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United States General Accounting Office
Washington, DC 20548

May 25, 2001

The Honorable John McCain
Chairman
Committee on Commerce, Science, and Transportation
United States Senate

Subject: Financial Management: Emergency Steel Loan Guarantee Program

Dear Mr. Chairman:

In a February 1, 2001 letter, you expressed concerns about repayments of federally guaranteed loans by borrowers under the Emergency Steel Loan Guarantee Program and the effect of the program on the U.S. steel industry. As agreed with your office, we conducted a financial analysis of the program and an economic analysis of factors relevant to the U.S. steel industry.

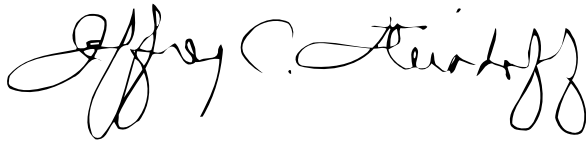
Our financial analysis covered program background; the status of program funding; loan guarantees applied for, approved, and disbursed; the federal government's maximum potential loss for the program; the financial condition of approved borrowers; and factors that affect the borrowers' ability to repay loans on time. Our economic analysis considered general factors that influence steel industry production, capacity, consumption, pricing, and international trade, as well as specific factors relating to the program. Our work was conducted in March and April 2001 in accordance with U.S. generally accepted government auditing standards.

On May 1, 2001, we briefed your office on the results of our analysis, including the status of the Emergency Steel Loan Guarantee Program from its inception on August 17, 1999, through March 31, 2001. This letter transmits the material from that briefing showing that there has been only one guaranteed loan disbursed by a private lender for \$110 million. With an 85 percent guarantee, the federal government's maximum potential loss is \$93.5 million, assuming no repayments and no recovery from property pledged as collateral. We noted that the financial condition of program applicants is not strong and repayments of loans depend upon many future factors. Our economic analysis noted a flat demand for steel, moderate prices, and static imports of foreign steel forecasted for 2002 and 2003. Due to the low loan amount, the program through March 31, 2001, has had a minimal overall effect on the U.S. steel industry. However, the program is currently accepting loan guarantee applications through August 31, 2001, and may, by law, extend the application date through December 31, 2001. As agreed with your office, this concludes our work on the program at this time.

We are sending copies of this letter to Senator Ernest Hollings, Ranking Member, Senate Committee on Commerce, Science, and Transportation; Representative W.J. Tauzin, Chairman, and Representative John D. Dingell, Ranking Minority Member, House Committee on Energy and Commerce; the Emergency Steel Loan Guarantee Board, and other interested parties. This letter will also be available on GAO's home page at <http://www.gao.gov>.

If you have any questions, please contact me at (202) 512-2600 or by e-mail at steinhoffj@gao.gov or Jeanette M. Franzel, Acting Director, at (202) 512-9471, or by e-mail at franzelj@gao.gov. Key contributors to this letter were Roger R. Stoltz, Richard R. Kusman, and Stephen M. Brown.

Sincerely yours,

A handwritten signature in black ink, reading "Jeffrey C. Steinhoff". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

Enclosure



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Emergency Steel Loan Guarantee Board Loan Guarantee Program

Financial and Economic Assessment

Briefing for the Staff of the Senate Committee on
Commerce, Science, and Transportation

May 1, 2001



- On August 17, 1999, the Emergency Steel Loan Guarantee Act of 1999 (Public Law 106-51) created a program to provide loan guarantees to qualified steel producing companies.
- On February 1, 2001, the Chairman of the Senate Committee on Commerce, Science, and Transportation requested that we review the program to address two specific questions:
 - Will borrowers be able to repay loans on time or is a federal bailout likely to be needed?
 - What is the effect of the program on U.S. steel production, capacity, and steel prices?

The Board has approved very few loans for guarantees and their repayment depends upon future events. Accordingly, as agreed to by Committee staff, the borrower's ability to repay and the financial implications for the federal government have been addressed in our financial review as follows:

- What is the status of program funding?
- Since program inception, how many guaranteed loans have been applied for, approved, and disbursed?
- What is the federal government's maximum potential loss for the program?
- What is the financial condition of approved borrowers under the program?
- What factors affect the borrowers' ability to repay the loans on time?



Also as agreed to by Committee staff, the effect of the program on U.S. steel production, capacity, and steel prices has been addressed in our economic review as follows:

- What are some general characteristics of U.S. steel industry production, capacity, and consumption?
- What are some general characteristics of U.S. steel industry prices?
- What are some general factors of international trade that affect the U.S. steel industry?
- What specific factors of the program affect U.S. steel industry production capacity and pricing?

