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Recapitalizing the Export-Import Bank of the U.S.: Why It Is Necessary; How It Can Be Accomplished

Statement of
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Before the
Subcommittee on International Finance,
Trade and Monetary Policy
Committee on Banking, Finance
and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear today to discuss our views on options available for recapitalizing the Export-Import Bank of the United States. As you know, the bank's mission is to provide financing to aid United States export sales in most parts of the world. It does this through programs that include direct loans and financial guarantees and insurance. The bank offers competitive credit so United States export sales will not be lost to foreign competitors who have access to low rate official export credit. We believe that the bank carries out an important mission, made all the more important by the trade deficit of the last several years, and in discussing recapitalizing options, we have directed our attention to actions we believe will assist the bank to effectively and credibly fulfill its mission.

Before discussing recapitalization alternatives, I believe it is important to review the bank's present financial condition and the reasons for its deterioration, which we have discussed in previous testimonies before this subcommittee. More recently, we addressed these concerns and other issues related to the bank in a January 29, 1988, letter to the Chairman, Committee on Banking, Housing and Urban Affairs, United States Senate. Further, in a February 11, 1988, letter to the Honorable Gerald D. Kleczka, a member of this subcommittee, we explained why the revenues the bank generates from its export loan portfolio are insufficient to service its Federal Financing Bank (FFB) debt, and offered our views on the potential effects of refinancing the bank's debt.

Copies of these letters are attached to this statement. Accordingly, we will only briefly summarize their key points.

THE BANK'S FINANCIAL CONDITION

The bank's reported equity is being eroded by operating losses, and, if the full extent of these losses were recognized, the bank would be insolvent--its liabilities would exceed its assets. It has experienced operating losses and corresponding declines in its equity each year since 1982. Between 1982 and 1986, the bank reported aggregate operating losses of $1.4 billion. The bank also expects an operating loss for 1987, estimated to be about $471 million. The losses have reduced the bank's reported equity from $3.2 billion at September 30, 1981, to an estimated $1.3 billion at September 30, 1987. These reported losses have largely resulted from the bank's interest expense exceeding its interest revenues. Although these losses are disturbing, they only tell part of the story.

The bank's financial reports materially understate the extent of losses it has incurred, because it has not recognized impairments to its portfolio of loans and receivables. Although generally accepted accounting principles (GAAP) require organizations to recognize losses related to uncollectible loans and receivables through a loss allowance, the bank has not complied even though the problem portion of its loans and receivables has been steadily increasing. We estimate that for fiscal year 1987, the bank should establish a loss allowance of between $3.3 and $5 billion. Even using the lower estimate for recording an allowance would reduce the bank's estimated equity at September 30, 1987, from a surplus of $1.3 billion to a deficit of $2 billion.

The Bank's Receipts Are Insufficient To Pay Its Debt

At September 30, 1987, the bank's primary earning assets included $12.2 billion in loans and receivables, while its primary liabilities were about $12.5 billion in notes payable to the FFB. The weighted average interest rate on the bank's loan portfolio was 8.36 percent, while the average rate on the FFB debt was 11.47 percent. This 3.11 percent negative spread adversely affects the bank's earnings and its ability to service its FFB debt. Based upon its portfolio, debt balances, and interest rates at September 30, 1987, we estimate the bank would be paying about $406 million more interest annually than it is collecting on its loans.

Delinquencies also adversely affect the bank's ability to service its debt. As of September 30, 1987, about $4.5 billion of the bank's $12.2 billion loan portfolio was delinquent by at least 90 days. The lack of, or delay in receiving, principal payments on the bank's delinquent debt further reduces the bank's ability to meet the scheduled payments to FFB. For fiscal year 1988, expected receipts of principal payments, assuming current delinquency levels, will be $1.1 billion, while the bank's scheduled principal payments to FFB will be $1.6 billion.

Loan Sales And Prepayment Penalties Weaken The Bank's Financial Condition

The bank's financial condition has been further weakened by the federal government's loan sale program and FFB prepayment penalties. The bank was required to generate no less than $1.5 billion in loan prepayments in fiscal year 1987. Current plans call for the bank to generate net receipts of an additional $1 billion through fiscal year 1989. To fulfill its goals under this program, the bank has encouraged debtors to prepay their loans, which they may do without penalty. The bank, in turn, uses a portion of the proceeds of these prepayments to reduce its indebtedness to FFB, but with a penalty.

Under most circumstances, early collection accompanied by the early retirement of debt would be viewed as beneficial to an organization's financial condition. This is not true for the bank. The bank loans that are being prepaid are generally those that are most profitable--carrying relatively high interest rates and having excellent payment histories. Early collection of this debt leaves the bank with a higher proportion of less desirable, weaker loans and decreases its interest collections. This adverse effect is compounded by the prepayment penalties the bank is paying FFB, which increase its current expenses, thereby further reducing its equity. During fiscal year 1987, the bank retired $670 million of debt on which it paid penalties of $121 million.

The prepayment penalty is designed to compensate the Department of Treasury for the theoretical interest losses it will incur because of early payment.[1] The Treasury does not generally redeem outstanding notes before maturity. Therefore, if the bank prepays its debt when interest rates are lower, the Treasury still incurs the interest costs associated with notes it issued to finance FFB loans to the bank. However, this rationale assumes that the Treasury issues notes with the same maturity dates as its advances to FFB. In practice, this is not the case--the Treasury uses the combination of long- and short-term borrowing to finance the government's operations, with the objective of minimizing its cost of borrowing. Accordingly, we have tended to question the need for such prepayment penalties.

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[1] FFB has financing arrangements with the Treasury which mirror its agreements with the bank.

