and provide Congress with reliable cost information to make key funding decisions. In addition, and, again, as discussed earlier, MARAD's inability to devote sufficient resources to properly implement credit reform appears to limit its ability to adequately carry out these credit reform responsibilities.

OMB Has Provided Little Oversight of MARAD's Estimates and Reestimates

Based on our analysis, we believe that OMB provided little review and oversight of MARAD's estimates and reestimates. OMB has final authority for approving estimates in consultation with agencies; OMB approved each MARAD estimate and reestimate, explaining to us that it delegates authority to agencies to calculate estimates and reestimates. However, MARAD has little expertise in the credit reform area and has not devoted sufficient resources to developing this expertise. The FCRA assigns responsibility to OMB for coordinating credit subsidy estimates, developing estimation guidelines and regulations, and improving cost estimates, including coordinating the development of more accurate historical data and annually reviewing the performance of loan programs to improve cost estimates. Had OMB provided greater review and oversight of MARAD's estimates and reestimates, it would have realized the assumptions were outdated and did not track with actual recent experience.

Conclusions

In conclusion, Mr. Chairman, MARAD does not operate the Title XI loan guarantee program in a businesslike fashion. MARAD does not: (1) fully comply with its own requirements and guidelines, (2) have a clear separation of duties for handling loan approval and fund disbursement functions, (3) exercise diligence in considering and approving modifications and waivers, (4) adequately secure and assess the value of defaulted assets, and (5) know what its program costs. Because of these shortcomings, MARAD lacks assurance that it is effectively promoting growth and modernization of the U.S. merchant marine and U.S. shipyards or minimizing the risk of financial loss to the Federal Government. Consequently, the Title XI program could be vulnerable to waste, fraud, abuse, and mismanagement. Finally, MARAD's questionable subsidy cost estimates do not provide Congress a basis for knowing the true costs of the Title XI program, and Congress cannot make well-informed policy decisions when providing budget authority. If the pattern of recent experiences were to continue, MARAD would have significantly underestimated the costs of the program.

Recommendations

We are currently considering a number of recommendations to reform the Title XI program, including actions Congress could take to clarify borrower equity contribution requirements and incorporate concentration risk in the approval of loan guarantees, as well as actions MARAD could take to improve its processes for approving loan guarantees, monitoring and controlling funds, and managing and disposing of defaulted assets. In addition, we are considering recommendations to help MARAD better implement its responsibilities under FCRA. Because of the fundamental flaws we have identified, we question whether MARAD should approve new loan guarantees without first addressing these program weaknesses.

This concludes my prepared statement. I will be happy to respond to any questions you or the other members of the Committee may have.

The CHAIRMAN. Thank you, Mr. McCool. We'll look forward to those recommendations.

Captain Schubert, you just heard Mr. McCool, who—those are some pretty strong criticisms. Do you have any response to those?

Mr. SCHUBERT. Yes, sir. Mr Chairman, first of all, I welcome a third-party review of the program to help improve the administration of the Title XI program, and it was one of the highest priorities that I had when I was sworn in, in December 2001. So I welcome all impartial recommendations to improve the program.

But that being said, as the GAO has testified, we did receive their draft report, which we're in the process of responding to. Since some of the recommendations also involve OMB, we're currently in the process of property vetting the response, a detailed response.

But that being said, I would like to make some general comments in response to his testimony. First of all, the statement with regards to the private-sector lending practices, I don't believe that we agree that there is a "universal trend," you might say, toward consolidation of the decisionmaking process or the monitoring process in the financial communities. I could say that my own experience in the private sector, in which I dealt with credit administration and shipping of over $7 billion in exports, but I dealt with many financial institutions during that timeframe, and I cannot say that I've observed that this statement is correct, that this is a standard practice. We will review this further and put it into our formal response.

With regards to this, regarding the consolidation—my comment just referred to the consolidation issue, but in terms of the not following, or always following, our program requirements, I think we do follow our program—we have followed our program requirements, as per our regulations. The issues that were raised regarding the waiver of financial—MARAD's financial requirements that had been done in the past, I will say that, as administrator, at least the $500 million that I've approved, that eight of the nine credits that I've approved have met all the financial requirements, and in only one case did we waive a provision, one of our provisions, for net worth on one of our projects. And we did get compensating provisions, as per the IG's recommendations.

But I would like to see—and, as I mentioned in my opening statement—that the changes that we make, working together, will outlive me and will continue in the program to truly improve it.

Now, with regards to the credit-risk model that we use to calculate the subsidy, I agree that we need to revisit that, and we need to work with the OMB to enhance and improve the current model. I believe that is something that we do agree with. But I would like to point out that, in the aggregate, the MARAD subsidy estimates, which includes the funds that are appropriated by Congress, plus the user fees, plus the recoveries that we have made, have provided adequate funds to cover all defaults to date. And so to say that it is has been totally inadequate might not be totally correct. But I do agree that we should make some improvements.

The CHAIRMAN. Mr. Mead, you said that there have been nine loan-guarantee defaults since 1998. Is that right?

Mr. MEAD. Yes.

The CHAIRMAN. And how much money was that?

Mr. MEAD. It was about—a little over $400 million, and they recovered, oh, I think about $80 million. My numbers might be a little bit off.

The CHAIRMAN. Since 1998, there's been a $320 million cost to the taxpayers.

Mr. MEAD. Yes, sir. As I said, you know, we were fortunate that—over $800 million more hadn't been lost, and that was simply because they went bankrupt before the money could be disbursed.

The CHAIRMAN. And those were AMCV, Quincy, Massachusetts, and the Searex platforms?

Mr. MEAD. Yes, sir. Well, and Quincy, of course, was the shipyard. And there were a couple of other minor ones. One was Surf Express. That was a catamaran undertaking in the Caribbean Islands.

The CHAIRMAN. Captain Schubert, out of curiosity, Mr. Mead mentioned that the Searex ships were chopped up?

Mr. SCHUBERT. That's correct. There was one completed rig out of the four. Three of the four were not completed. And the shipyard did cut up the hulls that were on the property.

The CHAIRMAN. Didn't that reduce the value?

Mr. SCHUBERT. I believe it did potentially reduce the value, but, to be quite honest, sir, it was probably worth scrap at that time, anyway.

Mr. MEAD. Well, you know——

The CHAIRMAN. Go ahead.

Mr. MEAD.—I don't know what the predicate for that, for saying it's only worth scrap. I mean, they were at least hulls. They'd have been worth a little more. Also, that same shipyard, one of the reasons it chopped them up was to make room for some more ships that it was going to build under a loan guarantee.

The CHAIRMAN. Now, just very briefly, the original AMCV deal was for five ships. Is that right? Or two ships?

Mr. SCHUBERT. Two ships, sir.

The CHAIRMAN. Two ships. And they were never completed. And we know that $300-and-some million of the taxpayers' money was lost. But suppose that AMCV had not set up the subsidiary. Would we have gotten more money back if it had just been AMCV's responsibility?

Mr. SCHUBERT. Well, first of all, the parent company also went into bankruptcy, the parent company to AMCV——

The CHAIRMAN. So we probably wouldn't have gotten any more money back even if they had not set up the subsidiary.

Mr. SCHUBERT. No, sir. I think there could have been stronger compensating controls, as recommended by the IG, that might have enhanced our recovery.

The CHAIRMAN. And what's happened to those two hulks——

Mr. SCHUBERT. Well——

The CHAIRMAN.—or shells or the uncompleted ships?

Mr. SCHUBERT. Uncompleted ships. Well, soon after I assumed the Maritime Administrator's position, I realized we had a very serious problem with what to do about the disposal of those assets. Really, there was only one hull, that was the first ship that was under construction. It was approximately 40-percent complete at the time that the default occurred and also the—you know, there wasn't any more work—I mean, at that time there wasn't any work on the vessel. I, personally, went down to the ship to inspect the vessel. I have a ship-operating background. I took my staff with me to take a look at the vessel to see what could be done, and we determined, at that time, that the vessel was not going to be marketable in the current condition. It couldn't float at the time. So we began negotiations and discussions with the shipyard to make the vessel—to complete the hull of the vessel so it was floatable and towable.

And we made good-faith attempts to advertise the vessel in its current condition. We were unsuccessful. In fact, the first offers we had would have meant that we would have had to get out the checkbook and write the buyer a $2 million check just to take the vessel. So, as you can see, we had a major problem here. We were trying to do everything possible to minimize the negative impact on the taxpayers to have to take on any more liability.

We then found a buyer, or actually the shipyard found a buyer, for both the ship 1 and the parts for ship 2. As I should have mentioned, ship 2 was never actually—construction had never started on it. We received an offer for 22 million. The Maritime Administration was guaranteed a $2 million net recovery out of those proceeds, because the vessel had to be completed to where it was floatable.

Now, the only other option we had was to probably spend anywhere from $20–$22 million additional of the taxpayers' dollars to finish the hull, to—it is a hurricane-prone area—to make it hurricane-proof, and to possibly tow it into the Beaumont reserve fleet, which is nearby. That would cost the taxpayers $20–$22 million, with no guarantee of any recovery whatsoever.

So we, under those circumstances, and also the fact that the shipyard space that they had the vessel sitting in was needed for a combatant program for the Navy, we agreed, as long as we could guarantee that we had net recovery of $2 million. And those vessels were sold—or the vessel, hull 1, plus the parts for hull 2, were sold to Norwegian Cruise Lines.

The CHAIRMAN. And taken to where?

Mr. SCHUBERT. Germany.

The CHAIRMAN. Germany. To where?

Mr. SCHUBERT. I don't remember the exact yard, sir.

