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Report on the Commodity Credit Corporation's GSM-102/103 Export Credit Guarantee Programs and Iraq's Participation in the Programs

Statement of
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Before the Committee on Banking, Finance and
Urban Affairs
United States House of Representatives

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the management and operations of the U.S. Department of Agriculture's Commodity Credit Corporation's (CCC) Export Credit Guarantee Program and Intermediate Export Credit Guarantee Program, referred to as the GSM-102 and GSM-103 programs, respectively. The GSM-102/103 programs are managed and operated by the Foreign Agricultural Service (FAS). Besides our overall views on management of the programs, you asked that we specifically address Iraq's participation and some of the issues involved.

In the past few years, we have conducted several reviews of these programs in response to requests from the Senate and House agriculture committees and the House Budget Committee's Task Force on Urgent Fiscal Issues. In general we have found that FAS needs to improve its management controls over the programs to better ensure the programs' integrity and to avoid excessive financial risk to the U.S. government. Regarding Iraq, a number of issues have arisen over its participation--most importantly perhaps, Iraq has stopped repayment on approximately $2 billion in guaranteed loans. Many of those loans are from one bank, the Atlanta branch of the Banca Nazionale del Lavoro, which has been under investigation for several irregularities.

HOW THE PROGRAMS WORK

The GSM-102/103 programs are U.S. government loan guarantee programs designed to increase exports of U.S. agricultural commodities. The GSM-102 program has been in effect since 1981 and the GSM-103 program has been in effect since 1986. Almost $33 billion in loan guarantees have been approved to finance U.S. agricultural exports under these programs.

Each year, FAS announces the availability of loan guarantees for credit sales of specified commodities made to buyers in specified countries. Loan guarantees announced for Mexico, Korea, and Iraq are among the highest under the programs. In return for payment of a relatively small guarantee fee, a U.S. exporter obtains a CCC guarantee that he or she will be repaid for a credit sale made to a buyer in an eligible foreign country. If the buyer fails to repay, then the exporter can file a claim with CCC for the loss. After paying the claim, CCC attempts to obtain reimbursement from the foreign buyer or the foreign buyer's government.

Exporters are generally not able to, or interested in, personally financing a sale. Therefore, the programs are designed to allow the exporter to obtain immediate payment on the credit sale by assigning the account receivable and the repayment guarantee to any financial institution in the United States desiring to participate in these programs. When this assignment is made, the financial institution pays the exporter for the value of the sale and begins collecting the periodic payments from the foreign buyer. If the foreign buyer defaults on a payment, then the financial institution can look to CCC for recovery. CCC must approve the exporter's assignment of guarantees to financial institutions.

CCC generally tries to share some of the financial risk with the exporter, or the exporter's assignee, by not providing 100-percent coverage for a loan's principal and interest. CCC guarantees 98 percent of the value of the sale plus a significant portion of the interest payable. The exporter or the exporter's assignee is at risk for 2 percent of the principal and a portion of the interest payable. However, CCC has flexibility to adjust the amount of guarantee coverage it provides. For example, in the past, CCC has guaranteed 100 percent of the value of commodity sales to Mexico.

There are no operational differences between the GSM-102 program and GSM-103 program; however, each program covers different repayment periods and has different funding authorization levels. Under the GSM-102 program, guarantees are provided for sales having credit terms of 36 months or less. Under the GSM-103 program, guarantees are provided for sales having credit terms of 3 to 10 years. In the 1985 farm bill, Congress directed CCC to make available not less than $5 billion annually in guarantees under the GSM-102 program and not more than $1 billion annually under the GSM-103 program.

CCC's contingent liabilities under the programs total about $8.9 billion as of September 30, 1990. CCC has paid out about $3 billion in claims since the programs' inception and is at risk for the approximately $2 billion not being serviced by Iraq.

RESULTS FROM PRIOR GAO REVIEWS

Over the past few years we have reported[1] that the GSM-102/103 programs were not being adequately managed. Specifically, we reported that CCC had not adequately (1) accounted for outstanding guarantees, (2) ensured that guarantees were being used only for U.S. agricultural commodities, (3) provided guidance to GSM-102/103 program users, and (4) reflected estimated program losses in its financial statements. We recommended that the Secretary of Agriculture direct the General Sales Manager, FAS, to do the following:

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[1] Status Report on GAO's Reviews of the Targeted Export Assistance Program, the Export Enhancement Program, and the GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-90-53, June 28, 1990; GAO/T-NSIAD-90-02, Feb. 21, 1990; and GAO/T-NSIAD-90-12, Nov. 16, 1989); Financial Audit: Commodity Credit Corporation's Financial Statements for 1988 and 1987 (GAO/AFMD-89-83, Aug. 1988); Commodity Credit Corporation's Export Credit Guarantee Programs (GAO/T-NSIAD-89-41, June 14, 1989; GAO/T-NSIAD-89-9, Mar. 1, 1989; and GAO/T-NSIAD-89-2, Oct. 6, 1988); International Trade: Commodity Credit Corporation's Export Credit Guarantee Programs (GAO/NSIAD-88-194, June 1988); and International Trade: Commodity Credit Corporation's Refunds of Export Guarantee Fees (GAO/NSIAD-87-185, Aug. 1987).