Remedies to Maintain Positive Operating Results Are Not Always Available

The normal operating practices for a lending institution to maintain a sound financial condition or to improve its financial condition, such as charging borrowers interest rates above its cost of funds, or reducing the risk of loan delinquencies by minimizing loans to borrowers with questionable creditworthiness are, in reality, not always available to the bank.

The bank's ability to avoid interest rate spread problems on its future lending activities is somewhat constrained by the need to match the official export financing of competitor nations. Minimum interest rates charged to borrowers are governed by the Organization for Economic Cooperation and Development Arrangement on Guidelines for Officially Supported Export Credit. The arrangement specifies interest rates for three country categories--relatively rich, intermediate, and relatively poor--and the rates, adjusted for the bank's discount to intermediary lenders, currently range from 8.65 to 10.40, 7.35 to 9.35, and 6.50 to 8.00 percent, respectively, depending on the term of the loan. The bank estimates that it makes 60 percent of its loans to relatively poor countries, with the remainder made to intermediate countries. Virtually none of the bank's loans are made to those countries classified as relatively rich. Although the arrangement establishes only minimum rates, as a result of competitive factors, the bank generally lends at the minimum rate allowed for that country and loan term. Using the midpoint of these ranges as a conservative example, the bank could expect to earn a weighted average rate of approximately 7.7 percent on its future portfolio. Currently, interest rates on new FFB debt would be about 8.4 percent. Thus, assuming no changes in the export environment or the bank's cost of funds, the bank will continue to have a negative interest spread and thereby earn less interest than it is paying on its debt.

Beginning in May 1987, the bank has acted to improve the yield on its new loans by assessing a onetime fee, commonly referred to as an exposure fee, on the loans it makes. This exposure fee will diminish the effect of this negative interest spread to some degree. However, based upon the performance of the bank's current portfolio, we do not believe these fees can compensate for both the negative interest rate spread and the risk of loss. Given the bank's mission, it is likely to have outstanding loans and other credits for which the risk of a default may be relatively high.

RECAPITALIZATION--A SOUND AND LOGICAL APPROACH TO THE BANK'S DIFFICULTIES

Given the bank's current financial condition and earnings outlook, we believe that some form of recapitalization is needed to restore the bank's financial capital and to restore its fiscal credibility to enable it to efficiently carry out its mission. Moreover, safeguards should be established to maintain the bank's future financial condition.

Some have suggested that the bank does not need to be recapitalized. They point out that because of its unlimited borrowing authority from FFB, the bank can continue to operate indefinitely, regardless of its losses and deficit. In contrast, others point out that a healthy capital position contributes substantially to the bank's international credibility, and that recapitalization would represent a positive statement by the Congress regarding its long-term commitment to exports and competitiveness and the bank's role in promoting both; we agree with the latter position.

Other factors affecting the bank's financial viability should also be considered. First, the bank may be unable to repay its current debt as well as any additional debt it incurs, which would shift the burden of the bank's losses to FFB or the Treasury. Second, the capitalization of government corporations has a long history in our government and is one means of trying to foster a more businesslike conduct of their affairs. Doing nothing, thus allowing the bank's capital position to continue to deteriorate, while its problem debt increases, may undermine its corporate structure. We believe this would be unwise.

In addition, recapitalization would serve to recognize, in part, the past subsidy costs of the bank's programs and would allow the bank to start over with a clean slate. Moreover, the effectiveness of recent initiatives to improve its operations would be clearly evident in future financial reports. Therefore, we support recapitalization of the bank.

Objectives of Recapitalization

We believe any recapitalization plan for the bank should have several objectives--first, to restore its equity to a positive amount, as measured by generally accepted accounting principles, and second, to help ensure its ability to operate on a sound financial basis. Recapitalization would help satisfy these objectives. To illustrate, if the bank received an infusion of capital and used it to reduce its higher interest rate FFB debt, its equity position would be improved and the unprofitable mismatch between its earning assets and its debt would be reduced.

As a third objective, the plan should provide a means for preventing the current situation from recurring. Had the bank fairly reported its financial condition over the past several years, the Congress would have had the opportunity to deal with the bank's problems when they were less costly to resolve. Accordingly, we would favor a requirement for the bank to seek additional funding should its capital fall below a specified amount in the future.

Fourth, we believe the recapitalization plan should be structured so that it would not increase the federal deficit. Essentially, the deficit is increased when a government entity disburses funds to organizations or individuals outside the government. However, disbursements from one government entity to another do not affect the deficit because the funds remain with the government as a whole. If the bank used funding obtained through recapitalization to retire its FFB debt, the federal deficit would not be affected because this transaction is only a transfer of funds from one government entity to another.

Finally, in our view, the effects of a recapitalization plan should be clearly recognized both in the federal budget and the bank's financial statements. The losses the bank has incurred, and may continue to incur in operating its programs, represent a true cost to the government. The costs of recapitalization would be more visible under certain of the available alternatives than others.

ALTERNATIVES FOR RESTORING THE BANK'S CURRENT EQUITY

The three alternatives we evaluated are (1) forgiveness of a portion of the bank's FFB debt, (2) the use of appropriations to restore the bank's capital position, and (3) capital stock purchases by the Treasury. Adoption of any or a combination of these alternatives would be best accomplished by legislation.

With respect to the latter two alternatives in which funds would be provided directly to the bank, we assumed the bank would use the funds to retire its FFB debt. We believe this assumption makes sense from a budgetary standpoint and also represents the bank's best use of additional funding. Further, the Congress may wish to require FFB to waive the prepayment penalty on the bank's debt. As discussed in the attached letter to Representative Kleczka, waiving the penalty and allowing the bank to refinance its existing high interest debt would significantly lower its interest costs, thus reducing its losses. Moreover, it is important to note the penalty's effect on recapitalization alternatives discussed below. If the bank were to receive additional funding to reduce its FFB debt, it would have to use a substantial portion of that funding just to pay the penalty to FFB. Under such circumstances, we do not believe imposition of the penalty is appropriate.

