

**TITLE XI LOAN GUARANTEE PROGRAM:
ACTIONS ARE NEEDED TO FULLY
ADDRESS OIG RECOMMENDATIONS**

Maritime Administration

Report Number: CR-2011-024

Date Issued: December 7, 2010




Memorandum

U.S. Department of
Transportation

Office of the Secretary
of Transportation
Office of Inspector General

Subject: **ACTION:** Title XI Loan Guarantee Program:
Actions Are Needed To Fully Address OIG's
Recommendations
Report Number: CR-2011-024

Date: December 7, 2010

From: Mitchell Behm 
Assistant Inspector General for Rail, Maritime and
Economic Analysis

Reply to
Attn. of: JA-50

To: Maritime Administrator

The Maritime Administration's (MARAD) Title XI loan guarantee program (Title XI) guarantees private loans to commercial ship owners and shipyards for ship and shipyard building and modernization. The program currently has a portfolio of guarantees that covers over \$2 billion in loans, and has the funding to expand it to almost \$4 billion. Since 2004, however, Title XI has approved only five applications, with commitments totaling approximately \$482 million, compared to an average of 11 approvals per year from fiscal year 1998 through fiscal year 2002. Furthermore, over the past 12 years, the program has suffered through periods of significant defaults. From February 1998 through April 2002, 9 borrowers defaulted on approximately \$490 million. Then, between August 2008 and January 2010, 6 more borrowers defaulted on approximately \$305 million.

We conducted two prior audits of MARAD's oversight of the Title XI program in 2003¹ and 2004² and made several recommendations to reduce the risks associated with the application process and improve portfolio monitoring. We followed up on this work with an October 2004 letter to the Secretary of Transportation stating that MARAD had developed procedures to address the 2003 recommendations, but had not completed effective implementation of these procedures.

¹ OIG report entitled *Title XI Loan Guarantee Program* (Report No. CR-2003-031). OIG reports can be found on our website: www.oig.dot.gov.

² OIG report entitled *Title XI Loan Guarantee Program* (Report No. CR-2004-095).

We conducted this follow up audit in response to a directive in Senate Report 110-131³ requesting that we certify to the House and Senate Committees on Appropriations whether MARAD is in compliance with the recommendations of our 2003 and 2004 reports.⁴ To accomplish this, our objectives were to determine: (1) the extent to which MARAD has implemented procedures to improve its oversight of borrowers in the Title XI portfolio; and, (2) whether the information necessary for conducting this oversight is readily accessible.

We conducted this performance audit from November 2009 to May 2010 in accordance with generally accepted government auditing standards. We selected a statistical sample of 60 Title XI loan guarantees out of 114 total loan guarantees approved by MARAD. We then conducted in-depth reviews of MARAD Office of Marine Financing's files for 20 of the 60 sample guarantees. These 20 guarantees were active during the scope of our audit and were held by 14 companies. Exhibit A details our scope and methodology.

RESULTS IN BRIEF

MARAD has not fully implemented new procedures for improving oversight of borrowers in its Title XI portfolio. The agency has not incorporated the guidance it developed to address our 2003 recommendations into the program policy it revised in 2007, resulting in inconsistent program policies. For example, the guidance calls for maintaining documents on the condition of assets in each guarantee's administrative file. However, the 2007 program policy was not updated using this guidance and, as a result, the files we reviewed did not contain documents on the condition of assets. MARAD also developed a computer-based financial monitoring system, but the system was not tailored during development to meet portfolio monitoring needs. Consequently, Title XI analysts do not use it.

The information needed to manage Title XI effectively is not readily accessible because of incomplete administrative files on program guarantees and borrowers, as well as limitations in its computer-based monitoring system. Neither Title XI program policy nor MARAD's 2004 guidance identifies what information is required for effective program monitoring, where the information should be stored, or how it should be shared. MARAD does not maintain a single, central file on each borrower. Instead, each of the three MARAD offices that monitor borrowers maintains its own files. Our review of files maintained by the Office of Marine Financing found that content varied from file to file and the files did not indicate where important documents, such as reserve fund and financial

³ Senate Report 110-131 accompanied the fiscal year 2008 Senate Transportation Appropriations Subcommittee bill and was printed on July 16, 2007.

⁴ The full text of these eight recommendations is in Exhibit B.

agreements, were maintained. As a result, there is no assurance that information MARAD needs to effectively oversee the \$2.3 billion Title XI program is readily accessible.