In order to meet the modified objectives, we

- interviewed the program's executive director, general counsel, and officials representing the three board members from the Department of Commerce, the Federal Reserve Board, and the Securities and Exchange Commission;
- reviewed and analyzed program legislation, applications and requirements for loans, and board minutes;
- reviewed the consultant's model for estimating subsidies consistent with the Credit Reform Act of 1990;
- prepared schedules on the status of program funding and loan applications as of March 31, 2001;
- assessed the federal government's maximum potential loss for the program;
- identified factors affecting loan repayment; and
- obtained and analyzed economic information on U.S. steel production, prices, and international trade issues.



Scope Limitations

- We did not perform detailed analysis of approved loan applicants' financial condition.
- All forecasted amounts are dependent upon future events.

Board Comments

- We received comments on a draft of these briefing slides from board officials. These comments are discussed on the last page of this briefing.

Government Auditing Standards

- Our work was conducted in March and April 2001 in accordance with U.S. generally accepted government auditing standards.



- The Emergency Steel Loan Guarantee Program is headed by a three member loan guarantee board. The board's staff consists of an executive director, executive secretary, a general counsel, a receptionist, and consultants.
- The program provides for loans by private lenders to qualified steel companies with up to \$250 million to a single company. The total amount of loans outstanding may not exceed \$1 billion and federal guarantees may not exceed 85 percent of loan principal. Interest is not federally guaranteed.
- The first application window was from October 27, 1999 to February 28, 2000, and a second window from November 1, 2000 to August 31, 2001.
- The act provides that the board may not make commitments to guarantee loans after December 31, 2001, and all loans must be repaid by December 31, 2005. The act does not provide a termination date for the board.

From program inception through March 31, 2001:

- 14 loan applications totaling \$924 million have been received; 7 loans have been approved for \$544 million*; and 1 loan has been disbursed for \$110 million.
- The federal government's maximum potential loss for the one disbursed loan is \$93.5 million assuming no repayments and no recovery from property pledged as collateral.
- The financial condition of program applicants is not strong, and repayment of loans depends upon many future factors.
- Flat demand for steel, moderate prices, and static imports of foreign steel are forecasted for 2002 and 2003.
- The program has had minimal overall effect on the U.S. steel industry due to the low loan amount.

*The Board expects that at least 4 approved loan applications will not be updated by the lenders.

Table 1: Status of Program Funding from Inception to March 31, 2001 (Dollars in millions)

	<u>Budget</u>	<u>Actual</u>
Guaranteed loans	<u>\$1,000.0</u>	<u>\$110.0</u>
Estimated credit subsidy*	\$140.0	\$12.9
Administrative costs	<u> 5.0</u>	<u> 2.0</u>
Total costs	<u>\$145.0</u>	<u>\$14.9</u>
One-half percent guarantee fee revenue**	\$5.0	\$.6

* The Credit Reform Act of 1990 requires all federal direct and guaranteed loan programs to estimate a credit subsidy. Accordingly, the Office of Management and Budget (OMB) estimated a credit subsidy rate for this program of 14 percent for principal only and the Board re-estimated the rate of 11.7 percent.

** P.L. 106-51 provides for a fee to cover costs of the program not to exceed 0.5 percent of the principal amount of the guaranteed loan.



Key Documents for Guarantee Loan Applications

1. Application for loan guarantee.
2. Environmental assessment.
3. Loan documents to be signed.
4. Borrower certification, which includes granting GAO audit access.
5. Lender underwriting analysis.
6. Lender certification that its underwriter analysis is the same as for a nonfederal guaranteed loan and the borrower is a qualified applicant.
7. Description and appraisal of collateral.
8. Audited borrower financial statements for the previous 3 years.
9. A 5-year history and projection of revenue, cash flow, and price and production costs.
10. Documentation that credit was not otherwise available from other sources.

Table 2: Current Status of the Loan Guarantee Program from Inception (October 27, 1999) Through March 31, 2001
(Dollars in millions)

Board Activity:	<u>Applications</u>	<u>Amount</u>
Total loan guarantee applications received	14	\$924.3
Adjusted loan guarantee application amounts*		(50.7)
Loan guarantee applications denied or withdrawn	<u>7</u>	<u>(329.3)</u>
Total loan guarantees approved	7	\$544.3
 Lender Activity on Board Approved Guarantees:		
Loans pending lender update of loan materials**	5	\$415.0
Loan disbursed by lender	1	110.0
Loan pending lender disbursement	<u>1</u>	<u>19.3</u>
Total loan guarantees approved	7	\$544.3

* Difference between the application amount and the approved amount by the Board.

**The Board expects that at least 4 of the 5 approved loan applications will not be updated by the lenders.

Interest Rates on 7 Approved Loan Guarantees

- Interest rates are prime rate plus basis points*.
- Most loans cite LIBOR** prime rate as the accepted index of cost of funds for lenders worldwide.
- Interest rates are variable and adjust frequently as lender cost of funds change.
- Interest rates for the 85 percent federally guaranteed are lower due to no lender risk.
- Interest rates for the remaining 15 percent vary based upon lender risk assessment.
- Basis points range from 100 to 2,200.

