

TITLE XI LOAN GUARANTEE PROGRAM

Maritime Administration

Report Number: CR-2003-031

Date Issued: March 27, 2003



Memorandum

**U.S. Department of
Transportation**
Office of the Secretary
of Transportation
Office of Inspector General

Subject: ACTION: Report on the Audit of the
Title XI Loan Guarantee Program
Maritime Administration
Report No. CR-2003-031

Date: March 27, 2003

From: Kenneth M. Mead
Inspector General

Reply to
Attn. of: JA-50

To: Maritime Administrator

This final report presents the results of our audit of the Maritime Administration's (MARAD) Title XI Loan Guarantee Program (Title XI). We initiated this audit in response to requests from the Ranking Member, Senate Committee on Commerce, Science and Transportation, and from the Chairman, Subcommittee on Commerce, Justice, State and Judiciary of the House Committee on Appropriations.

Our objectives were to: (1) perform a comprehensive review of the Title XI Program to determine whether procedures for submission, review, approval, and monitoring of selected Title XI loan guarantees comply with applicable laws and regulations and whether the procedures are adequate and effectively applied to protect the interests of the United States; and (2) assess the impact of the American Classic Voyages Co. (AMCV) bankruptcy filing on its Title XI loan guarantees. Our scope, methodology, and prior audit coverage are described in Exhibit A. Exhibit B lists the activities we visited or contacted during the audit.

We discussed this report with MARAD officials, and their comments have been incorporated, as appropriate. In preparing this report, we also considered MARAD's February 25, 2003 response (see Appendix) to our draft report. MARAD is cognizant of the need for improved oversight of the Title XI Program and was in agreement with our five recommendations for improving oversight. We note your commitment to tightening the controls over the approval of loan guarantees and taking more timely action to recover the maximum amount possible from foreclosed assets in the event of loan defaults. These actions, when

implemented, will go a long way toward improving the operation and efficiency of the Title XI Program.

BACKGROUND

Title XI of the Merchant Marine Act of 1936, as amended, established the Federal Ship Financing Guarantee Program (Program) to assist private companies in obtaining financing for the construction of ships or the modernization of U.S. shipyards. This Program authorizes the Federal Government to guarantee full payment to the lender of the unpaid principal and interest of a mortgage obligation in the event of default by a vessel or shipyard owner. Title XI was amended in 1972 to provide Government guarantees to commercial debt obligations, with the Government holding a mortgage on the equipment financed.

Regulations implementing the Merchant Marine Act of 1936 [Title 46 Code of Federal Regulations (CFR), Section 298] outline the application process for Title XI loan guarantees and require MARAD to assess the economic feasibility and the financial viability of an applicant's project. Upon approval of an application, MARAD agrees to guarantee these obligations with the full faith and credit of the U.S. Government through a commitment letter to the applicant. The applicant must provide at least 12.5 percent to 25 percent (depending on project use) of the project's projected cost as equity, and a commercial financial institution issues obligations for the remainder.¹ Loans guaranteed by the Program carry an inherently higher risk of default than commercial business loans. As a result, applicants generally receive more favorable loan terms than are available in the commercial market without a guarantee.

The Program has contributed to preserving a U.S. commercial fleet and modernizing U.S. shipyards. Vessels financed using loan guarantees include double-hull oil tankers, passenger ferries, cruise ships, and offshore drilling rigs. Shipyard modernizations have included capital improvement projects at shipyards located on the east, gulf, and west coasts.

As of December 31, 2002, MARAD's Title XI portfolio totaled approximately \$4.3 billion, consisting of \$3.4 billion in executed loan guarantees² (formal agreements to issue obligations) and \$849 million of loan guarantee commitments³ (formal offers for guarantees). The \$3.4 billion in executed loan guarantees represents 103 projects for 818 vessels and 4 shipyard modernizations. Included in the Title XI portfolio are eight projects totaling about \$226 million in commitments that MARAD approved in fiscal year (FY) 2002. As of December 31, 2002, MARAD had 26 applications pending, requesting about \$5.7 billion of Title XI financing.