We are making recommendations to MARAD to reconcile its Title XI policy with the 2004 guidance, and ensure that the information needed for effective program oversight is readily accessible.

BACKGROUND

Title XI of the Merchant Marine Act of 1936, as amended, is intended to promote the growth and modernization of the U.S. merchant marine and the Nation's shipyards by helping owners of eligible vessels and shipyards obtain long-term financing under terms and conditions that might not otherwise be available. Upon approval of a Title XI application, MARAD agrees to guarantee a privately-issued loan through a commitment letter to the applicant.

MARAD's Office of Marine Financing has primary responsibility for administering the Title XI program. The Department of Transportation's (DOT) financial oversight entity, the Credit Council, provides additional supervision. The Office of Marine Financing administers the program's application process and monitors borrowers' financial conditions throughout the terms of their guarantees. It also keeps DOT's Credit Council apprised of the status of the Title XI portfolio, including quarterly Credit Watch Reports on borrowers experiencing financial difficulty. Two additional MARAD offices—the Office of Shipyards and Marine Engineering and the Division of Marine Insurance—monitor certain aspects of the guarantees in the portfolio for compliance with program requirements.

MARAD receives appropriations from both DOT and the Department of Defense to subsidize Title XI loan guarantees. According to MARAD officials, as of February 2010, MARAD had approximately \$196 million to cover defaults and delinquencies on the loan guarantees in its \$2.3 billion Title XI portfolio. It also had \$78 million to use for new loan guarantees and to potentially expand the portfolio by almost \$1.5 billion.

INCONSISTENT PROGRAM POLICY AND A FINANCIAL MONITORING SYSTEM THAT DOES NOT MEET PROGRAM NEEDS COMPROMISES MARAD'S ABILITY TO EFFECTIVELY OVERSEE BORROWERS

MARAD has developed guidance for addressing the recommendations in our 2003 report, but the agency has not updated Title XI's policy based on this guidance.

Consequently, the guidance does not match Title XI's policy. MARAD has also developed a computer-based financial monitoring system, but since the system does not address portfolio monitoring needs, such as facilitating financial analysis of borrowers, Title XI analysts do not use it. Because MARAD has not fully implemented the procedures and developed a financial system that meets its need for computer-based portfolio monitoring, we cannot certify that MARAD is in compliance with our recommendations or has adequate oversight of the Title XI portfolio.

The Title XI Program's Policies and Guidance Are Inconsistent

In 2004, MARAD developed guidance⁵ to address our recommendations on improving policies and procedures for monitoring loan guarantees. However, the agency did not incorporate this guidance into the 2007 revision of Title XI's formal policy.⁶ Consequently, the guidance does not match the policy. For example, two of the guidance memoranda from 2004 address our recommendations on asset monitoring. Specifically, the guidance calls for maintaining documents on the condition of assets in the administrative file of each guarantee. However, the 2007 program policy does not include a requirement to maintain these documents and the files we reviewed did not include them. Furthermore, officials from the Office of Shipyards and Marine Engineering, which monitors asset condition, indicated that the office does not use the 2004 memoranda or the 2007 policy as criteria for overseeing asset condition.

In another example, the guidance's requirements for financial reporting do not match the requirements in the program's policy. The guidance calls for obtaining quarterly financial statements for all borrowers and, for borrowers in the high risk credit-watch category, obtaining monthly financial statements. However, both Title XI's policy and regulations require only semi-annual financial statements in addition to audited annual financial statements.⁷ Consequently, Title XI borrowers are held to a variety of standards for financial reporting.

Because MARAD has not reconciled Title XI's policy with its 2004 guidance, we cannot be certain that it has the necessary internal controls in place to continuously monitor the financial condition of borrowers.

⁵ In 2004, the Office of Ship Financing produced five memoranda addressing the five recommendations in our 2003 report. See Exhibit B for a list and explanation of the recommendations.

⁶ OMB A-123, Title XI Process Description (2007)

⁷ Loan guarantee agreements complicate the issue. Each agreement includes specific financial reporting requirements for the borrower, but these vary depending on which criteria (i.e., regulations, 2007 program policy, or 2004 memorandum) were followed when the RFFA was put in place. According to MARAD officials, these agreements are contracts between MARAD and borrowers that cannot be changed without mutual consent.

