STATEMENT BY RAYMOND J. DECARLI
ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF TRANSPORTATION
BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE
COMMITTEE ON MERCHANT MARINE AND FISHERIES
U.S. HOUSE OF REPRESENTATIVES

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Mr. Chairman and members of the Subcommittee on Merchant Marine. I am Raymond DeCarli, Assistant Inspector General for Auditing in the Department of Transportation (DOT). I appreciate the opportunity to be here today at your hearing on the Title XI Federal Ship Financing Program. With me is Mr. Joseph Kratz, the Deputy Assistant Inspector General for Auditing.

My testimony this morning will focus on two of our audit reports dealing with the Maritime Administration's (MARAD) management of the Title XI Program. The first report was issued in July 1983 and the second in September 1986. The objectives of both audits basically were to evaluate MARAD's administration and financial management of the Title XI Program.

Prior to 1980, the Title XI Program was financially stable and relatively few companies defaulted on loans. MARAD's Title XI loan portfolio grew from about $2 billion in 1973 to more than $7 billion in 1980. More than half of the loan guarantees were associated with oil and liquid natural gas equipment. Depressed economic conditions in the petroleum industry in the early 1980's, together with strong international competition in the maritime industry increased the potential for defaults on these loans. MARAD's loan portfolio is now valued at about $4.4 billion. The decrease from the $8 billion in 1983 was due to completion of loans and also $2 billion in loan defaults.

Our 1983 report was the first indicator that the Title XI Program had the potential for serious financial problems. Of the $8 billion of outstanding loan guarantees and commitments, MARAD considered a number of companies with a total guaranteed debt of $900 million to have a greater loan default risk than other Title XI companies. Many of these companies had already received fund advances or additional loans to prevent default. There was a real potential for some defaults to occur from this group. However, only about $200 million was readily available from the Title XI Revolving Fund to cover loan defaults. In the past, MARAD had been able to preclude defaults by assisting companies to reorganize or liquidate their assets, and to prevent large defaults through a series of cash advances to Title XI participants. However, at this time conditions in the maritime industry had reached the point where MARAD postponed repayment of some advances; and additional advances were made to cover interest payments on previous advances.

While unfavorable economic conditions in the petroleum industry was a major contributor to these Title XI Program problems, MARAD policies were also partially responsible. MARAD approved loan guarantees to companies in questionable financial condition, guaranteed loans in segments of the maritime industry which were already overbuilt, and shifted the program emphasis away from deep water vessels to oil drilling rigs and inland river barges.

Our primary recommendation was that MARAD thoroughly reassess the Title XI Program. We wanted MARAD to strengthen its criteria for approving loan guarantees by considering both the financial stability of the applicant and the economic conditions of the maritime industry.

The MARAD Administrator did not believe that the $900 million of loan guarantees cited in our report represented a good estimate of the Title XI loan defaults that would occur. He said such a loss was pessimistic and only conceivable under the assumption that recovery from the economic downturn would be delayed over a long period. However, the Administrator agreed with our recommendations, and advised that the Title XI regulations would be strengthened and firmer criteria would be established for approving loan guarantees. He also indicated that program priorities and goals would be clearly established regarding the types of vessels that would be funded. MARAD has revised its loan approval process, but we have not evaluated the new procedures. MARAD has not approved any loan guarantees since Fiscal Year (FY) 1986.

Our 1986 audit report concentrated on the financial condition of the Title XI Program, and the adequacy of decisions to provide assistance to financially troubled companies. We reported that the financial problems experienced by the Title XI Program had worsened since our prior audit report in 1983.

The Federal Ship Financing Fund did not have sufficient funds to support Title XI ship loan guarantee commitments. Changes in market conditions reduced the demand for services which, in turn, increased the number of guaranteed loan defaults. MARAD, acting in accordance with its authorities, borrowed significant amounts from the Treasury; and the need for such borrowing steadily increased. As of December 31, 1985, the fund borrowed $450 million from the Treasury to meet Title XI obligations with $800 million anticipated to cover additional FY 1986 defaults. By the end of 1986, interest expense for the fund exceeded projected revenues. MARAD continued to increase the fund balance through borrowings, which the fund did not have the resources to repay.

We recommended that MARAD request an appropriation from Congress to liquidate the debt owed to the Treasury. We also recommended that MARAD make annual projections of the fund's revenues and expenses, and request appropriations for any anticipated shortfalls.

MARAD officials advised us that they were working with DOT budget personnel to resolve the fund's financial problems. MARAD requested and Congress appropriated $1.4 billion to MARAD in FY 1987 to cover Title XI defaults. As of September 1987, MARAD had borrowed $420 million from the Treasury to cover additional defaults. MARAD intends to seek appropriations to cover the funds borrowed from Treasury.

When a company is unable to generate sufficient cash to pay operating costs, debt service, and Title XI loan guarantee fees, MARAD often attempts to restructure or reschedule the terms or conditions of the loan. This is done to facilitate repayment and meet the requirements of the lending institutions. The most common restructuring action includes the deferment of principal amortization payments and use of Title XI reserve funds to pay for Title XI debt service. Other actions have included restructuring of bond interest rates, transfers of vessels and related indebtedness, indirect loans by subordination of MARAD's prime lien position, and deferring collection of MARAD loan guarantee fees and advances.

Restructured loans to vessel owners with Title XI loan guarantees had not been effective in keeping maritime companies from defaulting on their loans, and increased the liability of the fund. Management officials approved revised loans, although they were not provided pertinent information concerning available alternative actions and their related costs. We reviewed 21 companies that had restructured loans during the 15-month period ended October 31, 1985. The guaranteed principal amount for these loans was over $790 million. We found that 11 of the 21 firms reviewed subsequently defaulted. The amount of the defaults totaled over $279 million or about 35 percent of the total guaranteed amount. We anticipated that unless market conditions improved, eight more firms would probably default between FYs 1986 and 1988.

Some restructured loans resulted in subordinating MARAD's rights to assets, and, therefore, had the potential to further increase losses to the fund by about $20 million. These actions were taken prior to August 24, 1984, when the Office of Management and Budget issued revised Circular A-70. The circular contained a statement that the Government's claims on assets must not be subordinated to other lenders in the case of a borrower's default on either a direct loan or a guaranteed loan.

We recommended that MARAD document its cost analyses for restructured loans and consider the potential cost to the fund, as well as alternatives and market conditions in the restructuring decision process. We also recommended that MARAD stop approving restructuring in cases which subordinated the Government's first position to participate in the proceeds from the sale of assets from defaulted loans. MARAD officials agreed with our recommendations in their December 1986 response to the final report.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions that you or the members of the subcommittee may have.

Thank you.