¹ These are bonds, notes, debentures or other evidence of indebtedness.

² Loan guarantees are legal obligations (by MARAD) to pay off the debt if an applicant defaults on a loan.

³ Loan guarantee commitments are legal agreements, stated in a commitment letter stipulating that MARAD will issue a loan guarantee for the project if the applicant fulfills agreed-upon terms.

RESULTS

Between FYs 1985 and 1987, 129 defaults occurred in the Title XI Program, and MARAD paid out approximately \$2 billion in guarantees. These defaults were attributed to a downturn in the economic conditions in two key industries—oil and agricultural products. The Federal Credit Reform Act of 1990⁴ was established, in part, to measure more accurately the costs of Federal credit programs. In the 5 years following implementation of this Act (FYs 1993 through 1997), only three loans defaulted, totaling approximately \$12 million.

In recent years, however, the Program has experienced an increase in loan defaults and in the number of firms with loan guarantees filing for bankruptcy protection. In the last 5 years, nine loans have defaulted, totaling approximately \$490 million, six of which have occurred since December 2001 (as shown in Table 1). The bankruptcy of AMCV significantly affected the Program, although it does not threaten the Program's immediate solvency. AMCV's bankruptcy affected over one quarter (\$1.3 billion out of \$4.9 billion at the time of default) of the value of MARAD's Title XI loan guarantee portfolio.

Table 1 – Recent Payouts and Recoveries on Defaulted Loans

Date of Default	Year of Origin	Company	Project/Vessel Name	Guaranteed Amount	Paid-Out Amount ⁵	Recovered Amount ⁶
2/1998	1996	Surf Express, Inc.	<i>FastCat</i> Catamaran	\$1,701,000	\$1,788,854	\$100,000
2/2000	1997	MHI, Inc.	Shipyard Modernization	55,000,000	59,071,658	24,108,619
3/2001	1995	SEAREX, Inc.	4 <i>Moses</i> -Class Vessels	77,269,000	78,099,782	25,405,708
12/2001	1999	AMCV	Project America 1 Cruise Ship	185,000,000	187,317,445	7,425,416
12/2001	2000	AMCV	<i>Cape Cod Light</i>	38,500,000	40,376,340	8,264,783
12/2001	2000	AMCV	<i>Cape May Light</i>	37,900,000	39,769,997	703,947
1/2002	1995	AMCV	<i>SS Independence</i>	33,334,000	25,185,531	0
1/2002	2001	AMCV	<i>Columbia Queen</i>	35,471,000	37,007,570	0
3/2002	1997	Friede Goldman Offshore	Shipyard Modernization	24,817,000	20,884,647	21,300,000
Source: MARAD						
Totals through January 2003				\$488,992,000	\$489,501,824	\$87,308,473

⁴ Public Law 101-508

⁵ These amounts include accrued, unpaid interest as well as the outstanding principal.

⁶ These amounts include recoveries from escrowed funds (as of January 2003).

These losses have generated both public and congressional concerns regarding adequate protection of the Government's financial interests in ships and other assets constructed through the Program. Concerns also exist regarding the potential for additional future defaults and losses to the Government, given the uncertain financial status of some of the companies with guaranteed loans. Three companies, with initial loan guarantees totaling \$173 million, are continuing to operate while their parent company, the Enron Corporation, is in bankruptcy. If these loans default, MARAD would be obligated to pay out over \$122 million, excluding interest (see Table 2).

Table 2 – Enron Companies with Title XI Guarantees

Company	Vessel Type	Outstanding Balance
Puerto Quetzal Power, LLC	Power barge	\$60,304,000
Empresa Energetica Corinto, LTD	Barge-mounted power plant	39,442,000
Smith/Enron Cogeneration, LTD	2 Barge-mounted power plants	22,376,000
<i>Total Outstanding Balance as of January 2003</i>		<u>\$122,122,000</u>

Source: MARAD

MARAD needs to improve administration and oversight in all phases of the Title XI loan process and is working to do so. During this audit, we identified a number of areas where MARAD could improve its Program practices, limit the risk of default, and reduce losses to the Government. The financial interests of the United States would be better protected through use of compensatory loan provisions to reduce risk, improved loan application review procedures, more rigorous financial oversight of borrowers during the term of loan guarantees, better monitoring and protection of vessels and shipyards while under a guarantee, and more effective stewardship of assets acquired through foreclosures.