Title XI Analysts Do Not Use MARAD's Computer-Based Financial Monitoring System

Title XI analysts do not use its computer-based financial monitoring system, the Credit Programs Portfolio Management System (CPPMS). According to Title XI analysts, the system does not provide a more efficient means of evaluating and sharing borrowers' financial performance information than existing processes.

In fiscal year 2005, MARAD provided \$2 million to a project with the Office of the Secretary to develop and implement a financial monitoring system for use by DOT credit programs,⁸ including Title XI. This joint project developed CPPMS, and Title XI's CPPMS module became operational in December 2007. However, according to MARAD officials who monitor the Title XI portfolio, CPPMS does not meet management needs because it is not capable of assessing borrowers' finances and operations, or of sharing financial performance information with the program's DOT stakeholders.

According to the MARAD Chief Information Officer and system developers, CPPMS has the capacity to track and manage loans, create reports for data analysis, and store documents related to processes and tasks. However, MARAD uses Microsoft Excel spreadsheets and a separate system, Moody's KMV RiskAnalyst, for collecting and analyzing financial information on the companies in Title XI's portfolio. RiskAnalyst, however, is not linked to CPPMS, and consequently, MARAD analysts have no means of automatically transferring the Title XI financial information in it to CPPMS. MARAD's Chief Information Officer stated that an interface between the two systems was never part of the agency's development plan for a financial monitoring system, and would require an upgrade of CPPMS. As a result, the \$2 million investment that MARAD made in CPPMS has not yet delivered a comprehensive computer-based financial monitoring system that the agency can use to enhance management of its \$2.3 billion portfolio.

TITLE XI POLICY DOES NOT IDENTIFY WHAT INFORMATION IS NEEDED TO MONITOR THE PORTFOLIO AND BORROWERS

Neither MARAD's Title XI program policy nor its 2004 guidance identifies what information is required for effectively monitoring the Title XI portfolio and borrowers, where the information should be stored, or how it should be shared. Currently, only the two Office of Marine Financing analysts responsible for managing the portfolio know what information they use to monitor the guarantees and how it is stored. Furthermore, comprehensive information on guarantees,

⁸ DOT credit programs with CPPMS currently include Transportation Infrastructure Finance and Innovation Act program (TIFIA), Railroad Rehabilitation and Improvement Financing program (RRIF), and Title XI.

borrowers, and assets is not maintained in one location. If the Office of Marine Financing analysts are not available, this information is inaccessible.

MARAD does not maintain a single, central file on each loan guarantee and borrower. Instead, each of the three offices that monitor the different aspects of compliance maintains its own files. In our review of files⁹ from the Office of Marine Financing, which are the files used by the two analysts to monitor guarantees, we found that content varied from file to file. Some files included information related to the application process, some financial statements and associated reviews, and memoranda between borrowers and MARAD. The files did not indicate where important documents, such as reserve fund and financial agreements, asset monitoring reports, external reviews of distressed loans, and documentation on borrowers' deposits to their reserve funds were maintained. Furthermore, while the Office of Shipyards and Marine Engineering and the Division of Marine Insurance is required to file quarterly reports on their activities with the Office of Marine Financing, MARAD officials informed us that the Office of Marine Financing does not maintain these quarterly reports or related information in its files on each guarantee.

Maintenance of separate files prevents easy access to complete information on each guarantee. Without maintaining readily-accessible files on each loan guarantee and borrower that include or reference important documents, MARAD cannot respond to requests for information in a timely manner. Moreover, if the institutional knowledge of current Office of Marine Financing staff is lost, the Agency cannot effectively monitor borrowers' compliance with Title XI's requirements.

CONCLUSION

MARAD developed new Title XI guidance and information systems to address the recommendations in our 2003 and 2004 reports, but did not effectively implement them. As a result, administration and oversight of the \$2.3 billion program still needs improvement. Given the potential for expansion of Title XI's portfolio to almost \$4 billion with existing funding, MARAD must ensure that it implements consistent policies and processes, and maintains ready access to important financial information on Title XI borrowers and their loan guarantees.

⁹ We requested the administrative files on 14 borrowers holding the 20 guarantees in our statistical sample. It took the agency 7 weeks, from November 2009 through January 2010, to provide the files.