Forgiveness of the Bank's FFB Debt

One recapitalization alternative would be to forgive a portion of the bank's higher interest rate FFB debt. This alternative could, depending on the amount of debt forgiven, restore the bank's net worth to a positive amount and also contribute to the bank's ability to operate on a self-sustaining basis. Eliminating for example, $2 billion of the bank's higher interest rate notes to FFB could reduce its interest expense over the life of the debt forgiven by about $340 million.

In evaluating this alternative, the following factors should be considered. First, because FFB borrows its funds to lend to the bank from the Treasury, forgiving the bank's debt could require similar forgiveness of FFB's debt to the Treasury. Second, the full cost of the bank's operations would not be reflected in the federal budget since budget authority is not required to forgive debt. Moreover, because debt forgiveness would be treated as income in the bank's financial statements, the bank's financial condition would appear better than its results justify.

Appropriation to Restore Capital Position

Another recapitalization alternative is a direct appropriation to reestablish a minimum capital level. Again, assuming this capital infusion would be used to reduce FFB debt, the amount needed to restore the bank to positive equity would be equivalent to the bank's estimated deficit, $2 billion, plus the prepayment penalty on that debt, which would be about $340 million. Although, as noted previously, the prepayment penalty could be waived.

An appropriation would require recognition in the federal budget of the budget authority provided but, as previously discussed, would not increase the overall budget deficit. The transaction would be reflected in the equity section of the bank's financial statements as invested capital, increasing the bank's overall equity balance.

Capital Stock Purchase

A capital infusion to the bank through the Treasury's purchase of additional bank stock would be another means of restoring the bank's capital. The amount of stock the Treasury would need to purchase to restore the bank's capital would be equivalent to that needed under the direct appropriation proposal. The capital infusion would be reflected in the equity section of the bank's financial statements as stock, an approach consistent with the bank's basic corporate structure. Like the direct appropriation discussed above, the stock purchase would require recognition in the federal budget of the budget authority provided.

PROVISIONS FOR MAINTAINING CAPITAL POSITION

Even if the bank's capital were restored to some minimum level through one of the recapitalization alternatives discussed above, the mismatch between the bank's earning assets and its FFB debt would not be entirely eliminated. Further, the bank's new fee structure for addressing the risk of loss and interest rate differential on its new loans may not be adequate to permit it to operate on a break-even basis, in our view. Accordingly, periodic infusions of capital may still be required to compensate the bank for the losses which may continue to be generated from the current portfolio and future lending activities. As a result, we believe consideration should be given to establishing a means for maintaining that capital level.

Annual Appropriation of Subsidy Cost

Currently, the government is considering credit reform proposals which would require annual appropriation actions for any future credit program subsidies. The governmentwide growth in loan guarantees and below-market rate direct loans in recent years, with attendant net costs over several years to the Treasury, poses a real budget control problem for the government. At this time, there are no steps in the annual budget and appropriations processes that require the Congress and the executive branch to consider and act upon the estimated net costs of credit programs. As a result, when the Congress approves a given level of guarantees or loans, it does so without a good understanding of the ultimate effects of that decision on the budget deficit. We think that this is a serious shortcoming, particularly at a time when deficit reduction is such a high priority.

We, therefore, have proposed in prior reports and testimonies, revised budget treatment of all federal credit programs--whether loan guarantees or direct loan programs. In our proposal, the Congress would annually provide appropriations for the estimated subsidy costs to the government of the new guarantees and loans to be made. The amount appropriated for direct loans, for example, would be the difference between the face value of the loans and the present discounted value to the government of the loans at the time they are made.

The President's budget for fiscal year 1989 has a similar credit reform proposal. The budget proposes appropriations to cover the subsidies extended in federal credit programs. We have differences with the administration over the proper method of calculating the subsidy amounts and have undertaken a study of the issue. We expect to report on this matter later this year.

With respect to the bank, implementation of our or the administration's credit reform proposals would minimize the need for future recapitalization resulting from losses on future lending activities. Instead of recognizing losses after the fact, the emphasis would be on anticipating and budgeting for subsidy amounts. Of course, as with all estimates, the projections may need revising and there would be a need for more recapitalization if there are underestimates of the subsidy costs.

However, to require the bank to seek an appropriation for the cost to subsidize its programs, unless other entities are required to adhere to these standards, could place the bank at a disadvantage when competing with other government programs for limited budgetary resources. The appropriation request for its program subsidies could make the bank's programs appear more costly than some other government programs, which in reality they may not be. In addition, this proposal by itself, only addresses the losses in the future portfolio and not those in the existing portfolio.

Annual Appropriation of Certain Losses

Until such time as credit reform is adopted on a governmentwide basis, an alternative which would address both the problems inherent in the current portfolio and those generated through future lending activities, would be for the Congress to establish a minimum GAAP capital level for the bank, and require it to seek replenishment appropriations or additional Treasury stock purchases if losses reduce the bank's equity below that level. This treatment is consistent with 31 U.S.C. 9103 (b)(2), which requires wholly owned government corporations to annually submit to the President an estimate of the appropriations needed to restore capital impairments.

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In summary, the bank's financial condition is continuing to deteriorate. Alternatives that only recapitalize the bank to a minimum capital level will not fully address the problems in the bank's current or future loan portfolios. If the Congress believes that the bank's activities are worthwhile and necessary, the bank's programs should be supported through adequate funding and its costs monitored through Congressional oversight.

Given these considerations, we believe any recapitalization plan for the bank should address five items:

-- First, the bank's capital position should be restored to provide it with positive equity as measured by generally accepted accounting principles and those funds should be used to retire its FFB debt.