MARAD Could Reduce the Risk of Losses Through Compensatory Loan Provisions Such as More Collateral and Higher Equity Contributions

MARAD routinely modifies financial requirements in order to qualify applicants for loan guarantees. These financial requirements, established by regulation, are designed to reduce the risks of default and losses from loan guarantees. Such modifications increase the risk of the loan guarantee to the Government, and MARAD should impose stricter compensating requirements on borrowers to offset this increased risk. All nine of the loans that have gone into default since 1998,

totaling about \$490 million in MARAD payouts, were approved with modifications to some of the financial criteria. Some examples include:

- The applicant's working capital was negative, contrary to requirements;
- Applicant's debt-to-equity ratio was more than 4 to 1, twice the criteria; and
- Parent company guarantees were not backed by any unencumbered assets.

Compensating requirements are routinely applied by financial institutions in constructing loan packages that match the lender's risk to the return it receives from the borrower. In the Title XI Program, compensatory provisions could include securing additional collateral (such as liens on other assets), requiring greater amounts of project equity from the applicant, and having a portion of the risk assumed by the applicant's lender. MARAD's use of compensatory provisions should be feasible because many Title XI applicants are subsidiaries of parent companies with other assets and financial resources.

MARAD Would Benefit From External Review of Applications

MARAD currently assesses loan guarantee applications primarily with its own staff using criteria adopted in regulations. Although MARAD has staff to do such assessments in house, the loan review process would benefit from the use of an additional external review using contract resources, especially for applications involving large loan amounts, requiring modifications to the approval criteria, or involving complex, novel, or new technologies. These external reviews would serve to verify MARAD's internal analysis and assist it in devising loan packages that reduce the default and loss risk to the Government. External reviews should include at least four elements: an assessment of the borrower's business plan; an evaluation of the borrower's credit risk; an independent assessor's analysis of the current market value of collateral and any encumbrances; and an independent summary analysis of the loan guarantee application that includes a recommendation on whether to approve the loan and on what terms.

MARAD Could Better Protect Its Interests Through Improved Oversight of Borrowers Over the Duration of Their Loans

MARAD does not closely monitor the financial health of its borrowers over the term of their loans; rather, it tends to be reactive to loan problems after they occur. MARAD should place covenants in its loan guarantees concerning the required financial performance and condition of its borrowers, as well as self-help measures to which MARAD is entitled should those provisions be violated. Financial performance criteria might include such conditions as minimum working capital levels, cash flow requirements, minimum financial ratios, future capital spending constraints, and timely financial reporting. Self-help measures might include the ability to require additional reserves or collateral, declare defaults, take possession of existing collateral, and repossess the guaranteed asset.

After establishing such conditions, MARAD needs to maintain close financial scrutiny of its borrowers to ensure the conditions are being met. The current minimal monitoring approach would not provide such information in a timely or sufficient manner. With sufficient forewarning and self-help measures in place, MARAD would be better able to protect its financial interests well before default and foreclosure.

MARAD Could Improve Its Return on Foreclosed Assets Through Better Tracking of the Vessels and Property Constructed With Loan Guarantees

MARAD does not closely monitor the physical condition of the vessels and property financed with guaranteed loans either during the loan period or after foreclosures. If borrowers experience financial difficulties, they may be inclined to under-maintain the assets constructed with loan guarantees. Therefore, to protect the Government's interest in such assets, MARAD should periodically inspect them, particularly those operated by firms experiencing financial difficulties identified by MARAD's financial monitoring. Likewise, when MARAD forecloses on assets after loan default, it could increase the return to the Government on those assets by closely monitoring their maintenance and protection.