RECOMMENDATIONS

To strengthen MARAD's oversight of the Title XI program, we recommend that the Maritime Administrator take action to:

1. Reconcile formal Title XI policy with the February 2004 guidance memoranda and practices used to manage the program.
2. Require the Office of Marine Financing and MARAD's CIO to work together to identify capabilities needed to complete the development of the comprehensive computer-based financial monitoring system. At a minimum, they should ensure that the system allows for efficient monitoring of portfolio performance and information sharing with DOT stakeholders.
3. Ensure that the information needed to oversee borrower compliance with program requirements is readily accessible, that the location and components of each administrative file are easily identifiable, and that each file contains all documentation needed for evaluating borrower compliance with Title XI requirements by inclusion or reference.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

We provided MARAD a draft of our report on October 19, 2010. We received MARAD's response on November 15, 2010, which is included in its entirety in the appendix of this report. In its response, MARAD detailed recent actions it has taken to improve its business practices, but noted that the largest opportunity to mitigate default risk occurs during the period prior to loan guarantee approval. While we appreciate MARAD's commitment to improving the implementation of procedures for the administration and oversight of Title XI borrowers, we maintain that by taking action to respond to our recommendations, including during the loan repayment period, MARAD can further limit the potential loss to the government when a default occurs. Nevertheless, MARAD fully concurred with all of our recommendations. However, MARAD did not provide a target completion date for actions to address our second recommendation. Since its response indicates that it has obligated the resources needed to implement changes to CPPMS, and that it is pursuing the additional resources to train its staff on the use of CPPMS, MARAD should be able to provide a target completion date for this recommendation. Accordingly, we are requesting that MARAD provide us with a planned completion date for those actions.

ACTIONS REQUIRED

MARAD provided acceptable actions and timeframes for recommendations 1 and 3, and we consider them resolved, subject to follow-up provisions in accordance with DOT Order 8000.1C. We request that within 30 days of this report, MARAD provide in writing a target completion date for recommendation 2. We appreciate MARAD's courtesies and cooperation during this audit. If you have any questions concerning this report, please contact me at (202) 366-9970 or Christopher Brothers at (202) 366-8811.

cc: Audit Liaison, OST, M-1
Audit Liaison, MARAD, MAR-392

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EXHIBIT A. SCOPE AND METHODOLOGY

We conducted a follow-up audit, as requested in Senate Report 110-131, to determine whether MARAD had addressed the eight recommendations in our 2003 and 2004 audit reports on the Title XI Loan Guarantee program. Through meetings with MARAD Headquarters officials, we obtained and evaluated documentation to determine whether MARAD had taken actions to fully address each OIG recommendation. We also reviewed a sample of loan guarantee files that were statistically selected by the OIG statistician and assessed the actions taken by MARAD from September 28, 2004 through December 31, 2009—after our 2004 report.

We interviewed officials from MARAD's Office of Marine Financing and the DOT Credit Council to obtain information about the management of the Title XI program. We received a demonstration of CPPMS; however, we did not audit the system or its procurement. We also conducted interviews with MARAD officials from the Office of the Maritime Administrator, Office of Shipyards and Marine Engineering, and Division of Marine Insurance.

We selected a statistical sample of 60 of 114 approved Title XI loan guarantees with probability proportional to the dollar amount of the loan guarantee. Upon receipt, we conducted an in-depth review of the files of 20 loan guarantees that had activity during the scope of our review. Our in-depth review of files for 20 loan guarantees covered 14 companies or borrowers. We also reviewed additional documentation that MARAD provided in May 2010.

We also reviewed relevant laws and regulations, and policies and procedures, such as DOT orders, Title XI program guidance, the February 2004 memoranda, MARAD's Maritime Administrative Orders, and related criteria.

We conducted this performance audit from November 2009 through February 2010 in accordance with generally accepted government auditing standards as prescribed by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, 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 our audit objectives.