The CHAIRMAN. Construction. I mean, construction is continuing on——

Mr. SCHUBERT. The construction is continuing on both hull 1, and they are going to commence construction on hull 2.

The CHAIRMAN. Did you want to say anything, Mr. Mead, about that?

Mr. MEAD. Well, I don't know, the notion here bothers me that this is a program that is supposed to be designed to enhance U.S. shipyards, enhance U.S. shipbuilding. And here, we have a situation where a loan guarantee was made to build two ships in the United States. They go belly up, and they're ending up getting built overseas. There just seems something wrong—or something incongruous with that picture.

The CHAIRMAN. Well, after they're finished, they may be the most expensive cruise ships, pound for pound, that ever has been worked on.

I thank you both, Mr. Mead and Mr. McCool. I want to yield to Senator Stevens and then Senator Breaux.

But, Captain Schubert, there are several changes, obviously, that Mr. Mead and Mr. McCool have recommended. Some of them may require legislative—and I'd like you to work with both Mr. Mead and Mr. McCool to see if we can't come up with whatever reforms are necessary, including if any legislative fixes are needed. I would appreciate that.

Mr. SCHUBERT. Well, can I just briefly comment, Mr. Chairman, that we have submitted legislation, cleared through OMB, that does just that. One is the ability to go out and get a third-party—to retain a third-party financial advisor. We believe that our legislation request accomplishes that.

And I might also mention we have also asked for a provision in the title that the Secretary may make a determination that an application under this title requires additional equity because of the increased risk factors associated with the markets—technology, financial structures, and other risk factors identified by the Secretary. So we are also trying to address that, too.

The CHAIRMAN. Thank you.

Senator Stevens?

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Senator STEVENS. Well, thank you very much, Mr. Chairman.

I'm very much interested in this program, because living where I do, in an offshore state, we are subject to the Jones Act, and it seems that almost a hundred percent of our vessels have to have a Title XI guarantee in order to be economic with the foreign ships that come bring products directly from other countries.

Mr. McCool, let me start with you, if I may. I'm told that, of the past 10 years, nine of the 108 Title XI loan guarantees have defaulted. Would you agree with that? Nine——

Mr. MCCOOL. That's correct, sir.

Senator STEVENS.—out of 108. And I'm told that the loan guarantees, per se, brought in $261 million of fees and interest charged to the loan recipients, but that defaults cost $490 million, meaning there's been a loss to the taxpayer of about $230 million. Is that correct?

Mr. MCCOOL. I'm not sure those are the exact numbers, but that's—the orders of magnitude seem right.

Senator STEVENS. Well, I'm further informed that because of this recent bankruptcy added to it, the AMCV, that the total now is $330 million in losses, that MARAD borrowed $136 million from the Treasury, and it has, from its own funds, repaid $124 million. So the balance that is due is $12 million, and, when that's paid, the taxpayers haven't lost anything. Do you want to check that out?

Mr. MCCOOL. Well, we could check that out. The question is——

Senator STEVENS. If would, if I were you, because——

Mr. MCCOOL. The question is——

Senator STEVENS.—your report indicates that there's been a severe loss. And I'm told, because the financing, really, that when it's all added up, it's not a bad program. We've been through a period of time here now that has been—the whole economy's been in a severe slide. As a matter of fact, I'm told that five of the defaults took place since 9/11 of 2001.

Mr. MCCOOL. That's correct.

Senator STEVENS. So over half—half of the losses that have taken place have been taking place at a time of severe economic disruption in the overall economy. I would urge you to take a look at that.

I'd like to go into another part, and that is that the assumption that the basis for a prediction of losses, default amount, timing of defaults, recovery amount, timing of resources—of recoveries and fees, that is used by MARAD to estimate losses, you refer to that as being simplistic. But if you look at the period prior to 9/11 of 2001, it was very accurate. It was overly accurate, as a matter of fact. Would you do that, please?

Mr. MCCOOL. We will look at that, sir, but I think it's also true that there were some indications even before 9/11 that some of these projects were in trouble, so I'm not sure that you can attribute all the losses to 9/11.

Senator STEVENS. Well, but only four of them happened before that time.

Mr. McCOOL. I understand. I understand. But, as I said, there are indications that some of the projects—and Project America, I think, was one of them—were potentially in deep trouble even before 9/11.

But I think our sense, sir, is simply that it may be that there is currently enough funding to take care of what losses have taken place, but in order for the program to not operate at a loss, it would mean that the performance in the future is going to have to be better than expected and in sufficient amounts to compensate for the losses that have taken place——

Senator STEVENS. Your report——

Mr. McCOOL.—in the last 6 years.

Senator STEVENS.—says eight of these nine defaults, totaling 487.7 million, occurred since MARAD implemented its risk-recovery system, in 1996. But five of them happened after 9/11.

Mr. McCOOL. That's right.

Senator STEVENS. So you're criticizing the system of estimating losses without taking into account the period that you're applying it to. It was a system that was based on a 10-year rolling average, as I take it, and probably there will be a recalculation based on these five new losses, but I don't want to see the baby thrown out with the bath, you know. And it does seem to me that the period we're in right now of severe economic stress ought not to be used to judge a period of validity of a loan-guarantee program.

Mr. McCOOL. Well, I think that the question is, you need to take it into account to some extent. You have to adjust for the fact that you think it's an anomaly, if you think it's an anomaly, but you also have to take into account the empirical facts in making these estimates. And that's all we're saying, that some adjustments based on empirical actuality have to be included in the estimates.

Senator STEVENS. Well, I'm sorry, Mr. Chairman, I'm going to move on, because I've got another—I know Senator Breaux has questions, too, and I have one more other comment to make.

You say, on page 26 of the report, "Consequently"—you've had, in conclusion, concept—it says, "Consequently, the Title XI program could be vulnerable to waste, fraud, abuse, and mismanagement." Did your examination find waste, fraud, abuse, or mismanagement?

Mr. McCOOL. Well, we certainly didn't find fraud. We did find—our problems with internal controls, I think, would qualify as areas where we think management could be improved. And——

Senator STEVENS. What about fraud?

Mr. McCOOL.—in terms of waste, again, without good internal controls, it's hard to know whether money is being used efficiently. And that's, I think, what we mean by that.

Senator STEVENS. That ought to be seized by some of our brethren there in the news media, to say there's been an allegation that waste, fraud, abuse, and mismanagement. You're not making that allegation, are you?

Mr. McCOOL. No, we're just saying that——

Senator STEVENS. There's a "could" in there, "It could be."

Mr. McCOOL. That's what—we say "could." We say "could."

Senator STEVENS. You're not reporting that there's been any at all so far, right?

Mr. McCool. That's correct.

Senator Stevens. You've made questions about the management——

Mr. McCool. That's correct.

Senator Stevens.—and say that those questions "might" add up to mismanagement——

Mr. McCool. Correct.

Senator Stevens.—right?

Mr. McCool. Correct, sir.

Senator Stevens. Mr. Mead, would you care to comment on the waste, fraud, abuse, and mismanagement concept that could be applied to this program?

Mr. Mead. I can't discuss, in this session, active investigations that we have underway. I would say that——

Senator Stevens. Do you have any involving waste, fraud, abuse, or——

Mr. Mead. Yes, we do.

Senator Stevens. You do. All right. When will you decide those?

Mr. Mead. That's something that would be done in concert with the Justice Department, and I can't predict exactly when.

Senator Stevens. All right.

Mr. Mead. But I would not—I think, in fairness, I don't want to characterize this program as "riddled with fraud, waste, or abuse," but my comment is simply that I cannot categorically say, because of some investigations we have pending, that the program is totally free of it.

Senator Stevens. Would it be improper to ask if they applied to the subjects reviewed by Mr. McCool in terms of these last severe losses?

Mr. Mead. I think that I would not want to——

Senator Stevens. All right. I thank——

Mr. Mead.—respond to that.

Senator Stevens. Well, I do thank you, Mr. Chairman, for holding the hearing. I, again, want to say, without this program, I don't think Alaskan trade could survive, so I have a deep interest in its preservation.

Thank you very much.

The Chairman. Thank you, Senator Stevens.

I'd point out that the money that MARAD used to pay off the defaults were appropriated funds, so they are taxpayers' dollars. I don't know how you could—it's funny math when you say that we didn't cost taxpayers a whole lot of money.

Senator Breaux?

Senator Stevens. They had $124 million of earnings which were applied to that. That's not the taxpayers' money.

STATEMENT OF HON. JOHN B. BREAUX, U.S. SENATOR FROM LOUISIANA

Senator Breaux. Thank you, Mr. Chairman, and thank you the panel members——

The Chairman. Any earnings, therefore——

Senator Breaux.—for their——

The Chairman.—any earnings would, therefore, counterbalance any cost to the American taxpayer.

Please go ahead, Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman, for having the hearing, and thank our witnesses, as well.

It's certainly not a newsworthy item that someone has found out that there's a Federal program in Washington that could be subject to waste, fraud, and abuse.

[Laughter.]

Senator BREAUX. What an interesting and novel concept.

[Laughter.]

Senator BREAUX. As one who deals with the $270-billion-a-year Medicare program, as just one among many, waste, fraud, and abuse in many areas of our Federal Government is just incredibly—the amount that we have in so many of our programs is just incredible in comparison to this one.

Trains, planes, and ships. When you look at what we spend in this country in Amtrak to keep the trains running on tax dollars and subsidies, when you look at how much this Congress has appropriated and authorized to keep bankrupt airlines out of getting into further difficult times, and you compare all of those other areas with what we do in this one area of shipbuilding to ensure a U.S. fleet, instead of looking at a black eye on this program, it should be getting a gold star when you compare it with everything else that we do.