AMCV's Bankruptcy Significantly Affected the Title XI Program but Does Not Threaten Its Solvency

AMCV's bankruptcy in 2001 threatened over one quarter of the value of MARAD's Title XI portfolio at that time (\$1.3 billion out of \$4.9 billion in MARAD's loan guarantee portfolio). However, not all of these funds had been disbursed, and the impact on MARAD's resources was limited to about \$330 million. Nevertheless, MARAD was forced to borrow \$136 million from the Treasury to meet its loan guarantees. To date, MARAD has repaid \$124 million to the Treasury. The balance of \$12 million is due by FY 2005. The circumstances surrounding AMCV's loan approvals and defaults illustrate the problems identified above. Had these program revisions and protections been in place at the time of AMCV's loan application, the losses to the Government would likely have been much less.

FINDINGS AND RECOMMENDATIONS

MARAD Could Reduce the Risk of Losses Through Compensatory Loan Provisions Such as More Collateral and Higher Equity Contributions

MARAD currently assesses loan guarantee applications primarily with its own staff using financial criteria in regulations adopted from the Merchant Marine Act of 1936, as amended.⁷ Routinely, however, MARAD modifies these financial requirements to allow applicants to qualify for loan guarantees, and these modifications lead to increased risk of loss. All nine of the loans that have gone into default since 1998 were approved with modifications to some of the financial criteria.

We found examples of approved loan applications where the applicant's working capital was negative, contrary to the requirements. Specifically, SEAREX, Inc., did not meet the positive working capital requirement in 1994 when it requested a loan guarantee; it defaulted in 2001. We also found examples in which applicants had long-term debt-to-net-worth ratios of more than the 2 to 1 permitted in the regulations.⁸ In fact, one active project, approved for a loan guarantee of over \$15 million, had a long-term debt-to-net-worth ratio of more than 4 to 1.

Although MARAD's regulations permit it to modify financial requirements for loan guarantees, and modifications may be appropriate in some cases, MARAD must have a process in place so that when modifications are made, compensating conditions are imposed on the borrower to offset the increased risk to the Government. This is particularly true because MARAD's primary collateral for loan guarantees, liens against the assets funded by the loans, often provide little security. Specifically, such collateral may be of little or no value if the vessel is incomplete at the time of default or the projected market for the vessel does not materialize.

For example, the hull and materials for a vessel being built for Project America, Inc., a subsidiary of AMCV, and guaranteed by MARAD for \$185 million, were recently sold by the shipyard, with MARAD recovering \$2 million. This subsidiary had no tangible assets beyond the guaranteed vessel, as in all six of the guaranteed loans to AMCV. In the case of SEAREX, resulting in a liability to MARAD of about \$62 million after default, MARAD recovered only \$8.7 million for the nearly completed *Trident Crusader* and about \$1 million for the hulls, materials, and equipment for three partially completed vessels.

MARAD often accepts parent company guarantees of loan repayment for a subsidiary that either cannot qualify for a loan guarantee on its own or cannot

⁷ 46 CFR 298.13

⁸ The long-term debt-to-net-worth ratio measures the capital contributed by creditors and capital contributed by owners.

qualify without modifications to the loan criteria. In fact, 50 percent of the projects we examined (21 of 42) relied on parent company guarantees.⁹ In these cases, the applicants could not independently qualify for a loan guarantee, had few or no assets to offer as collateral, and provided the parent company guarantee as the sole form of security. Of these 21 projects, 14 could not qualify without modification of some loan approval criteria.

If these parent company guarantees were backed by liens on specific assets, the Government's loan guarantee would be relatively secure. However, these parent company guarantees were general pledges by the company to honor the loan commitment that did not specifically pledge unencumbered assets as collateral. Therefore, these parent company guarantees provide no real security if the parent company itself were not creditworthy or had few unencumbered assets, as was the case in six of nine recent defaults.

There appears to be a problem of insulating a parent company from liability for Title XI loans. A parent company seeking a loan guarantee establishes a subsidiary for the sole purpose of acquiring and operating the guaranteed asset. Because such subsidiaries have neither collateral nor a financial operating history, they require a parent company guarantee. By only offering a general guarantee, the parent company insulates its other assets should the subsidiary default.