-- Second, the prepayment penalty should be waived and the bank permitted to refinance at current interest rates, thus reducing the losses in its current portfolio.

-- Third, the plan should require the bank to request appropriations to cover any future losses that cause its capital to fall below a specified level. This requirement would provide the Congress with timely notice of the bank's financial operating results and with an opportunity to obtain explanations for those results.

-- Fourth, requirements to generate proceeds from loan sales should be eliminated. These sales have stripped the bank's portfolio of its better loans and future sales could result in additional losses.

-- Finally, we strongly believe any recapitalization plan should be accompanied by a requirement that the bank's financial statements conform to generally accepted accounting principles because the Congress needs accurate, fairly presented financial information to exercise its oversight functions. We do not believe oversight is well served by permitting the bank to continue to disguise the full extent of its probable losses.

Mr. Chairman, this concludes my statement. At this time, I will be pleased to respond to any questions you have.

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-197710

February 11, 1988

The Honorable Gerald D. Kleczka
House of Representatives

Dear Mr. Kleczka:

This letter responds to your January 13, 1988, request for our views on how the Export-Import Bank of the United States would be affected if the prepayment penalty on its Federal Financing Bank (FFB) debt were waived. You also asked for information on the bank's current financial condition.

As discussed below, the penalty waiver accompanied by refinancing the bank's debt at current rates would reduce but, in our view, not entirely eliminate its losses. Although we have not completed our audit of the bank's fiscal year 1987 financial statements, we have obtained sufficient information to state that the bank's financial condition continues to decline. We addressed the bank's financial condition and related matters in a January 29, 1988, letter to the Chairman, Committee on Banking, Housing and Urban Affairs, United States Senate, a copy of which we are providing as enclosure 1 to this letter.

THE BANK'S FINANCING ARRANGEMENTS WITH FFB

The bank finances its operations primarily by borrowing from FFB. The interest rate on such debt is based on the Department of the Treasury's borrowing rate at the time the loan is made plus one-eighth of one percent. In general, the notes are for 10 years, with principal payments due either in equal quarterly installments or at maturity. Interest is due quarterly on all debt. Traditionally, the bank has not attempted to match the terms of its FFB debt with the scheduled maturities of the loans it makes to facilitate exports but has instead tried to smooth its cash outflows by scheduling its FFB debt to mature in approximately equal quarterly installments.

Prior to December 1982, the bank's debt agreements with FFB provided for prepayment without penalty based on mutual consent. As of September 30, 1987, 46 percent of the bank's debt contained this provision. Beginning in

December 1982, all of the bank's borrowing agreements with FFB have provided for a prepayment penalty if the bank accelerates its payment of this debt.

The prepayment penalty is designed to compensate the Treasury for the theoretical interest losses it will incur because of early payment.[1] The Treasury does not generally redeem outstanding notes before maturity. Therefore, if the bank prepays its debt when interest rates are lower, the Treasury still incurs the interest costs associated with notes it issued to finance FFB loans to the bank. However, this rationale assumes that the Treasury issues notes with the same maturity dates as its advances to FFB. In practice, this is not the case--the Treasury uses a combination of long- and short-term borrowing to finance the government's operations. Accordingly, we have tended to question the need for such prepayment penalties.

Before fiscal year 1987, the bank generally did not make early payments on its FFB debt and, therefore, was not significantly affected by the prepayment penalty arrangement. However, for fiscal year 1987, the bank was required by the federal government's loan sale program to generate no less than $1.5 billion in loan sales. To fulfill this goal, the bank encouraged certain debtors to prepay their loans, which they did without penalty. The bank generated $1.9 billion in receipts. Although most of the $1.9 billion was used to help fund its operations, the bank was able to prepay $670 million of its FFB debt.[2] The bank was assessed a penalty of $121 million on the debt prepayment, which it financed by additional borrowing from FFB.

THE BANK'S RECEIPTS ARE INADEQUATE TO SERVICE ITS FFB DEBT

As of September 30, 1987, the bank's preliminary financial statements (unaudited) reflect loans and receivables of $12.2 billion and FFB debt of $12.5 billion. The weighted average interest rate on the loan portfolio was 8.36 percent, while the average rate on the FFB debt was

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[1]FFB has financing arrangements with the Treasury which mirror its agreements with the bank.

[2]The loan sales program did not require the bank to prepay its FFB debt.

11.47 percent. This 3.11 percent negative spread between the stated interest rate on the bank's portfolio and the interest rate on its FFB debt adversely affects the bank's liquidity position, and hence, its ability to retire its FFB debt. Based on its portfolio, debt balances, and interest rates as of September 30, 1987, the bank would be paying approximately $406 million more interest annually than it is collecting on its loan portfolio.

Equally important is the effect delinquencies in its portfolio have on the bank's liquidity position. As of September 30, 1987, about $4.5 billion of the bank's $12.2 billion portfolio of loans and receivables was delinquent by at least 90 days. Assuming no cash receipts on the delinquent portion of the portfolio, interest payments on FFB debt would annually exceed the bank's interest receipts by approximately $784 million.

Similarly, scheduled principal payments on the bank's portfolio, when adjusted for the current delinquencies, are not adequate to meet the FFB debt service requirements. For fiscal year 1988, expected principal repayments, assuming current delinquency levels, will be $1.1 billion, while scheduled principal payments of FFB debt will be $1.6 billion.

PENALTY WAIVER WITH REFINANCING COULD REDUCE LOSSES

As suggested by your staff, we considered the effect of waiving the prepayment penalty under two scenarios: (1) assuming prepayments to FFB are made proportionate to early payoffs the bank receives under the loan sales program and (2) assuming the bank refinances its existing debt that has interest rates exceeding current FFB rates.