That is clearly not to say we can't do what we do better than we do, and I think that Captain Schubert has clearly indicated the department's willingness to try and look at ways to improve the program. But if we are going to look in the MARAD program for huge amounts of waste, fraud, and abuse compared to everything else, I would suggest that we're going to be spending a lot of time, with little results.

But the fact of the matter is that the program, over the years, has been one of the more successful partnerships between the government—not in direct subsidies, but merely in allowing companies to go to the private sector to use private capital which the Federal Government guarantees. It's a perfect partnership with regard to government and private sector doing something that is important to this country. That is different from what we do with Amtrak. That is different from what we do with aviation.

It is important to note that during the period between 1993 and 2001, we've had three defaults and literally hundreds of loan guarantees. When the two twin towers came down, the cruise industry in this country collapsed, as well, and it sunk. And it's not surprising to find three or four ships that were destined for a cruise industry that, before 9/11, probably looked fairly decent, as far as the potential outcome. But after 9/11, whether you were in the cruise business or the hotel business or the airline business or the transportation business or the entertainment business, for a period of time, much of that literally collapsed. And I think the MARAD program is, obviously, adversely affected by it, just like all of these other areas.

But prior to the bankruptcy and the default of the American Classic Voyage venture, the loan guarantee program in MARAD, I think, was in strong financial condition and actually collected, as

I remember it, more in fees and interest than was lost to the default during that period. Is that correct, Captain?

Mr. SCHUBERT. That's correct, sir.

Senator BREAUX. There's not a lot of programs that we could say that the way we've run them we've actually made money while trying to help people by loaning them money. This happens to be an example. The increased default rate, I think, that we have in the ships since 9/11, is certainly, I think, not inconsistent with default rates that we have seen in other areas and bankruptcies that we've seen in other areas.

I thank Mr. Mead and Mr. McCool for their work. I would hope that Captain Schubert is cooperative in what you all are trying to do and, out of this, we can produce a better administration, a better product for the services that we are trying to provide. I do not think that we need to wholesale change it. It's a good formula. It works. It's a good combination, private sector working with government.

Are there problems? There's not a program that doesn't have problems. And I would hope that we'd be able to work something out that would be an improvement and would work with the Chairman to hopefully accomplish that.

The CHAIRMAN. Thank you, Senator Breaux.

Captain Schubert, the Justice Department filed suit against Newport News Shipbuilding alleging that the company knowingly mischarged the U.S. Navy on costs incurred for work under commercial contracts from 1994 to 1999. Do you have any evidence about that?

Mr. SCHUBERT. The Newport News—the investigation on Newport News, sir?

The CHAIRMAN. Yes.

Mr. SCHUBERT. No, I don't.

The CHAIRMAN. Have you heard that the Department of Justice filed suit against Newport News Shipbuilding?

Mr. SCHUBERT. To be honest, I have not heard that.

The CHAIRMAN. Captain Schubert——

Mr. SCHUBERT. Can I add one——

The CHAIRMAN. There is a loan guarantee before MARAD that seeks a $750 million loan guarantee for a project known as Fast Ship, which I understand would consist of four high-speed container vessels crossing the North Atlantic. It's my understanding the application has been pending since September 1999. Does this project qualify for a loan guarantee under Title XI?

Mr. SCHUBERT. Mr. Chairman, this is a pending application. We are currently reviewing all the submittals. We've advised the applicant the areas that would need to be corrected for us to move forward. But since it is a pending application, I cannot go into, in a public forum—because much of the information is proprietary and confidential. But as the chairman of the committee with oversight, if you requested, in writing, some of these materials, we——

The CHAIRMAN. It's somehow confidential to ask whether it qualifies for a loan guarantee under Title XI?

Mr. SCHUBERT. Well, since we have not made—Mr. Chairman, since we have not made a final determination, it is still a pending application.

The CHAIRMAN. But my question is, does it qualify to be considered under Title XI?

Mr. SCHUBERT. Mr. Chairman, it qualifies to be considered under Title XI.

The CHAIRMAN. Do you think so, Mr. Mead and Mr. McCool?

Mr. MEAD. I think that this—I'm familiar with the Fast Ship thing, and I don't want to breach any rules of confidentiality, certainly, in a session like this, but I do think this application is an excellent candidate for that second recommendation that we're offering, that they not approve these loan guarantees in the absence of independent third-party external review.

Second, you need to make sure on this one that it's not just an R&D undertaking. The Department of Defense, I think, has some interest in this. I'd like to know a little bit more about why they have that interest.

And, finally, I think if Mr. Schubert had a chance to respond to the record for you, that he would point out some things that still need to be completed in the application.

The CHAIRMAN. Well, what I don't get is—my understanding is, it's been—the application has been pending since September 1999. We're approaching 4 years here.

Mr. MEAD. Yes, well, it's not complete.

The CHAIRMAN. Is that correct——

Mr. SCHUBERT. Mr. Chairman, that's correct.

The CHAIRMAN.—Captain Schubert?

Mr. SCHUBERT. Mr. Chairman, that is——

The CHAIRMAN. Is it normal for us to have an application in September 1999, and in June 2003 the application is not complete? Is that a normal, sort of, set of circumstances?

Mr. SCHUBERT. I would not say that this would be a normal circumstance, but I—since you've raised the issue of old applications, I would like to say, for the record, that we are undertaking——

The CHAIRMAN. Well, I'm really talking about this particular issue, since it entails $750.5 million. I appreciate your policy toward it, but there's something wrong with this picture. Is there something that I should know about—that Congress should know about this?

Mr. SCHUBERT. Mr. Chairman, as the Chairman of the Committee that has the oversight over this program, we would be willing, if you request it in writing, to give you what items are outstanding for this application.

The CHAIRMAN. Well, you know, I'm not often at a loss for words, but I don't think I've quite encountered anything quite like this, that you make an application, and 3–1/2 years later, more than 3–1/2 years later, the application is not complete. Obviously, I think we need to know more about this.

Mr. SCHUBERT. We have been——

The CHAIRMAN. Mr. McCool or Mr. Mead, can you shed any light on this pending application which is not complete?

Mr. MEAD. I don't understand why it's been pending for so long, and I think—it's not uncommon, though, for applications at MARAD to be alive for an extended period of time. They probably need to scrub the portfolio of applications they have. And I've heard some estimates that they probably could cut that portfolio in half.

The CHAIRMAN. Maybe, Captain Schubert, I've cut you short, then. Please go ahead.

Mr. SCHUBERT. I was going to testify, for the record, that we are in the process of cleansing—or, let's say, cleaning out old inventory of applications, and there is a substantial number of applications that we can, by our regulations, terminate. And we're in the process of doing that as one of the many areas that we're trying to improve the program.

But I also was going to say, back to the Fast Ship application, that when I came in, in December 2001, that I pretty much asked the same question you asked, is, why is it so many years later, and how come we haven't moved on this? So I did begin a top-to-bottom review, you might say, of the application to really identify what it is that would need to be corrected for it to be considered a sound application.

The CHAIRMAN. Well, here's what I'd like you to do, all three of you, if you don't mind. I'd like to know your recommendations, both in GAO and from the IG, and yours, Captain, that need to be changed in the rules and regulations and the way you do business, the statutory changes—you have referred to one, at least—that are recommended, and those, Captain Schubert, that Mr. McCool and Mr. Mead make that you would not actively support or you think are unnecessary or unwanted. And that way maybe we could sort out, one, what rules and regulations need to be changed, but, far more importantly, from the standpoint of our responsibilities, what legal and statutory changes need to be made. Is that agreeable to you, Captain?

Mr. SCHUBERT. Mr. Chairman, that's agreeable. I would like to add that we are implementing all five recommendations of the IG, and we're creating an audit trail so that it can be periodically verified that we are complying, and we're actively working with the staff to accomplish that very soon. And I believe that we have—the administration has proposed a couple of areas in legislation that would help implement the IG's recommendations.

The CHAIRMAN. Just briefly, I'm told by staff that your request, right now, only addresses two of the five recommendations. Mr. Mead, are you—is that correct?

Mr. SCHUBERT . That's correct, Mr. Chairman. But the other areas that we're addressing in the recommendations are more of a process change, and we've been working very closely. I agree that we need more than just my word that we're going to implement it. We're actually creating forms and a way, a very systematic process change to the Title XI application and the review after we grant applications and approve applications, plus the areas that—what we'd need to do to improve monitoring in case of defaults. So all those things are—I believe most of them are process-type changes that we are actively implementing right now.

The CHAIRMAN. That don't require statutory——

Mr. SCHUBERT. That don't require legislation.

The CHAIRMAN. Is that your view, Mr. Mead?

Mr. MEAD. I think we've had some downs—we had some real downs in the 1980s in this program. I think that there are some similarities that existed in the 1980s that could have been corrected administratively that were—for a few years we backslided.

And now Mr. Schubert is advancing the case that he could administratively implement them. I agree, you can. But sometimes you need the reinforcement of legislation, even on things that are process in nature.

The CHAIRMAN. Mr. McCool, do you have any additional comments?

Mr. MCCOOL. No, I would actually agree with Mr. Mead, that a lot of these can be done through the regulations in the program, but there are probably some areas where legislation would be helpful to keep things consistent across administrators.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. I'll take it that on the application. I'm not familiar with—what the Chairman referred to, but it's taken 4 years. The type of vessels they're looking at are not yet a proven technology, and one of the obligations that MARAD would have to determine is that this new type of technology, which is not yet common technology, or accepted, in most terms, has to be proven to be economically viable in order for you to approve a loan. And it would seem to me, that is one of the difficult tasks that you have, and it seems to be one of the reasons why it's taken so long. You have to have some adequate proof that what this new technology can do is also commercially feasible. Is that part of the problem with the process?

