



MICHAEL W. TANKERSLEY  
INSPECTOR GENERAL

## Export-Import Bank of the United States

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March 30, 2009

James L. Lambright  
Chairman  
Export-Import Bank of the United States  
811 Vermont Ave. NW  
Washington DC 20571

RE: Evaluation Report Relating to Medium Term Export Credit Program (OIG-EV-09-01)

Dear Chairman Lambright,

This letter is provided by the Office of Inspector General (“OIG”) of the Export-Import Bank of the United States (“Ex-Im Bank” or the “Bank”) as a supplemental Evaluation Report (the “Report”) relating to the Medium Term Export Credit Program that is the subject of the Performance Audit Report dated March 30, 2009 (“MT Audit”) prepared by Protiviti, an independent risk consulting firm<sup>1</sup> (the “MT Audit Contractor”) and delivered to Ex-Im Bank today.

A number of conditions affecting the efficiency and effectiveness of Ex-Im Bank’s medium term guarantee and insurance programs (MT program) were identified by the OIG during the course of the MT Audit where the scope of the MT Audit limited available evidence to support audit findings and recommendations in accordance with generally accepted government auditing standards. This Report addresses those conditions by providing to management supplemental observations, findings and related suggestions. A draft of this Report was provided to management for their consideration as they reviewed and responded to the recommendations of the MT Audit. Their response to this Report dated March 10, 2009 appears as Appendix A to this Report. Please see the MT Audit report for further background.

### Summary

It is important that readers of this Report and MT Audit understand the overarching goals of this work and the context within which the MT Audit and this Report have been prepared. The goal of this work is to improve the MT program so that it better serves the Bank’s mission of supporting U.S. jobs through exports while providing good stewardship of taxpayer resources and complying with applicable law. This is

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<sup>1</sup> Protiviti Government Services is the contractor selected by this office to conduct the MT Audit.

particularly important as private sector sources of financing for U.S. exports have diminished in response to the international financial crisis. A secondary objective is to give management the necessary tools to manage the MT program to operate at a near break-even level, other than by drastically decreasing authorizations or raising borrower quality requirements, in order to give management and the Board confidence that the Bank can meet its self-sustaining budgetary limitations and requirements of international treaty organizations such as the Organisation for Economic Co-operation and Development (“OECD”) and the World Trade Organization (“WTO”) that the Bank’s export credit programs break even over time so that they do not constitute a prohibited subsidy.

We believe that these objectives are achievable through the thoughtful implementation of the recommendations and suggestions made in the MT Audit and in this Report. We are aware of the concern expressed by the Bank’s management that changes made in the MT program to reduce fraud exposure and increase recoveries of defaulted loans will result in either the Bank turning deserving transactions away, or the proponents of those transactions being discouraged from even applying. We do not believe that will be the result of the proposed changes if they are thoughtfully implemented and monitored as recommended.

The principal findings addressed and conclusions expressed in this Report are as follows:

- A. The fraud risks associated with the MT program need to be addressed directly, as recommended in the MT Audit, rather than indirectly as proposed by management, in order to provide assurance that the causes of the program’s excessive fraud losses in recent years do not continue to produce unacceptable levels of performance.
- B. The cash flow-based lending/underwriting model upon which the MT program is based is unlikely to achieve an acceptable level of performance because it is fundamentally inconsistent with the inherent risks presented by conditions existing in the MT program marketplace. While the cash flow-based lending model provides a reasonable basis for addressing the economic risk associated with MT program transactions, additional actions addressing the inherent fraud risks in the MT program will be required.
- C. In order to address the risks inherent in the MT program marketplace, Ex-Im Bank should model the “structural” elements (application requirements, factual verifications, documentation, payment terms, monitoring and collection practices) of the MT program more closely on the practices and procedures used by private sector lenders in the markets it serves to limit fraud exposure. Structural requirements that are comparable to other private sector lenders in the borrower’s markets should not be a disincentive to use the MT program or result in an undue burden on MT program lenders.

### Management's Response

In a letter dated March 10, 2009, attached as Appendix A to this Report, management responded to the findings and suggestions in this Report. Management undertakes to consider employing many of the tools suggested in this Report more consistently in the MT program, particularly in the context of developing more objective, transparent criteria for classifying transactions according to their risk profile. Management also notes its actions since 2005 to develop and employ tools to decrease the risk of fraud in the MT program, and states that it believes that these measures are working. Management disagrees with the conclusion expressed in this Report that the MT program remains at significant risk of recurrence of the sorts of large-scale fraud schemes experienced in the past, noting that a potential fraud scheme involving five transactions totaling \$11 million was identified in 2006 and referred to the Department of Justice in 2007, before a default or claim had occurred.

#### *Why is the MT program at particular risk of fraud?*

A number of conditions affecting Ex-Im Bank and the MT program increase its inherent fraud risk. These include:

- (i) the Bank's mission to extend credit in more than 160 countries and the resulting wide variations in business and credit practices and legal systems;
- (ii) the Bank's mission to accept risks that the private sector cannot or will not accept;
- (iii) the Bank's public disclosure of its underwriting standards, which can guide borrowers in misrepresenting their financial statements;
- (iv) the limited resources of many of the MT program lenders to verify the veracity of borrowers and conduct thorough due diligence;
- (v) the limited resources available to the Bank to fully scrutinize every transaction within a reasonable time after an application is submitted;
- (vi) the "moral hazard" resulting from the 100% guarantee provided to MT program lenders creates a disincentive for private sector participants to conduct thorough due diligence inquiries that would be more likely to identify potentially fraudulent transactions;
- (vii) the inexperience of many of the exporters, lenders and buyer/borrowers supported by the MT program; and
- (viii) a perception among transaction participants, particularly foreign parties, that defrauding Ex-Im Bank carries relatively little risk, particularly in smaller transactions, due to the limited ability of Ex-Im Bank to pursue those responsible.<sup>2</sup>

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<sup>2</sup> The significant reallocation of Department of Justice and Federal Bureau of Investigation resources to pursue anti-terrorism cases after 2001 is reported to have contributed to a reduced perception of serious negative consequences from fraudulent actions against the Bank that has begun to be reversed in the past three years through the actions of the Bank's private sector debt collection contractor and the indictments and convictions of responsible parties reported in the past 15 months.

The recommendations in the MT Audit and the suggestions in this Report can only mitigate, but not eliminate, these conditions and the challenges they present for the performance of the MT program. The positive performance record of the Bank's other export-credit programs suggests that these conditions have been effectively addressed in those programs, and that it is possible to effectively address them in the MT program.

We acknowledge the positive effect of the changes management has made in the MT program to reduce fraud risk in recent years. For example, the Bank has imposed more scrutiny on, and substantially decreased the volume of, transactions in some segments that were more affected by fraud, such as transactions involving used equipment. However, we do not believe that these changes are likely to be effective to reduce overall MT program fraud risk to an acceptable level. We are concerned that many of the transactions included in the large, publicly disclosed fraud schemes would still be accepted at the Bank today under its current standards because they involved otherwise credible companies. The additional modifications recommended in the MT Audit and suggested in this Report, combined with regular monitoring and adjustment, will be required to accomplish the objective of reducing fraud risk and resulting claims to a consistently reasonable level.

A. The fraud risks associated with the MT program need to be addressed directly, as recommended in the MT Audit, rather than indirectly as proposed by management, in order to provide assurance that the causes of the program's excessive fraud losses in recent years do not continue to produce unacceptable levels of performance.