Regarding the first scenario, the administration is calling for net receipts from loan sales of $500 million and $525 million for fiscal years 1988 and 1989, respectively. As just discussed, the bank's expected receipts from its loan portfolio are substantially less than its costs to service its existing debt. Accordingly, the bank plans to use the loan sales receipts to fund its operations instead of prepaying its FFB debt. Notwithstanding the bank's plans, if the bank was authorized to use loan sales receipts to reduce $1.025 billion of principal on its high interest rate FFB debt without incurring a penalty, and to borrow a corresponding amount at FFB's current rate to sustain its operations, we estimate that the bank could save a total of about $200 million, which represents the present value of future interest costs not paid because of the refinancing.

Regarding the second scenario, refinancing all debt in excess of the current borrowing rate would reduce the bank's cost of funds to about 9.0 percent. However, as stated previously, the current yield on the bank's portfolio is only about 8.4 percent. Thus, if the bank refinanced its FFB debt at current rates with no penalty, the interest expense on its FFB debt would still exceed the interest receipts on its loan portfolio by approximately $99 million annually, assuming the bank collected interest on the entire portfolio. If interest receipts were adjusted for anticipated delinquencies, the bank would pay an estimated $477 million more than it received in interest.

Nonetheless, refinancing the bank's debt in this manner would significantly improve its operating results. The reduction in the weighted average interest rate on its borrowings from about 11.4 percent to about 9.0 percent would significantly reduce interest costs on the bank's current debt. We estimate such a reduction would benefit future operations by about $1 billion--the present value of currently required interest payments that the bank would not pay as a result of refinancing.

THE BANK'S CURRENT FINANCIAL CONDITION

You also asked about the bank's current financial condition. At this time, the bank has not finalized its fiscal year 1987 financial statements and, accordingly, our annual financial audit is still in progress. Nevertheless, the information obtained to date indicates that the bank's financial condition continues to worsen, primarily due to its negative interest rate differential and increasingly impaired loan portfolio. Regrettably, the bank has not seen fit to report in its financial statements the probable losses on its loans and other receivables, thus masking its true financial condition from the Congress and U.S. taxpayers.

These matters are discussed in enclosure 1. We are also providing a brief analysis of the bank's financial condition. (See enclosure 2.)

B-197710

We trust this information is responsive to your request. Should you have any questions or comments, please contact Mr. David M. Connor, Group Director, at 275-9406.

Sincerely yours,

Frederick D. Wolf
Director

Enclosures

GAO
United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-197710

January 29, 1988

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

Dear Mr. Chairman:

This letter responds to your December 23, 1987, request for our views on the financial condition of the Export-Import Bank of the United States, on recapitalization alternatives for the bank, and on the cost-to-benefit ratio of the bank's programs discussed in a recent New York Times article.

The bank was created in 1934 to facilitate U.S. exports, which it does by making direct loans, guaranteeing loans made by private lenders, and providing export credit insurance. Although the value of exports generated solely by the bank's operations cannot be precisely measured, we believe the bank's programs have yielded benefits.

To the extent that the Congress determines that supporting exports in this manner continues to be a valid public policy objective, we believe that any continued funding for the bank's programs should stipulate that program costs be more clearly presented. Specifically, we believe the Congress should require the bank to fully recognize any operating losses and to fairly report its financial condition. Our reasons for this position are presented below.

BACKGROUND

The bank was initially created by executive order in 1934. Subsequent legislation, the most significant being the Export-Import Bank Act of 1945, gave the bank essentially the powers it has today. Later in 1945, the bank was designated a wholly owned government corporation in the Government Corporation Control Act.

The bank was capitalized under the Export-Import Bank Act of 1945 through the Department of the Treasury's purchase of $1 billion of capital stock in the bank. Under the act, the bank was authorized to borrow from the Treasury, but these borrowings may not exceed $6 billion. The bank also borrows from the Federal Financing Bank (FFB). No explicit statutory limitation on the amount of borrowings the bank may have outstanding with FFB exists. However, the bank is indirectly restricted in the amount of FFB borrowing by congressional limitations on the bank's programs.

The primary rationale for this form of operation--a government corporation with an initial infusion of capital and the authority to borrow and use revenues--is that the entity may operate on a substantially self-sustaining basis much like a private corporation. Until the early-1980s, the bank was generally successful in generating adequate revenues to cover its expenses. However, the bank's program objectives along with other government policies, as discussed below, have hindered the bank's ability to remain self-sustaining.

Through 1981, the bank reported that it increased its equity from the initial $1 billion contribution to as much as $3.2 billion. Moreover, between 1945 and 1979, the bank paid approximately $1 billion in dividends to the Treasury made possible by its positive operating results. However, since 1982, the bank has suffered operating losses (not including probable losses on its loans and other receivables) that, as of the end of fiscal year 1987, had reduced its reported equity to an estimated $1.3 billion.

Several factors have contributed to this decline. First, the bank attributes its financial deterioration primarily to the negative interest rate spread, which arose in the late 1960s and widened beginning in 1979 when interest rates on its FFB debt rose rapidly while its lending rates remained virtually unchanged to keep the price of U.S. exports competitive with those of other countries. By January 31, 1982, interest rates on the bank's debt exceeded interest rates on its receivables by 3.0 percent. At the end of 1987, the negative spread was approximately 3.2 percent, based on the stated rates of the bank's receivables and debt.

A second factor is that pursuant to an informal understanding with FFB, the bank uses any funds in excess of its immediate operating needs to prepay its FFB notes. When it does this, it pays a penalty as required by FFB.[1]

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[1]Although all FFB notes issued since December 1982 include a prepayment penalty clause, at September 30, 1987, instruments governing 46 percent of the bank's $12.5 billion FFB debt stated that the notes may be prepaid based on mutual consent without penalty.

