



Office of Inspector General
Export-Import Bank of the United States

Medium Term Export Credit Program – Credit and Fraud Risk Management Business Process Improvement

March 30, 2009
OIG-AR-09-04



Michael W. Tankersley
Inspector General

**Export-Import Bank
of the United States**

March 30, 2009

To: James L. Lambright
Chairman

From: Michael W. Tankersley
Inspector General

A handwritten signature in black ink, appearing to read "MT", is written over the printed name of Michael W. Tankersley.

Subject: Performance Audit of Medium Term Export Credit Program

This memorandum transmits Audit Report OIG-AR-09-04, *Medium Term Export Credit Program – Credit and Fraud Risk Management and Business Process Improvement*. The medium term export credit programs provided by the Export-Import Bank of the United States (the "Bank") have significantly underperformed other Bank programs in recent years, accounting for a disproportionate share of credit and fraud losses. The audit found that the Bank had not developed adequate customized policies, controls, systems and tools to address the enhanced risks of the medium term export credit programs.

With regard to a majority of the findings made in the Report, management acknowledged the need for improvement and cited actions management has recently taken or will take to address the issues raised by the findings and recommendations. Management accepted and committed to act upon six of the eight recommendations and declined to take action on two of the eight recommendations.

We engaged Protiviti, an independent risk consulting firm, to perform the audit under a contract managed by this office. Protiviti affirmed that the audit was performed in accordance with United States generally accepted government auditing standards.

We appreciate the cooperation and courtesies provided to Protiviti and this office during the audit.

Michael W. Tankersley
Inspector General

Export-Import Bank of the United States

Performance Audit Report - Credit and Fraud Risk Management Business Process Improvement



Medium Term Export Credit Program Audit March 2009

Executive Summary

The Export-Import Bank of the United States (“Ex-Im Bank” or the “Bank”) is the official export-credit agency of the United States. Ex-Im Bank supports the financing of U.S. goods and services in international markets, allowing U.S. companies of all sizes to create and maintain jobs in the United States. Ex-Im Bank assumes the credit and country risks that the private sector is unable or unwilling to accept. Ex-Im Bank also helps U.S. exporters remain competitive by countering the export financing provided by foreign governments on behalf of foreign companies. At the same time, the Bank must safeguard taxpayer resources. To execute this mission, Ex-Im Bank offers short term (“ST”), medium term (“MT”) and long term (“LT”) export credit financing products.

The MT program has significantly underperformed the ST and LT programs in recent years, accounting for a disproportionate share of Ex-Im Bank’s credit losses. In terms of origination volume (authorizations), the MT program is much smaller than the ST and LT programs – representing \$806 million in 2007, or 6.4% of the Bank’s total authorizations of \$12.6 billion. Conversely, in terms of claims volume (net claims as a percentage of disbursements), the MT program has experienced double digit losses dating back to FY 2001 compared to less than 1% of losses for the Bank’s other programs during this same timeframe (see Table 1 at end of Executive Summary for a detailed breakout of MT program authorizations, disbursements, claims and recoveries by year for the period 1998 to 2007). As management has worked to reduce the number of defaulted transactions and incidences of fraud against the Bank, transaction requirements and processing times have increased, which has been reported to have decreased the appeal and utility of the MT program for many exporters and borrowers.

It is important to note that the primary business credit relationship in an Ex-Im Bank supported transaction is between the U.S. exporter (insurance transactions) or a U.S. or foreign lending institution (guarantee transactions) that makes the direct loan or extension of credit to the foreign buyer/borrower. The exporter or lender is charged with completing a commercially reasonable underwriting and due diligence review of the buyer/borrower, with Ex-Im Bank then reviewing the quality and completeness of the exporter/lender’s work in order to support its decision to provide insurance or guarantee coverage to the exporter or lender.

This MT Export Credit Program Audit was initiated by the Office of Inspector General (OIG) at the request of the Bank’s Chairman to address these challenges. Its principal objectives were:

- Credit and Fraud Risk Management – evaluate the effectiveness of processes in place to manage credit risk and losses and to identify and respond to fraud risk; and
- Business Process Improvement – review the design and operating effectiveness of the MT program transaction process with primary focus on business process effectiveness and identification of control deficiencies, and a secondary emphasis on process efficiency.

We also undertook at the same time a performance audit (the “IT Audit”) of the Bank’s IT systems, support and governance relative to the MT programs with the objectives of (i) assessing the adequacy of Ex-Im Bank IT systems and support to provide timely, accurate and useful information with primary focus on the Bank’s Ex-Im Online (“EOL”) system and other related systems used throughout the MT program transaction lifecycle and (ii) reviewing the state of IT governance as it relates to Ex-Im Bank’s processes for creating, modifying and executing plans for the development and improvement of IT system support for the MT program. The results of the IT Audit are presented in a separate report but are in some cases referred to where relevant to the findings and recommendations presented in this report.

Executive Summary

The many findings and recommendations made in this report and the IT Audit report all derive from the conclusion that Ex-Im Bank has encountered significant credit and fraud loss, process efficiency challenges and IT issues associated with the MT program, because the Bank has not developed customized policies, controls, systems and tools to address the enhanced risks of the MT program. Instead, the Bank has attempted to manage the MT program by making slight modifications to its policies and systems that support the LT and ST programs and this has not been successful. If the MT program is to be operated within customer response and credit and fraud loss tolerances that are sustainable, it needs to be viewed as a distinct program that is supported by more robust policies, controls, systems and tools.

Management has described its decisions in setting policy for the MT program as reflecting the tension between potentially conflicting directives from Congress set forth in the Ex-Im Bank Charter: (a) take risks the private sector is unable or unwilling to accept; (b) provide for reasonable assurance of repayment; (c) ease the administrative burdens and procedural and documentary requirements imposed on program users; (d) render the MT program as supportive of exports as is the Bank's direct loan program; and (e) obtain a broad participation of lenders in the MT program. In a number of instances addressed in this report, the Bank's management has responded to the directive to ease administrative burdens and procedural requirements by consciously abandoning or rolling back credit policies and requirements that other private and public sector lenders and credit insurers rely upon to manage fraud and credit risks.

Ex-Im Bank OIG has advised us that their review of the Charter and the legislative history of the relevant provisions leads them to conclude that in directing the Bank to ease administrative burdens and procedural and documentary requirements, Congress did not intend that the Bank abandon customary, prudent lending practices that are necessary to mitigate fraud and credit risks and that are common practice in lending/guarantee transactions. It appears that Congress was responding to customer criticism of an Ex-Im Bank lending process that was in too many cases significantly slower and more cumbersome than what would be the norm for a private sector lender. Accordingly, the recommendations in the report are intended to refocus Ex-Im Bank's lending processes for the MT program to more closely approximate what would be encountered in a private sector transaction, which should in most cases facilitate a swifter underwriting and authorization process and decreased risk of fraud. It should not impair or disadvantage a borrower to provide information, assurances and documentation to Ex-Im Bank that are comparable to what any other lender would require.

The principal findings of the audit can be summarized as follows:

Credit and Fraud Risk Management – The MT program is a high-risk credit program that responds to the Bank's mission of making export credit available in situations where the private sector is unable or unwilling to do so. The MT program relies upon a business model and supporting processes and systems that have proven adequate for the Bank's other export credit programs, but which are not well adapted to the specific risks associated with the MT program. A number of actions that would typically be taken by a high-risk lender in the private sector to effectively manage credit and fraud risk, and which are recommended or required by government pronouncements such as Office of Management and Budget's Circular A-129 – *Policies for Federal Credit Programs and Non-Tax Receivables* ("Circular A-129"), have not been consistently required elements of the MT program.

Among the actions recommended in this report to improve credit and fraud risk management are:

- Require on-site inspections and appraisals of financed goods/equipment;
- Require borrowers to submit bank/brokerage statements to confirm liquidity;

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- Establish an automated monitoring system and require more frequent remittance of borrower payments;
- Formalize a lender oversight function for MT program lenders;
- Revamp the exposure fee pricing structure for non-sovereign transactions to more effectively price for the risk; and
- Consider moving away from 100% guarantee for non-sovereign transactions towards more risk sharing (100% guarantee product would remain available for sovereign deals).

For a variety of historical and policy reasons, MT program borrowers have not been consistently subjected to a credit underwriting due-diligence and monitoring regime that is directly comparable to what they would encounter if approaching a private sector transaction-based lender in the U.S. or in their home countries. As a result, credit and fraud risks have not been effectively managed in Ex-Im Bank's MT program. The OIG's review of transactions investigated for fraud, and which have been the subject of the publicly disclosed fraud indictments and plea agreements, confirms that many of those schemes could not have succeeded had these recommendations been in place at the time of the initial transactions.

Business Process Improvement – As Ex-Im Bank staff has attempted to implement more rigorous credit review and underwriting standards to address credit and fraud risks, turnaround time has increased, which has been reported to decrease the appeal and utility of the MT program for many exporters and borrowers. While the EOL system that supports the MT program does not itself appear to be responsible for processing delays, neither does it realize opportunities to make application, underwriting and monitoring processes more efficient.

Among the actions recommended in this report to improve the Bank's business processes that support the MT programs are:

- Establish quality control processes focused on the MT program;
- Standardize borrower submission requirements, including better defining what constitutes a complete application;
- Implement a second processing track for more challenging applications; and
- Develop a strategic plan to provide stronger leadership and direction for the MT program.

Management's Response: With regard to a majority of the findings made in this Report, management acknowledged the need for improvement and cited actions management has recently taken or will take to address the issues raised by our findings and recommendations. Management accepted and committed to act upon six of the eight recommendations, mostly setting June 30, 2009 or September 30, 2009 as the intended response date for each with the exception of two recommendations in which management declined to commit to a specific date for taking action (pending "consultation with Bank leadership and key stakeholders"). Conversely, for two of the eight recommendations, management declined taking specific actions to make modifications in the MT program, either by implementing our recommendations or implementing other actions intended to address our findings. The full text of management's response to this Report appears as Appendix A.

Auditor Comment: Management generally agreed with the findings presented in this Report, although their level of concurrence was mixed in some instances. For the two key recommendations that were not accepted, management declined to commit to taking specific actions to make modifications in the MT program, either by implementing our recommendations or implementing other actions intended to address our findings. As a result, we believe that the root causes of the conditions described in our findings – excessive exposure to credit and fraud losses and slow

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turnaround time – are likely to persist. We acknowledge that management has in recent years undertaken a number of initiatives intended to address these issues with some positive effects becoming apparent. At the same time, the performance of the MT program still falls significantly below the Bank's results for its other programs and we believe that these losses are likely to continue.