*How Do Exporters and Foreign Buyer/Borrowers Defraud Ex-Im Bank?*

Our review of the facts of more than 100 claims submitted to Ex-Im Bank since 2002 that have been proven, or appeared, to involve fraud indicate that the responsible parties (generally exporters and foreign buyer/borrowers) succeeded in misleading the direct lender, and thereby defrauding the Bank as the direct lender's guarantor or insurer, by misrepresenting one or both of the following key elements supporting Ex-Im Bank approval of a transaction:

Misrepresentation No. 1: The exporter and the foreign buyer/borrower provide misleading information about the nature and value of the goods being sold and shipped by the U.S. exporter to the foreign buyer/borrower receiving an Ex-Im Bank insured or guaranteed extension of credit – no goods are actually sold, different goods worth less than is represented to the Bank are sold, cheaper foreign content goods are sold, fewer items are sold than is represented to the Bank – and the fraudulently obtained net proceeds are shared by the exporter and importer. This scenario can be summed up as “lying about what is in the box.”<sup>3</sup>

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<sup>3</sup> The shipping container in which the goods are shipped to the buyer.

Misrepresentation No. 2: The foreign borrower or guarantor provides misleading information about its financial position, submitting false financial statements claiming more revenue, more cash flow or greater cash balances or other assets than it has, allowing the foreign buyer/borrower to obtain goods that its financial position would not allow it to purchase on credit otherwise or misrepresenting that the foreign buyer/borrower has cash to fund the required 15% down payment on the purchased goods.<sup>4</sup> This scenario can be summed up as “lying about the buyer’s cash in the bank.”<sup>5</sup>

The nature and prevalence of these “two big lies” in the MT program fraud related claims have been well known to Ex-Im Bank at least since 2005, when the Bank made its initial referrals to the Department of Justice for investigation and prosecution of significant numbers of fraud cases arising in the Philippines based on Ex-Im Bank staff having identified previously unknown links among the deals. The discovery of the widespread use of the “two big lies” in the schemes associated with the San Antonio Trade Group was made shortly thereafter. These cases have resulted in publicly reported indictments and convictions over the past 18 months.<sup>6</sup>

#### *How Has The Bank Responded to the “Two Big Lies”?*

Since that time management has sought to address the fraud risk associated with the “two big lies” in a number of ways: applying greater scrutiny during its underwriting review, focusing more on the legitimacy of the exporter, providing “Know Your Transaction” (“KYT”) recommendations for lenders, brokers and agents and implementing enhanced due diligence standards generally and for specific transaction types deemed to be high risk. Commencing in 2008, lenders that demonstrate they have implemented these actions responsibly are offered the incentive of faster processing or “turn-around time” of their transactions by the Bank’s staff. These actions can be summed up as the Bank trying harder to assure the honesty and integrity of transactions submitted to it.

#### *How Does the MT Audit Propose to Address the “Two Big Lies”?*

Recommendation 1 in the MT Audit takes a different view of how to effectively address the fraud risk associated with the “two big lies.” Recommendation 1 suggests that the Bank directly address them by (1) requiring on-site inspections and appraisals of the goods being sold to the foreign buyer/borrower (“look inside the box”), and (2) requiring that the borrower and guarantor (in non-sovereign transactions) submit copies of their bank/brokerage statements (“look inside the bank”). The MT Audit notes that these

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<sup>4</sup> Ex-Im Bank generally insures or guarantees no more than 85% of the value of the U.S. goods being exported in a covered transaction; the foreign buyer/borrower is required to make at least a 15% down payment.

<sup>5</sup> A smaller, but significant, number of fraudulent transactions have involved the foreign buyer/borrower lying about their intended use of the purchased goods – selling them shortly after receipt to obtain cash rather than using them in their business.

<sup>6</sup> Philippines: <http://washingtondc.fbi.gov/dojpressrel/pressrel07/wfo101107.htm>  
San Antonio (Mexico): [http://www.usdoj.gov/usao/twx/press\\_releases/2008/Parker\\_ind1.pdf](http://www.usdoj.gov/usao/twx/press_releases/2008/Parker_ind1.pdf)

actions are widely practiced by private sector lenders to limit their fraud risk, and are recommended by the terms of OMB Circular A-129 – *Policies for Federal Credit Programs and Non-Tax Receivables*. Management has declined to implement Recommendation 1 on a programmatic basis,<sup>7</sup> but has noted that bank statements are requested in some categories of transaction or where other risk factors raise a question. 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) borrowers that provide unaudited, internally prepared financial statements (which management noted represent more than one-half of MT program transactions).

Given the nature of the markets where Ex-Im Bank’s mission is most actively called upon, many of which suffer widespread fraud and corruption, even among more substantial businesses, we are skeptical that the Bank’s strategy of seeking to do business only with honest exporters and foreign buyers/borrowers will be as effective as our recommended strategy of “looking in the box” and “looking in the bank”. Diogenes spent his life looking for an honest man without finding one, and he was not looking in many of the challenging locales where Ex-Im Bank does business.

For example, a significant number of the fraudulent transactions reported from the Philippines and from San Antonio Trade Group involved parties that would likely meet program guidelines under the Bank’s current policies – they were substantial businesses. The OIG is currently investigating a multiple transaction fraud scheme involving both of the “two big lies” that was executed in 2006 and 2007, after the Bank had increased its scrutiny of MT program transactions. We have received anecdotal evidence that some perpetrators of fraudulent transactions may have determined it to be good for their business to make scheduled biennial payments to the Bank on fraudulent transactions for years in order to limit the potential for scrutiny. One of the great challenges in addressing fraud risk in the MT program is that four or more years may pass between the date a transaction is authorized and the time that a clear indication of potential fraud may be received, generally after a claim is filed following a borrower default.

A more recently identified area of fraud risk for the Bank is the potential that it might support a transaction involving trade-based money laundering – the use of cross-border transactions in export goods to launder drug or terrorism associated money. The typical perpetrator of these schemes will likely present a credible front and reasonably documented cash flow and cash balances that will support receiving lender and Bank

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<sup>7</sup> Management’s response to Recommendation 1 states that programmatic implementation of the recommendation 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 also noted 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.

approval during the underwriting process. They will rely on one or both of the “two big lies” but will likely focus on shorter-term transactions that will in most instances be paid in full, since the objective is to move illicit money, not steal legitimate funds. The likelihood of detecting this sort of scheme will increase if the Bank adopts a policy of “looking in the box” or “looking in the bank” as recommended in the MT Audit.

*How Do the Bank’s Current Policies and the MT Audit Differ in Addressing the Root Causes of Fraud?*

At its most fundamental level, fraud is understood to be driven by three factors that are consciously or unconsciously evaluated by a person thinking about committing a fraudulent act:<sup>8</sup>

Motivation – how badly do they need money, how much money can they get?

Opportunity – are they in a position where actions within their ability and control will be sufficient to pull the scheme off?

Rationalization – how does the perpetrator rationalize their behavior – is it morally “OK” to steal from the target, or is there a low perceived likelihood of experiencing significant adverse consequences?

When an average person is highly motivated to commit fraud, based on need or a significant amount of money being available, has the opportunity to commit fraud, and perceives there is little likelihood of being discovered or punished, it is much more likely that they will commit the fraud. As any one or more of these factors changes, it becomes more or less likely a given individual will commit fraud. From this perspective, effective action to reduce the incidence of fraud must be responsive to adverse changes in these factors, and must address and significantly limit one or more of them.

In the context of the Bank’s MT program export credit transactions, where the Bank takes on 100% of the risk of fraud that might otherwise impact a U.S. exporter or a U.S. or foreign bank extending credit, these three factors can be analyzed as follows:

Motivation - Criminals, both domestic and foreign, have always been highly motivated to commit fraud and always will be. Legitimate businesses can be highly motivated to commit fraud when they have little or no access to capital or are otherwise experiencing significant financial strain. A lender or export-credit insurer can do relatively little to favorably impact motivation in a specific borrower, but can decrease its exposure to fraud risk by choosing to do business with persons having relatively less motivation to commit fraud. Ex-Im Bank’s recent strategy to try harder to assure integrity and honesty in transaction participants can be described as seeking to do business with parties who either have less of a motivation to commit fraud because they don’t need to do it to be

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<sup>8</sup> See Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*.

financially successful, or parties that over time have shown a greater ability to resist whatever motivation exists (or avoid detection).