MARAD can prevent this problem by requiring parent company pledges to be backed by liens on other unencumbered assets. This approach should be feasible because many Title XI applicants are subsidiaries of parent companies that have other assets and financial resources. For example, MARAD approved a loan guarantee for over \$150 million to a company for an oil-drilling unit without requiring a lien on other assets, yet the company had a number of other unencumbered assets it could have used to secure the guarantee.

MARAD also needs to ensure that any modifications to the application requirements on behalf of the applicant or the parent company are offset by compensating measures in the guarantee agreements that protect the interests of the U.S. Government. These compensating measures could include securing liens on additional collateral, requiring greater amounts of project equity from the applicants, or having a greater portion of the risk assumed by the applicant's lender. General pledges from parent companies do not meet this test of protecting the Government's interests.

MARAD Would Benefit From External Review of Applications

MARAD primarily conducts in-house reviews of applications and does not routinely obtain independent assessments of proposed projects to determine if they

⁹ We examined all 9 of the recently defaulted projects and a stratified random sample of 33 of the remaining projects in MARAD's loan portfolio at the time of our audit. Therefore, we analyzed 42 percent of the projects (42 out of 100).

are economically and financially sound. MARAD officials have acknowledged a lack of in-house expertise to review projects that employ new technologies, are financially complex, or are high-cost. Independent assessments of such projects would assist MARAD in its internal analysis and reduce the risk of default and loss to the Government.

For example, the Export-Import Bank of the United States (Bank), which operates a loan guarantee program, hires outside independent financial, legal, and technical advisors for projects with financial transactions that exceed \$30 million. After the Bank selects the advisor, the applicant is required to pay an evaluation fee and execute a contract with the advisor. The Bank uses the advisor's report as part of the evaluation package to determine if a loan guarantee will be made. The use of advisors has significantly reduced the Government's risk and better protected the taxpayers' investment.

MARAD officials stated that a loan guarantee application, pending since 1999 for a 6,200-passenger cruise ship costing over \$1.3 billion, would benefit from an outside review due to the ship's size and cost, and entrance into a new market. MARAD officials have also noted that a current application for two high-speed container vessels for about \$750 million in loan guarantees is being reviewed by an outside firm due to the ships' cost, the use of new technology, and the start-up nature of the company. A similar external review may have highlighted the potential for cost growth in the SEAREX application for the construction of four vessels—a project that had a 71 percent cost increase prior to its default.

MARAD's Title XI Program would benefit from the adoption of a system similar to that used by the Bank of contracted external reviews of loan applications. These independent external reviews should encompass four elements: an assessment of the borrower's business plan; an evaluation of the borrower's credit risk; an independent assessor's analysis of the current market value of collateral and any encumbrances; and an independent summary analysis of the loan guarantee application that includes a recommendation on whether to approve the loan and on what terms.