Mr. SCHUBERT. Senator, that is correct. We have both a technical review of the application and the economic soundness test. But, obviously, one would relate to the other, in some cases. If you're selling a premium service on new technology, it's got to work.

Mr. MEAD. I think you've put your finger on it. The key here is, there's been application made of the Maritime Administration to approve this loan—this application for these things called Fast Ships. If this is really a Department of Defense initiative, query whether the Department of Defense ought to pony up the money for it.

Senator BREAUX. Yes, I take it that you cannot approve loans for research-type of projects. You can only approve loan guarantees for commercially feasible projects, not for research activities. Is that correct?

Mr. SCHUBERT. Senator, that's correct. This program, in particular, should never become a lender of last resort, which, in cases of research and technology, if you don't have a commercially viable vessel, it does, in my opinion, put the taxpayer at a high risk. But the program is not structured to be that.

Senator BREAUX. OK, thank you, Mr. Chairman.

The CHAIRMAN. Captain Schubert, I take you at your word that you're trying to clean up these requests. I see you have one dating back to 1995. So——

Senator BREAUX. It's probably from one of my constituents.

The CHAIRMAN. It is. Actually, it is. From Harvey, Louisiana.

[Laughter.]

Senator BREAUX. What's taking so long on that one?

The CHAIRMAN. Maybe fear.

[Laughter.]

The CHAIRMAN. So, you know, you ought to get——

Mr. SCHUBERT. But we have—under statutory authority now, we can terminate, at our discretion, any application that hasn't met the requirements. And then I would like to point out that the applicant, within a year, can reapply without paying any fees.

The CHAIRMAN. I see.

I want to thank the witnesses. This has been a very helpful hearing, and I have——

Did you want to say something else, Mr. Mead?

Mr. MEAD. Yes, I've wanted to—I understood the line of questioning—some of the line of questioning was that the problems here surfaced post-9/11, and I wanted to clarify, for the record, that the systemic issues we're speaking of here were in existence before then, and the documentation I'd point to on that is AMCV. Before—in the early part of December, their stock had gone from about $35 to about 50 cents a share. And there also were eight of these defaults before 9/11. Quincy Shipyard did not happen after 9/11.

So I'm sure, as with other industries, Mr. Chairman, that 9/11 compounded an already difficult situation. It's the same thing in the airlines. The airlines came in here, and they said, well, we had all these problems after 9/11. But if you look back at the data, it goes back—their problems go back far before then.

So, I'm sorry, I just wanted to clarify that for the record.

The CHAIRMAN. No, you know, I think everybody is aware that the AMCV thing was one of the most incredible boondoggles in history, in recent history. $330 million of the taxpayers' money was incredibly wasted, a deal to cruise Hawaii, which would have then cost people who did cruise Hawaii a higher cost because of granting a monopoly. I mean, it was an outrageous rip-off of the taxpayers. And to blame it on 9/11, of course, flies in the face of the facts.

I thank the witnesses.

This hearing is adjourned.

[Whereupon, at 3:40 p.m., the hearing was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF THE AMERICAN SHIPBUILDING ASSOCIATION

The American Shipbuilding Association (ASA), which is the national trade association for the six largest shipbuilders and 27 companies engaged in the manufacture of ship systems and equipment in the United States, is pleased to present this statement for the record in strong support of the Maritime Administration's (MARAD) Title XI Ship Loan Guarantee Program.

In 1993, Congress amended and revived the Title XI Ship Loan Guarantee Program to bring it into compliance with the 1990 Credit Reform Act. The reformed program was designed to ensure that strong economic soundness criteria be met in order for ship owners to qualify for Title XI guarantees while carefully balancing the fact that some degree of risk always exists with the financing of major capital investments. Congress also amended the program to allow for guarantees of commercial loans for shipyard facility investments applying the same economic soundness criteria. As the Inspector General's report acknowledged, the program was performing very successfully until the 2001 default by American Classic Voyages (AMCV). Until this tragic event, the program was experiencing a default rate of three (3) percent—one of the lowest of all Federal loan guarantee programs.

Since 1993, the MARAD has guaranteed or formally agreed to guarantee more than $4.3 billion in commercial loans for the construction of approximately 820 vessels and the modernization of four shipyards. The 820 vessel construction programs financed have included six 45,000 DWT double hull clean product tankers built at Newport News Shipbuilding in Virginia; four 45,000 DWT double hull clean product tankers built at Avondale in Louisiana; one Roll-on/Roll-off ship built at National Steel and Shipbuilding Company (NASSCO) in California, with an application for the second ship of the class pending; four offshore oil supply vessels and two 2,000 passenger oceangoing cruise ships at Ingalls in Mississippi (which will be addressed later in this statement). Two ASA shipyards, Avondale and NASSCO, which at the time were employee-owned companies, received Title XI guarantees for facility investments in steel fabrication and pre-outfitting facilities, respectively.

Title XI loan guarantees are essential to providing small and medium-sized ship owners with affordable financing to replace and expand their fleet of ships engaged in commerce. The financing rates facilitated by Title XI are comparable to the rates that large corporations have access to from commercial banks in the replacement of their vessels. The projects listed above, with the exception of the cruise ships, were for the construction of cargo ships moving refined oil and other cargo between ports in the United States, and all of the above referenced vessel guarantees went to small and medium-sized ship operating companies. The higher interest rates and conditions charged medium and smaller companies by commercial banks would have made the construction of these cargo ships unaffordable to these companies without the Title XI loan guarantee. Title XI guarantees 87.5 percent of a commercial loan over 25 years. The 25-year length of the loan guarantee is extremely important to ship owners financing a large capital investment such as ships. By analogy, the majority of American home buyers would probably not qualify for a home loan if they could not finance that loan over 30-years, thus making their monthly mortgage payments affordable.

During Operation Iraqi Freedom, six of the clean product tankers referenced above were chartered by the Military Sealift Command to supply our forward deployed troops with jet fuel. These ships would not have been built, but for Title XI, and thus, would not have been available to our Nation in the war against Iraq. Terrorist attacks on New York and Washington, forward deployed troops in Saudi Arabia, and the USS Cole have underscored the need for American-built, owned, and manned ships to re-supply our forward deployed troops to mitigate, if not eliminate, the threat of terrorist attack. The Military Sealift Command chartered 25 clean product tankers for the Iraqi operation, but there were only six American-built, owned and crewed ships available for the mission. More clean product tankers need to built in the U.S. to address this security risk, and Title XI will be instrumental in this security objective.

The other commercial ship types that the military desperately needs in times of war are Roll-on/Roll-off ships (RO/RO's), which can efficiently deliver Army jeeps, trucks, helicopters and other heavy equipment. The two RO/RO's NASSCO is building for Totem Ocean Trailer Express (TOTE) of Washington State, the construction of one, which has been guaranteed by Title XI, and the guarantee of the sister ship is awaiting application approval, will be critical to our military in the on-going war against terrorism. One of TOTE's older RO/RO ships, which was built with a Title XI guarantee, was also chartered by the Military Sealift Command in Operation Iraqi Freedom.

Apart from the military usefulness of the ships constructed under Title XI Loan Guarantees, it is important to emphasize that we must have sufficient domestic shipping capacity to meet the commercial demands of all Americans in order to enable militarily useful ships to be diverted to the war zone from their domestic routes. These tankers and RO/RO's would not have been available to the Department of Defense if we did not have sufficient grain barges, oil barges, and other domestic oceangoing ships, financed by Title XI, to ensure that our domestic energy and commercial transportation needs were met to serve the U.S. economy.

The U.S. Navy and Department of Defense further benefit from Title XI in the reduced cost of naval ships as a result of lower shipyard overhead costs charged to DOD; increased production throughput in our supplier base reducing the unit prices of hull, machinery and electrical equipment ordered for naval ships; and sustaining our highly skilled engineering and production work force, and thereby avoiding the high cost of firing to later hire and train a workforce at great expense and time to meet naval ship construction and repair requirements. It takes years to train the many specialized trades required to build the world's safest and most technologically advanced ships. The cost to train our workforce as a result of low and unstable rates of naval ship construction is reflected in our unit prices and the unit prices of our suppliers. Commercial shipbuilding, facilitated by Title XI, significantly reduces these costs, and more importantly helps to sustain the industrial and skill base essential to building warships that waged the war in Afghanistan, Iraq, and defended our homeland from additional terrorist attacks following September 11, 2001.

The American Shipbuilding Association has, and will continue, to oppose any and all efforts to waive the economic soundness criteria used by the Maritime Administration in determining qualified applicants for Title XI Loan Guarantees. The MARAD has done an excellent job in thoroughly reviewing and analyzing the economic soundness of each project brought before it. With the exception of one shipyard modernization guarantee, which MARAD was by law required to change the economic soundness criteria and approve the guarantee over its objection, MARAD has exercised good and sound judgment in its review and approval process.

The solid administration of this program by the MARAD has been demonstrated by the low default rate prior to the end of 2001. In spite of this record, the MARAD has acknowledged that there is always room for improvement, and has moved to implement the recommendations of the Inspector General's (IG) report. This IG report was requested in the aftermath of the defaults in the program as a result of the bankruptcy of American Classic Voyages (AMCV). While the MARAD, maritime industry, and Title XI have been under attack as a result of these defaults, it is important to look at the guarantee applications from the cruise market perspective at the time they were approved.