Recommendation 1 of the MT Audit is premised on the fact that Ex-Im Bank's mission of extending export credit where the private sector is unwilling to do so will often place it in markets where a high motivation to commit fraud exists. The current state of international financial markets and a worldwide recession are likely to increase the motivation of both criminals and legitimate businesses to commit fraud. A prudent lender is sensitive to conditions that may suggest an increase in the general or specific levels of motivation to commit fraud in their markets, and responds by either (i) addressing element one by withdrawing substantially from the market or (ii) addressing elements two and three by attempting to further limit the opportunity to commit fraud and increasing the perceived likelihood that an attempt at fraud will be detected promptly and result in significant adverse consequences.

Opportunity – Export credit transactions generally, and particularly “one-off” transactions like those in the MT program where the parties have little prior experience with one another, present significant problems in fraud risk control because the parties do not have established business relationships and because they are geographically dispersed, limiting the potential for localized, in-person factual and reputational verification. These issues are discussed in more detail below, but their effect is to create a significantly greater opportunity to commit fraud than is the case in entirely domestic transactions between parties who know one another. Where transactions are completed primarily in reliance on faxed and couriered documents, the opportunity to further the fraud by faking the documents is increased.

Management's current strategy to address fraud risk in the MT program by increasing scrutiny of the integrity of MT program participants does not directly address opportunity risk inherent in the MT program. Recommendation 1 in the MT Audit directly attacks the perceived opportunity to commit fraud - it is much more difficult to fake a transaction or the foreign buyer/borrower's financial capability if the proper goods are confirmed to be “in the box,” and the right amount of cash is confirmed to be in the borrower's bank accounts. Management's enhanced due diligence standards for transactions involving used equipment does address opportunity in that it appears that it is easier to misstate the value of used goods than new goods for which list prices are available. It is our understanding from discussions with management that the enhanced due diligence standards for used equipment transactions have resulted in a near complete withdrawal of those transactions from the Bank's mix of business in the MT program.

Rationalization – Individuals motivated to obtain funds from the MT program by fraud, and who are presented with an opportunity to use one or both of the “two big lies” to do so, are likely to rationalize their behavior by concluding that there is a limited likelihood of being detected and punished, and by concluding that it is not morally reprehensible to defraud the government of the United States. The most common response of parties at risk of fraud to address rationalization is to emphasize the importance, and expectation,



of higher moral standards of behavior, and to increase the perception that attempted fraud is likely to be detected and punished. Management's current strategy of seeking to assure honesty and integrity in Ex-Im Bank transactions does emphasize the importance of higher moral standards of behavior, but does nothing to address either the perceived likelihood of getting caught or having a meaningful penalty imposed.

Recommendation 1 of the MT Audit directly addresses the perceived risk of an attempted fraud being detected before a transaction is completed. Recommendation 2, which suggests more frequent reporting and payment requirements to provide earlier notice of potential defaults, increases the perceived risk that fraud in a transaction will be detected more promptly after a transaction is completed. Management declined to implement Recommendation 1 programatically, stating that to do so would "chill the market," and would have a "profound adverse effect" on the cost-competitiveness and utility of the MT program. Management did undertake to require bank/brokerage statements more frequently based on consideration of the risk associated with specific transactions and classes of transactions. Management declined to implement Recommendation 2, but undertook to evaluate the possibility of implementing portions of it at a future date.

*Why does the MT program have significantly greater credit and fraud losses than other Ex-Im Bank export credit programs?*

As Exhibit 1 in the Executive Summary of the MT Audit shows, the MT program, while representing less than 10% of the Bank's credit authorizations, has accounted for more than 60% of its claims since 1998. The OIG's informal review of alleged and proven fraud against Ex-Im Bank suggests that the MT program accounts for an even higher percentage of the Bank's fraud losses. We believe that the cause for this disparity is twofold: (1) the MT program encounters inherent fraud and credit loss risks that differ significantly from the risks encountered in other Ex-Im Bank export-credit programs, and (2) the Bank's policies that address fraud risk in the MT programs have been less effective than in other programs. In order to significantly improve the loss and recovery experience of the MT program, we believe that the particular risks of the MT program must be identified and addressed in direct fashion by the procedures the Bank requires of its insured exporters and guaranteed lenders, and by the Bank's own review and underwriting procedures.

The Impact of Geographic Dispersion of Parties. One of the leading sources of inherent risk in the MT program arises from the fact that the Bank, and the guaranteed lender/insured exporter in most MT program transactions, are located in the U.S. and are geographically separated from the foreign buyer/borrower. Geographic separation makes it difficult or impossible to have the sort of direct contact with the relevant parties and markets that provides assurance of legitimate parties and transactions in ordinary U.S. domestic business lending. This increases the opportunity for fraud, and also supports the perpetrator's rationalization that they are unlikely to be penalized by parties located far away. Defrauding a U.S. lender or Ex-Im Bank may also not be feared as carrying the same negative moral connotations as would defrauding a local institution. As discussed

above, the core risks inherent in the geographic dispersion of the parties are: (i) the goods described as a basis for the transaction are not the goods actually shipped to the borrower and (ii) the borrower and any guarantor are not as financially sound and capable as represented.

The significant problem of risk associated with geographic separation between a lender and a borrower is well recognized in other contexts. U.S. banks providing revolving loans to exporting companies based in the U.S. typically will not advance credit against foreign receivables absent private sector or Ex-Im Bank insurance, which is one of the key facts driving the need for Ex-Im Bank support. U.S. financial sector regulators criticize insured lenders if they undertake significant loan activity in other regions of the U.S. or internationally that are “out of market.” This risk is multiplied when the relevant parties are separated by thousands of miles, as well as cultural and language barriers and differing legal and commercial regimes, as is the case with Ex-Im Bank and U.S. based MT program lenders and most of the foreign buyer/borrowers receiving Ex-Im Bank credit support.

The inherent risk of geographic separation exists in other Ex-Im Bank export credit programs that have a better history of avoiding credit and fraud losses. It appears that these programs have successfully mitigated this risk by involving local lenders or sovereigns more frequently, by dealing with parties who have a presence in U.S. or E.U. markets and legal and financial systems, by dealing with larger, more well established foreign buyer/borrowers, by relying upon pre-existing business relationships between the exporter and the foreign buyer/borrower and by requiring more face-to-face contact between lender and Ex-Im Bank personnel and the exporter and foreign buyer/borrower.

We do not believe that the Bank’s dissemination of the Know Your Transaction policy and enhanced due diligence standards to its lenders and exporters is adequate to fully address the fraud risk inherent in the wide geographic dispersion of the parties to most MT program transactions. Very few MT program lenders or exporters have a sufficient physical presence in the markets they lend into to allow them to effectively address this risk – their offices are in the U.S. and it is difficult to obtain a level of familiarity with foreign parties based upon limited personal visits that is comparable to that established when the lender and borrower are located in the same market. Of all of the parties participating in MT program transactions, Ex-Im Bank, while located in Washington D.C., does the largest number of transactions, and has the most consistent levels of contact, with parties in the largest number of foreign markets, placing it in the best position to marshal those resources to directly address the fraud risk associated with MT program transactions.

The Impact of Supporting Smaller “One-Off” Transactions. The larger transactions supported by the Bank tend to involve larger foreign companies or sovereigns, where the risk of the foreign buyer/borrower substantially misrepresenting itself is significantly lowered and where the reliability of financial statements audited by internationally respected accounting firms is greater. Larger transactions also support more active

involvement by the Bank's employees and the applicable lender, including foreign travel that allows personal, on-site verification.