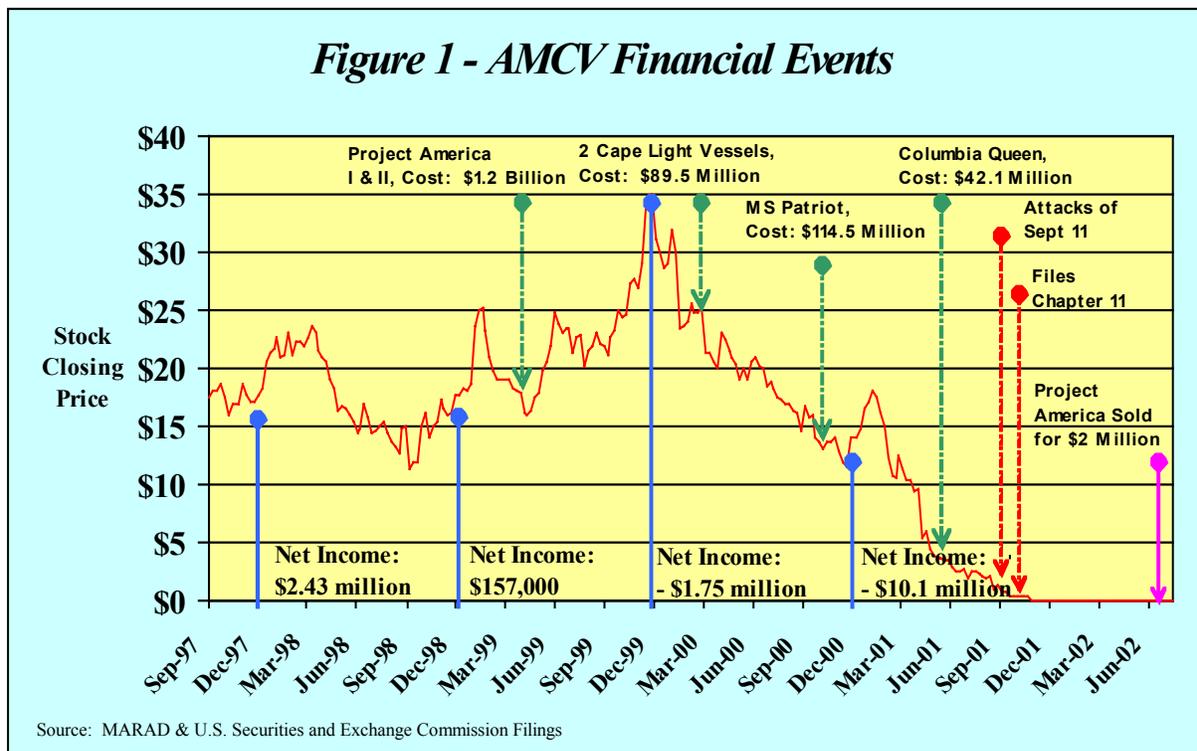
MARAD Could Better Protect Its Interests Through Improved Oversight of Borrowers Over the Duration of Their Loans

MARAD does not closely monitor the financial health of its borrowers over the term of its loan guarantees. Borrowers submit annual financial statements to MARAD. Although MARAD has the authority to require additional financial statements, examine and audit the books and records pertaining to the project, and assess the vessels, MARAD typically does not take these additional steps to oversee the financial condition of its borrowers.

Currently, MARAD records loan payments, obtains documentation of insurance coverage of the guaranteed assets, and monitors the portfolio for delinquent

accounts. Although MARAD maintains communications with lenders, insurance companies, and loan guarantee recipients, MARAD has no established procedures or policies incorporating periodic reviews of a company's financial well-being once a loan guarantee is approved.

Firms rarely enter into bankruptcy or find themselves forced to default on guaranteed loans without many preceding quarters or years of financial results that indicate developing financial distress. For example, AMCV's stock price fell from \$35.00 a share in December 1999 to less than \$0.50 before its bankruptcy filing in October 2001, as shown in Figure 1.



Furthermore, AMCV's filings with the Securities and Exchange Commission show a marked decrease in net income from December 1997 to December 2000. In spite of AMCV's declining net income and stock valuation, MARAD continued to approve loan guarantees to AMCV for \$76 million for the two *Cape Light* ships, and over \$35 million for the *Columbia Queen*. Just prior to AMCV's bankruptcy filing, MARAD was considering a disbursement from AMCV's Project America I escrow account to fund further construction of this vessel.

Increased financial monitoring is only useful if MARAD also includes financial covenants in its loan guarantee commitments. These covenants should prescribe the required financial performance and condition of its borrowers as well as self-help measures to which MARAD is entitled should those provisions be violated. These performance targets might include minimum working capital levels, cash flow requirements, minimum financial ratios, future capital spending constraints, and timely financial reporting. Self-help measures might include the ability to require additional reserves or collateral, declare defaults, take possession of existing collateral, and repossess the guaranteed asset. By having the right to invoke these measures earlier, when firms begin to experience financial distress, MARAD may be able to limit its losses by avoiding additional commitments and acquiring existing assets before they are dissipated by the failing firm.