In 1997, AMCV solicited bids and proposals from all capable American shipbuilders for the design and construction of two 2,000 passenger cruise ships. AMCV was an established American cruise company operating two American-built and crewed ships in the Hawaii trade and modern paddle wheel cruise vessels up and down the Mississippi. The ships in the Hawaii trade were old, out-dated, and in need of replacement. The cruise industry serving the American market, including Hawaii, had been experiencing a 20-year growth, and every projection was that this industry would continue to grow as more and more Americans sought cruise ships as their ultimate tourist destination. American shipbuilders viewed this as a promising commercial market in which to re-establish themselves after an absence of 40 years. They developed cruise ship designs and realized the ideal mix of skilled trades associated with the construction and integration of naval ships with that of cruise ships. Because of the promising growth in the cruise market coupled with the benefits of sustaining our companies and skilled workforce during the lowest rates of naval ship production since 1932, three ASA shipbuilders bid on the AMCV Project America Cruise Ship Project—Avondale, Ingalls, and NASSCO. In 1998, Ingalls was selected by AMCV to build two cruise ships with options for four additional ships.

In March 1999, the MARAD approved the loan guarantee for Project America. Based on the past performance of the cruise market operating out of the United States, projections for continued growth in the market, and the growing market demand for AMCV cruises in Hawaii and its rising bookings, it is understandable why American shipbuilders and the MARAD found AMCV and its replacement and expansion plan to be economically sound. No one—AMCV, shipbuilders, or the MARAD—could have anticipated the economic downturn that began in late 1999 that took its toll on the Hawaii cruise market. The attacks of September 11, 2001, shut down air travel and cruises in Hawaii. AMCV, as other cruise lines undergoing large capital investments and associated dept service, could not survive, and filed for bankruptcy at the end of October of 2001.

When AMCV filed for bankruptcy, Ingalls was forced to stop work on the construction of the first of two cruise ships—which was approximately 50 percent complete. It was forced to lay-off and re-assign to other programs 1,250 people on the cruise ship project. Ingalls and MARAD both looked for alternative customers to assume ownership of the program so that the ships could be completed on schedule to protect the taxpayer from a default and to minimize disruption to the workforce and workload planning at the shipyard. There were no willing or able customers to assume the project in the months following the 9/11 disaster without the shipyard agreeing to support changes in U.S. law to allow the ships to be operated in Hawaii with foreign crews.

This program was a tragedy for the taxpayer, the Title XI program, the MARAD, AMCV, and the shipbuilding industry. The default on Project America was $185 million to the taxpayer, a black eye for Title XI, a loss of $60 million to Ingalls for bills not paid by AMCV, and the displacement of hundreds of skilled taxpaying shipbuilders. The demise of AMCV also devastated the shipbuilding industry's momentum to recapture the cruise ship construction market serving American ports for the benefit of all taxpaying Americans—builders, owners, Crews, and tourists. As a result, the U.S. Treasury and the American worker will not see a return on investment in the foreign cruise industry operating from our shores, which pays no taxes to the U.S., but is supported by American tourists and American tax dollars in port infrastructure, channel dredging, and Coast Guard inspections and search and rescue.

Hind sight is 20/20. MARAD, AMCV, and shipbuilders did not have a crystal ball to predict an economic downturn prior to the Title XI application approval of Project America in March 1999. And none of us predicted the terrorist attacks of 9/11, which brought AMCV to its knees as the cruise market in Hawaii collapsed. Following 9/11, Congress acted to establish a loan guarantee program to mitigate the financial collapse of the airline industry as a result of the economy and terrorist attacks. It would be devastating for the maritime industry if the Title XI program were to fall victim because of a default linked to the same economic factors and terrorist attack, which mobilized the country to come to the aid of the airline industry.

In closing, ASA supports the recommendations made by the IG report on procedures MARAD could undertake to safeguard even further taxpayer dollars on Title XI Loan Guarantees—recommendations that MARAD is already implementing. ASA urges the Committee's continued support of Title XI to foster commercial ship construction, job creation, and the sustainment of America's defense shipbuilding industrial base. Thank you.

Sincerely,

CYNTHIA L. BROWN,
President.

NY WATERWAY
Weehawken, New Jersey, May 13, 2003

Hon. JOHN MCCAIN,
Chairman,
Committee on Commerce, Science, and Transportation,
Washington, DC.

Hon. ERNEST F. HOLLINGS,
Ranking Member,
Committee on Commerce, Science, and Transportation,
Washington DC.

RE: TITLE XI REFORM HEARING

Dear Chairman McCain and Ranking Member Hollings:

I am writing to request that my letter be included in the official record for your May 15, 2003 hearing on Title XI Reform.

Background

My name is Arthur Imperatore, Jr. and I am President of New York Waterway, the largest private ferry company in the country. My father Arthur Sr. started our family owned business in 1986 at a time when it was widely referred to as "Arthur's Folly". Today we have the largest ferry and excursion fleet in New York Harbor. Our company was recognized by Federal, state and local officials for its life-saving role in evacuating mid-town New York after the tragedy of September 11th. New York Waterway operates commuter ferries between New York and New Jersey as well as harbor sightseeing cruises. Last year alone we carried more than 15 million commuters on our fleet of vessels.

The success and growth of our company is due in large part to Marad's Title XI loan guarantee program. The Title XI program is the only Federal financing program available to private operators like New York Waterway to assist in the construction of ships. Over the past 6 years our company has financed over $28,000,000 in the construction of eighteen new vessels through the Title XI program and we have a pending application for the financing of another five vessels. The favorable lending terms of the Title XI program have allowed us to accelerate our construction program to meet the needs of our customers. Since September 1lth. commuters as well as various government agencies have requested more frequent trips and additional destinations as they rely on our company to meet their transportation needs. In response to these needs, New York Waterway has built a significant marine transportation network providing essential transportation services to commuters and tourists. Our privately owned and operated ferries are the most significant form of non- subsidized public transit in the New York area.

Because the individual cost of our ships is relatively small (about $1.5 million) and we have used the same shipyard, our Title XI projects have been straightforward and without controversy. Our eighteen newest ships have all been built in Sitka, Alaska and delivered on time and within budget. Nevertheless on every application Marad has required our company to undergo and comply with the same level of scrutiny used for much larger projects. In our experience the cost of the project financed is almost immaterial to the process and review employed by Marad.

Those of us familiar with the Title XI program are aware of a few "problem" projects. Frankly, it's not clear whether these problem projects are a result of inadequate financial resources of the applicant, incapable or inexperienced shipyards, poor project management or political interference. Whatever the reasons, I believe these projects represent a few exceptions to the norm and I would urge the Committee not to judge the effectiveness of the program on a few failed projects. In all the years dealing with Marad, New York Waterway has never defaulted on a loan guarantee and we've never missed a payment. We could not have expanded to meet the needs of our passengers without Title XI financing. I believe there are many other companies with a similar success record and these cases, not the few problem projects, are the testament to the success and importance of the program.

Finally, some critics have called the Title XI program "corporate welfare" designed to provide subsidies to the maritime industry. From New York Waterway's perspective, nothing could be further from the truth. The program has provided essential financing for our company. In addition to the application fee, we pay a significant guarantee fee for the privilege of receiving the federally guaranteed loan. After the loan is paid off, I believe you will find that the government has actually made money from issuing the guarantee. As you may know, the National Marine Fisheries Service of the Department of Commerce administers the Title XI program for fishing vessels and fish processing facilities (under the same legal authority) and in the

President's FY 04 proposed budget, the Office of Management and Budget scored that program as a negative cost to the government—meaning that the program has made money for the government. We believe that with a few minor reforms the Marad Title XI could achieve similar returns to the government.

Recommendations

While the Title XI program has provided critical financing for New York Waterway, there are a few areas where we believe legislative and administrative reform could make the program even stronger.

Acquisitions—Because the Title XI program was designed to promote construction in U.S. shipyards, only new vessels may be financed through the program. However, there are a number of recently built ferries that New York Waterway has wanted to buy. These purchases would have been less costly than new builds and satisfied our needs. We would also like to use the program to help finance maintenance related facilities and piers. We request that the Committee consider amending the program to allow for the financing of recently built U.S. vessels (less than 5 years old) as well as related marine facilities.

Economic Soundness—Each project must meet Marad's economic soundness test. While we support the goal of only financing projects that are economically sound, the manner in which this test is currently applied may not be the best. For example, when New York Waterway submits an application for a new ferry we must show that that specific ferry will be economically sound. We are asked to submit projected ridership numbers and a market analysis. For new routes or when adding additional capacity to existing routes, this can be very difficult. For existing business we believe a better approach would be to look at the economic soundness of the company as a whole. In other words, is the applicant company—as opposed to a specific vessel—financially sound and capable of repaying a loan? Applying the economic soundness test in a broader context would in our view improve the program and possibly reduce the number of problem projects.

Military Usefulness—The most recent congressional appropriation of funds for Title XI carried with it a directive to MARA to "ensure that priority is given to vessels that not only provide commercial viability but also exhibit military utility," such as tank vessels or roll-on/roll-off vessels. We are deeply concerned that this may eliminate ferries as eligible types of vessels as they are not generally militarily useful. We are also concerned that Title XI funding may be exhausted on other projects before ferries can be considered. New York Waterway has worked exceedingly hard to build a regional transportation network throughout the New York-New Jersey area. The benefits of marine transportation are well known and the success of our company and others like it means less congestion, less pollution and a savings in energy. Our vessels are also available in times of national disaster or emergency. We request that your Committee consider repealing this restriction or alternatively adding as priority projects those which expand and improve America's marine transportation network.