EXHIBIT B. OIG'S 2003 AND 2004 RECOMMENDATIONS

2003 OIG Audit Report (CR-2003-031)
1. Require a rigorous analysis of the risks from modifying any loan approval criteria and impose compensating provisions on the loan guarantee to mitigate those risks.
2. Formally establish an external review process as a check on MARAD's internal loan application review and as assistance in crafting loan conditions and covenants.
3. Establish a formal process for continuously monitoring the financial condition of borrowers, including requirements for financial reporting over the term of the guarantee as a condition of loan approval.
4. Establish a formal process for continuously monitoring the physical condition of guaranteed assets over the term of the loan guarantee.
5. Develop an improved process for monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.
2004 OIG Audit Report (CR-2004-095)
1. Perform a full accounting of each borrower's Reserve Fund, and require all borrowers to cure any defaults under the requirements of their Reserve Fund and Financial Agreements, including full funding of Reserve Funds.
2. In coordination with the Department of Transportation Credit Council, secure access to advisors outside MARAD with the requisite capacity and technical sophistication to negotiate solutions to distressed loans, including appropriate compensating provisions to mitigate risk.
3. With the concurrence of the Department of Transportation Credit Council, seek appropriations language allowing the use of as much of the \$25 million wartime supplemental appropriation as necessary to develop a comprehensive computer-based financial monitoring system.

EXHIBIT C. MAJOR CONTRIBUTORS TO THIS REPORT

Name	Title
Brenda R. James	Program Director
Christopher Brothers	Project Manager
Regan Maund	Senior Analyst
Marvin Tuxhorn	Senior Auditor
Michael English	Analyst
Doris Kwong	Analyst
Petra Swartzlander	Senior Statistician
Harriet Lambert	Writer-Editor
Susan Neill	Writer-Editor

Monitoring System (CPPMS) functionality that will enable it to better serve MARAD's multifunctional mission requirements. Finally, MARAD is implementing an updated centralized electronic filing system that will enable the organization to store images of standardized information requirements in a single place, accessible to all program officials.

Recommendations and Response

Recommendation 1: Reconcile formal Title XI policy with the February 2004 guidance memoranda and practices used to manage the program.

Response: Concur. MARAD has recently taken several actions that will ensure better alignment of procedures with the February 2004 guidance memorandum. First, MARAD has commissioned a business process review of the Title XI program. This review, expected to be completed by May 31, 2011, will document in detail the current policies and procedures in place, identify any gaps such as those identified in the draft report, and recommend measures to reconcile gaps or inconsistencies and, further, to improve the management of the existing Title XI portfolio and provide better processing of Title XI applications. MARAD intends to complete actions necessary to ensure that all policy, guidance and procedures for the Title XI program are consistent by July 15, 2011.

In addition, the Office of Marine Financing has hired three Financial Analysts since the beginning of June 2010. As part of the training and orientation process for these employees, the senior staff of the Office of Marine Financing will ensure that the new Financial Analysts are trained in a manner consistent with the February 2004 guidance.

Finally, MARAD will conduct a Title XI policy review to ensure that support offices are adhering to the 2004 guidance. This review will include a study by the Office of Chief Counsel about the legal authority and potential to make changes to existing contracts with Title XI borrowers in order to harmonize financial reporting requirements among all borrowers.

Recommendation 2: Require the Office of Marine Financing and MARAD's CIO to work together to identify capabilities needed to complete the development of the comprehensive computer-based financial monitoring system. At a minimum, they should ensure that the system allows for efficient monitoring of portfolio performance and information sharing with DOT stakeholders.

Response: Concur. MARAD has obligated its portion of the resources necessary to implement changes to CPPMS to make it more useful to Title XI program staff and DOT stakeholders. MARAD will also seek to work with the DOT Office of the Chief Information Officer to identify resources to train DOT stakeholders on the use of CPPMS for use in sharing information and monitoring program performance. MARAD looks forward to a partnership with the DOT Chief Information Officer and the DOT Office of Budget and Program Performance to complete the development of this department-wide computer-based financial monitoring system.

Appendix. Agency Comments

Recommendation 3: Ensure that the information needed to oversee borrower compliance with program requirements is readily accessible, that the location and components of each administrative file are easily identifiable, and that each file contains all documentation needed for evaluating borrower compliance with Title XI requirements by inclusion or reference.

Response: Concur. Since the OIG concluded its performance audit in May 2010, MARAD's Office of Marine Financing has taken several steps to increase the usability of its administrative files. First, the files have been placed in a centralized location and organized in a more logical fashion. Second, MARAD has executed a contract for scanning services, with the objective of scanning all required documents for each transaction and organizing them on MARAD's internal network, accessible both through CPPMS and the network. This will allow ready identification of files, easing monitoring of borrower compliance. In addition, as part of the training and orientation process for the new Financial Analysts, the new analysts will be trained on the required contents of each administrative file. As the scanning contract is concluded, the documents will be placed on the network in a consistent manner and in a format that favors easy identification. We anticipate having the scanned files available by August 31, 2011.