Executive Summary

Table 1: Total Authorizations & Claims - Breaking Out MT (\$ in millions) – FY1998 to FY2007

FY	No. of Trans.	Total Authorized	Total Disbursed	Total Claims	Claims as % of Disb.	Recoveries	Recovery % of Claim	Net Claims	Net Claims as % of Disb.
1998-MT	408	\$1,352.8	\$925.4	\$79.1	8.5%	\$45.4	57.1%	\$34.2	3.7%
1998-Other	1784	\$9,196.8	\$7,075.0	\$95.2	1.3%	\$26.7	28.0%	\$68.5	1.0%
Total	2192	\$10,549.6	\$8,000.4	\$174.3	2.2%	\$72.1	41.3%	\$102.7	1.3%
1999-MT	370	\$1,234.2	\$754.7	\$52.7	7.0%	\$26.4	50.1%	\$26.3	3.5%
1999-Other	1853	\$11,833.4	\$8,933.9	\$31.8	0.4%	\$5.0	15.8%	\$26.8	0.3%
Total	2223	\$13,067.6	\$9,688.6	\$84.5	0.9%	\$31.4	37.2%	\$53.1	0.5%
2000-MT	567	\$1,794.5	\$1,071.9	\$109.7	10.2%	\$29.1	26.5%	\$80.7	7.5%
2000-Other	1962	\$10,842.6	\$8,144.2	\$110.6	1.4%	\$48.5	43.8%	\$62.2	0.8%
Total	2529	\$12,637.1	\$9,216.1	\$220.3	2.4%	\$77.6	35.2%	\$142.9	1.6%
2001-MT	446	\$1,179.9	\$780.0	\$126.4	16.2%	\$25.2	20.0%	\$101.1	13.0%
2001-Other	1912	\$8,061.6	\$6,257.5	\$41.2	0.7%	\$4.9	11.9%	\$36.3	0.6%
Total	2358	\$9,241.5	\$7,037.5	\$167.6	2.4%	\$30.1	18.0%	\$137.4	2.0%
2002-MT	443	\$1,209.9	\$724.7	\$88.6	12.2%	\$12.4	14.0%	\$76.2	10.5%
2002-Other	2083	\$8,909.3	\$7,798.1	\$42.7	0.5%	\$11.7	27.5%	\$31.0	0.4%
Total	2526	\$10,119.2	\$8,522.8	\$131.3	1.5%	\$24.1	18.4%	\$107.2	1.3%
2003-MT	484	\$1,232.5	\$653.9	\$116.2	17.8%	\$22.4	19.3%	\$93.8	14.3%
2003-Other	2223	\$9,274.7	\$8,465.1	\$22.6	0.3%	\$9.1	40.2%	\$13.5	0.2%
Total	2707	\$10,507.2	\$9,119.0	\$138.8	1.5%	\$31.5	22.7%	\$107.3	1.2%
2004-MT	684	\$1,452.1	\$965.0	\$256.3	26.6%	\$13.7	5.3%	\$242.7	25.1%
2004-Other	2423	\$11,868.9	\$8,646.4	\$85.1	1.0%	\$7.7	9.0%	\$77.4	0.9%
Total	3107	\$13,321.0	\$9,611.4	\$341.4	3.6%	\$21.4	6.2%	\$320.1	3.3%
2005-MT**	569	\$850.4	\$588.7	\$98.3	16.7%	\$8.0	8.1%	\$90.4	15.3%
2005-Other**	2559	\$13,085.8	\$11,620.9	\$85.1	0.7%	\$3.7	4.4%	\$81.4	0.7%
Total	3128	\$13,936.2	\$12,209.6	\$183.4	1.5%	\$11.7	6.4%	\$171.8	1.4%
2006-MT**	474	\$1,029.0	\$578.2	\$58.9	10.2%	\$1.2	2.0%	\$57.7	10.0%
2006-Other**	2203	\$11,121.5	\$9,269.0	\$19.9	0.2%	\$1.9	9.4%	\$18.1	0.2%
Total	2677	\$12,150.5	\$9,847.2	\$78.8	0.8%	\$3.1	3.9%	\$75.8	0.8%
2007-MT**	360	\$806.0	\$465.5	\$3.3	0.7%	\$0.1	0.3%	\$3.2	0.7%
2007-Other**	2433	\$11,763.4	\$10,426.3	\$12.3	0.1%	\$0.7	5.8%	\$11.0	0.1%
Total	2793	\$12,569.4	\$10,891.8	\$15.6	0.1%	\$0.8	4.7%	\$14.2	0.1%

This table compares the relative amounts of MT program authorizations, disbursements, claims paid and recoveries to the comparable data for all other Ex-Im Bank transactions for fiscal years 1998 to 2007 as of July 31, 2008. It also indicates the amount of claims paid with respect to each year's disbursed loans as a percentage of the total amount of disbursed loans for that year, both gross and net of recoveries, and indicates the amount recovered by Ex-Im Bank on defaulted loans and as a percentage of the claims paid with respect to that year.

** Claims and recovery data in the most recent fiscal years are not fully seasoned and thus not as meaningful. The lag time between the dates a transaction is authorized and funded can extend to more than 12 months. Also, defaults and resulting claim payments typically do not occur for another 12 to 36 months.

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Background and Objectives

Background The Export-Import Bank of the United States (“Ex-Im Bank” or the “Bank”) is the official export credit agency (“ECA”) of the United States. Ex-Im Bank supports the financing of U.S. goods and services in international markets, turning export opportunities into actual sales that help U.S. companies of all sizes to create and maintain jobs in the United States. Ex-Im Bank assumes the credit and country risks that the private sector is unable or unwilling to accept. Ex-Im Bank also helps U.S. exporters remain competitive by countering the export financing provided by foreign governments on behalf of foreign companies. At the same time, the Bank must safeguard taxpayer resources by determining that there is a reasonable likelihood of repayment with respect to each of its transactions.

Ex-Im Bank offers short term (“ST”), medium term (“MT”) and long term (“LT”) export credit financing products. The core MT products offered by Ex-Im Bank are as follows:

MT Loan Guarantees: Ex-Im Bank loan guarantees cover the repayment risks on the foreign buyer’s debt obligations incurred to purchase U.S. exports. Ex-Im Bank guarantees to a lender that, in the event of a payment default by the borrower, the Bank will pay to the lender the outstanding principal and interest on the loan. Ex-Im Bank’s comprehensive guarantee covers 100 percent of the commercial and political risks for up to 85 percent of the U.S. contract value of the export transaction. Guarantees extended under the MT program typically have repayment terms of one to seven years and range in amount from \$100,000 or less to \$10,000,000.

MT Export Credit Insurance: The Export Credit Insurance Program helps U.S. exporters develop and expand their overseas sales by protecting them against loss should a foreign buyer or other foreign debtor default for political or commercial reasons. Similar to the loan guarantee product, Ex-Im Bank covers 100 percent of the commercial and political risks for up to 85 percent of the U.S. contract value of the export transaction. Credits insured under the MT program typically have repayment terms of one to seven years and range in amount from \$100,000 or less to \$10,000,000.

Direct Loans: The direct loan program is a foreign buyer credit program in which Ex-Im Bank makes a loan to a foreign buyer to purchase U.S. exports. Ex-Im Bank’s loan disbursements go directly to the U.S. exporter as the export products are shipped to the foreign buyer. Ex-Im Bank has made very few direct loans in the MT program.

See Table 2 for a breakdown of authorizations by program and product.

The MT program book of business has significantly underperformed the ST and LT programs in recent years. Indictments and plea agreements in several high-profile fraud cases emanating from the MT program have been announced in the past 12 months.¹ Notably, of the \$965 million of MT transactions authorized in 2004 that were funded, approximately \$101 million of the \$256 million in claims paid by the

¹ Philippines: <http://washingtondc.fbi.gov/dojpressrel/pressrel07/wfo101107.htm>
San Antonio (Mexico): http://www.usdoj.gov/usao/txw/press_releases/2008/Parker_ind1.pdf

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Bank were associated with the publicly disclosed fraud schemes. Claims rates and reported instances of fraud for subsequent years have declined from this high level, but have remained above historic norms (see Table 1 at end of Executive Summary).

The Ex-Im Bank Office of Inspector General (“OIG”) is charged with investigating and referring for prosecution instances of fraud committed against Ex-Im Bank. Ex-Im Bank OIG reported to us that common elements of the publicly reported fraud schemes against Ex-Im Bank have included (i) misstatements of financial statements to report non-existent cash and revenues, (ii) creation of false documents to support the apparent existence of different or non-existing businesses, (iii) misrepresented or non-existent goods that result in excess payments to the exporter and the receipt of cash loan proceeds by the foreign buyer/borrower and (iv) corrupt payments to agents, brokers, shippers and others for their roles in facilitating these schemes. Other private and government sector lending programs are also exposed to risks of this nature. Our audit work and recommendations are intended to identify how management can address these specific risks in an efficient and cost effective manner.

Table 2: Authorizations by Fiscal Year (in millions)

Authorizations	FY 2005	FY 2006	FY 2007
Long Term			
Loans	\$0.0	\$56.5	\$0.0
Guarantees	\$8,076.1	\$6,603.5	\$7,234.0
Subtotal, Long Term	\$8,076.1	\$6,660.0	\$7,234.0
Medium Term			
Loans	\$0.0	\$0.0	\$0.0
Guarantees	\$399.4	\$387.6	\$504.2
Insurance	\$451.0	\$641.4	\$301.8
Subtotal, Medium Term	\$850.4	\$1,029.0	\$806.0
Short Term			
Working Capital	\$1,096.3	\$1,173.8	\$1,255.3
Insurance	\$3,913.4	\$3,287.7	\$3,274.1
Subtotal, Short Term	\$5,009.7	\$4,461.5	\$4,529.4
Total Authorizations	\$13,936.2	\$12,150.5	\$12,569.4

source: Annual Report 2007

Objectives

The specific objectives of the MT Export Credit Program Audit were as follows:

- Credit and Fraud Risk Management – evaluate the effectiveness of processes in place to manage credit risk and losses and to identify and respond to fraud risk.
- Business Process Improvement – review the design and operating effectiveness of the MT program transaction process with primary focus on business process effectiveness and identification of control deficiencies, and a secondary emphasis on process efficiency.

Scope and Methodology

The scope of the audit focused on Ex-Im Bank's Medium Term ("MT") Export Credit Program. Fieldwork was conducted on-site at Ex-Im Bank's headquarters in Washington, DC in June and July 2008.

A judgmental sample of five MT guarantee and five MT insurance transactions originated between 1/1/2006-1/31/2008 were obtained for review. In selecting the sample, we made certain to include two guarantee and two insurance transactions that had gone to claim. In addition, we made sure to select transactions from countries that account for the largest percentage of MT program volume. Also, since the Ex-Im Online ("EOL") system was a key focus of our audit, we made certain that the majority of transactions selected (7 out of 10) were originated after January 2007 when the EOL system went "live" for MT transactions. Based on the results of our testing of these 10 initial transactions, we determined that due to the number and type of exceptions, selecting an additional sample of transactions for review was not necessary.

In addition to transaction file testing, interviews were held with key personnel in order to understand and evaluate significant processes, controls and risks prevalent in the MT program, including process efficiencies, e.g. transaction cycle times. Specifically, we met extensively with representatives from Credit Applications and Processing ("CAP"), Trade Finance & Insurance ("TFI"), Credit and Risk Management, Domestic Business Development, Finance/CFO's Office, Asset Management Division ("AMD"), Resource Management and Information Technology.