During fiscal year 1987, the bank retired $670 million of debt on which it paid penalties of $121 million.

Third, the bank's financial condition has been weakened by the federal government's loan sale program requirements. The bank was required to generate no less than $1.5 billion in loan sales in fiscal year 1987. Current plans call for the bank to generate net receipts of almost $1.3 billion through fiscal year 1989. To fulfill its goals under this program, the bank has encouraged debtors to prepay their loans, which they may do without penalty. The bank, in turn, uses the proceeds of these prepayments to pay down its indebtedness to FFB, but with a penalty.

Under most circumstances, early collection accompanied by the early retirement of debt would be viewed as beneficial to an organization's financial condition. This is not true for the bank. Bank loans that are being prepaid are generally those that are most profitable--carrying relatively high interest rates and having excellent payment histories. Early collection of this debt leaves the bank with a higher proportion of less desirable, weaker loans, thus decreasing its interest collections. This adverse effect is compounded by the prepayment penalties the bank is paying FFB, which increase its current expenses and further reduce its equity.

Finally, the bank's financial condition has deteriorated because of its problem debt. The bank's portfolio has significantly declined in value because of the impaired ability of a number of borrowers to repay their loans. Essentially, the types of problems many U.S. commercial banks have experienced with less developed country debt also plague the bank's portfolio. While the bank has chosen to ignore such probable losses and, thus, not report them in its financial statements, they are nonetheless real and further impair its financial condition.[2]

THE BANK'S CURRENT FINANCIAL CONDITION

Annually since 1982, the bank has had operating losses and corresponding declines in its equity. The bank reported aggregate operating losses for fiscal years 1982 through 1986 of $1.4 billion. The bank also expects to report an operating loss for 1987, estimated to be about $471 million. Operating losses have reduced the bank's

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[2]In a letter to you, dated December 14, 1987, we discussed the bank's reasons for not recognizing such probable losses, with which we strongly disagree.

reported equity from $3.2 billion at September 30, 1981, to an estimated $1.3 billion at September 30, 1987.

Although these figures are disturbing, the bank's financial reports materially understate the extent of losses it has incurred because they do not recognize impairments to the bank's loans and receivables arising from claims paid under its loan guarantee and export credit insurance programs. Under generally accepted accounting principles, organizations are required to recognize losses related to the uncollectible portion of loans and other receivables through a charge against the current year's income and a corresponding increase in a loss allowance. However, the bank has chosen not to comply with this aspect of generally accepted accounting principles, even though the problem portion of its loans and other receivables has been steadily increasing.

Based on this noncompliance, we reported that the bank's financial statements for fiscal years 1983, 1984, 1985, and 1986 do not fairly represent its financial condition and results of operations. The impact of the bank's noncompliance with established accounting principles for problem debt is becoming increasingly significant--between 1982 and 1986, the bank's problem debt increased from 13 percent to 38 percent of its total portfolio.

Because the bank does not record probable losses on its receivables, we have estimated such losses as part of our audits. For 1986, we estimated that the bank needed to provide a loss allowance of between $2.7 and $3.8 billion. Establishing this allowance would have resulted in a deficit equity position of between $1.9 and $3.0 billion at September 30, 1986. In contrast, because it did not recognize those losses, the bank reported equity of about $1.8 billion. Although the bank has not finalized its 1987 financial statements, preliminary reports and our audit work indicate continuing operating losses and further impairments to the bank's loan portfolio. In addition, as noted above, selling its best loans will accelerate the deterioration of the bank's financial condition. We have again urged the bank to properly account for its losses, but, to the best of our knowledge, it has no intention of changing its accounting practices.

VIEWS ON RECAPITALIZATION ALTERNATIVES

The bank's borrowing from FFB and its refusal to fully report loan losses obscures the full costs of the bank's programs from the Congress and the public. The FFB borrowing has enabled the bank to continue operating without seeking funds from the Congress, even though in recent years it has steadily incurred losses and has been in a deficit equity position when measured by generally accepted accounting principles. As required by 12 U.S.C. 635i-2, the bank recently reported to the Congress that its equity position had fallen below the reporting threshold of almost $1.4 billion mandated by the Congress. However, the bank's refusal to properly account for its problem debt resulted in the bank delaying its report and not disclosing to the Congress the extent of its losses.

Because the bank is expecting to incur operating losses that will soon place it in a deficit position even by its own liberal accounting practices, there is growing interest in strengthening the bank's financial condition. In this regard, bank officials have suggested a range of options including taking no action, waiving prepayment penalties, refinancing the bank's debt at lower interest rates, and providing the bank with additional capital.

In evaluating such proposals, we believe the Congress should consider the following factors. First, none of these alternatives would affect the federal budget deficit as long as program levels are not increased because of recapitalization. The deficit is not affected because fund transfers from one federal entity to another offset each other. None of the recapitalization alternatives represent outlays and, thus, would not impact the budget deficit.

Second, the bank could sustain its operations without recapitalization as long as it could borrow from FFB. However, with the bank's increasing operating losses resulting from interest rate differentials, and its decreasing cash flow due to the increasing number of loans on which it is not receiving payments, the bank may need to seek more loans from FFB, which it may be unable to repay. Thus, the burden of the bank's losses would be shifted to FFB.

Third, the prepayment penalty the bank pays is designed to compensate the Treasury for the theoretical interest losses it will incur because of the early payment. The Treasury does not generally redeem outstanding notes before maturity. Therefore, if the bank prepays its debt when interest rates are lower, the Treasury still incurs the interest costs associated with notes it issued to finance loans to the bank. For example, if the bank prepaid a $1.5 billion, 9 percent loan when the interest rate was

7 percent, the 2 percent difference on $1.5 billion would represent a $30 million annual carrying cost for the Treasury. While the bank could add similar prepayment provisions to the loans it makes, such provisions could make its loans less competitive and, thereby, undermine the bank's program objectives.