The relatively smaller dollar amounts associated with MT program transactions will not support extensive international travel and face-to-face interaction by the participants and Bank employees at the same level that is encountered in the Bank's larger long-term transactions. It is rare for a MT program lender based in the U.S. to be able to physically verify what the exporter has shipped or the borrower/buyer received, before or after the transaction. The borrower's requirement for the longer repayment period offered by the MT program can signal financial weakness, and greater repayment risk, than is encountered in the Bank's short-term credit programs. Foreign buyer/borrowers in MT program transactions frequently have little prior history with the exporter or lender, who does not share Bank's risk in the credit.

In the smaller transactions supported by the Bank's working capital program, the insured lender shares risk with Ex-Im Bank and the exporter often has an established trading relationship with the foreign buyer, all of which mitigate fraud, credit and recovery risks.

*Are There Other Actions That Will Address Fraud Risk?*

Suggestions: Based on the considerations expressed in the MT Audit and in the preceding paragraphs, we reiterate the comment of the auditor expressed in the MT Audit that management should undertake to implement Recommendations 1 and 2 on a prompt basis to address the inherent fraud risk in the MT program. Among the further actions that we suggest Ex-Im Bank management consider and adopt to address the enhanced fraud risk associated with MT program transactions are:

1. Obtain, or require that parties to MT program transactions provide Ex-Im Bank, documentary evidence of the completed export transaction, in the form of shipping documents and U.S. and foreign customs documents, promptly after the exported goods are received.<sup>9</sup> These documents frequently identify fraudulent transactions based on misrepresentation of the purchased goods. Knowing that they will be reviewed by the Bank will increase the perceived likelihood of a fraudulent transaction being detected at an early date when more effective remedies may be available.
2. Arrange with this office to provide random on-site inspections of shipments of goods covered by MT program transactions, immediately prior to the date of shipment or promptly following delivery to the buyer. This action will increase

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<sup>9</sup> In many of the fraudulent transactions evaluated by the OIG, these documents, which were in the hands of the parties to the transaction but were not required to be delivered to the insured lender/exporter or to Ex-Im Bank, showed on their face material discrepancies between the goods described and the goods represented to Ex-Im Bank and the lender. As noted elsewhere in this Report, the terms of the documentation of MT program loans will also need to be modified to permit action against the borrower if discrepancies or misstatements are discovered.

the perceived likelihood of a fraudulent transaction being detected at an early date when more effective remedies may be available.

3. Arrange with this office or other law enforcement agencies such as FINCEN to more regularly screen parties to proposed transactions for involvement in international criminal activities. This action will identify individuals who may have a higher motivation to commit fraud, or decreased likelihood of resisting, allowing the Bank to avoid them or require enhanced due diligence and assurance procedures that will decrease the opportunity to commit fraud.
4. Arrange with reliable accounting, law, due diligence or financial advisory firms based in the buyer/borrower's home nation, who do not have a profit incentive related to the success of a transaction,<sup>10</sup> to verify the existence, capability and reputation of the buyer/borrower, on a regular or random basis. This action directly attacks the inherent risk associated with geographic dispersion of the parties, decreasing the opportunity to mislead the lender and Ex-Im Bank.
5. Create an Ex-Im Bank staff or contractor capability to conduct site visits and targeted lender audits of borrowers that is comparable to the function executed by middle-market transactional lenders in the U.S. and many foreign nations. This action directly attacks the inherent risk associated with geographic dispersion of the parties, decreasing the opportunity to mislead the lender and Ex-Im Bank. It also will impact the parties' perceived likelihood of being detected.
6. Evaluate whether the sorts of factual verifications and transaction structuring standards described in the MT Audit and this Report will allow the Bank to accept greater financial risk, and provide credit to foreign buyers/borrowers that are not sufficiently well-known to the lender or established in business to satisfy the current KYT standards.<sup>11</sup>
7. The Bank's strategic plan for the MT program should provide for (i) regular monitoring of key indicators of performance in the areas of claims, fraud and recoveries, as well as the implementation and effectiveness of modifications made to the MT program, and (ii) regular analysis of the resulting data at a high management level to identify emerging issues and risks and appropriate

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<sup>10</sup> One of the inherent risks of current MT program procedures noted in the MT Audit is the existence of "moral hazard" resulting from the Bank's assumption of all risk in MT transactions, while the lender and other parties are incented by fees received from successful transactions without retaining any risk of loss for fraud or credit losses. Reliance on third parties or Ex-Im Bank staff who are compensated for their work without regard to approval of the transaction to conduct the described due diligence review should result in more consistent and reliable conclusions.

<sup>11</sup> Private sector U.S. lenders that implement these strategies, such as asset-based lenders, are financially successful in lending to U.S. businesses with poor credit histories or other high-risk circumstances. We are not advocating the adoption of an asset-based business model where the recoverable value of pledged collateral assures repayment, just noting strategies applied by those lenders to attempt to mitigate similarly enhanced risks.

responses. The challenges and risks associated with the MT program suggest that a more frequent cycle of management review and modification of program policies and procedures is required than is necessary for the Bank's other export-credit programs, which appear to operate within more consistent norms over time.

We do not believe that these actions will slow Ex-Im Bank's processing time or impose undue costs on transaction participants or Ex-Im Bank if they are carefully implemented, particularly in view of the magnitude of the fraud risk they address. We also believe that adoption of lending policies and practices that more directly focus on the root causes of fraud, and the particular core risks associated with the MT program, can be as, or more, effective in executing the Bank's mission to support transactions that the private sector cannot or will not finance than is possible relying primarily on the Bank's enhanced "Know Your Transaction" ("KYT") and Due Diligence ("DD") procedures adopted in recent years.

The sort of background checks, site visits and spot audits suggested above are common requirements of private sector lenders, usually take no more than two business days to execute and do not result in objectionable expenses. The cost of inspections, local verifications or Bank inspection/audit teams could be charged to the borrower, directly or by being included in the loan balance, or could be absorbed by Ex-Im Bank, as is determined to be most consistent with Ex-Im Bank's mission and cost management.<sup>12</sup> When balanced against the tens of millions of dollars of credit losses that continue to be encountered in the MT program, particularly in markets that have experienced significant fraud, and the potential opportunity to act on the Bank's mission by accepting greater financial risk if exposure to fraud risk is reduced, the return on the Bank's investment for these activities should be adequate.

The suggested actions will contribute to reducing the risk of fraud against Ex-Im Bank in MT program transactions, as well as improving the prospects for claims recoveries. Prompt action against perpetrators of any fraudulent schemes that were not deterred is more likely to produce a recovery for the Bank than is the current practice of waiting months or years for a payment default to trigger a claim. More significantly, these actions should significantly limit the potential for the creation of multiple fraudulent transactions over the one to two years that can elapse under the Bank's current procedures before an authorized transaction defaults and results in a claim that alerts Ex-Im Bank to the existence of a potentially fraudulent transaction.

B. The cash flow-based lending/underwriting model upon which the MT program is based is unlikely to achieve an acceptable level of performance because it is fundamentally inconsistent with the inherent risks presented by conditions existing in the MT program marketplace. While the cash flow-based lending model provides a

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<sup>12</sup> One U.S. based middle market transactional lender interviewed by the OIG reported that the cost of transaction audits/site visits performed by its staff and charged to borrowers typically ranged from \$2,000 to \$3,000, which the potential borrower was required to pay at the time the application was submitted.

reasonable basis for addressing the economic risk associated with MT program transactions, additional actions addressing the inherent fraud risks in the MT program will be required.