-- Enforce compliance with the requirement that exporters submit complete reports of exports to ensure accurate accounting of outstanding guarantees.

-- Design, develop, test, and implement internal controls, including random on-site verifications, to ensure that loan guarantees are only used to obtain U.S. agricultural commodities.

-- Clarify program regulations by providing specific definitions of what constitutes a U.S. agricultural commodity and a firm sale and demand acknowledgement of these requirements on guarantee applications.

-- Provide timely and accurate decisions on document revisions requested by exporters or their assignees.

-- Initiate suspension or debarment actions against program participants found to have violated program regulations.

-- Act to prevent less-than-arms-length transactions between participating financial institutions in the United States and in the importing countries.

We also recommended that CCC include an allowance for estimated losses in its financial statements.

Action has been taken on some of our recommendations. For example, CCC has improved its accounting for outstanding loan guarantees, enhanced some internal controls over the programs, and is in the process of recognizing estimated losses in its 1989 financial statements.

However, we believe that further improvements are still needed in tightening internal controls, specifically those related to financial institutions' participation in the programs, and in defining an agricultural commodity eligible for export under the programs.

PARTICIPATION OF FINANCIAL INSTITUTIONS IN THE GSM PROGRAMS

The success of the GSM-102/103 programs depends greatly on the active participation of financial institutions. These institutions disburse the approximately $4 billion in GSM loans each year, providing direct credit to the foreign buyers. About 100 financial institutions have participated in the programs since their inception. They make money on this low-risk business by charging fees for advising on letters of credit and by collecting the interest on the credit sales. However, of the 100 or so participating financial institutions, only a few have been major participants and have dominated the lending activity under the programs. Representatives of the banking industry claim that while the GSM-102/103 loans are very low in risk, they are also very low in profits. We found that the few financial institutions heavily involved in the programs specialize in government loan programs and use their specialization to minimize costs and maximize profits.

Despite the important role played by the institutions, CCC has only two regulations covering their GSM-related activities. The first is that participating institutions must be located in the United States. The second prohibits a participating U.S. financial institution from being affiliated with the overseas bank issuing the letter of credit, which the foreign buyer uses to pay for the commodities exported under the GSM programs.

Although the second regulation prohibits participation in transactions by affiliated banks, it does not fully protect U.S. interests from other less-than-arm's-length relationships. CCC has guaranteed the financing of exports to foreign governments who were also owners of the U.S. institutions lending the money and receiving the GSM guarantees.

During a recent review, we found three U.S.-based financial institutions that were either directly owned by or otherwise affiliated with government-owned banks in GSM customer countries. The three financial institutions had foreign customer ownership ranging from 14 percent to 100 percent of the institution's equity. Since inception of the GSM programs, CCC has guaranteed about $1.3

billion in these related-party transactions. Although these financial institutions are complying with current regulations, should a default occur, any guarantee payment made by CCC to these U.S.-based institutions would financially benefit the foreign government that is in default. These apparent less-than-arm's-length transactions increase the risk of losses to the U.S. government.

In fact, two of these three financial institutions held guaranteed debt on which their foreign government owners defaulted. One institution is owned by a consortium of several banks and 43.7 percent of its equity is owned by a defaulting government's central and nationalized banks. The other institution is also owned by a foreign consortium and has financed about $588 million in GSM transactions to one of its owner countries which owns 14 percent of the institution's equity. These loans represent about 62 percent of the institution's total GSM portfolio.

In one of the three cases in which there appear to be less-than-arm's-length relationships, there have been no defaults. This U.S.-based financial institution is a branch of the foreign country's national bank and has financed over $474 million in commodity exports to its own country under this guaranteed loan protection from the United States.

IRAQ'S PARTICIPATION IN THE GSM-102/103 PROGRAMS

Iraq's participation in the GSM-102/103 programs began in 1983, just before we re-established official diplomatic relations with that country. Iraq was initially allocated $230 million in loan guarantees under the GSM-102 program to purchase feedgrains, rice, and wheat. The Iraqis were depleting their foreign exchange reserves due to their war with Iran and they desperately needed credit. In 1984 Iraq's allocation was almost tripled, to about $680 million. Iraq began importing protein concentrates, tobacco, vegetable seeds, and other commodities in addition to the feedgrains, rice, and wheat. By 1988 Iraq's GSM-102/103 allocations totaled about $1.1 billion and were used to purchase some 30 different commodities. This level of GSM-102/103 allocations continued in 1989 and the Iraqis sought the same levels in 1990. However, when the unauthorized loans involving Iraq came to light in the Banca Nazionale del Lavoro case, the Agriculture Department decided to scale back the 1990 program for Iraq to $500 million, with the possibility of another $500 million allocation pending results of Justice's investigation of the bank.