Fourth, permitting the bank to refinance its debt at lower interest rates would reduce its interest costs, thus enhancing its ability to operate on a self-sustaining basis. However, this option would probably not be sufficient to entirely eliminate the negative interest rate spread and would not correct the bank's current capital deficiency.

Fifth, the capitalization of government corporations has a long history in our government and is one means of trying to foster a more businesslike conduct of their affairs. Doing nothing, thus allowing the bank's capital position to continue to deteriorate, while its problem debt increases, may undermine its corporate form and sharply contrasts with policies that the Congress is following to ensure the safety and soundness of commercial banks. In 1983, the Congress directed the federal banking agencies to require banks to maintain adequate capital levels and to set up "special reserves" for certain categories of international debt, such as loans for which there were no definite prospects for the orderly restoration of debt service.

Given these considerations, we believe any recapitalization plan for the bank should address three items. First, the bank's capital position should be restored to provide it with a positive equity as measured by generally accepted accounting principles. Second, the plan should require the bank to request an appropriation to cover losses that cause its capital to fall below a specified level. This requirement would provide the Congress with timely notice of the bank's financial operating results and with an opportunity to obtain explanations for those results. Finally, we strongly believe any recapitalization plan should be accompanied by a requirement that the bank's financial statements conform to generally accepted accounting principles because the Congress needs accurate, fairly presented financial information to exercise its oversight functions. We do not believe oversight is well served by permitting the bank to continue to disguise the full extent of its probable losses.

COST-TO-BENEFIT RATIO OF THE BANK'S PROGRAMS

Your letter also asked us to assess the cost-to-benefit ratio of the bank's programs as attributed to the bank's President and Chairman of the Board of Directors in a December 21, 1987, New York Times article. According to the article, he stated that over the half-century of the bank's existence, taxpayers have paid between $2 and $3 billion for the subsidies it provides, but the bank has facilitated $190 billion in exports. As a methodology, cost-benefit analysis generally tries to assess all of the costs and benefits to society of a government program. However, because the comments of the bank's President referred only to costs to the government and the impact on U.S. exports, our comments will refer primarily to these costs and benefits.

According to the bank's Treasurer-Controller, the $2 to $3 billion cost estimate is based on actual losses as reported in its financial statements since 1982, and projected losses on its current portfolio through 1996. The $190 billion benefit cited represents the bank's estimate of the total amount of exports that have been associated with its loans, insurance, and guarantees. We believe these estimates understate the costs to the government of these programs and overstate the value of any resulting exports. However, there are some additional benefits not included in the $190 billion which we cannot quantify, but will discuss below.

The $2 to $3 billion cost estimate understates the economic cost to the U.S. government in two ways. As previously discussed, the bank has taken no charges against income to create a loan loss reserve for likely losses on its outstanding portfolio. However, even if the loan loss reserve were created through charges to the bank's income, the reported accounting losses would not represent the full economic cost to the government of the bank's programs.

In 1945, the bank received an initial capitalization of $1 billion. Over the years, it also accumulated up to $2.2 billion in retained earnings and paid the Treasury about $1 billion in dividends. From the start of the bank's operations until 1968, the bank made loans at rates of interest that exceeded the government's cost of borrowing. Hence, there was no hidden cost to the government involved in the bank's lending during this period. In fact, the government received a net financial benefit. However, this situation changed in 1969, when the bank began to lend on average at negative spreads--that is, the interest rates it charged borrowers were less than the cost of government borrowing.

The resulting subsidy was not evident in the bank's financial statements because the aggregate interest it earned on its loans exceeded the interest payments it made on its borrowings from FFB and the Treasury for the years 1969 through 1981. Thus, the bank reported a profit in its financial statements for those years despite the negative spread in interest rates because it did not have to borrow all of the funds which it lent out. The bank had available for its programs its initial capital and retained earnings on which no interest was paid. Hence, there existed the seemingly anomalous situation in which the bank reported a profit yet the government bore a subsidy cost.

Since 1982, the bank has reported operating losses. Nevertheless, regardless of the loan loss reserve issue, these reported losses have understated the cost to the government of the bank's programs for the same reasons discussed above.

The annual interest subsidy cost can be estimated by multiplying the negative interest rate spread by the bank's outstanding portfolio of loans. Alternatively, the interest subsidy can be estimated by multiplying the cost of government borrowing by the bank's capital and retained earnings and adjusting the result for any financial statement income or loss. Over the years, the bank did pay the Treasury about $1 billion in dividends, and those dividends should be netted out of any subsidy estimates.

The annual subsidy cost will vary from year to year as interest rates and the bank's equity change. At one extreme, to use numbers representative of those reported at the beginning of the decade when both interest rates and reported bank equity were at their highest, the bank's programs represented a subsidy cost of as much as $445 million a year.

We also believe the benefits reported overstate the extent to which the bank's programs have increased U.S. exports. A bank official told us that the $190 billion in exports cited in the article represents estimated exports associated with all loan, guarantee, and insurance commitments made by the bank. However, this estimate overstates the actual exports supported because it is based on bank commitments, not the actual amount of loans disbursed (or guaranteed) or of shipments insured. For example, in 1986, the bank insured $3.4 billion in shipments out of $4.4 billion in commitments. Even if the actual value of total exports supported were known, estimating the economic benefits of the bank's programs with any precision would be very difficult, if not impossible. Program accomplishments should be measured as equal to the net exports "created," that is, the exports that would not have been made without the support of the bank. This addition to total exports is generally referred to as "additionality." However, we know of no generally accepted methodology for reliably estimating additionality for the bank's programs, or for export promotion programs in general.