The technology review focused on the key systems and IT processes supporting the MT program. The primary system reviewed was the EOL system hosted on Ex-Im Bank's on-site servers. A high level review was also performed of other relevant systems supporting the MT program, particularly those that interfaced with EOL. These systems included:

- The Loan and Guarantee Accounting System ("LG/A");
- The Claims and Recovered Debt Servicing System ("CARDS");
- The Insurance Information System ("IIS"); and
- The Asset Management System ("AMS") [does not interface with EOL].

In addition to interviews and transaction testing, we also compared Ex-Im Bank's current business and IT operations in support of the MT program against leading industry practices, inclusive of the private sector. In doing so, our primary focus was on other transaction-based guarantors such as the Small Business Administration ("SBA"). To a lesser extent, we also compared Ex-Im Bank to financial institutions in the private sector that originate export finance transactions on an infrequent basis for existing customers. In our view, the transaction-based guarantors, while not ECAs, were the better comparison since they provide a window into the operational and compliance processes and internal controls that should be in place when conducting transaction-based lending. Foreign ECAs were not viewed as useful comparisons due to limited information about their business methods and their substantially

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different policy and legal imperatives.² Ex-Im Bank management also reported that U.S. exporters participating in the MT program encounter competition supported by foreign ECAs less frequently than in the Bank's other programs.

In addition to comparisons to the private sector, we reviewed the MT program against government policies and guidance such as the Office of Management and Budget ("OMB") Circular No. A-129 – *Policies For Federal Credit Programs and Non-Tax Receivables* ("OMB Circular A-129"). OMB Circular A-129 sets standards for extending credit, providing oversight to private sector lenders participating in government guaranteed loan programs, servicing credit and non-tax receivables and collecting delinquent debt.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on the audit objectives for the MT program.

² See comparison of Ex-Im Bank and foreign ECAs in "Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States" (June 2008).

Findings and Recommendations

Section 1: Credit and Fraud Risk Management

Insufficient Credit Underwriting Due-Diligence Requirements and Processes

Finding 1

Of the 10 sampled MT export credit transactions, there was no evidence of an on-site inspection and appraisal of the equipment being exported. Moreover, due to the lack of an appraisal, a cash flow analysis that takes into account the useful life of the equipment or goods for export was not present in the credit memoranda. Also, while the obligor's financial statements were obtained and reviewed, there was no evidence of bank/brokerage statements for the obligor or guarantor confirming cash on hand to demonstrate liquidity.

Ex-Im Bank management stated that equipment appraisals and bank statements are not routinely requested nor required as part of the MT program application submission and subsequent credit underwriting review and approval process. For LT program transactions, Ex-Im Bank has recognized the value of appraisals and one of the responsibilities of the Bank's Engineering Group is the review of equipment descriptions, valuation and useful life in larger transactions.

Circular A-129, Appendix A section III.A.2. *Loan Documentation*, states that "loan origination files should contain loan applications, credit bureau reports, credit analyses, loan contracts, and other documents necessary to conform to private sector standards for that type of loan." OMB Circular A -129, Appendix A section III.A.3. further states that "the Government can reduce its risk of default and potential losses through well managed collateral requirements." As an example of an effective collateral management practice, Subsection a. requires that appraisals should be conducted for direct or guaranteed business loans relating to real property over \$250,000 in amount. Subsection b. specifies that where an asset is collateral for a loan, "the loan maturity should be shorter than the estimated useful economic life of the collateral."

In a transaction-based lending environment, which by nature often means that there is limited knowledge about transaction participants, it is a standard credit underwriting due-diligence practice to require an appraisal of the assets (equipment, goods, etc.) being financed in all transactions regardless of size. For export finance transactions, by verifying the existence, quality and value of the assets to be exported, the lender or guarantor will be less susceptible to fraud or gross negligence by the exporter, supplier or buyer in the transaction. The appraisal also benefits the parties in the transaction by reducing the likelihood of disagreements between the exporter and the buyer over the quality or value of the assets once exported.

Also, one of the key components of the appraisal includes the useful life of the equipment or goods being financed. This is very important from a credit underwriting perspective since the useful life of the equipment/goods should be factored into the repayment terms of the transaction if their value as collateral or the ability to sell them to recover the debt is a material consideration in

Findings and Recommendations

extending credit or obtaining reasonable assurance of repayment. For example, if the useful life of the equipment is 2-3 years and their value as collateral is a material consideration, then the repayment terms should not exceed 3 years. Given Ex-Im Bank's mission, it may be understandable in some instances to provide a repayment term beyond the useful life of the goods or equipment being exported. However, this should be done on an exception basis with appropriate approvals.

Similarly, requiring bank/brokerage statements from the obligor and guarantor in the transaction is a critical credit underwriting due-diligence step in verifying liquidity and financial health of those parties, as well as the accuracy of financials provided. It is widely accepted in transaction-based lending that putting sole reliance on financial statements to verify financial health and capacity to make loan/fee payments is not prudent. In fact, the OIG has reported that in a significant number of Ex-Im Bank's fraud cases, the borrower appears to have overstated its cash/liquidity.

By not requiring an appraisal of the assets being exported and not requiring bank/brokerage statements of the obligor and guarantor in the transaction, Ex-Im Bank is at greater risk for fraud and credit losses in the MT program.

Recommendation

1

We recommend that Ex-Im Bank management require as part of its credit underwriting due-diligence on-site inspections and appraisals of the equipment being exported as well as bank/brokerage statements of obligors and guarantors for MT transactions. Both the appraisals and bank statements should be the responsibility of the lender to obtain and submit to Ex-Im Bank as part of the initial application. Given their criticality from both a fraud and credit risk management perspective, the appraisal and bank statements should be required on all MT transactions regardless of size. Furthermore, given their importance, until the appraisal and bank statements are received, Ex-Im Bank should not accept and begin processing the MT application.

For original equipment manufacturers ("OEMs"), where there is a high degree of assurance of the existence, quality and market price of the exported goods, the appraisal would not require an on-site inspection. Comparison of the stated price to market or confirmation of serial numbers or other identifying information would remain advisable.

For some MT transactions, a period of weeks to as long as 18 months may elapse between the date of authorization and the date of shipment. This can make it difficult to identify specific goods at the time an application is received. In these cases, the effective date of the authorized coverage should be conditioned upon receipt of an inspection and appraisal confirming the condition and value of the goods and conformity to the description in the application close in time to shipment. If the exporter decides to substitute goods or equipment at a late stage, e.g. close to time of shipping, the transaction should be re-evaluated and, if necessary, re-underwritten and a new appraisal obtained.

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Lastly, as it relates to the appraisal requirement, Ex-Im Bank should develop a process to manage the quality of appraisers and appraisals received. For the appraisal process to be effective, either the Credit Underwriting department or quality assurance function should be responsible for managing appraisal quality. There are several public sources available for guidance on equipment appraisal standards and best practices including the Appraisal Foundation's Uniform Standards of Professional Appraisal Practice (USPAP), the American Society of Appraisers (ASA) and the Equipment Appraisers Association of North America (EAANA).

Management Response

Management disagreed with the finding that the MT program has insufficient due diligence requirements and processes and declined to implement the recommendations on a programmatic basis, but acknowledged that some of the recommendations should be adopted using a "risk-based" approach. More specifically, management disagreed with requiring lenders to obtain independent appraisals or on-site inspections as part of the credit underwriting due-diligence process, and stated that it does not believe that Appendix A, section III A.3. of OMB Circular A-129 is applicable to the Bank's MT program transactions. Instead, management intends to rely on the Bank's Engineering and Environment Division to make determinations of equipment quality and useful life based on its review of documentation submitted by transaction participants and without any on-site inspection of the equipment. Management did agree with requiring bank/brokerage statements more broadly than in current practice, using a risk-based approach, on all transactions submitted by a) new lenders, b) poor performing lenders, c) transactions subject to the Bank's high risk policy and d) transactions involving company-prepared statements (which management noted represent more than one-half of MT program transactions).

Management believes that programmatic implementation of the recommendations to require the provision of bank/brokerage statements and especially appraisals/inspections of equipment would "chill the market," and would have a "profound adverse effect" on the cost-competitiveness and utility of the MT program. Management states that these requirements would discourage the use of the MT program by U.S. exporters and foreign buyers of U.S. products and would impose an unreasonable burden on the preponderance of lenders that have a satisfactory record with Ex-Im Bank and on transactions where both obligor financial capacity and the value of goods/transaction integrity are highly transparent. Management states that many of Ex-Im Bank's better quality lenders have ceased to participate in the MT program because they cannot realize a reasonable return given the investment required in terms of people and capital.

Resolution Date: To be determined after consultation with the Bank's participant lenders, senior management and Bank leadership.

Findings and Recommendations

Responsible Parties: SVP, Credit & Risk Management

Auditor Comment

Management has declined to implement Recommendation 1 on a programmatic basis. Management does state that it will require submission of bank/brokerage statements using a “risk based” approach, but disagrees with the use of independent appraisers. OMB Circular A-129 requires credit analyses and recommends appraisals as an effective collateral management tool in business transactions exceeding \$250,000 in amount. Management’s selective implementation of the recommended requirements does not satisfy OMB Circular A-129 requirements. As noted in Finding 6, application of additional underwriting requirements on an ad hoc, discretionary basis after an application has been submitted is a significant contributor to delays in processing time and lack of transparency.

We recognize that, based on experience and supporting documentation, exceptions to the recommended requirements will be justifiable in some cases. Among those we have discussed with management are:

Excepting transactions guaranteed by a foreign bank or sovereign from the requirement for review of guarantor financial statements.

Excepting sales of new equipment delivered from an OEM exporter to a foreign buyer/borrower.

These sorts of exceptions should be supported in a written justification, approved by the Bank’s senior management and made part of the permanent policy records for the MT program. To the extent exceptions are determined to be applicable to specified classes of transactions such as those described above, the disclosure of those excepted classes, while continuing the requirement for all other transactions, will increase transparency and contribute to processing efficiency. Written policies and procedures should be developed that directly address Circular A-129 requirements.

We do not believe that it is likely that asking borrowers and guarantors to provide copies of their bank/brokerage statements to the lender and to Ex-Im Bank, or asking lenders to compare those bank statements for consistency with the borrower and guarantor financial statements currently required to be submitted to the lender and Ex-Im Bank, will impose an unreasonable burden on borrowers or lenders. Nor do we believe that requiring inspection/appraisal reports costing a few thousand dollars³ on transactions averaging \$2 million in amount will impose an unreasonable burden. The recommended actions, or their functional equivalents, are customary requirements the applicable borrowers will encounter from private sector lenders they approach, and

³ We note that such transaction costs are routinely “rolled into” the amount financed so that neither the lender nor the foreign buyer/borrower is required to pay them out-of-pocket.

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address issues of transaction integrity much more directly and efficiently than do the Bank's current policies and procedures.