In the meantime, the Agriculture Department began conducting its own review of Iraq's participation in the GSM-102 program. In May 1990, the Department concluded that certain exporters to Iraq had been charging high prices and providing Iraq "after-sales services" which, in the Department's view, may have violated program regulations. The Department plans further inquiry into these potential violations at the conclusion of the Banca Nazionale del Lavoro investigation, when more information becomes available.

Problems identified in the GSM programs for Iraq so far include the following:

-- Iraq has suspended payment on its approximately $2 billion in outstanding GSM guaranteed loans, exposing CCC to a substantial loss.

-- One bank, the Banca Nazionale del Lavoro, has a high concentration of loans to Iraq, a significant amount of which are guaranteed under the GSM programs. However, most of the GSM guaranteed loans were not authorized by higher level bank officials. I'll discuss this in more detail later in this statement.

-- Foreign origin agricultural commodities have been exported to Iraq under the GSM programs. Such exports are contrary to program regulations which state that the guarantees are to be provided for U.S. agricultural commodities. Eight tobacco exporting companies have pleaded guilty to shipping foreign tobacco to Iraq or Egypt under the programs and have been fined a total of $300,000. The companies were also directed to pay restitution costs to CCC of up to $1.1 million should CCC incur losses related to those shipments.

-- Money obtained under Iraqi participation in the GSM programs has been used for purposes other than those permitted, including after-sales services that are unrelated to agricultural exports.

BANCA NAZIONALE DEL LAVORO
INVESTIGATION CONTINUES

In previous testimony, we reported that the Department of Justice was investigating allegations that Banca Nazionale del Lavoro's Atlanta, Georgia, branch made more than $2 billion in loans to Iraq, of which only a fraction had been authorized by higher-level bank officials. Some of these loans, amounting to approximately $750 million, were guaranteed under the GSM programs and, of that amount, only about $130 million had been authorized. The investigation is still ongoing, and none of the related information has been made available.

Banca Nazionale del Lavoro is Italy's largest state-owned bank. Headquartered in Rome, it has several branches operating in the United States. The New York City branch is responsible for North American operations, and its Atlanta, Georgia, branch has provided the GSM loans.

There may be lessons to be learned from the Banca Nazionale del Lavoro investigation. Once it is complete, we plan to evaluate the extent to which individual financial institutions participate in GSM programs. We will also assess the potential impact that such participation may have on CCC's guarantee liability. In particular, we will review the bank's involvement with Iraq and determine the appropriateness of allowing one bank to participate to such a large extent in the GSM programs, especially if that bank's loan exposure is concentrated in a single country.

Our work in this area is continuing at the request of Chairman Charlie Rose of the Subcommittee on Tobacco and Peanuts, House Committee on Agriculture and Congressman Charles Schumer. Investigations by the Department of Justice and U.S. Customs Service on these issues are also continuing.

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Mr. Chairman and members of the Committee, this concludes my statement. I will be happy to answer any questions you may have.

TOTAL GSM-102 PROGRAM GUARANTEES MADE AVAILABLE AND APPROVED
(Dollars in Millions)

Fiscal year	Guarantees made available	Guarantees approved
1981	$2,189.1	$2,082.1
1982	3,224.6	1,543.3
1983	4,079.9	3,709.3
1984	4,125.6	3,431.2
1985	4,485.2	2,512.8
1986	4,175.3	2,522.4
1987	3,821.4	2,622.5
1988	4,792.0	4,141.4
1989	4,965.2	4,769.8
1990	4,610.7[a]	3,957.4[a]
Total	$40,469.0	$31,292.2

[a]Tentative figures as of October 11, 1990.

Source: GSM-102 Commitment Reports prepared by the U.S. Department of Agriculture's (USDA) Foreign Agricultural Service, CCC Operations Division.

TOTAL GUARANTEES MADE AVAILABLE AND APPROVED FOR THE GSM-103 PROGRAM
(Dollars in Millions)

Fiscal year	Guarantees made available	Guarantees approved
1986	$377.0	12.7
1987	410.9	250.4
1988	504.4	362.9
1989	485.3	425.5
1990	468.3[a]	332.1[a]
Total	$2,245.9	$1,383.6

[a]Tentative figures as of October 11, 1990.

Source: GSM-103 Commitment Reports prepared by USDA's Foreign Agricultural Service, CCC Operations Division.

APPENDIX III

CCC'S CONTINGENT LIABILITY
UNDER THE GSM-102/103 PROGRAMS FOR IRAQ
(By Fiscal Year)

Fiscal year	Contingent liability
1990	$154,336,744
1991	930,144,855
1992	622,021,012
1993	287,593,955
1994	6,971,205
1995	3,817,090
1996	3,593,898
1997	121,227
Total	$2,008,599,986

Source: USDA's Foreign Agricultural Service, Financial Management Division.