Discussions with management regarding the observations in this Report and the MT Audit have illuminated a key difference in perspective regarding how the MT program should be designed and operated in order to be optimally efficient and effective in executing the Bank's mission. Many aspects of the MT program as currently in effect are consistent with a cash flow focused lending program, and it has been described to this office as such in discussions with management. Focus on borrower/guarantor cash flow as the primary source of repayment was described by management as a reason why a number of the recommendations presented in the MT Audit and this Report, such as requirements for inspections and appraisals, and for lien documentation, have not been implemented previously and need not be undertaken now. The MT Audit, and our review and evaluation supporting this Report, conclude that the inherent risks in the MT program market place require that additional procedures and actions be implemented by the Bank to effectively manage the inherent risks in the MT program.

In a cash flow-based lending program, the primary question addressed by the lender's underwriting is: Do the borrower and any supporting guarantor have sufficient cash flow to provide reasonable assurance of repayment? If so, the transaction can be approved without spending a lot of additional time and effort focusing on physical verifications, collateral values, liens and other structuring approaches. Cash flow-based lending is simpler and faster to document, satisfying Congress' direction to make the MT program easy to use. Actions like those suggested by the KYT and enhanced DD procedures would likely be seen by domestic cash flow-based lenders as adequate to address the core risks of the U.S. market.

The recommendations made in the MT Audit, to some extent, and the suggestions in this Report to a considerable extent, derive from the perspective that a traditionally structured cash flow-based lending program is not well suited to the specific inherent risks existing in the business environment served by the MT program:

- Successful cash flow-based lending requires first and foremost a high degree of confidence in the borrower's and guarantor's reported cash flow. The Bank's limited ability and willingness to demand, monitor and enforce compliance with its KYT and DD standards, the unreliability of foreign audits, the absence of post-transaction cash flow reporting and monitoring and the general opacity of finances in many foreign markets all combine to deny the Bank a level of assurance of MT program borrower/guarantor cash flow remotely comparable to that available to cash flow-based lenders in the U.S. or G-7 countries.
- Cash flow-based lending is undertaken primarily by lenders with a long-standing close relationship with the borrower. The lender typically manages the borrower's operating cash, and so achieves a much higher degree of knowledge of

the borrower than is possible in MT program transactions, which typically involve parties with no prior relationship, with the borrower's operating accounts being maintained by another lender.

- Cash flow focused lenders typically require that the borrower provide cash flow covenants and related frequent reporting that will allow the lender to take action to restrict credit or collect its loan if the borrower's cash flow diminishes, requirements not found or likely to be practicable in the MT program.
- Cash flow lenders frequently require borrowers to provide a covenant not to grant other lenders liens on their assets so that if collection is required, the cash flow lender is not seriously disadvantaged relative to other creditors.
- Cash flow lending is generally available only to the largest and best credits in a market. These are not the customers of the MT program.
- Cash flow-based lenders, as well as private sector export-credit insurers whose underwriting practices are comparable to those of a cash flow lender, are very rigorous in ceasing to do business with parties whose honesty and reliability are subject to question, or those producing a poor performance history in transactions they are associated with. As an agency of the U.S. government providing a service under the mandates of its Charter, and with a mission of supporting exports and U.S. jobs rather than maximizing return on capital, the Bank's management has not viewed the Bank as having the discretion to manage its risk by refusing to do business with persons who would be declined by the private sector.

The Bank's primary responses to poor performance in the MT program, specifically the KYT and DD policies and more skeptical and time-consuming underwriting, appear in this context to amount to trying harder to be effective at cash flow-based lending in an environment where cash flow-based based lending is severely disadvantaged and appears unlikely to perform at an acceptable level.

Even in 2004, the year when the MT program experienced its high-water mark of credit and apparent fraud losses, more than 70% of the loan volume supported by the MT program was repaid without loss to Ex-Im Bank. The logic of the Bank's current approach to the MT program appears to be based on the assumption that if Ex-Im Bank can identify and restrict its support to something approximating that 70% of its borrowing cohort that is reliable, give or take 5%, acceptable program performance would ensue. It is our conclusion in this Report, and the MT Audit Contractor's in the MT Audit, that the means that the Bank has chosen are unlikely to achieve this objective because it is unlikely that the Bank and its lenders and agents can successfully and consistently

identify that 70% of honest and faithful borrowers in the markets served by the MT program.<sup>13</sup>

If the MT program cannot adequately respond to inherent fraud risk as a pure cash flow-based lending program, this Report and the MT Audit conclude that specific changes can be made to mitigate the particular risks impacting the MT program and the markets and borrowers where it is used. Many of the proposed changes are drawn from specific actions that lenders in transaction-based and asset-based lending businesses have used to successfully manage comparable risks. Use of these techniques will not in and of themselves convert the MT program to an asset-based program.<sup>14</sup> A better way to think of the suggested changes in the MT program is that they will make it a stronger cash flow-based lending program that is more responsive to the risks of the international environment in which it must operate.<sup>15</sup>

The MT Audit and this Report do not speak to the business aspects of the Bank's underwriting standards – the analytical methods the Bank uses to decide who is likely to repay their loans, and how much risk is acceptable. If management determines to consider a borrower's cash flow as the primary determinant of the credit decision to support a loan, the Bank may very well lend well beyond the available collateral coverage or useful life of the financed equipment, even after implementing all recommended changes in the MT program. The recommendations made here and in the MT Audit are intended to provide reasonable assurance in such transactions that: (i) the fundamental facts of the transaction are as presented when the Bank made the credit

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<sup>13</sup> In fact, it is possible that the effort to identify the “good” 70% of transactions may undercut the Bank's mission by turning away other transactions that, with the sort of enhanced structural elements recommended here and in the MT Audit, would not be at excessive risk for fraud or credit losses.

<sup>14</sup> Management has described findings and recommendations in this Report and in the MT Audit 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 except where specific reference is made in this Report to practices of asset-based lenders, our findings and suggestions reference practices used by “transaction-based” lenders to manage their credit and fraud risks. Transaction-based lending, like the MT program, is predicated on defining specific product criteria and program requirements which are 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. The findings and suggestions in this Report do not assume or require that the MT program be considered to be, or treated, as an asset-based lending program. . Among other issues, the challenges associated with obtaining valid liens and then efficiently acting upon them to obtain repayment in many foreign jurisdictions would make a pure asset-based lending model difficult to execute successfully.

<sup>15</sup> We acknowledge that under the portion of the Bank's mission of “leveling the playing field” when a U.S. export faces competition from a foreign exporter backed by its national ECA offering terms that do not include the enhanced requirements proposed in this Report and the MT Audit, the Bank may consider matching the foreign terms. Such consideration should be approached from the perspective of using all other available tools to reduce the resulting increased risk of the transaction so that the minimum acceptable level of assurance of repayment is maintained.



decision; and (ii) if the borrower defaults, the Bank's legal rights, and resulting likelihood of repayment, are as well established as reasonably possible in the circumstances.

The Bank's focus on a cash flow lending model appears to have contributed to management decisions at various times to ignore other available means of decreasing the risk of fraud and credit losses and increasing the Bank's recoveries of defaulted loans, such as those outlined in Section C of this Report. The position articulated in this Report and the MT Audit can be described in response as: "Underwrite based on cash flow, then use every other available tool to reduce credit and fraud losses and improve collections."

Suggestion: As management develops the strategic plan for the MT program recommended in the MT Audit, implements the MT Audit recommendations and considers the suggestions made in this Report, the core question should be: "Will this action contribute to reducing fraud and credit risks and improving recoveries?" rather than "Is this action inconsistent with the historical focus and operating premises of the MT program?"

C. Ex-Im Bank should model the structural requirements (application requirements, factual verifications, documentation, payment terms, monitoring and collection activity) of the MT program more closely on the practices and procedures used by successful lenders to limit fraud and credit losses and increase the likelihood of repayment in the markets it serves. Structural requirements that are comparable to other private sector lenders in the borrower's markets will not be a disincentive to use of the MT program.