MARAD Could Improve Its Return on Foreclosed Assets Through Better Tracking of the Vessels and Property Constructed With Loan Guarantees

MARAD does not closely monitor the physical condition of the assets produced with the guaranteed loans over the term of its loan guarantees. MARAD relies on annual Coast Guard inspections to ensure that vessels subject to guarantees are maintained and operated in a safe manner. Notices from the insurance underwriters will also advise MARAD of problems or concerns with the vessels such as accidents. We found that site visits from MARAD's field offices were conducted on guaranteed vessels or property only in response to problems or notices of potential problems from third parties or from borrowers. These third-party notices do not necessarily ensure that the value of the asset is maintained at a level commensurate with the remaining loan balance.

MARAD also does not adequately monitor and protect assets after loan defaults occur. At the time of AMCV's bankruptcy, MARAD was not aware of the current condition and status of four of the five vessels whose loans ultimately defaulted (totaling about \$330 million). The *Cape May Light* had completed its maiden voyage, but was improperly moored at another location and was grounded during low tide. MARAD directed AMCV to take action and the vessel was reanchored

in the middle of the river, but only after significant exposure to the elements and deterioration had occurred.

Furthermore, MARAD does not adequately manage assets acquired from foreclosure. There are no set timeframes or procedures to maximize recovery of funds from defaulted loans. Thus, vessels and equipment may deteriorate due to exposure, vandalism, and neglect, diminishing their value and potential return. For example, in 1998, MARAD paid out approximately \$1.8 million for a default on a vessel owned by Surf Express. The initial appraisal valued the 3-year-old vessel at only \$793,000, and MARAD advertised it for sale several times, but rejected the bids in an attempt to recover more money. Meanwhile, MARAD stored the vessel in a wet-berth where it was exposed to the elements, including Hurricane Georges. When MARAD finally found a prospective buyer, the bidder rejected the vessel because of seized up engines and general deterioration due to exposure to tropical weather and the hurricane. As a result, MARAD recovered only \$100,000 from the sale.

In another example, MARAD gained custody of the nearly completed SEAREX vessel *Trident Crusader* in March 2001 and clear title to the vessel in November 2001 without having a disposal plan for the vessel. The default of SEAREX, Inc., resulted in a liability of approximately \$62 million to the Government covering four vessels in various stages of completion.¹⁰ MARAD has only recently recovered \$8.7 million for the *Trident Crusader*. The other three hulls and materials were sold for scrap in an auction held on July 11, 2002, which brought in approximately \$1 million, resulting in a net loss of about \$52 million to the Government on this loan.

To better protect the Government's interest in the assets that are collateral for its loan guarantees, MARAD needs to periodically inspect such assets, particularly those operated by firms that MARAD's financial monitoring identifies as experiencing financial difficulties. Likewise, when MARAD forecloses on assets after loan default, it could increase the return to the Government on them by better managing these assets to ensure they are maintained in good condition.

AMCV's Bankruptcy Significantly Affected the Title XI Program, but Does Not Threaten Its Solvency

AMCV's bankruptcy affected over one quarter of the value of MARAD's Title XI portfolio (\$1.3 billion out of \$4.9 billion at the time of default). This \$1.3 billion represented commitments covering seven vessels. However, only \$391 million in guarantees had actually been signed when AMCV filed for bankruptcy protection

¹⁰ The original loan amount was for \$77.3 million, but \$15.7 million was being held in escrow at the time of the default, resulting in a liability of \$61.6 million.

and ceased operations on October 19, 2001. To pay almost \$330 million in guarantees (the loan on one vessel did not default), MARAD had to borrow \$136 million from the Treasury. To date, MARAD has repaid \$124 million to the Treasury. The balance of \$12 million is due by FY 2005. See Table 3 for a description of the AMCV loan guarantees.