Program Funding—As you can appreciate, the lead time needed to design, order, construct and deliver a new vessel is significant and at New York Waterway we attempt to plan for vessel purchases 2 years in advance. Unlike highway funds, Title XI Program funding is subject to annual appropriation which means that predicting whether funding will be available is a challenge. We ask that your Committee explore alternative funding mechanisms that would improve the predictability of the Title XI Program in terms of the availability of funds.

I want to thank you in advance for your consideration of our views. New York Waterway is very appreciative of the support Congress has provided for the Title XI program and we hope our comments have been useful.

Sincerely,

ARTHUR IMPERATORE, JR.
President.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JOHN MCCAIN TO HON. KEN MEAD

Question 1. Current practice allows applications for Title XI loan guarantees to linger for years without any formal action by MARAD. How long should an application be allowed to remain pending?

Answer. MARAD does not have rules or policies governing the length of time an application for a Title XI Loan Guarantee can remain pending without MARAD taking formal action to reject or approve the guarantee. Although MARAD recently earmarked several pending applications for removal that did not appear to be making material progress toward meeting the requirements necessary for approval, there are still seven applications that have remained in "pending" status for more than 1 year.

Project applications may remain in an extended pending status for a variety of reasons and it is not necessarily inappropriate for a project to take more than one year to approve. Although MARAD would ideally prefer that every application be submitted fully complete, in reality, the applications and requisite supporting materials are extensive, and MARAD often requires additional information, documentation, explanation, and analyses.

In some cases, however, applications are permitted to remain on the "pending" list, despite the applicant's lack of progress toward demonstrating the viability of the project. In these cases, MARAD has neither acted to approve, nor formally reject, the applications. In some cases, applications are permitted to remain pending because the project may have strong political support or community backing.

We would recommend that MARAD either remove all applications that remain in a "pending" status for more than one year or provide a written justification with the concurrence of the Office of the Secretary which includes the extraordinary circumstances that necessitate maintaining the specific application as active. The Committee's proposed MARAD reauthorization legislation, S. 1262, the Maritime Administration Authorization Act of 2003 ("S. 1262"), would require MARAD to act on an application within 270 days with an allowance of one 270 day extension upon the applicant's request. This would sufficiently address our concerns.

It is relevant to note that the Title XI program currently has 7 executed letter commitments for guarantees that MARAD has said will never close. We would recommend that similar requirements be established for letter commitments.

Question 2. I have recently been made aware of alleged improprieties by MARAD in the disposal of defaulted assets. I know that both the DOT IG and the GAO, as part of their separate investigations, looked at what actions MARAD takes following a default to secure and maintain the associated assets, but I would like to know if you looked at MARAD's actions regarding the disposition of assets? If so, did you find any improprieties?

Answer. Although we did not encounter any improprieties by MARAD in its efforts to dispose of assets acquired from foreclosure, we did find cases where MARAD did not adequately manage foreclosed assets. We have had several investigations in the past involving MARAD personnel, but not in regards to the disposition of assets. Last year, a MARAD employee was convicted of bribery and sentenced to serve 2 years in jail for bid rigging. In addition, we are currently investigating an entity for submitting false statements to MARAD concerning a Title XI loan guarantee.

Question 3. Do you believe that by waiving or modifying statutory and regulatory requirements of the Title XI program that MARAD is taking on greater risks in the loans they are guaranteeing? If so, what changes need to be made to minimize the effect of waivers on risk?

Answer. Waiving or modifying statutory and regulatory requirements of the Title XI program can result in greater risk to the taxpayers. However, that risk can be mitigated if appropriate steps are taken to gain adequate compensatory loan provisions for any waiver or modification of the financial requirements.

We found that MARAD has been routinely modifying financial requirements in order to qualify applicants for loan guarantees without requiring stricter loan provisions and covenants on borrowers to mitigate those risks. In fact, all nine loans that have defaulted since 1998 were approved with modifications to some of the financial criteria.

In many cases, MARAD accepts parent company guarantees of loan repayment for a subsidiary that would not have been able to qualify for a loan guarantee, based on its own financial history. In 50 percent of the projects we examined during our audit (21 of 42), a parent company guarantee was the sole form of security aside from the ship or shipyard itself. When these guarantees are general pledges by the company and do not specifically pledge unencumbered assets as collateral, these guarantees provide no real security if the parent company, itself, is not creditworthy or has few unencumbered assets. MARAD can prevent this problem by monitoring the financial condition of the parent company as well and when warranted, requiring pledges to be backed by liens on other unencumbered assets or requiring greater amounts of project equity from the applicants. This is what we recommended in our March 27, 2003 report. MARAD agreed with our recommendation, and the Office of the Secretary has directed MARAD to comply with it. Additionally, S. 1262 directs the Secretary to promulgate regulations concerning circumstances under which waivers of financial conditions can be made so long as the economic soundness of the project remains in tact and compensating measures are imposed on the applicant.

Question 4. Can MARAD effectively implement all of your recommendations for reform of the Title XI program without additional statutory requirements? If not, what specific action does Congress need to take to reform the program?

Answer. With one exception, MARAD can effectively implement all of our recommendations for reform of the Title XI Loan Guarantee program without additional statutory requirements. We have recommended that MARAD establish an external review process as a check on its internal loan application review and as assistance in crafting prudent loan conditions and covenants. Such external reviews should be financed by the applicant, not taxpayers. Therefore, we concur with MARAD's request to modify the statute to give MARAD legislative authority to charge an applicant for the cost of obtaining independent financial and economic reviews as part of the application review process. This would allow MARAD to clearly place the burden of this cost on the applicant.

Although a case could be made that MARAD already has this authority, we think that it is advisable to make this authority explicit and crystal clear. With regard to the rest of our recommendations (*i.e.,* compensating provisions for financial waivers and/or modifications; financial monitoring; monitoring of the physical assets in and out of default), MARAD can manage the program to implement these changes under the current law, but our experience with the program suggests that they be institutionalized to survive from administration to administration and therefore may be appropriate to reinforce statutorily. S. 1262 effectively addresses two of our recommendations (compensating provisions for financial waivers and/or modifications and financial monitoring).

Question 5. MARAD currently has discretionary authority to require an outside review and opinion of certain aspects of a project's merits and the sponsor's financial condition. Do you believe this authority is adequate? If not, what additional authority is needed?

Answer. MARAD is in the process of developing and implementing a policy documenting the circumstances and procedures for conducting external reviews. The current authority to require an outside review is sufficient to enable MARAD to implement this policy; however, we agree with MARAD's request for a statutory change to enable MARAD to explicitly charge the cost of the reviews to the applicant. S. 1262 provides this explicit authority for MARAD to impose this cost on the applicants.

Question 6. Do you believe the use of external reviews of applicants should remain discretionary, or should all applications be subjected to such reviews?

Answer. As a rule, all applicants should be subjected to external reviews. However, MARAD should retain some limited discretion to waive this requirement. Waivers should be extremely rare and must clearly state the extraordinary reasons for the waiver. An example of a potential waiver situation would include a recent repeat applicant with an extremely strong balance sheet requesting a second loan guarantee for a similar vessel that would clearly not suggest any potential overcapacity. In any event, the Office of the Secretary has directed MARAD to obtain independent reviews on all applications until further notice.

Question 7. Do you agree with GAO's assertion that the processes for review and approving applications, monitoring project financial condition, and monitoring asset condition should be separated as it is in the private sector?

Answer. Yes, ideally the functions for approving applications, monitoring financial conditions, and disbursing funds should all be performed through separate reporting lines. MARAD has a dual mission—promoting the growth and financial health of the maritime industry and protecting the Government's interest—roles which may be in conflict at times. Vesting the responsibility for determining whether continued disbursements of funds on a troubled project are in the best interest of the Government with the same government officials who were responsible for approving the loan guarantee, places the official in a position where his or her objectivity or impartiality could be questioned.

Question 8. How do you explain the lack of oversight, poor record-keeping, unrealistic risk assessments, and generally poor management of the Title XI program?

Answer. The Title XI program management has placed too much emphasis on disbursing loans and needs to be brought back into balance with a careful consideration of the risks imposed on the taxpayer. This return to balance is reflected in S. 1262.

Title XI of the Merchant Marine Act (the "Act") was established in 1936 to assist private companies in obtaining financing for the construction of ships or the modernization of U.S. shipyards. Regulations implementing the Act outline the application process for Title XI loan guarantees and require MARAD to assess the economic feasibility and financial viability of an applicant's project.

Between 1993 and December 2002, MARAD's portfolio of executed loan guarantees more than doubled, growing from $1.3 billion to $3.4 billion, while the actual number of MARAD staff assigned to process the applications and monitor the loan guarantees decreased.

In addition, MARAD has not developed the kinds of systematic policies and procedures for processing applications, approving loan guarantees, monitoring existing loan guarantees, and proactively intervening when signs of financial distress first emerge. Without these systematic policies and procedures, MARAD has not always been an effective custodian of taxpayer dollars.

In line with our recommendations, MARAD is in the process of developing policies and procedures for improving program oversight, record-keeping, risk assessment, and management. As part of our Congressionally-mandated certification of MARAD's compliance with our recommendations, we will certify that these procedures are in place and being applied by MARAD staff to all new and existing loan guarantees.

Question 9. Given the recent history of the Title XI program, should the required percentage of equity to be provided by the loan applicant be raised above 12.5 percent of project costs and if so, what level do you consider appropriate?

Answer. MARAD regulations require that an applicant contribute a minimum of 12.5 percent of the project cost in equity. The interest and fees associated with the loan guarantee are included when calculating the project cost. The actual cost of the vessel can be considerably less than the total project cost. We believe that the 12.5 percent equity contribution is sufficient if the applicant is required to contribute 12.5 percent of the vessel cost as well as the interest and fees so that the guarantee is fully secured (the loan amount is for less than the cost of the vessel) at day one of the loan. Additionally, we agree with the provision included in S. 1262 that any application with increased risk factors should require additional equity.