*100 basis points equals 1 percent interest.

**London InterBank Offered Rate (LIBOR).

Table 3: Use of Proceeds on 7 Approved Guaranteed Loans

	<u>Amount</u>	<u>Percent</u>
• Debt refinancing	\$216.0	39.7
• Capital expenditures	191.0	35.1
• Bankruptcy financing and other	95.9	17.6
• Working capital	<u>41.4</u>	<u>7.6</u>
Total	\$544.3	100.0



Balloon Payments on 7 Approved Loan Guarantees

- Repayment schedules call for quarterly interest and minimal principal payments that result in \$423 million (78 percent) of balloon payments due by December 31, 2005.
- If the balloon payments are not made, the loan is in default and the lenders most probably will seek immediate payment of the 85 percent federal guarantee.
- After federal payment to a lender, the amounts become a government claim with three options for recovery:
 - sell the loan to another financial institution,
 - negotiate a repayment schedule as a direct loan, or
 - foreclose and sell the property pledged as collateral.

Table 4: The Federal Government's Maximum Potential Loss on the Emergency Steel Loan Guarantee Program

Based upon the one guaranteed loan disbursed as of March 31, 2001, the government's maximum potential loss for the one disbursed loan is \$93.5 million assuming no repayments and no recovery on property pledged as collateral as follows:

	(Dollars in millions)
Loan disbursed	\$110.0
85 percent federal guarantee	\$93.5
14.0 percent credit subsidy estimated by OMB	\$15.4
11.7 percent credit subsidy re-estimated by Board	\$12.9
If the loan is repaid	\$0



Financial Condition of 7 Approved Borrowers

We did not perform detailed analysis of the 7 approved borrowers' financial condition. Applicants are not in strong financial condition because to qualify for a guarantee loan they must

- have experienced layoffs or production or financial losses since January 1998 and
- be unable to obtain credit from other sources on reasonable terms and conditions.

Additionally, 6 of 7 approved applicants have either been through bankruptcy, are currently in bankruptcy, or are emerging from bankruptcy.

Some Factors that Affect Ability to Repay Loans

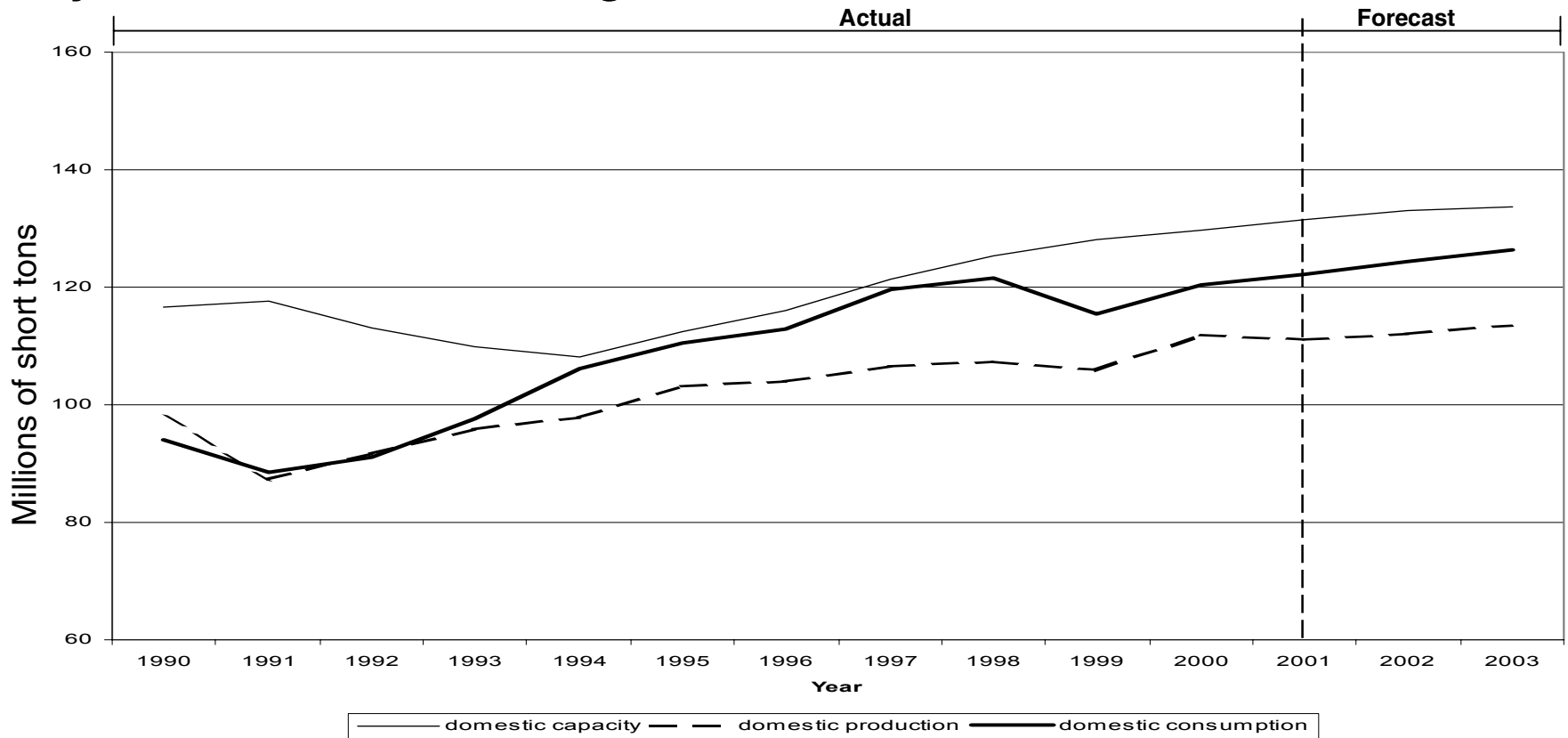
Factors are heavily dependent upon future events and include:

- Generating cash flow to pay loan principal and interest when due.
- Ability to maintain short-term liquidity to pay suppliers and employees.
- Ability to generate sales and profits, particularly in a declining market.
- Extent of dependency on major customers for sales and profits.
- Stability and commitment of top company management.

Some General Characteristics of U.S. Steel Industry Production and Capacity (See figure 1)

- U.S. consumption of domestic and foreign steel rose from about 94 million tons in 1990 to about 120 million tons in 2000 for an increase of about 28 percent, or about 2.5 percent annually.
- Forecasts are for relatively flat consumption levels in the next few years.
- U.S. steel industry production reached a near-record level in May 2000, but has generally been flat since then.
- U.S. steel industry capacity has increased from about 108 million tons in 1994 to about 130 million tons in 2000 for an increase of about 20 percent, or about 3 percent annually.
- Recession concerns about the current and near term economy.
- Some growth in new ‘mini-mill’ production relative to traditional ore-based production.

Figure 1: Domestic Steel Capacity, Production, and Consumption by Year from 1990 Through 2003



Source: Standard and Poor's DRI.

Some General Characteristics of U.S. Steel Industry Prices (See figure 2)

- Standard and Poor's composite of 8 carbon steel product prices was \$317 per ton in February, 2001-- a record low since 1980.
- Current prices for almost all types of carbon steel are well below a low of \$350 per ton which occurred in the first quarter of 1999 at the height of the Asian financial crisis.
- Forecasts are for prices to increase modestly over the next few years, but they are likely to remain below 1997 levels.
- Large inventory build-ups at mills and distributors are still being worked off.
- Low steel prices can negatively impact cash-flow and profits.

Figure 2: Spot price Per Ton of Eight Carbon Steel Products by Quarter from 1990 Through 2002 (In nominal and constant dollars)



Source: Purchasing Magazine and Standard and Poor's DRI.

Note: The 8 steel products are: hot rolled sheet, cold rolled sheet, galvanized sheet, plate, structurals, rebar, cold finished bars, and wire rods.

Some General Factors of International Trade that Affect the U.S. Steel Industry (See figure 3)

- Significant growth in foreign steel (expressed as a percentage of total domestic consumption): about 1 percent of consumption in 1950, about 18 percent in the early 1990s, to about 33 percent in 2000, peaking at about 34 percent in 1998 at the height of the Asian financial crisis.
- Over the next few years, forecasts are for steel imports to be about 28 percent of domestic steel consumption.
- Internationally, there are issues of government involvement in steel production in many countries, which distort market signals and add to global over-capacity in the steel industry.
- U.S. companies have referred many below cost ‘dumping’ of foreign steel and other import relief practice cases to the Department of Commerce and the International Trade Commission.
- Lower foreign labor costs and some new technology issues.

Figure 3: Foreign Steel as a Percent of U.S. Consumption by Year from 1990 Through 2003



Source: Standard and Poor's DRI.



Program Factors that Affect U.S. Steel Industry

- Currently, the program has had minimal overall effect on the U.S. steel industry as only one loan for \$110 million to a diversified product producer with no significant segment of the market has been disbursed through March 31, 2001.
- However, loans may have significant local or regional effect and may affect the quantity of certain steel products.



We provided a draft of these briefing slides to officials of the Emergency Steel Loan Guarantee Board for their review and comment. They agreed with the contents of the briefing slides and provided comments that we have incorporated where appropriate.