Management in several instances describes our findings and recommendations as being derived from commercial practices of "asset-based" lenders, which management does not believe to be relevant to the MT program. We note that our findings and recommendations instead reference practices used by "transaction-based" lenders to manage their credit and fraud risks. Transaction-based lending, as is the MT program, is predicated on defining specific product criteria and program requirements which is then marketed widely to prospective borrowers many of whom may have limited or no prior relationship with the lender. It is to be contrasted with relationship-based lending, where the lender provides a range of financial products and services to support the borrower and thereby achieves a degree of familiarity with the borrower that can substantially mitigate the lender's credit and fraud risk. In asset-based lending models, which can be used by lenders in both transaction-based and relationship-based lending contexts, the lender looks primarily to its ability to foreclose upon and sell collateral as a source of assurance that the loan will be repaid. Our findings and recommendations do not assume or require that the MT program be an asset-based lending program.

Management's indefinite resolution date is not commensurate with the level of effort required to implement the recommendation within a reasonable time period. We do not believe the described actions are responsive to our recommendations. Management should more expeditiously develop and implement procedures to meet the intent of the recommendation.

Lack of Early Warning/Delinquency and Performance Reporting Capabilities

Finding 2

A defined, standardized and robust process for collecting and analyzing performance data on authorized MT transactions is not in place. Furthermore, routine reporting of payment history by lenders is either not required or not enforced.

Several conditions contribute to the lack of performance reporting capabilities:

The current IT infrastructure that supports the MT program is characterized by disparate systems with limited interfacing capabilities. Specifically, the EOL system does a satisfactory job originating the transaction on the front-end but does not have performance reporting functionality. Nor does EOL interface effectively with a back-office system with performance reporting capabilities. Also, there are data integrity concerns in the source systems, most notably related to participant information, that further hinder the ability for end-to-end performance reporting from origination through to monitoring and collections.

Ex-Im Bank currently does not have a standardized process in place for lender reporting of payment history on authorized transactions. Thus,

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even when payment history is received, there is no mechanism that automates or partially automates the review and analysis of that information.

The payment frequency requirement for the MT program has historically been semi-annual with a small percentage of authorized transactions requiring payments quarterly or on another basis. For early warning and delinquency reporting capabilities to be effective and reliable, it is critical that more data points (borrower payments) be captured.

Ex-Im Bank does not employ any quantitative analysts (PhD or equivalent) experienced in the design and implementation of credit risk management tools and models, a skill-set that is viewed as critical in private sector lending institutions in order to effectively manage and price risk.

The Chief Financial Officers Act of 1990 (Public Law 101-576)⁴ (“CFO Act”) specifies that agency financial management systems must provide for the systematic measurement of performance. The CFO Act also states that better management information, such as reports of performance indicators, can be an early warning measure which identifies developing problems before they reach critical proportions. Moreover, for transaction-based lenders and guarantors that retain the risk of credit losses in their portfolios, it is a leading industry practice that robust early warning/delinquency and performance reporting capabilities be utilized in managing credit losses and the overall risk profile of their portfolios. Having a greater understanding of the determinants of delinquencies and defaults translates into the ability to make better, more informed credit decisions at the time of origination.

Due to the lack of early warning/delinquency system capabilities and the lack of a standardized process for lenders to report payment history, Ex-Im Bank’s ability to manage the credit risk in its MT program portfolio is marginalized and is passive and reactive in nature. Moreover, since historical transaction performance of past participants and/or like transactions is not readily available, Ex-Im Bank’s credit decision at the time of origination is at enhanced risk of not being able to identify fraudulent transactions or participants with questionable or poor payment history. While Ex-Im Bank’s Asset Management Division (“AMD”) performs a very detailed and sound post-review of transactions representing an aggregate of \$20 million or more in exposure, this is not a replacement for having an automated or partially automated process for tracking performance in some degree on all authorized transactions. Currently, at the \$20 million threshold, less than 5% of MT program transactions are subject to AMD’s review.

⁴ Section “Financial Management Plans,” sub-section “Improved Financial Information.” This reference is provided as an example of good management practice for federal agencies. Ex-Im Bank is not subject to the CFO Act and has not undertaken to produce Performance Accountability Reports (“PAR”) contemplated by the Accountability of Tax Dollars Act of 2002 (Pub. L. No. 107 – 289) under the terms of OMB Circular A-136, which states that, while not required of Ex-Im Bank and most other wholly-owned government corporations, preparation of PAR reports is “strongly encouraged.”

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Recommendation

2

We recommend that Ex-Im Bank management institute a defined and standardized process for lenders to report payment history. One approach to accomplishing this initiative would be to design a standard payment remittance template that would be required to be completed by the lender no later than 30 days after the payment due date. A standard template should allow for upload into an Ex-Im Bank system where automated early warning and performance reporting data analysis could be performed. This process could be done in-house or outsourced and management should review the cost/benefit of both options. Also, as enhancements are made to Ex-Im Bank's technology infrastructure, significant priority should be given to the end-to-end build out of performance reporting capabilities and Ex-Im Bank should strongly consider hiring a quantitative analyst (PhD or equivalent) with experience in the design and implementation of pricing, risk management and credit analysis tools and models to lead that effort. Lastly, we recommend that the payment frequency for MT transactions be consistent with local country norms which, in most instances, would require monthly payments.

Management Response

Management agreed that enhancing performance reporting capabilities and systems would provide additional benefit in supporting decision-making on new commitments. The following initiatives are reported by management to be in process and will be completed in response to the finding:

- Development of a default notice reporting module for the EOL system⁵.
- Consideration of a proposal to change and implement new claim filing procedures for all MT products, including a shorter claim filing window and a standard default report form.

Also, subject to completion of the above, management will evaluate the cost-benefit of retaining additional staff to conduct quantitative analyses of default and claims data.

Furthermore, management agreed as a general matter that structuring transactions in accordance with local country norms is prudent and improves repayment performance and stated that greater consideration will be given to requiring quarterly as opposed to semi-annual payments. However, management noted that many MT program transactions involve cash-flow patterns that deviate significantly from "country norms" and that requiring more frequent payments may be counterproductive in stressing the cash position of borrowers. Management also noted that other ECA's will likely continue to offer semi-annual repayment schedules for their MT business, which would disadvantage U.S. exporters if the recommendation were implemented programmatically.

⁵ Ex-Im Online ("EOL") is the Bank's interactive, web-based transaction origination system that allows exporters, brokers and financial institutions to transact business with Ex-Im Bank electronically.

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Resolution Date:

- Implementation of revised claim filing procedures – June 30, 2009.
- Implementation of Ex-Im Online Default Reporting Module – September 30, 2009.
- Evaluation of cost-benefit of retaining quantitative analysts to assess performance and early-warning data – September 30, 2009.

Responsible Parties: SVP, Export Finance

Auditor Comment

When accomplished, the above actions are *unlikely* to satisfy this recommendation. While we note that the proposed development of an enhanced default reporting system will provide useful and more timely information to management that is not consistently available at present, the reporting of defaults is not the functional equivalent of the recommended reporting of borrower payments and build out of early warning/delinquency reporting capabilities. In response to management's concern that the recommended changes to payment terms will disadvantage U.S. transactions that compete with transactions supported by foreign ECA's, it would not be inconsistent with the recommendation for the Bank to continue its present policy of matching more favorable terms offered by foreign ECA's when they are presented in individual cases, if the decision to do so is appropriately documented and the Bank's reasonable expectation of repayment is not materially degraded as a result.

Insufficient Lender Oversight and Quality Assurance Control Activities

Finding 3

Formal lender oversight and quality assurance processes and related internal controls over MT program transactions are not currently in place.

Ex-Im Bank management informed us that a limited compliance role has been established over the new Medium Term Delegated Authority ("MTDA") program. However, the general practice of Ex-Im Bank has been to provide *suggested* transaction due diligence guidelines to lenders while stopping short of requiring and monitoring compliance with the due diligence guidelines.

Internal controls are an integral component of an organization's management and serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud⁶. OMB Circular A-129, Appendix A section III.B. *Management of Guaranteed Loan Lenders and Services*, stipulates that "specific eligibility criteria for lender participation in Federally guaranteed loan programs" be established and that "agencies shall review and document a lender's eligibility for continued participation in a guaranteed loan program at least every two years."

Moreover, for transaction-based originators and guarantors, it is a leading

⁶ "Standards for Internal Control in the Federal Government," published by the General Accountability Office in November 1999.

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industry practice that some level of transaction-level monitoring and quality assurance be conducted on a periodic basis. The lender oversight and quality assurance functions may also be responsible for or share in the responsibility of monitoring the performance of external customers/vendors such as agents, appraisers, etc. Internally, the quality assurance function often re-underwrites and reviews the processing/closing steps performed on a sub-sample of transactions periodically to verify accordance with established policies and procedures. For the lender oversight and quality assurance functions to be most effective, they should report into a division independent of day-to-day originations.

The absence of a formal lender oversight function will make it difficult for Ex-Im Bank management to successfully move down the path of turning recommended lender due-diligence best practices into requirements. Allowing a wide degree of variance in lender performance makes it more likely that Ex-Im Bank's own underwriting and origination processes will fail to achieve a level of standardization that will support improved transaction turnaround times. Inherently, a lender due-diligence requirement must be actively monitored on a periodic basis to be effective. Also, while our review of 10 sample MT export credit transactions did not identify non-compliance with existing policies and procedures, the absence of a defined quality assurance function negates an internal control that most transaction-based lenders find essential in managing quality, especially with complex transactions.

Recommendation 3A

We recommend that Ex-Im Bank management institute a formal lender oversight function. The most critical roles will be to actively manage and monitor performance of transactions on a lender-by-lender basis and to assess the quality of lender due-diligence performed on a periodic basis, quarterly at a minimum. As noted above, the lender oversight function should report into a division independent of front-office originations such as Credit Review and Compliance. We recognize and value that Ex-Im Bank management is currently implementing a new lender scorecard process that is being used to identify opportunities for accelerated processing based on positive performance of a lender's portfolio of transactions over a period of years. However, without a dedicated lender oversight function to proactively manage the lender scorecard process, the data analysis underlying the lender scorecard is at risk of becoming stale after a short period of time.

Management Response

Management concurred with the recommendation to establish a formal lender oversight function, noting that since 2006 management has worked to develop a lender analysis framework to provide a basis for medium-term lender performance evaluation. That framework became operational in 2008. Management stated that the Bank will formalize the lender analysis process, based on the already developed framework, and anticipates conducting quarterly updates to the lender analyses and annual reviews of lender ratings. This process is led by Trade Finance & Insurance, the division charged with

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day-to-day transactional responsibilities, with oversight by the Credit Review and Compliance division.

Resolution Date: June 30, 2009

Responsible Parties: SVP, Export Finance
SVP, Credit & Risk Management

Auditor Comment

When accomplished, the above actions *may* satisfy this recommendation. As management moves to formalize the lender analysis process, management should clearly define the responsibilities of the Credit Review and Compliance division in its oversight role.

Recommendation 3B

We recommend that Ex-Im Bank management establish a quality assurance function for the MT program. One role that the quality assurance function may be responsible for is to manage and monitor performance of transaction participants, such as agents and appraisers. Another role that should be the responsibility of the quality assurance function is to manage the process of performing periodic MT export credit transaction file reviews on a sub-sample of transactions. If resource constraints preclude Ex-Im Bank from appointing dedicated resources to this role, then Ex-Im Bank should consider outsourcing the transaction file reviews to a qualified service provider.