The terms of Ex-Im Bank supported MT program transactions, and the practices of Ex-Im Bank and its insured and guaranteed lenders in underwriting these transactions, appear to vary significantly in a number of respects from generally accepted lending and export-credit insurance practices in the private sector. These variances have been identified in anecdotal reports received by the OIG from Ex-Im Bank's debt collection contractor, Ex-Im Bank staff, MT program transaction participants and the MT Audit. The differences in approach have a variety of causes and explanations that, taken individually, in most cases have reasonable plausibility and might not be expected to have a material adverse impact on the MT program. But we believe the combined effect of all of these deviations from practices that contribute to acceptable fraud and credit loss and recovery experience for other lenders have been a significant cause of the poor performance of the MT program in recent years, and that its performance cannot be expected to improve materially unless many of them are addressed.

Adverse impacts resulting from these variances have included:

1. Unscrupulous exporters, borrowers and other transaction participants have accurately perceived an opportunity to defraud the Bank with limited effort and a low likelihood of being detected or experiencing any significant penalty, other than possibly being required to pay back a portion of the loan.

2. Ex-Im Bank has been disadvantaged in its collection efforts, particularly relative to other creditors, because it does not consistently require liens on the financed goods or other available collateral in countries where that would be a feasible and commonly accepted lending practice. MT program lenders have also in some instances used legal documentation that was not enforceable in the courts of the borrower's home country. The very simple documentation used in the MT program does not allow (nor require) the lender to act to protect its (and Ex-Im Bank's) interests prior to a payment default if the borrower has made material misrepresentations or encounters material adverse developments in its business. These conditions have limited the Bank's legal remedies and ability to negotiate with the borrowers on defaulted loans from a position of strength. The Bank has also been disadvantaged relative to other creditors when defaulted borrowers seek to restructure their obligations.
3. Foreign borrowers perceive that the lenders in Ex-Im Bank supported transactions, and Ex-Im Bank itself, are not as seriously concerned with being repaid as are other private sector lenders in their home country because the required credit terms and transaction structures are significantly less restrictive than what is required by lenders in their country. The adverse impact of this perception is exacerbated in countries that the Bank's debt collection contractor has characterized as "having a culture of non-payment," where some borrowers are unwilling to repay legal debts, despite the ability to do so, unless the lender takes action to legally compel payment.
4. Unscrupulous exporters, borrowers and other transaction participants perceive an opportunity to avoid restrictive legal requirements imposed on Ex-Im Bank supported transactions by over-pricing or otherwise misrepresenting the exported goods in order to obtain working capital that would not be permitted under OECD rules, or to obtain financing for goods not having the required U.S. source content.
5. Significant periods of time are allowed to elapse between:
  - a. the date that a MT program transaction is approved and the date the first payment is required;
  - b. the date that the lender first becomes aware that a borrower may be at an enhanced risk of default and the date that a claim is delivered to Ex-Im Bank so that it can take action; and
  - c. the date that the borrower defaults and the first date that Ex-Im Bank or the lender responds to restructure or collect the defaulted loan.<sup>16</sup>

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<sup>16</sup> Management's response to Recommendation 2 in the MT Audit notes that the Bank is considering an unspecified proposal to change the claim filing procedures for the MT program

Delays of this nature are known to significantly undermine the ability of a lender to restructure a troubled credit to return it to performing status, or to act to successfully collect the debt if it cannot be restructured. These delays are further exacerbated by MT program terms that continue to pay interest to the lender after a default, provide no incentive for the lender to act prudently to protect Ex-Im Bank's interests and effectively delay by months Ex-Im Bank's own ability to respond.

The significant impact on the MT program of the moral hazard created by the 100% guarantee is discussed at length in Finding 5 of the MT Audit and contributes to the risk associated with the conditions described above by reducing the incentive that other transaction parties might have to respond to these specific risks or otherwise avoid problem transactions and participants. Other key variances from generally accepted lending practices in Ex-Im Bank lending requirements that have been described as contributing to these adverse impacts are:<sup>17</sup>

- (i) limited or no physical verification of the borrower or that the goods being shipped conform to the disclosures to Ex-Im Bank;
- (ii) reliance upon borrower-prepared financial statements (in transactions below \$1 million) and local audits (for larger transactions) with limited or no verification of banking records;
- (iii) public disclosure of the Bank's underwriting standards, providing guidance to unscrupulous borrowers seeking to misstate their financial condition;
- (iv) the use of every-six-months payment terms so that no payment is required for six months after the initial closing;
- (v) limited or no requirements for providing interim financial information for borrowers and guarantors to the lender or to Ex-Im Bank;
- (vi) the insured/guaranteed lender is not required to actively monitor the credit or to respond promptly to adverse developments affecting the borrower, slow payments and defaults;
- (vii) the Bank's collections and legal staff as a general rule decline to actively respond to address threatened or actual defaults until a claim has been submitted to and accepted by the Bank;
- (viii) limited contact between the lender and/or Ex-Im Bank and the borrower and any guarantor, particularly once the transaction is closed;
- (ix) not consistently requiring liens on the purchased goods or broader liens on the borrower's other assets if they are not pledged to another lender;
- (x) including no covenants in the simple form of promissory note that MT program borrowers are required to execute that would protect the lender and Ex-Im Bank from misstatements and other negative developments affecting the borrower;

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<sup>17</sup> Items (i) and (ii) are addressed in detail in the MT Audit; the remaining items are discussed elsewhere in this Report.

- (xi) limited assurance that the borrower understands the terms and limitations applicable to Ex-Im Bank guaranteed/insured transactions so they will not be misled by unscrupulous transaction participants or their own lack of understanding to participate in transactions that violate Ex-Im Bank restrictions; and
- (xii) limited assurance in some cases that the Bank can assert its legal rights to collect a defaulted loan in that jurisdiction.

Management ascribes these variances to a variety of causes:

- A. The use of practices and procedures that: (i) have been adequate in other Ex-Im Bank export-credit programs, (ii) are consistent with the cash flow-based lending criteria for the MT program, (iii) are customary in private sector export insurance transactions or (iv) are used by other nations' export-credit agencies.
- B. Excessive cost for the borrower or the Bank, or delays in transaction processing, relative to the perceived benefit of changing applicable practices and procedures.
- C. The limited monitoring and oversight capabilities of many of the MT program lenders and of the Private Export Finance Corporation (PEFCO), a privately owned company that purchases and holds substantial numbers of Ex-Im Bank guaranteed loans.<sup>18</sup>
- D. Directions from Congress expressed in the Bank's Charter to that effect that the MT program should (i) accept risks the private sector is unable or unwilling to accept, (ii) ease administrative burdens and procedural and documentary requirements imposed on program users and (iii) be as supportive of exports as are the Bank's direct loan programs.<sup>19</sup>
- E. Concern that requiring additional procedures or documentation to reduce fraud risk or improve collection experience in the MT program will lead to a material loss of MT program lenders, exporters and foreign buyer/borrowers.

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<sup>18</sup> See the explanation of the Bank's relationship with PEFCO in Note 19 of the Notes to the Financial Statements in the Ex-Im Bank Annual Report for the year ended September 30, 2008.

<sup>19</sup> Sec. 2(a)(3) of the Bank's Charter states: To enhance the medium-term financing program established pursuant to paragraph (2), the Bank shall establish measures to--

(A) improve the competitiveness of the Bank's medium-term financing and ensure that its medium-term financing is fully competitive with that of other major official export-credit agencies;

(B) ease the administrative burdens and procedural and documentary requirements imposed on the users of medium-term financing;

(C) attract the widest possible participation of private financial institutions and other sources of private capital in the medium-term financing of United States exports; and

(D) render the Bank's medium-term financing as supportive of United States exports as is its Direct Loan Program.