Question 10. Transportation Infrastructure Finance and Innovation Act or TIFIA loans are limited to 33 percent of project costs. Would a similar limit be appropriate for Title XI? Is there another Federal loan program that could serve as a model for MARAD to follow?

Answer. The TIFIA program provides credit assistance to major transportation projects of critical national importance. The program provides loans, guarantees, or lines of credit to major infrastructure projects of at least $100 million. TIFIA-approved projects require substantial private co-investment. The project also must be supported in whole or part by user charges or other non-Federal dedicated funding sources and must be included in the State's transportation plan.

The objectives of the TIFIA program and Title XI are very different. TIFIA is a direct loan program while the Title XI program provides loan guarantees. TIFIA projects are financed with a combination of other loans and bonding instruments in addition to the direct Federal funding. TIFIA projects are generally large projects for which a large private and public constituency exists, while Title XI projects may be of limited public and economic appeal and therefore not able to generate capital from private markets at attractive rates. If the Government's loan guarantee were capped at 33 percent for ship-building or shipyard modernization, it is likely that either very few projects would be able to generate the additional private financing and equity to qualify or companies would not pursue these projects after considering the impact of the increased cost of capital, essentially undermining the goals of the Title XI program.

Other Federal loan guarantee programs such as that administered by the Export-Import Bank, have similar Federal caps and equity contribution ratios as Title XI.

Question 11. Does your office audit the Title XI program on a regular basis? Should Congress statutorily require periodic reviews?

Answer. The OIG does not have a statutory requirement to audit MARAD's Title XI Loan Guarantee program on a regular basis, although we have reviewed several segments of the program in the past. Most recently, the Fiscal Year 2003 Emergency Wartime Supplemental Act required the OIG to certify that the recommendations included in our March 2003 report had been implemented. We are in the process of completing this work.

Although we do not believe that Congress needs to statutorily require periodic reviews of the program, we intend to perform periodic reviews to gauge the success of the revisions now under way and to determine whether additional recommendations are required. We would have no objection to a statutory requirement for periodic reviews of the program although we are aware that S. 1262 does not include such a provision.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JOHN MCCAIN TO THOMAS MCCOOL

Question 1. What has the full and true cost of the Title XI program been to the taxpayer since it was revived in 1994?

Answer. The total actual cost of Title XI loans originated since 1994 will not be fully known until they have either paid off or defaulted. However, the Federal Credit Reform Act (FCRA) requires that agencies prepare estimates of the total subsidy cost of new lending activity at the time of budget formulation. When the budget is executed, this estimated long-term cost is a cost to the taxpayer. Over the life of the loan program, this estimated cost could increase or decrease, depending on the actual performance of the loans MARAD guarantees.

Question 2. Current practice allows for applications for Title XI loan guarantees to linger for years without any formal action MARAD. How long should an application be allowed to remain pending?

Answer. Our review did not address how long an application should be allowed to remain pending. However, MARAD should ensure that applicants continue to meet all program requirements when the application is finally approved.

Question 3. I have recently been made aware of alleged improprieties by MARAD in the disposal of defaulted assets. I know that both the DOT IG and the GAO, as part of their separate investigations, looked at what actions MARAD takes following a default to secure and maintain the associated assets, but I would like to know if you looked at MARAD's actions regarding the disposition of assets? If so, did you find any improprieties?

Answer. We did not assess the process for disposing of assets.

Question 4. In your review of the Title XI program, did you find any evidence that MARAD has changed its processes as a result of the AMCV and other recent defaults?

Answer. After the default of Project America, MARAD reorganized its Title XI offices in an attempt to gain better control of the disbursement of funds from the escrow account. However, the reorganization did little to correct disbursement concerns and raises additional concerns about consolidation of duties.

Question 5. GAO found that MARAD has seriously underestimated defaults and overestimated recoveries from defaults. If risk is properly assessed, should the amount of funds set aside for defaults—the loan cohorts—be sufficient to cover all expected losses from defaults?

Answer. If risk were properly assessed, then the estimated cost of the program received through appropriations should be sufficient to cover all expected losses from defaults. The subsidy cost estimates are based on expected defaults and recoveries, and if MARAD were able to estimate these perfectly, then the subsidy costs would cover any defaults MARAD were to experience. However, we would not expect MARAD, or any other credit agency, to perfectly estimate the subsidy cost. We believe MARAD could do a better job calculating its subsidy cost estimates by updating its assumptions to take into account the differences between its estimated defaults and recoveries and recent actual defaults and recoveries, and by taking concentration of credit risk into consideration.

Question 6. What impact would realistic risk estimates have had on the amount of loan guarantees MARAD could have committed to in the past 10 years?

Answer. Realistic risk estimates, based on documented analyses of estimated and actual defaults and recoveries, and annual updates of the assumptions used to calculate the subsidy cost estimates, would probably have caused MARAD to commit fewer loan guarantees over the past 10 years, as the estimated subsidy costs would most likely have been greater—all other things, such as level of appropriations, being equal—unless there were an equal reduction in the remaining years' estimated defaults and an increase in estimated recoveries.

Question 7. In your written testimony, you pointed out that "MARAD uses a relatively simplistic cash-flow model that is based on outdated assumptions, which lack supporting documentation, to prepare its estimates of defaults and recoveries." Further, you state "MARAD's estimates have significantly understated defaults and its recovery estimates have significantly overstated recoveries." What is the effect of this poor estimation of defaults and recoveries and how does it impact what is known about the true cost of the program?

Answer. The poor estimation of defaults and recoveries results in questionable subsidy cost estimates that do not provide Congress a basis for knowing the true costs of the Title XI Program. If MARAD were to continue to underestimate defaults and overestimate recoveries, and if the pattern of recent actual experience were to continue, then MARAD would have significantly underestimated the true costs of the program.

Question 8. Who is responsible for ensuring that the assumptions used by agencies in their estimations, along with calculating risk and associated subsidy rates, is complete, accurate, and done in accordance with the Federal Credit Reform Act?

Answer. The Federal Credit Reform Act assigns responsibility to the Office of Management and Budget (OMB) for coordinating credit subsidy estimates, developing estimation guidelines and regulations, and improving cost estimates, including coordinating the development of more accurate historical data and annually reviewing the performance of loan programs. OMB has final authority for approving estimates in consultation with agencies, but usually delegates authority to agencies to calculate estimates and reestimates.

Question 9. Both GAO and the DOT IG found that MARAD had issued waivers or modifications to approve applications even though borrowers had not met all financial requirements. All nine of the applications that have gone into default since 1998 were approved with some form of modification to the financial criteria. Were waivers also issued for other active projects and from your analysis is it possible to conclude that there is a direct correlation between waivers and the likelihood of default.

Answer. MARAD has approved waivers and modifications for both active and defaulted projects. We did not assess the correlation between the use of waivers and the likelihood of default. However, by waiving or modifying financial requirements, MARAD officials may be taking on greater risk in the loans they are guaranteeing. Consequently, the use of waivers or modifications could contribute to the number or severity of loan guarantee defaults and subsequent Federal payouts. For this reason the IG recommended that MARAD require a rigorous analysis of the risk of modifying any loan approval criteria.

Question 10. Your written statement draws attention to the fact that MARAD has not used sound business practice in administering the Title XI program and that this lapse leaves the program vulnerable to fraud, waste, abuse, and mismanagement. Do you believe more investigative work is needed to determine that total extent of the program's problems?

Answer. We believe that because of the programs vulnerability to fraud, waste, abuse and mismanagement, the program should continue to receive close oversight and MARAD should take steps to ensure that the recommendations made by GAO and the IG are implemented. Specifically, the IG needs to look periodically at the program.

Question 11. What actions do you believe this Committee should take to address the vulnerabilities you have identified?

Answer. This Committee should consider clarifying borrower equity contribution requirements. Specifically, the Committee should consider legislation requiring the entire equity down payment, based on the total cost of the project including total guarantee fees currently expected to be paid over the life of the project, be paid by the borrower before the proceeds of the guaranteed obligation are made available. Further, the Committee should consider legislation that requires MARAD to consider, in its risk category system, the risk associated with approving projects from a single borrower that would represent a large percentage of MARAD's portfolio.

Question 12. In your written statement, you pointed out that MARAD has failed to ensure that it received, let alone reviewed, reports on the financial condition of companies holding loan guarantees which are required to be submitted semi-annually. Do you know of anything that would explain such flagrant disregard of the laws and regulations governing the program?

Answer. MARAD officials told us that they did contact companies to obtain missing financial documents and that financial analysis was conducted. However, we saw no evidence of such analysis and, in the absence of financial information don't see how it could have been conducted.

Question 13. In your written statement, you pointed out that "MARAD relied on the shipowner's certification of money spent in making decisions to approve the disbursements from the escrow fund." Does that mean MARAD was not independently verifying progress, and associated costs?

Answer. For the projects we reviewed, we did not see evidence that MARAD routinely independently verified progress and associated costs. A limited number of disbursements from the escrow fund were actually verified by MARAD. MARAD has two headquarters staffers and one full-time marine surveyor in the field that conduct site visits to Title XI projects.

Question 14. If MARAD had been providing proper oversight of the progress and costs associated with projects under construction, is it reasonable to assume that MARAD should have been able to determine, in the case of the product tankers that where constructed at Newport News Shipyard and are now the subject of a DOJ suit against that yard, that costs that should have been annotated to the tankers, where, according to the DOJ, being passed onto the DOD in the form of mischarges to the Navy?