Management Response

Management concurred with the recommendation and is in the process of establishing:

- A quality assurance function to manage and monitor performance data on agents and other relevant transaction participants.
- A process for the Credit Review and Compliance division to conduct periodic reviews of MT transaction files.

Resolution Date: September 30, 2009

Responsible Parties: SVP, Credit & Risk Management

Auditor Comment

When accomplished, the above actions will satisfy this recommendation.

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Section 2: Export Credit Program Design

Insufficient Exposure Fee Pricing Structure for Non-Sovereign Transactions

Finding 4

Ex-Im Bank's exposure fee pricing for non-sovereign MT program transactions has only a limited connection to the specific risks of the transaction and is inflexible. The current exposure fee pricing structure does include a mechanism to apply pricing add-ons, called "transaction risk increments," to determine the final exposure fee for non-sovereign transactions. However, the transaction risk increments for non-sovereign transactions are arbitrarily set (not based on data analytics/past performance) and are calculated from too low of a starting point.

Ex-Im Bank's exposure fee pricing structure is based on the minimum country-specific risk fees established by the Organisation for Economic Cooperation and Development (OECD). While Ex-Im Bank management openly expressed concern about the inability to risk-base price, there was not a clear understanding of who "owned" the pricing structure and who could change it.

OMB Circular A-129, Appendix A section II.3.b., states that "agencies should establish interest and fee structures for direct loans and loan guarantees and should review these structures at least annually" and that "interest and fees should be set at levels that minimize default and other subsidy costs, of the direct loan or loan guarantee, while supporting achievement of the program's policy objectives." This section also states that "riskier borrowers should be charged more than those who pose less risk."

For transaction-based lenders and guarantors that retain the risk of credit losses in their portfolios, it is a leading industry practice that the pricing structure governing transactions be risk-based and aligned with the approval decision. Depending on the level of risk in a given transaction, the incremental pricing add-ons could result in a guarantee fee that is several hundred percent over the minimum base pricing. Establishing risk-based pricing is not just a revenue generator but serves as a critical risk management tool. If pricing is not risk-based, the lender or guarantor is at greater risk of under-pricing transactions in riskier markets and over-pricing transactions in less risky markets. The end result is that the lender or guarantor will be left owning a portfolio of underlying transactions that is based on adverse selection and above its desired risk tolerance. Furthermore, as it relates to Ex-Im Bank's mission, over-pricing in less risky markets may drive away transactions that could be economically viable at lower pricing levels, while under-pricing in more risky markets may drive up authorizations and conflict with the Bank's "additionality" requirement that it not displace private sector transactions.

The complexity and risk of MT program transactions can vary significantly based on several key factors including the quality of the participants, the type and condition of the equipment or goods for export and past performance of similar or like transactions. Under Ex-Im Bank's current pricing structure, two non-sovereign transactions from the same country, albeit one having much

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more risky underlying characteristics than the other, will upon credit approval receive exposure fees that are not materially different. Ex-Im Bank management expressed concern that exposure fee pricing is too low in certain countries where Ex-Im Bank's performance has been deteriorating, whereas pricing in other countries where the private sector deems transactions to have lower risk may be too high.

Recommendation

4

We recommend that Ex-Im Bank management revamp its exposure fee pricing structure for non-sovereign MT program transactions to more effectively account for transaction-level risk. Specifically, Ex-Im Bank should consider establishing minimum, base exposure fees for non-sovereign MT transactions that are at a premium to the OECD floor pricing that Ex-Im Bank utilizes for its exposure fee pricing of sovereign transactions. From there, Ex-Im Bank should still apply "transaction risk increments" to adjust exposure fee pricing further based on the risk characteristics of the underlying transactions. Over time, as Ex-Im Bank enhances its early warning and performance reporting capabilities (Recommendation 2), Ex-Im Bank will have the ability to calibrate the "transaction risk increments" based on past performance and data analytics.

Management Response

Management stated that it agreed with the finding and recommendation, acknowledging the need to assess – and likely adjust – the Bank's pricing mechanism for the MT program. Management stated that any such adjustment will be predicated on the outcome of the current OECD negotiations on buyer pricing, which are expected to set revised minimum premium rates and establish a framework for rating individual non-sovereign buyers. Upon the conclusion of those negotiations, management will evaluate and implement appropriate adjustments to its medium-term pricing regime.

Responsible Parties: SVP, Export Finance
SVP, Chief Financial Officer (CFO)

Resolution Date: To be determined in accordance with OECD negotiation on buyer pricing and in consultation with Bank leadership and key stakeholders.

Auditor Comment

Management noted a general concurrence without committing to take any action other than to evaluate and implement appropriate adjustments after the conclusion of OECD pricing negotiations.⁷

Management stated that it plans to evaluate the outcome of current OECD

⁷ The current OECD pricing discussions respond to a decision in a World Trade Organization proceeding involving U.S. Department of Agriculture export finance support for exports of cotton to Brazil which is viewed as requiring that Export Credit Agency lending programs such as the MT program break even over time in order to avoid being deemed a prohibited government subsidy for the sale of its nation's exports. WTO Dec. WT/DS267/R, 8 September 2004 (04-3421), United States – Subsidies on Upland Cotton. The Bank's Policy Analysis Division has suggested that the OECD pricing discussions may be resolved by the end of calendar 2009, although more time could be required.

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buyer pricing negotiations prior to making any changes to the MT program exposure fee pricing structure. However, since the OECD is responsible for setting a pricing floor, we do not believe the planned evaluation is responsive to our recommendation that focuses on the need to set pricing premiums for more risky, non-sovereign transactions. The Bank's Policy Analysis Division reports that the general parameters within which a new understanding on pricing may be reached will be known after January 2009 meetings, which should provide an adequate base of information for management to begin developing a structure and supporting policies for a more flexible pricing system. Such a system would be expected to be sufficiently flexible to respond on a relatively prompt basis to changes in the market and changes in floor pricing terms set by OECD.

OMB Circular A-129 requires that fees be set at levels that minimize default costs, avoid an unintended additional subsidy to riskier borrowers and that fee structures be reviewed at least annually. Management's plan to evaluate the outcome of current OECD negotiations does not satisfy A-129 requirements. Written policies and procedures should be developed to address A-129 requirements.

Management's proposed indeterminate resolution date for the initiation of evaluation and planning is not commensurate with the level of effort required to implement the recommendation within a reasonable time period. Management should more expeditiously develop and implement procedures to address Finding 4.

Consequences of 100% Guarantee for Non-Sovereign Transactions

Finding 5

A central feature of the MT program has been the provision of a broad "100% guarantee" – Ex-Im Bank assumes 100% of the credit and default risk associated with the export financing transaction (above the amount of the buyer's cash payment, which must equal at least 15% of the purchase price of the exported goods). The Ex-Im Bank guarantee also covers risks that private sector export credit insurance may not cover, such as fraud risk. Ex-Im Bank management stated that the 100% guarantee threshold for the MT program was instituted in the early 1980's in response to the Latin American debt crisis. Since that time, the guarantee threshold has remained at 100%.

Offering a 100% guarantee product to participants involved in non-sovereign transactions creates a "moral hazard" in the MT program, most notably for the lender responsible for submitting the Ex-Im Bank application and performing due diligence on the export finance transaction. "Moral hazard" can be defined as the prospect that a party insulated from risk may behave differently from the way it would behave if it were partially or fully exposed to the risk. The 100% guarantee product insulates the lender from the risk of loss on that transaction. The history of disproportionate credit and fraud losses in the MT program are clear indicators that the behavior of lenders participating in the program has been significantly different with respect to actions to address credit and fraud

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risk than it would have been if they bore some or all of the risk.

Agents and brokers who originate many MT program transactions and are compensated with a fee based on the amount of the transaction are subject to a similar moral hazard. While Ex-Im Bank's policies and practices call on these individuals and companies to provide due diligence screening to protect the Bank from excessive exposure to credit and fraud losses, they bear no risk of loss if their efforts are inadequate.

OMB Circular A-129, Appendix A section II.3.a., recognizes the important impact of moral hazard and the sharing of risk. It states that "lenders and borrowers who participate in Federal credit programs should have a substantial stake in full repayment in accordance with the loan contract" and that "the level of guarantee should be no more than necessary to achieve program purposes." This section also states that "programs in which the Government bears more than 80 percent of any loss should be periodically reviewed to determine whether the private sector has become able to bear a greater share of the risk." In the private sector, for transaction-based originators and guarantors, it is a consistent industry practice to require some level of risk sharing or "skin in the game" among participants in the transaction in order to achieve strong transaction and/or loan performance.

The 100% guarantee threshold currently permitted for MT transactions eliminates the lender's financial incentive to perform adequate due-diligence on the transaction. Instead, the lenders, even those that have robust due-diligence capabilities, are unintentionally transformed into agents whose primary incentive focuses on delivering quantity over quality, maximizing their origination fees charged to borrowers in the case of guaranteed lenders or maximizing their sales revenue in the case of insured exporters.

Recently, in June 2008, Ex-Im Bank unveiled a new Medium Term Delegated Authority ("MTDA") program that requires that the lender retain 8-10% of the credit risk on the transaction in exchange for lender authority to underwrite and authorize Ex-Im Bank's guarantee without advance approval or additional underwriting review by Ex-Im Bank. In July 2008, management informed us that the MTDA program had received limited interest from Ex-Im Bank's leading lenders. This may be an indication that lenders value the 100% guarantee above reduced processing times that would be realized under delegated authority. It also may indicate that lenders are reluctant to commit to performing enhanced MT program transaction due diligence unless Ex-Im Bank develops a formal requirement. Management has also suggested that many of the smaller lenders who participate in the MT program would not be expected to participate in the MTDA program because they do not have sufficient capital. Implementing policies that would decrease participation in the MT program by these smaller lenders is a concern to management in view of Congress' direction in the Ex-Im Bank Charter that it should seek to "attract the widest possible participation of private financial institutions and other sources of private

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capital” in the MT program.

Recommendation 5

We recommend that Ex-Im Bank management evaluate the impact of implementing a greater degree of risk sharing or other incentives for non-sovereign transactions to reduce the moral hazard currently associated with the MT program. A number of possible techniques to achieve this result should be considered, which would include a) requiring that the lender retain a stated percentage of risk in the transaction, possibly a variable percentage based upon that lender’s success in making good loans or the risks of a particular market, b) in instances of first payment defaults with aspects of fraud or gross misrepresentation, including/enforcing the clause in the contract that allows Ex-Im Bank to request that the lender return the guarantee payment on those claims, c) limiting or terminating the lender’s or broker/agent’s participation in the program if more than specified maximum “acceptable” levels of claims result or other similar measures. The possibility that requiring lender risk sharing in the MT program might cause the MTDA program to become more appealing to Ex-Im Bank’s lenders should also be considered.