While these rationales may adequately explain each of the MT program's notable variances from what we believe are customary lending practices that are applied by lenders to high-risk borrowers in the U.S. and in most foreign countries, we do not think that any one of the noted variances is singularly responsible for the poor results experienced by the MT program. The combined effect of all of these variances is to assure that the MT program cannot meet reasonable performance standards for credit losses, fraud losses and recoveries. Enhanced KYT and DD policies as recently adopted by the Bank, and the greater scrutiny applied to some categories of transactions such as used equipment sales, are likely to weed out some of the sorts of fraudulent transactions encountered in recent years, but we do not believe that they will be adequate to overcome the effect of the other inherent risks of the MT program resulting from the identified conditions.

As to the rationales for the status quo detailed above, we offer the following observations:

- A. Relative to the MT program's reliance on the use of practices and procedures that have been effective in other contexts, we note that the real test of a lending program's requirements is whether they are effective in its specific context. As discussed elsewhere in this Report, the MT program presents a fairly unique set of risks and limitations that are not typical of the Bank's other programs, cash flow-based lending or private sector export-credit insurance. This unique combination of risks requires a unique set of responses.<sup>20</sup>
- B. With regard to the cost-benefit analysis underlying some of the Bank's policy choices in this area, we note that one of the weaknesses of the Bank's cost/benefit and return-on-investment analyses in prior years has been that the risk of the sort of fraud and credit losses experienced by the MT program, and the cost of reduced recoveries on defaulted loans, has not been factored into the analysis. With the MT program continuing to produce claims payments of more than \$100 million per year on a base of transactions of approximately \$1 billion per year, representing more than 60% of average claims payments on less than 10% of the Bank's volume of transactions, and the significant benefit in terms of reduced cost-of-funds for the borrower in many Ex-Im Bank supported transactions, the vast majority of MT program transactions should be able to support the out-of-

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<sup>20</sup> Some MT transactions face competition from foreign nation export-credit agencies that do not require one or more of the elements suggested in the MT Audit or this Report. In those cases, we are not suggesting that the Bank be inflexible or turn away from its mission to level the playing field for U.S. exporters. What is suggested is that the decision to relax a particular requirement be based on the specific facts of that transaction and with due regard for risk and other possible mitigating factors. If another nation, particularly one not compliant with OECD requirements, wants to structure what are in effect grants not expected to be repaid as loans competing with the MT program, we do not believe the Bank's Charter requires the Bank to match the offered terms because there would not be a reasonable expectation of repayment.

- pocket costs attributable to the suggested changes, particularly if they are treated as ancillary costs that can be “rolled into” the financing.
- C. The limited monitoring and oversight capabilities of many of the MT program lenders and PEFCO will need to be addressed, and additional monitoring capability required of the lenders, or developed and applied by Ex-Im Bank.<sup>21</sup> The principal arguments against this action noted in discussions with management have centered on the cost of additional monitoring (addressed in B. above) and the fact that the Bank’s documents don’t currently provide for it. The use of automated support, the relatively small number of MT program transactions and the ability to develop improved monitoring over time as new transactions are booked under revised documentation should combine to make this action manageable to implement over a two to three year period.<sup>22</sup>
- D. Our review of the legislative history of the relevant provisions of the Bank’s Charter leads us 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 in order to achieve a reasonable expectation of repayment, and that are common practice in lending/guarantee transactions in the U.S. and in the borrower’s home nation. We believe that Congress was responding to exporter 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. If the MT program relies on structural and process requirements that are comparable to what would be encountered in the private sector in order to manage fraud and credit losses, while accepting business and financial risks that the private sector will not, that should be viewed as successfully executing the Bank’s mission and should not discourage honest borrowers and exporters from using the MT program.
- E. We do not believe that asking lenders and borrowers in MT program transactions to produce and evaluate documentation, and provide verifications, that are comparable to what they would expect to see in a comparable private sector transaction should result in significant loss of interest in the MT program.

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<sup>21</sup> To the extent that management continues to interpret the direction from Congress to attract the widest possible participation in the MT program of lenders and private sources of capital to include lenders lacking the ability to monitor transactions, the Bank should further develop its capability to execute this function, and should also consider whether its efforts to support these lenders should be reflected in the pricing for these transactions.

<sup>22</sup> We note that the Bank’s Asset Management Division has been working on a project to expand its monitoring of MT program transactions.

Suggestions:

1. Management should consider modifying the MT program in the following respects:
  - a. Removing the Bank's public disclosure of its precise underwriting standards. We have received anecdotal reports that the Bank's efforts to make the MT program easier to use by posting its underwriting standards have contributed to a number of instances of fraud. Other U.S. government lenders have not viewed transparency and user friendliness to require this action. Making public relevant ranges for a few key financial measures, and the institutional knowledge held by the many agents, brokers and lenders using the MT program, should provide enough information to support user needs while limiting the incentive and encouragement for window-dressing applications.<sup>23</sup>
  - b. Requiring monthly or quarterly, rather than semi-annual, payments to match the repayment terms commonly offered by private sector banks in the foreign buyer/borrower's locale. As noted in the MT Audit (Recommendation 2), more frequent payments provide a better barometer of the borrower's financial condition and also establish that there is an expectation of repayment. If another payment period is customary in that market, for example deferring payment until a financed crop is harvested, that might be deemed a reasonable exception that does not undermine the parties' payment expectations.
  - c. Requiring simplified regular reporting of the borrower's income statement and balance sheet, or perhaps copies of the borrower's bank statements, to provide more data points on the borrower's performance and to confirm the continuing interest of the lender and Ex-Im Bank in the borrower's financial condition and likelihood of repayment of the loan, as well as providing helpful information when response to a weakening or defaulted borrower is required.
  - d. Requiring that lenders monitor Ex-Im Bank credits on a specified basis, or a comparable basis to their other loans if they maintain an active lending business. Where the lender does not have this capability, Ex-Im Bank may need to modify the transaction documentation and its own practices to support Ex-Im Bank staff conducting this activity, and should consider

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<sup>23</sup> Our understanding of the Bank's underwriting methodology is that failing to meet the Bank's financial underwriting standards does not result in automatic rejection of a proposed transaction, but rather initiates a process of review to determine if other mitigating factors will support approval of the transaction despite the borrower's failure to meet certain financial ratio tests. If a borrower meets the standards, this additional review and search for mitigating factors is not deemed necessary. In this sort of system of "underwriting by exception," and given the inherent risks of the MT program, we do not believe there will be a material adverse impact on the actual level of transactions submitted or approved as a result of this action.

- reflecting the effort required in transaction pricing for lenders not performing this function.
- e. Terminate the accrual of guaranteed interest on MT program credits at the time that a default could be reasonably anticipated by the lender. Provide for the lender and Ex-Im Bank to jointly work on potentially defaulting or defaulted credits to see if they can be restructured or to initiate other protective or collection activities before a claim is submitted and paid. Arrange for an immediate and active response on a problem credit by a representative of the Bank's collections group and the individuals in the Bank's Trade Finance and Insurance and Credit Underwriting divisions responsible for the application.<sup>24</sup>
  - f. Attempt to address the limited post-transaction contact with borrowers by one or more of (i) arranging spot visits by locally based contractors (accountants, attorneys, due diligence firms), (ii) requiring such visits on some basis by the lender or (iii) coordinating travel by Ex-Im Bank personnel so that local borrowers are visited when possible.
  - g. Requiring liens on the financed goods. The Bank's collections group and its debt collection contractor both report significantly greater recoveries of defaulted credits when the Bank holds a lien. It is recognized that the cost and utility of liens varies from jurisdiction to jurisdiction, but if a domestic lender in a comparable transaction in the borrower's home country would require a lien, there is a strong case that Ex-Im Bank should require one as well. Liens can provide other benefits to the soundness of a transaction before a default. Liens can limit the borrower's ability to sell the purchased goods in order to convert them to cash, and provide the Bank a means of pursuing the goods if they are sold, a circumstance encountered in some of the MT program fraudulent transactions. A requirement for liens also communicates to the borrower that the lender and Ex-Im Bank are serious about being repaid.
  - h. Requiring that a small number of basic covenants be included in the promissory note or other loan documentation signed by the borrower to allow the lender/Ex-Im Bank to take action to protect its interests in cases where the borrower has misled the Bank, where the borrower's financial