Answer. We have no information about this project.

Question 15. Your findings show that MARAD, in violation of its own rule, allowed AMCV to define the total costs of Project America in a way that allowed AMCV to exclude certain costs that previously had always been considered by MARAD. This meant a lower cost evaluation and MARAD then allowed for the early release of escrowed funds. In practice, this permitted AMCV to avoid expending the statutorily required 12.5 percent of the total cost of the project prior to receiving guaranteed funds. Can you explain further how this affected the guarantee?

Answer. MARAD procedures and regulations require that borrowers pay 12 1/2 percent of the actual cost of the vessel before proceeds of the guaranteed obligations are made available. The statute defines "actual cost of a vessel" as of any specified date as follows:

> ". . . the aggregate, as determined by the Secretary, of (i) all amounts paid by or for the account of the obligor on or before that date, and (ii) all amounts which the obligor is then obligated to pay from time to time thereafter, for the construction, reconstruction, or reconditioning of the vessel." 46 U.S.C. App. 1271(f).

On February 1, 2000, MARAD and AMCV entered into a security agreement that defined the "Actual Cost of the Vessel" as $610,797,578. The security agreement also stated that the government would not disburse any funds until the obligor had paid 12 1 percent of the "Actual Cost of the Vessel." While this amount was not stated in the agreement, this amounted to $76,349,697.

However during the spring of 2000, both parties orally agreed to modify the Actual cost of the vessel for the purpose of computing AMCV's equity share by excluding the escalation fees and delaying inclusion of the guarantee fees until they were actually incurred. In addition to these exclusions, it is apparent that AMCV also excluded capitalization interest and owner furnished property from the equity share. These exclusions resulted in AMCV's equity share being reduced to $58,373,402.

The reduction of AMCV's equity share resulted in the escrowed funds being disbursed earlier than they would have been had the original equity share been provided by AMCV, reducing AMCV's equity contribution by $17,976,295.

Question 16. Was AMCV taking on less risk, while the taxpayers were taking on more?

Answer. To the extent that the change in the equity requirement resulted in AMCV providing a smaller down payment, the government's potential exposure In the event of default was increased.

Question 17. Do you think this practice was within the spirit and intent of the law?

Answer. Because the law is unclear as to what constitutes actual costs, it is unclear if MARAD's practices were within the spirit and intent of the law. However, if the intent were to mitigate losses by requiring that owners provide a certain amount of equity in a project, then MARAD's practice would not meet this intent. This practice served to reduce owner equity and would appear to be in conflict with this intent. We therefore recommend that Congress consider clarifying the borrower's equity contribution requirements.

Question 18. What other unique exemptions were granted AMCV? Should guidelines be established regarding the waiving of program requirements, or perhaps, there should be no waivers permitted at all?

Answer. As mentioned in the report, MARAD modified the working capital requirement by using a cash-flow test. In addition, as mentioned above, MARAD orally agreed to define total cost in such a way as to limit borrower equity contributions. MARAD policy calls for such agreements to be made in writing. In September 2001, MARAD amended the loan commitment permitting the owner to further delay the payment of equity. Because of concern over the diligence that MARAD uses in considering approving modifications and waivers, we recommend MARAD establish a systematic process for considering and resolving findings when approving loan guarantees involving waivers and exceptions to program requirements.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. ERNEST F. HOLLINGS TO THOMAS MCCOOL

Question 1. Analysis done by GAO was of a small sample size, five projects, of which three had defaulted, these numbers are not in line with the overall performance of the program. Why were these projects selected and can you explain the methods behind selecting the sample?

Answer. We selected these five projects based on a number of factors, including the project size, risk category, status (defaulted, active and paid off), and type (*e.g.,* barge, cruise line, shipyard). This judgmental sample is not representative of the universe.

Our conclusions regarding the operations of the Title XI program are not based on the case studies alone, although these case studies did uncover policies and practices that do not effectively protect the government's interest. Our conclusions also draw on the work of the Department of Transportation Inspector General (IG), which looked at far more projects (42 projects), as well as our comparison with practices of selected private sector lenders. Finally, we also relied on our experience in analyzing other Federal loan guarantee programs.

Question 1a. What analysis was done on the entire portfolio?

Answer. In addition to the IG and other work referred to above, we conducted an analysis of MARAD's implementation of credit reform that examined the loan performance of the entire portfolio.

Question 1b. What do you see as the current risk of the overall portfolio?

Answer. The risk of the overall portfolio is uncertain. We found that in comparison with recent actual experience, MARAD's default estimates have significantly understated defaults, and its recovery estimates have significantly overstated recoveries. If this pattern of recent experience were to continue, MARAD would have significantly underestimated the costs of the program.

Question 2. Who were the private sector lenders selected in the study? How were they selected?

Answer. We spoke with maritime lending professionals from Bank One, JP Morgan Chase, and American Marine Advisors, Inc. We judgmentally selected the private sector lenders based on references from MARAD, as well as from banking experts, and on these lenders' publicly recognized expertise in the maritime industry and their willingness to meet with us. These lenders are not meant to represent the entire maritime industry; however, their practices are consistent with sound internal control mechanisms. Therefore, we believe that these practices have the potential to help MARAD to more efficiently meet its mission.

Question 3. How many Federal loan guarantee programs are there?

Answer. According to the Office of Management and Budget's (OMB) Fiscal Year 2004 Federal Credit Supplement, which summarizes information about Federal direct loan and loan guarantee programs subject to the Credit Reform Act of 1990, there are approximately 64 different Federal loan guarantee programs.

Question 3a. What is the percentage default rate on average for all these loan guarantee programs?

Answer. Currently, there is not an average default rate published for all of these loan guarantee programs. However, according to OMB's Fiscal Year 2004 Federal Credit Supplement, estimated lifetime defaults as a percentage of disbursements range from a low of nearly 0 percent in the Government National Mortgage Association Guarantees of Mortgage-Backed Securities program to a high of 45.6 percent in FHA Section 221(d)(3) program. For those programs that reported estimated default rates in this publication, 12 programs had default rates less than 5 percent, 13 programs had default rates of 5–10 percent, 18 programs had default rates of 10.01–15 percent, 11 programs had default rates of 15.01–20 percent, 8 programs had default rates of 20.01–30 percent, and 3 programs had default rates greater than 30 percent.

Question 3b. How does Title XI compare, with and without the AMCV defaults?

Answer. In contrast to the information presented above, MARAD's Title XI program had an estimated average default rate (including AMCV) of 37.85 percent in the Fiscal Year 2002 Federal Credit Supplement, the last year this program published default information. Because MARAD was unable to provide us with the necessary data to determine the estimated lifetime default rate, we are unable to calculate this rate excluding the AMCV loans.

Question 4. In general, is it your experience that most of the Federal loan guarantee programs have a somewhat less stringent review and approval process than similar loan programs in the commercial market?

Answer. It is difficult to generalize the levels of stringency used in the review and approval processes across Federal loan guarantee programs, since mechanisms for review and approval can vary by program. For example, the Small Business Administration (SBA) and the Federal Housing Administration (FHA) operate loan guarantee programs involving smaller and more standardized loans than MARAD guarantees. These agencies heavily rely on private sector lenders to underwrite loans with smaller loan amounts, and focus more on lender compliance with underwriting standards. However, other loan programs that deal with larger, unique loans may underwrite the loans directly, or are more involved in the underwriting. Because MARAD is providing guarantees on larger, unique loans, it is imperative that MARAD provide the highest level of stringency in its review and approval process. Private sector lenders are also more likely to increase the level of review for larger, unique types of loans, and MARAD should do the same. While program flexibility in financial and economic soundness standards may not be as stringent in order to help MARAD meet its public purpose, oversight and the strict use of internal controls are necessary to effectively use and guard the government's limited financial resources.

Question 5. In general, how volatile is the maritime market, and is it a complex market in which to make financial assessments?

Answer. The lenders we interviewed told us that timing is important in maritime lending and that it is a cyclical business. The lenders use a combination of historical performance, economic and market data to determine whether the loan is economically sound prior to approval. For this reason, MARAD should fully consider economic soundness analyses based on up to date information when considering applications for Title XI loan guarantees.

Question 6. Do you think that the impact of September 11 could have been reasonably modeled or predicted?

Answer. The events of September 11, 2001 were unprecedented and therefore could not be predicted. These events may have contributed to some Title XI loan defaults experienced by MARAD, including those associated with AMCV loans, however, AMCV had been experiencing financial difficulties prior to September 2001. Nonetheless, our analysis demonstrated that when the effects of the AMCV defaults are excluded, MARAD still underestimated the amount of defaults the program would experience between 1996 and 2002 by over 260 percent or $114.6 million.

Question 7. One of your conclusions is that too much of the guarantee portfolio was issued to one owner, AMCV. You state that the commercial lending industry does a better job of assessing the concentration of credit risk to one company. This practice of having "single issuer limits" definitely seems to be a good concept. But, from what I understand this is a new practice at major banks that is the result of the Enron and WorldCom situations.

Answer. Concentration of credit risk is not a new concept in banking. Bank regulators have imposed concentration limits and bank examiners have been assessing this aspect of risk when examining the safety and soundness of banks for many years.

Question 7a. If these limits had been in place and the and there had been limits of concentrations to a single company, meaning that AMCV would not have been a part of the Title XI portfolio, how would the program have performed?

Answer. As indicated in response to question 6, when we excluded defaults from AMCV loans from our analysis, MARAD still underestimated the amount of defaults the program would experience between 1996 and 2002 by over 260 percent or $114.6 million.

○