Ex-Im Bank management has expressed concern that altering the 100% guarantee threshold may result in a significant reduction in MT program applications, undercutting the Bank’s mission. The extent to which requiring lender risk sharing might deter lenders and brokers/agents from submitting MT program applications should be part of the recommended evaluation. It appears that the MT program may generate origination fees and risk adjusted interest rate spreads for the lender that are above those available through other, more traditional lending programs or channels. It is recommended that participant profitability from the MT program be included as an element of the recommended evaluation.

Lastly, it should be noted that there is a direct relationship between the issues and recommendations discussed in “Section 1: Credit and Fraud Risk Management” and the 100% guarantee threshold. So long as Ex-Im Bank retains the 100% guarantee as an element of the MT program for non-sovereign deals, its origination, underwriting, monitoring and collection policies will need to be more stringent and highly developed in order to counteract the significant degree of moral hazard. Conversely, if management determines to require significant risk sharing for non-sovereign transactions in the MT program, then the Bank could consider implementing the recommendations in Section 1 in a phased approach over a longer period of time and with greater flexibility to test market response to the changes made to the MT program. In either case, because the MT program is intended to accept risks that the private sector cannot or will not accept, and because the impact of ineffective risk management techniques in a given year may not be evident for 12 to 36 months, management should regularly test and evaluate the effectiveness of the recommendations in Section 1 and of other actions that management takes to address fraud and credit risk.

Findings and Recommendations

Management Response

Management agreed with the finding, acknowledging the inherent moral hazard in offering 100% cover under the MT program and agreed that risk sharing may be an impactful tool in enhancing program performance. Management stated that Ex-Im Bank will continue to evaluate the impact of more frequently requiring risk retention on MT transactions and mechanisms for linking such retention to lender performance or other transaction risk factors. Management noted that the relatively limited response to the MTDA program implemented in 2008 confirms the lack of ability or inclination of MT program lenders to accept even limited uncovered risk.

Responsible Parties: SVP, Export Finance

Resolution Date:

- Development of framework for risk-based characterization of transactions and associated incentives/dis-incentives – June 30, 2009.
- Evaluation of impact on MT program of reducing cover from 100% – to be determined after consultation with Bank leadership and key stakeholders (to include the Small Business Exporter's Association, Coalition for Employment through Exports, Private Export Funding Corporation and Bankers Association for Finance and Trade).

Auditor Comment

Management noted a general concurrence without committing to take any specific actions that are responsive to Finding 5. Management provided no documentation of the Bank's ongoing evaluation of the impact of moral hazard from providing 100% cover in the MT program, or possible responses, during the course of the audit, suggesting that the proposed continuing review is to be informal. Furthermore, we believe that management's determination not to implement Recommendation 1 related to strengthening fraud and credit risk controls is inconsistent with the need to address excessive losses and weak performance of the MT program.

We do not believe the described actions are responsive to our recommendation for management to evaluate the impact of implementing a greater degree of risk sharing or other incentives for non-sovereign transactions. Management should expeditiously develop and implement procedures to meet the intent of the recommendation.

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Processing Time Inefficiencies: Definition of a Complete Application

Finding 6

Since the EOL System went into production in January 2007 for the MT program, there has been a perception by some that it has contributed to lengthening rather than shortening the average turnaround time to approve MT program transactions. While manual workarounds continue to exist, our review has not uncovered evidence to support this view. Although the average turnaround time to complete a MT transaction has not declined since the EOL system went into production in January 2007, EOL is not the direct cause.

The primary causes of the long turnaround time for MT transactions are:

- The unwillingness of Ex-Im Bank to define certain data as mandatory before a participant can submit an application (i.e. definition of a complete application). Ex-Im Bank does not want to discourage participants if they do not have all the documentation readily available. However, the review process cannot progress very far without such data. As a result, there can be multiple iterations between the applicant and Ex-Im Bank until all the necessary documentation has been obtained.
- The additional time Ex-Im Bank representatives in Trade Finance & Insurance (“TFI”) and Credit Underwriting (“CU”) spend working with applicants trying to help them get their applications and supporting documents up to minimum approval standards. This work is generally performed outside of the EOL system. Also, this is work typically expected to be performed by the lender submitting the transaction as part of the lender due diligence process.
- External pressures to give multiple “second looks” to transactions of questionable credit quality. While the target processing time for an application is 20 business days, we noted that of the roughly 700 MT program applications submitted in EOL between January 2007 and May 2008 that were ultimately denied or withdrawn (excludes amendments), the mean processing time was 107 calendar days and over 20% exceeded 150 days in the system. During this time, along with periods of inactivity, Ex-Im Bank and the transaction participants would go through numerous iterations trying to get the transaction to meet minimum standards.

Overall, given the complexity of the MT program export credit finance transactions, the willingness to begin processing incomplete applications and the lack of required lender due diligence, it is understandable that mean processing times are in the 80 day-range, a figure shared with us by management and that we validated through our analysis.

Findings and Recommendations

Recommendation 6 To improve the turnaround time in processing applications, we recommend that management develop a definition of a complete application by defining documentation requirements at initial application. As noted in Section 1 of this report, we recommend that the appraisal and bank/brokerage statements be two of the required documents. Also, we recommend that management consider creating dedicated teams in TFI and CU that would be responsible for processing transactions from first-time lenders as well as those transactions considered highly complex or risky. Under the approach, this separate workstream in TFI and CU could take the added time necessary to process and underwrite the more high maintenance transactions without impacting the processing time of those applications that are considered straightforward such as repeat borrowers with good loss experience.

Management Response

Management disagreed with the finding and recommendation, stating that requirements for a “complete application” are denoted in the EOL system by the required fields in the borrower application that must be completed prior to submission. Management further stated that while enhancing these required data elements may limit staff time consumed in processing applications that are not sufficient for a complete analysis to be made, the inherent riskiness, complexity and non-transparency of MT program transaction participants will always result in credit underwriting and processing time challenges. Management has encouraged Bank staff to more carefully assess the quality of submissions and return unprocessed those applications that do not meet substantive standards. In addition, staff and management are more aggressively monitoring the status of medium-term transactions and have implemented a regular pipeline review chaired by the Vice Presidents of the Credit Underwriting and Trade Finance & Insurance Divisions.

Management does not believe that creating dedicated teams to support processing of transactions from “first time lenders” or those that are highly risky or complex would provide material tangible benefit. As a practical matter, transactions with such characteristics are assigned to appropriately experienced staff based on workflow and other considerations.

Responsible Parties: SVP, Export Finance

Resolution Date: Not applicable

Auditor Comment

Management stated that it disagreed with Finding 6. Management’s statement that requirements for a “complete application” are defined within the EOL system avoids the core question of whether those requirements as presently composed and implemented by the Bank’s staff contribute optimally to the efficient, effective, timely and transparent operation of the MT program. We believe that the absence of consistent requirements for a complete application

Findings and Recommendations

that includes information like that described in Recommendation 1 and other information that the Bank frequently requires to address commonly encountered informational or credit issues are a root cause of the Bank's difficulty in processing MT program transactions on a timely basis in line with management's stated goal of an average turnaround time of 20 business days.

Management has declined to implement the recommended modifications or any other actions that are responsive to Finding 6. The actions that management describes as having been implemented to address processing time inefficiencies are positive steps. Management should expeditiously develop and implement procedures to address Finding 6.

Lack of Strategy and Vision for the Medium Term Program

Finding 7

A documented strategy for the MT program is not currently in place.

The last strategic plan for Ex-Im Bank was completed more than five years ago and covers the period of 2002 to 2006. Recognizing the potential influence of the internet and e-commerce on the structure of trade, the plan emphasized the importance of technology as an essential component of operating Ex-Im Bank as an integrated entity.

Shortly after the creation of the 2002-2006 Strategic Plan, Ex-Im Bank underwent a major reorganization which resulted in the establishment of the Export Finance Group and the Credit and Risk Management Group. The strategic plan was never updated after the reorganization, nor was a new plan issued after 2006. Moreover, strategic plans were never developed for each of the major program offerings (i.e., Short Term, Medium Term, Long Term).

OMB Circular A-129, Appendix A section I.4.b.(7), stipulates that management shall "prepare, as part of the agency CFO Financial Management 5-Year Plan, a Credit Management and Debt Collection Plan for effectively managing credit extension, account servicing, portfolio management and delinquent debt collection." OMB Circular No. A-130 – *Management of Federal Information Resources*, Transmittal Memorandum No. 4 section 7.i., states that "the agency strategic plan will shape the redesign of work processes and guide the development and maintenance of an Enterprise Architecture and a capital planning and investment control process. This management approach promotes the appropriate application of Federal information resources."

Additionally, all organizations (private, public and non-profit) can benefit from a well-defined and supported strategic planning process. An effective strategic plan should:

- Be guided by the organization's mission;
- Identify the major goals of the organization;
- Be based on sound planning principles with appropriate stakeholder

Findings and Recommendations

- involvement;
- Given limited resources, make the best allocation of human and financial resources; and
- Take into account the organization's strengths, weaknesses, opportunities and challenges

Without a solid strategic business plan in place, it has been and continues to be challenging for Ex-Im Bank management to develop meaningful strategies and a collective vision for the MT program that effectively balances the Bank's competing objectives of supporting U.S. exporters while safeguarding taxpayer dollars. This may explain why the Bank has been slow to respond to adverse changes in the MT program's borrower/participant profile even though management had been aware, as they have indicated to us, of the deteriorating credit profile and increased losses in the MT program.

Recommendation

- 7 We recommend that Ex-Im Bank management develop and document a strategic plan for the MT program, even if one is not documented for Ex-Im Bank as a whole. The plan should identify the major goals of the MT program over the next 3 to 5 years, the strategies that management will deploy to achieve the goals, including the use of technology and targets for key performance measures (e.g., transactions approved, amounts authorized, volume target percentages for small businesses, etc.). The goals and strategies should take into account the observations and recommendations presented in this report.

Management Response

Management agreed with the finding and recommendation while stating that it does not believe that an overarching, detailed plan for the MT program can be established as a stand-alone independent of the Bank's overall goals and objectives. As part of an overall strategic review to be conducted with Bank leadership, management will develop a strategic plan for the MT program identifying long-term strategic goals and near-term objectives that will underlie the Bank's actions in continuing to adapt the MT program to maximize its utility to the Bank's stakeholders. Management disagreed in particular with the element of Finding 7 suggesting that the Bank has been "slow to respond to adverse changes in the MT program borrower/participant profile," noting in their response to Finding 7 and in the response to Finding 1 a number of specific actions management has taken to respond to increased fraud and credit losses since 2005.

Responsible Parties: SVP, Export Finance

Resolution Date: September 30, 2009

Auditor Comment

When accomplished, the above actions *may* satisfy this recommendation.

Findings and Recommendations

However, management's proposed resolution date of September 30, 2009 is too prolonged and not commensurate with the level of effort required to implement the recommendation. Delay in preparing a statement of long-term strategic goals, even if limited to management's current understanding of those goals and subject to further development and revision, will inhibit the ability of management and the Bank's staff to effectively manage the MT programs and develop, implement and monitor positive changes that have been made in recent years to improve MT program performance and that are required to meet current and expected demands on the MT programs. Management should more expeditiously develop and implement procedures to meet the intent of the recommendation.