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<sup>24</sup> The terms of private sector credit insurance give the insured/guaranteed lender four compelling incentives to quickly, aggressively and successfully address problem credits: (i) interest after a default is not insured, (ii) the lender typically shares 10% of the risk and will lose money if a loss results, (iii) the lender is not allowed to submit the claim for payment for six months – creating a period in which the lender's interests are better served by restructuring the loan and (iv) the export-credit insurer will routinely deny coverage if the lender has not responded to the problem credit on a comparable basis to its own credits. The incentives created by Ex-Im Bank's present guarantee and insurance terms are almost the precise opposite, making it unsurprising that the Bank's experience in collecting defaulted loans in the MT program has been poor. We note that management reports in its response to the MT Audit that it is working on proposals to shorten the notice period and otherwise modify its policies in this area to improve performance.



- condition deteriorates materially, where the borrower ceases to do business, is insolvent or suffers other material economic decline.
- i. Develop a concise native-language document that explains some of the fundamental requirements for Ex-Im Bank support for a transaction in areas that have proven susceptible to fraud and misrepresentation: (i) the borrower cannot receive additional cash working capital in the transaction, (ii) no party can receive undisclosed compensation, (iii) the purchased goods cannot be resold without the lender's consent and paying the proceeds to the lender, (iv) the goods purchased must have been made in the U.S., (v) Ex-Im Bank does expect to be repaid and will hire local lawyers to collect the loan if it is not paid and (vi) misleading the Bank is a criminal offense. We have received anecdotal information that a number of unsophisticated borrowers may have been persuaded to participate in fraudulent or otherwise illegal transactions based in part on their lack of understanding of some of these requirements.
  - j. The Bank should obtain assurance that its loan documents are enforceable in the relevant jurisdictions, and the failure to use those forms should be a basis for denial of coverage to a claiming lender. In the Bank's larger transactions, U.S. law and jurisdiction is agreed to by relatively sophisticated parties many of whom have significant business dealings or presence in the U.S. In MT program transactions, this is much less frequently the case, requiring that the Bank be able to enforce its rights in local courts to be effective.

We believe that requirements comparable to these are imposed by local lenders in many of the countries where Ex-Im Bank supports transactions, but have not undertaken to survey the world to verify this. Ex-Im Bank retains reliable local counsel in most countries, and the Bank's debt collection contractor has established contacts in most of the countries where MT program transactions are occurring, so it should not be difficult for Ex-Im Bank to obtain confirmation of local commercial lending practices to provide a guide for its requirements.

In some cases, local practices may dictate a more relaxed approach to some of the suggested risk mitigants because they are effectively addressed in that market by other actions taken by domestic lenders. If Ex-Im Bank or its guaranteed or insured lender is in a position to adopt those approaches, that would be a defensible basis for relaxing some of the terms for Ex-Im Bank transactions in those nations. Meeting head-to-head competition from foreign export credit agencies may sometimes require relaxing some requirements. Commercial lending practices that are commonly encountered among commercial lenders in the countries served by Ex-Im Bank should not be perceived as unusual or onerous by local buyer/borrowers such that they would discourage use of Ex-Im Bank export-credit support.

Conclusion – It Should Be Possible to Improve the MT Program without Slowing Service or Discouraging Participation

It is important that readers of this Report and MT Audit understand the overarching goals of this work and the context within which the MT Audit and this Report have been prepared. The goal of this work is to improve the MT program so that it better serves the Bank's mission of supporting U.S. jobs through exports while providing good stewardship of taxpayer resources and complying with applicable law. This is particularly important as private sector sources of financing for U.S. exports have diminished in response to the international financial crisis. A secondary objective is to give management the necessary tools to manage the MT program to operate at a near break-even level, other than by drastically decreasing authorizations or raising borrower quality requirements, if necessary to meet the Bank's self-sustaining budgetary limitations or requirements of international treaty organizations such as the Organisation for Economic Co-operation and Development (OECD) or World Trade Organization.

We believe that these objectives are achievable through the thoughtful implementation of the recommendations and suggestions made in the MT Audit and in this Report by management based upon management's experience in managing the Bank's other export-credit programs to achieve acceptable or exemplary levels of performance. It should be possible to process the majority of MT program transactions within a predictable timeframe that will be acceptable to MT program participants, while incurring no more than an acceptable level of credit and fraud losses. Incurring no more than the level of losses determined to be acceptable by management should allow the Bank to support the maximum volume of deserving transactions.

We are aware of concerns within the Bank that making material changes in the MT program to reduce fraud exposure and increase recoveries of defaulted loans, particularly by instituting more requirements that would be typical for private sector lending or export-credit insurance, will result in either the Bank turning deserving transactions away, or the proponents of those transactions being discouraged from even applying. We do not believe that will be the result of the proposed changes if they are thoughtfully implemented and monitored as recommended.

To understand our reasoning on this point, it is useful to think of the Bank's credit processes as having two parts, which can be labeled "structural" and "economic." The structural elements of the MT program consist of things such as: information required to be submitted with the application, application and underwriting procedures, payment terms, documentation, protective covenants focused on major issues such as legal existence, authority and solvency, lien requirements and third-party verifications of facts. The economic elements of the MT program consist of things such as: financial ratios the borrower must satisfy, the borrower's credit experience, financial covenants that are triggered by less than anticipated financial results, the financial condition of the borrower's business and its country of origin, and its results and prospects. For the most part, the structural elements of the MT program, and in fact any lending program, have much less impact on who applies for credit and who receives it than do the economic elements.

A small business that needs a loan will not be discouraged from applying because of structural requirements such as having to fill out an application, sign a note and security agreement having reasonable and frequently encountered commercial terms, having its business premises and collateral inspected, representing that it is legally existing and able to pay the debt, and being required to provide the lender with copies of its bank statements and financial statements at the time of application and going forward. These structural requirements are fairly universal, relate directly and reasonably to the lender's interest in being repaid and are not particularly burdensome compared to the benefit of receiving borrowed funds at a reasonable rate. On the other hand, lenders that are highly risk averse raise a high bar for accepting credit risk by adjusting their financial elements – they avoid risky borrowers with limited credit histories that are based in high-risk countries, they require very strong financial ratios, and they include covenants that will allow them to restrict credit or move to collect the debt if the borrower's financial results decline even slightly.

The recommendations in the MT Audit and the suggestions in this Report focus solely on the structural elements of the MT program, and not at all on the financial elements. Accordingly, we do not believe that implementing these changes is likely to discourage borrowers from applying for MT program support, nor that these changes will result in the rejection of borrowers that meet the MT program's financial requirements.

We appreciate the opportunity to be of service to the Bank in presenting these observations and suggestions. We will be glad to discuss these issues and any others relating to the MT program that you believe would be helpful in management's effort to make improvements.

Very truly yours,

A handwritten signature in cursive script that reads "Michael W. Tankersley". The signature is written in black ink and is positioned below the text "Very truly yours,".

Michael W. Tankersley  
Inspector General

Appendix A

Management's Response to Evaluation Report

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 (*Ed. Note – this attachment addresses the findings and recommendations in the Audit and is not included here; it is included as an attachment to the Audit*). 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 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. Lambright  
Chairman and President