Survey questionnaire data support the belief that the bank has a positive influence on export activity, but also shows that a substantial amount would have occurred without the bank's assistance programs. During our review of the bank's insurance program (GAO/NSIAD-87-189, September 30, 1987), respondents to our survey of 1986 policyholders reported they believed that 55 percent of the exports would have been made without the bank's insurance. Direct loans may be more effective in promoting exports, especially if they are used to offset subsidized official credit offered by foreign competitors, but it is doubtful that additionality is 100 percent. Hence, while the bank's programs make a contribution to U.S. exports, we cannot accurately measure it.

Even without a quantitative assessment of benefits, we believe it is worth noting other important contributions the bank makes to U.S. exports. The first involves efforts to reduce worldwide export subsidies, and the second involves filling a possible gap in international lending.

The United States has negotiated with other countries since the early 1970s to reduce various forms of export subsidies, including official export credit subsidies. One way to make our trading partners more willing to reduce such subsidies is to "take the profit out of them." The bank has been used as a "fighting ship" to offer competing subsidized credit so that U.S. export sales would not be lost to a subsidized foreign competitor. Some of the bank's reported losses are the result of these actions. Progress has been made in negotiations to reduce export credit subsidies, and the bank played a role in promoting that progress. Thus, the bank's contributions extend beyond specific export sales and include the benefits to U.S. exporters of reducing foreign subsidies.

In addition, the bank can be used to extend the market for international long-term lending. Long-term lending at fixed rates is not always available to finance the export of long-lived capital goods, even for creditworthy borrowers. Hence, the bank's ability to lend long-term at fixed rates can help fill the lending gap that might otherwise restrict exports.

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In closing, we wish to emphasize our view that any actions the Congress undertakes to restore the bank's financial condition should include the requirement that the bank fairly report its financial condition and present its financial statements in accordance with generally accepted accounting principles. We trust this letter responds to your inquiry. Should you require other assistance in this area or have any questions, please contact me at 275-9461 or Mr. Allan I. Mendelowitz, Senior Associate Director, National Security and International Affairs Division, at 275-4812.

Sincerely yours,

Frederick D. Wolf

Frederick D. Wolf
Director

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Enclosure 2

	---------ALL AMOUNTS IN MILLIONS---------					
	UNAUDITED FY87 (4)	FY86	FY85	FY84	FY83	FY82
LOANS AND CLAIMS RECEIVABLE	$12,217	$15,285	$16,712	$17,504	$16,883	$16,565
PROBLEM LOANS (1)						
DELINQUENT LOANS	$4,522	$2,825	$2,673	$2,707	$1,904	$1,377
% OF TOTAL LOANS	37.0%	18.5%	16.0%	15.5%	11.3%	8.3%
RESCHEDULINGS	$3,720	$3,564	$3,052	$1,546	$1,194	$1,178
% OF TOTAL LOANS	30.4%	23.3%	18.3%	8.8%	7.1%	7.1%
LOANS PURCHASED	$1,034	$972	$984	$757	$397	$289
% OF TOTAL LOANS	8.5%	6.4%	5.9%	4.3%	2.4%	1.7%
TOTAL PROBLEM LOANS (2)	$5,855	$5,751	$4,912	$4,633	$2,654	$2,098
GROWTH (FY82 BASE)	279%	274%	234%	221%	127%	100%
REVENUES:						
INTEREST REVENUE	$1,191	$1,410	$1,478	$1,458	$1,342	$1,272
FEES, PREMIUMS & MISC	$78	$82	$86	$99	$82	$124
EXPENSES:						
INTEREST EXPENSE	$1,604	$1,769	$1,828	$1,746	$1,624	$1,479
NET LOAN WRITE-OFFS (3)	($6)	$2	$5	($20)	$5	$32
NET CLAIMS PAID (3)	($10)	$14	$78	$139	$14	$25
ADMINISTRATIVE	$16	$17	$19	$17	$15	$14
OTHER EXP AND ADJUSTMENTS (5)	$134	$23	($22)	$18	$12	$6
NET LOSS	($471)	($333)	($344)	($343)	($247)	($160)
CAPITAL	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
RETAINED EARNINGS	$301	$773	$1,106	$1,450	$1,792	$2,040
CAPITAL AND RETAINED EARNINGS	$1,301	$1,773	$2,106	$2,450	$2,792	$3,040
UNREALIZED INTEREST INCOME						
RESCHEDULED	$183	$105	$276	$268	$199	$126
DELINQUENT	$347	$223	$305	$278	$186	$149
CAPITAL AND REALIZED EARNINGS	$771	$1,445	$1,525	$1,904	$2,407	$2,765
TOTAL PROBLEM LOANS	$5,855	$5,751	$4,912	$4,663	$2,654	$2,098
AS A % OF RETAINED EARNINGS	1945%	744%	444%	322%	148%	103%
AS A % OF CAP & RETAINED EARN	450%	324%	233%	190%	95%	69%
AS A % OF CAP & REALIZED EARN	759%	398%	322%	245%	110%	76%

NOTES:
(1) LOANS THAT EXHIBIT CHARACTERISTICS THAT LEAD TO DELINQUENCY AND ULTIMATE UNCOLLECTIBILITY
(2) EXCLUDING DOUBLE-COUNTING AMONG CATEGORIES
(3) INCLUDES "LAKER AIRWAYS" LOSS OF $50M IN FY82 AND $35M GAIN IN FY84
(4) PRELIMINARY FY87 DATA: UNAUDITED
(5) INCLUDES PENALTY OF $121 MILLION IN FY 87 PAID TO FFB FOR EARLY RETIREMENT OF DEBT

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