Our audit did not undertake a detailed review of MT program data available to management in 2001 through 2006 nor management's specific responses to that data in the following years. We believe the absence of a strategic plan and associated performance goals and annual management evaluations for the MT program contributed to a less than immediate response when adverse conditions in the MT program were first noted in 2005. As noted elsewhere in this report, we believe the actions cited by management are positive, but not sufficient, responses to manage fraud and credit risk in the MT program.

Appendix A – Management’s Response

March 10, 2009

Michael W. Tankersley
Inspector General
Office of Inspector General
Export-Import Bank of the United States

Re: Medium Term Export Credit Program Audit

Dear Mr. Tankersley:

Thank you for the opportunity to respond to the findings and recommendations in the Performance Audit of the Medium Term Program (“Audit”) and the supplemental report (the “Report”), each dated January 30, 2009. This letter provides our observations with respect to the Report. Ex-Im Bank’s responses to the specific Audit findings and recommendations (excluding those relating to information technology) are set forth in attachment A hereto. Although management has already responded to the information technology findings and recommendations, we understand that this portion of the Audit remains a work in progress and we look forward to receiving the updated materials in the coming weeks.

Ex-Im Bank welcomes the many constructive findings and recommendations contained in the Report. While we disagree with the scope and applicability of some recommendations, we will undertake to consider employing many of the suggested tools more consistently in the medium term export credit guarantee and insurance program (the “Medium Term Program”). In particular, the Bank looks forward to working with you to develop more objective, transparent criteria for classifying transactions according to their risk profile. This risk classification system would be used to determine which structural enhancements are necessary to mitigate the identified risks.

The development of such criteria and consideration of appropriate structural enhancements will be undertaken in a manner consistent with the objectives and priorities of Ex-Im Bank’s leadership and in consultation with the Bank’s stakeholders. These efforts will build on the progress that the Bank’s management has made over the past several years in minimizing vulnerability to fraud in the Medium Term Program.

As you know, since 2005 when Ex-Im Bank uncovered two major fraud schemes (involving the Philippines and San Antonio Trade Group), Ex-Im Bank has directly addressed the heightened risk of fraud in the Medium Term Program through the selective application of enhanced due diligence, credit, and structural enhancements for high risk transactions. These requirements include many of the recommendations contained in the Audit and Report, such as

Appendix A – Management’s Response

security interests, local bank guarantees, more frequent payments, evidence of inspection, evidence of acceptance, bank brokerage statements, and evidence of full cash payment. In addition, Ex-Im Bank has emphasized sound “Know Your Customer” due diligence practices aimed at ensuring that the Bank’s customers investigate sources of origination, credibility of financial information, involvement of politically exposed persons, and whether a transaction has been conducted on an arm’s length basis. Ex-Im Bank has also increasingly emphasized prior lender performance as a key underwriting component.

Ex-Im Bank has employed these tools on a selective basis for high risk transactions, such as those involving equipment aggregators, inexperienced exporters or buyers, lenders with poor claims history, and used equipment. We have not broadly imposed these criteria across all transactions under the Medium Term Program. We believe that this type of sweeping, programmatic approach would unduly burden transactions with a high likelihood of integrity and discourage customers with a strong performance history from participating in the Bank’s programs.

Early indications suggest that these measures are working. The quality of applications has improved and our lenders have demonstrated a more selective approach to originating business and vetting potential customers. Most importantly, Ex-Im Bank staff has gained a better understanding of past fraud schemes, which improves the Bank’s ability to detect fraud in new transactions. For these reasons, we disagree with the Report’s conclusion that the fraud schemes experienced in the past would likely be replicated in Ex-Im Bank’s current underwriting environment. While the Medium Term Program has experienced some fraud since 2005, it is very unlikely that schemes with the breadth of San Antonio Trade Group or the Philippines would occur today. For example, in 2006, Ex-Im Bank uncovered a potential fraud scheme involving five transactions totaling \$11 million. Ex-Im Bank took immediate and decisive action to prevent further losses during its investigation, and ultimately referred these matters to the Department of Justice in 2007. These decisions were made before any claim or default had occurred. While any fraud is unacceptable, Ex-Im Bank’s heightened awareness of fraud patterns and willingness to take decisive actions prevented greater losses to the taxpayer.

We are interested in working with you to more systematically identify high risk transactions to ensure that Ex-Im Bank assumes prudent risks in the Medium Term Program. As indicated in the attached responses to the Audit, we are committed to evaluating and implementing several of the recommendations consistent with the broader objectives of the Bank’s leadership. In doing so, we will closely coordinate with your staff, law enforcement authorities, exporters, lenders, members of Congress and other key stakeholders to ensure that the Bank continues to maintain the appropriate balance between prudent allocation of the taxpayer funds with which we are entrusted and the Bank’s mission to create and sustain American jobs through financing exports.

Sincerely,

James H. Lambricht
Chairman and President

Appendix A – Management’s Response

MANAGEMENT RESPONSES TO: THE EXPORT-IMPORT BANK OF THE UNITED STATES AUDIT REPORT – CREDIT AND FRAUD RISK MANAGEMENT BUSINESS PROCESS IMPROVEMENT

FINDING 1. Ex-Im Bank disagrees with the finding that the Medium Term Program has insufficient due diligence requirements and processes. Many of the requirements and processes recommended in the Audit are, in fact, utilized selectively by the Bank in underwriting the Medium Term Program.

Before responding to the specific items cited as deficiencies, management would like to comment on the methodology used. Management believes the Audit’s evaluation of the Bank’s underwriting and due diligence procedures lacks sufficient rigor to reach conclusions as to primary causes of the program’s poor performance in recent years. We believe among other things consideration should have been given to evaluation of the history of the Medium Term Program. For example, the Audit fails to take into account the program’s favorable results in 1998 and 1999, as illustrated in Table 1 of the report, when net claims were relatively low (less than 4%) and fraud-related claims were essentially nil. We also believe it ill-advised to use the practices of domestic, private sector asset-based lenders as a primary basis for comparison to the Medium Term Program. Ex-Im Bank programs are designed to be additional and otherwise not to compete with the private sector. Based on the fundamental mission of Ex-Im Bank, we should take more risk than the private sector is willing or able to assume. Overall, we find the recommendations to be lacking in terms of implementation, while we recognize that some recommendations should be adopted to a degree.

Another important consideration is that the Bank has already put in place an approach that management believes strikes a reasonable balance in terms of mitigating fraud and credit risks without materially impacting the utility of the medium-term program. This approach to a large extent was based on lessons learned from the large-scale fraud experienced involving transactions in the Philippines and Mexico. While it is still early, the actions taken by the Bank appear to have had a positive effect by improving lender behavior and identifying bad actors and suspect transactions. These actions were vetted with the export community and have been largely positively received by our lenders. Management believes we should give them a chance to work. Among these actions are:

- Development of “Transaction Due Diligence Best Practices” posted on our website for the particular benefit of lenders and exporters (2008)
- Development and codification of transaction due diligence procedures for internal use on a bank-wide basis (2009)
- Development of a medium-term lender rating system used to identify strengths and weaknesses of lenders, the performance of their portfolio, and the net financial impact of their portfolio on the Bank. The rating system is used to provide lender feedback and identify top performers for expedited processing and

Appendix A – Management’s Response

- poor performers whose deals are subject to greater scrutiny. It is also a material consideration when making credit decisions on new transactions. (2008)
- Development of risk-based enhanced due diligence procedures such as requiring Bank review of transaction documents prior to disbursement, e.g., where the exporter is a new aggregator. (work in progress)
 - Development of a “fraud tricks” guide developed from our experience and training (2007)
 - Development of “High Risk” credit standards required in high risk markets including pre-export inspections, etc. (2005)
 - Development of special credit standards for high risk, small agricultural-related borrowers (2005)
 - More frequent use of credit enhancements such as liens, escrow accounts, etc. to mitigate credit risks. This is done selectively based on the risks associated with a transaction. (2008)

With respect to the specific items cited in the findings, the Bank currently uses a risk-based approach in determining the level of due diligence performed on a transaction and the extent to which credit enhancements are required. Not having the benefit of examining the 10 sampled medium-term transactions, management cannot comment on the merits of requiring an on-site inspection of the products that were exported, a cash flow analysis taking into account the useful life of products supported, or bank/brokerage statements for those specific transactions. Ex-Im Bank currently requires pre-export inspection of products if exporter performance risk is high. Ex-Im Bank would not typically conduct a cash flow analysis unless the predominant source of repayment was the equipment being financed, which is rarely the case with medium-term transactions. Bank and brokerage statements are routinely required for a segment of our business in which we have had issues with financial statement reliability and quality, i.e., small agricultural-related buyers.

Contrary to the assertion in the Audit, Ex-Im Bank’s Engineering and Environment Division currently makes determinations of both useful life and appraisals for all medium-term, used equipment transactions and on new equipment transactions on a risk-based basis. The maximum term on new medium-term transactions, except for special initiatives, is governed by the contract amount, not to exceed useful life.

With regard to independent appraisals, we do not believe that OMB Circular A-129, Appendix A, section III.A.3 applies to Ex-Im Bank medium-term transactions. The circular speaks to appraisals being required when two things are present: i) real property; and ii) that real property is being used as collateral for the loan. There is no demand for support under the Bank’s medium-term program for the export of real property. Real property is rarely offered as collateral for medium term transactions.

While Ex-Im Bank has the right to use an independent appraiser on particularly risky transactions, we believe that this review can be performed more reasonably by Ex-Im Bank’s Engineering personnel, and this approach has served the Bank well in the past.

Appendix A – Management’s Response

The appraisal or price reasonableness analysis conducted by Engineering is effective for the vast majority of medium-term transactions and strikes the right balance in terms of weighing the risks, the Bank’s mission, and allocation of scarce resources.

RECOMMENDATION 1. Broad implementation of the recommendations would result in the Medium Term Program taking on the structure of an asset-based program and would “chill the market” by imposing a burden on the preponderance of transactions generated by lenders that otherwise have a satisfactory record. This would have a profound adverse effect on cost competitiveness, and likely utility or feasibility of the Medium Term Program. Many of our better quality lenders have already exited this business because they cannot realize a reasonable return given the investment required in terms of people and capital. Broad implementation would lead to more good lenders exiting the business. The Medium Term Program is not an asset-based program by design and the incorporation of these two features on a broad, programmatic basis would be difficult to implement and manage. Moreover, it would render US exporters uncompetitive with their foreign competitors. The timing could not be worse given the effects of the current global crisis.

Using a risk-based approach, we believe it is reasonable to implement the recommendations (except the use of independent appraisers) more broadly than is current practice on a higher risk segment of our business, specifically on all transactions submitted by:

- new lenders,
- poor performing lenders as identified in our lender rating model, and
- all transactions subject to our “high risk policy”

Based on criteria to be developed, the Engineering and Environment Division will evaluate transactions to determine useful life, the appropriate repayment term, and price reasonableness.

We believe it is reasonable and consistent with a risk-based approach to require submission of bank/brokerage statements for all transactions involving company-prepared statements. Such business represents more than half of all medium-term transactions.

Responsible Parties: SVP, Credit & Risk Management

Committed Resolution Date: To be determined after consultation with our participant lenders, senior management, and Bank leadership.

FINDING 2. Management agrees with the element of the finding suggesting that the Medium Term Program may benefit from more robust early-warning/delinquency and performance reporting capabilities. Although the Bank’s current processes require and capture default notification on the part of lenders and the Bank’s existing systems

Appendix A – Management’s Response

capture performance history of transaction participants, we agree that enhancements in both of these areas would provide additional benefit in supporting decision-making on new commitments.

Management also agrees that, as a general matter, structuring transactions in accordance with local country norms to the extent possible is prudent and improves repayment performance. In this context, greater consideration will be given to requiring quarterly amortization. However, management notes that transaction-specific considerations impacting cash-flow patterns present in many Ex-Im Bank backed medium-term transactions deviate significantly from “country norms” exercised by local lenders and, as such, requiring more frequent payment may be counterproductive in stressing the cash position of borrowers. Competitive pressure from other Export Credit Agencies, which likely will continue to offer semi-annual repayment schedules for their medium-term business, may also disadvantage U.S. exporters.

RECOMMENDATION 2.

The following initiatives are in process and will be completed in response to Finding 2:

- At the request of the Bank’s Default Committee, the Office of the Chief Financial Officer and Information Technology Division are engaged in the development of a default notice reporting module for the Ex-Im Online platform.
- Ex-Im Bank is also considering a proposal to change and implement new claim filing procedures for all medium term products. These changes include a shorter claim filing window and a standard default report form (this proposal has been reviewed by CEE, the Coalition for Employment through Exports and BAFT, the Bankers Association for Finance and Trade)

In addition:

- Subsequent to completion of the above, management will evaluate the cost-benefit of retaining additional staff (on either a full-time or subcontracted basis) to conduct quantitative analyses of default and claims data.

Resolution Date:

- Implementation of Ex-Im Online Default Reporting Module expected September 30, 2009 (EOL Release 22).
- Implementation of revised claim-filing procedures – June 30, 2009
- Evaluation of cost-benefit of retaining quantitative analysts to assess performance and early-warning data – September 30, 2009

Responsible Parties: SVP, Export Finance

FINDING 3. Ex-Im Bank agrees with the finding that the lender oversight and quality assurance function should be formalized and expanded.

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RECOMMENDATION 3A. Management concur with the recommendation to establish a formal lender oversight function and in 2006 initiated development of a lender analysis framework to provide a basis for medium-term lender performance evaluation. This framework evaluates lenders according to key elements of performance and adherence to the requirements of the Medium Term Program. Specifically, the rating model captures portfolio performance (to include claims rates relative to disbursements, expected losses and timing), quality of transaction origination, “Know-Your-Transaction” capabilities (to include adherence to anti-money laundering, Patriot Act and other regulatory requirements) and underwriting capability. Based on the rating model and underlying data, a comprehensive “lender analysis” is being prepared for all active medium-term lenders. The Bank anticipates conducting quarterly updates to the lender analyses and annual reviews of lender ratings. Based on current allocation of resources, this process is led by the division charged with day-to-day transactional responsibilities with oversight by the Credit Review and Compliance Division

- The Bank will complete its expansion and formalization of the lender analysis process, based on the already developed framework

Resolution Date: June 30, 2009

Responsible Parties: SVP, Export Finance and SVP Credit and Risk Management

RECOMMENDATION 3B. Management concur with both elements of the recommendation and is in the process of:

- Establishing a quality assurance function to manage and monitor performance data on agents and other relevant transaction participants.
- Establishing a process for the Credit Review and Compliance division to conduct periodic reviews of medium-term transaction files

Resolution Date: September 30, 2009

Responsible Parties: **Responsible Parties:** SVP, Credit & Risk Management

FINDING 4.

Management agrees with the finding that in certain cases, the current medium-term, non-sovereign exposure fee pricing is insufficient to offset risks incurred. Management recognizes the need to assess – and likely adjust – the Bank’s pricing mechanism for the Medium Term Program (and contrary to the statement contained in the finding, is well aware of its authority to establish the Bank’s pricing schedule and its responsibility to do so in accordance with relevant budgetary, policy, legal, competitive and other constraints). However, such adjustment will necessarily be predicated on the outcome of the current OECD negotiations on buyer pricing. These negotiations are likely to not only establish minimum premium rates but also a framework for rating individual non-sovereign buyers. The Bank remains highly sensitive to the impact of potential pricing changes on the competitiveness of its products and will evaluate potential changes in consultation with all key stakeholders.

Appendix A – Management’s Response

RECOMMENDATION 4. Ex-Im Bank will revise its exposure fee pricing regime for the Medium Term Program.

Responsible Parties: SVP, Export Finance and SVP and CFO

Committed Resolution Date: To be determined in accordance with OECD negotiation on buyer pricing and in consultation with Bank leadership and key stakeholders.

FINDING 5.

Management agrees with the finding regarding 100% coverage. The Bank is well aware of the inherent moral hazard in offering 100% cover under the Medium Term Program and agrees that requiring risk-sharing on the part of transaction participants may be an impactful tool in enhancing program performance. However, we note that other existing Ex-Im Bank programs that require risk retention have performed poorly (specifically, the Financial Institution Buyer Credit Policy, which requires 10% retention on the part of the lender, and has incurred losses well in excess of premium income), suggesting that risk-retention, absent other program elements, does not assure improved performance. Moreover, the lack of activity under the Bank’s existing medium-term risk-sharing program (“Medium-term Delegated Authority”), despite the complete control and elimination of Ex-Im Bank’s transaction-specific underwriting process that is offered, demonstrates the lack of ability or inclination of medium-term trade finance lenders to accept even limited uncovered risk in this class of business.

RECOMMENDATION 5.

Ex-Im Bank will:

- Conduct an evaluation of the impact of more frequently requiring risk retention on medium-term transactions and
- Develop mechanisms for linking possible risk retention to lender performance or other transaction risk factors. This process will be undertaken in conjunction with the actions in response to Recommendation 1. The Bank will establish a framework for more objectively characterizing transactions according to their risk profile -- specifically taking into account lender performance -- and developing associated incentives and dis-incentives that may include risk-retention or other limitations on participant access to the Medium Term Program.

Responsible Parties: SVP, Export Finance

Committed Resolution Date:

- Evaluation of impact on medium-term program of reducing cover from 100% -- to be determined after consultation with bank leadership and key stakeholders (to include the Small Business Exporter’s Association, Coalition for Employment through Exports, Private Export Funding Corporation, and Bankers Association for Finance and Trade).
-

Appendix A – Management’s Response

- Development of framework for risk-based characterization of transactions and associated incentives/dis-incentives – June 30, 2009.
-

FINDING 6.

Management disagrees with what appears to be main element of the finding, that transaction processing time is related primarily to the Bank’s unwillingness to more rigorously define what constitutes a complete application that is eligible for processing. Requirements for a “complete application” are defined within the Ex-Im Online system as required fields and an application may not be submitted without such information being provided. Management agrees that potentially enhancing these required data elements may limit the staff time consumed in processing applications that are not sufficient for a complete analysis to be made. However, management notes that irrespective of the particular items required to define a “complete” application, staff review and assessment of the substance of the material provided will still be required to determine whether or not there is sufficient basis for evaluation and analysis of the transaction.

Management notes that a significant amount of transaction processing time is related not to achieving formulaic completeness of application submissions but to substantive challenges in underwriting inherently risky, complex, frequently non-transparent entities in emerging markets. As such, management has provided guidance to Bank staff to more carefully assess the quality of submissions and return unprocessed those that do not meet substantive standards. In addition, staff and management are more aggressively monitoring the status of medium-term transactions (to include the implementation of a regular pipeline review chaired by the Vice Presidents of the Credit Underwriting and Trade Finance & Insurance Divisions) and taking action to recommend approval, denial or withdrawal of cases reaching certain processing milestones. These actions have had a positive impact as reflected in a significant reduction of the aging of the medium-term pipeline.

Management does not believe that creating dedicated teams to support processing of transactions from “first time lenders” or those that are highly risky or complex would provide material tangible benefit. As a practical matter, transactions with such characteristics are already assigned to appropriately experienced staff based on workflow and other considerations.

RECOMMENDATION 6.

Management does not agree that the proposed recommendations will have a material, positive impact on transaction processing time. We believe that the recommendations to be implemented in response to Finding 5, above, will provide the greatest benefit in reducing transaction turnaround time as the more consistent and standardized application of a transparent set of transaction due diligence and structural enhancements will have a positive impact in reducing the number of iterations between the Bank and applicant in assessing transactions.

Appendix A – Management’s Response

FINDING 7. Ex-Im Bank agrees with the finding that a “documented strategy for the medium-term program is not currently in place.” While the development of a long-term strategic plan can provide useful guidance in orienting the further development of the Medium Term Program, we do not believe that such an overarching, detailed plan can be established as a stand-alone independent of the Bank’s overall goals and objectives. Targeting performance measures such as transactions approved and amounts authorized is difficult to do in a meaningful way as Ex-Im Bank is fundamentally driven by global demand for U.S. goods and services and the capacity and risk appetite of numerous private sector actors.

Management disagrees with the element of Finding 7 stating that the Bank has been “...slow to respond to adverse changes in the MT program’s borrower/participant profile even though management had been aware, as they have indicated to us, of the deteriorating credit profile and increased losses in the MT program.” Quite to the contrary, the Bank, in a relatively short period of time subsequent to identifying the significant risk factors underlying many of the fraudulent and unsound transactions processed in 2004-2005, adopted numerous changes to its approach to assessing and underwriting these transactions. These changes include:

- Development and distribution of a set of "Transaction Due Diligence Best Practices" intended for use by Ex-Im Bank’s lenders and exporters outlining the Bank’s expectations for transaction due diligence with respect to transaction parties.
- Development and distribution of a bank-wide set of Character, Reputational and Transaction Integrity Due Diligence Internal Policies and Procedures to provide staff guidance in assessing these issues
- Establishment of a monthly due diligence meeting chaired by the Bank’s General Counsel and attended by officers at the level of Vice President or higher, which reviews on-going due diligence matters, plus specific instances of potentially fraudulent activities, and/or participants that have been added to the Bank’s watch list.
- Establishment of a set of Medium-term Credit Standards for Medium-term Higher Risk Private Sector Transactions
- Establishment of a set of sector specific underwriting guidelines for small agricultural sector transactions
- Enhanced disclosure and due diligence requirements for transactions involving equipment aggregators

Appendix A – Management’s Response

Based on claims experience on recent medium-term cohorts and the lack of identification of new, significant instances of fraud in the Medium Term Program, these actions appear to have had a positive impact with respect to the soundness of the medium-term portfolio.

RECOMMENDATION 7A.

As part of an overall strategic review to be conducted with bank leadership, management will develop a strategic plan for the Medium Term Program, identify long-term strategic goals and near-term objectives that will underlie the Bank’s actions in continuing to adapt the Medium Term Program to maximize its utility to the Bank’s stakeholders.

Resolution Date: September 30, 2009

Responsible Parties: SVP, Export Finance