**Table 3 – MARAD’s Liability for AMCV Vessels
as of December 2002**

Date of Origin	Date of Default	Applicant	Parent Company*	Project or Vessel Name	Cost of Vessel to Owner	Guaranteed Amount	Paid-Out Amount	Disposition/Recovery**
May 2001	January 2002	Great Pacific NW Cruise Line, L.L.C.	Delta Queen Steamboat Co.	<i>Columbia Queen</i>	\$42,140,568	\$35,471,000	\$37,007,570	Maintained by MARAD
March 2000	December 2001	Coastal Queen West, L.L.C.	Delta Queen Coastal Voyages, L.L.C.	<i>Cape May Light</i>	44,950,728	37,900,000	39,769,997	Maintained by MARAD
March 2000	December 2001	Coastal Queen East, L.L.C.	Delta Queen Coastal Voyages, L.L.C.	<i>Cape Cod Light</i>	44,582,720	38,500,000	40,376,340	Maintained by MARAD
April 1999	December 2001	Project America Ship I, Inc.	Project America, Inc.	Project America Vessel I	610,797,578	185,000,000	187,317,445	Sold for \$2 million
April 1999	n/a	Project America Ship II, Inc.	Project America, Inc.	Project America Vessel II	622,946,837	0	0	Part of the above settlement for \$2 million
November 1995	January 2002	Great Independence Ship Co.	Great Hawaiian Cruise Lines, Inc.	<i>S.S. Independence</i>	44,774,271	33,334,000	25,185,531	Maintained by MARAD
July 1995	n/a	Great American Queen Steamboat L.L.C.	Delta Queen Steamboat Co.	<i>American Queen</i>	69,424,647	60,746,000	0	Full Recovery-Refinanced to new owner

Source: MARAD

Totals: \$390,951,000 \$329,656,883

* AMCV is the parent company to Delta Queen Steamboat Co. and AMCV Holdings, Inc. Delta Queen Steamboat Co., in turn, is the parent company of Delta Queen Coastal Voyages, L.L.C. AMCV Holdings, Inc., is the parent company of Project America, Inc., and Great Hawaiian Cruise Lines, Inc. Applicants are subsidiaries of Delta Queen Steamboat Co.; Delta Queen Coastal Voyages, L.L.C.; Project America, Inc.; and Great Hawaiian Cruise Lines, Inc.

** These amounts do not include recoveries from escrowed funds.

The circumstances surrounding AMCV’s loan approvals and defaults illustrate the problems identified above. Specifically, modifications to loan approval criteria were made without compensating collateral, and parent company guarantees were accepted without liens on specific assets of the parent companies. Close financial monitoring of AMCV did not occur over the terms of the loans before default, and

neither did close monitoring of the foreclosed assets. Had our recommended program revisions and protections been in place at the time of AMCV's loan application, the losses to the Government would likely have been much less.

The AMCV defaults serve as a good example of how modifying the financial requirements without obtaining compensating collateral creates a liability for the U.S. Government. On their own, only one of the AMCV subsidiaries would have met all of the qualification requirements for a loan guarantee. By modifying the financial requirements for each of AMCV's consecutive loans, MARAD approved guarantees beyond AMCV's ability to service the debts, thereby creating a potential default situation.

With MARAD's approval of the last guarantee application in May 2001, for the vessel *Columbia Queen*, AMCV had received loan commitments of approximately \$1.3 billion—the largest amount of loan guarantees issued to an affiliated group of entities in the history of the Program. Of the 10 vessels owned and operated by, or under construction by, the AMCV group, 7 vessels (in 6 loan approvals) were supported by Title XI loan guarantees. The other three vessels were encumbered with debt from commercial banking facilities. MARAD failed to secure collateral in the form of tangible assets other than the first mortgages from AMCV's subsidiaries on the vessels being constructed, and thus, AMCV was insulated from financial responsibility for the loans.

For each of the six loan approvals, MARAD cited the Secretary of Transportation's authority to waive or modify the financial terms or requirements otherwise applicable, upon determining that there was adequate security for the Title XI guarantees.¹¹ However, prudent financial analysis of AMCV as a whole would have highlighted the great risk of default and should have prompted MARAD, in turn, to require more collateral or stricter covenants to protect the Government's interest.

One of the practices that MARAD employed to limit losses was the use of incremental payments to control the disbursement of loan proceeds. This practice allowed MARAD to release funds to the borrower incrementally as construction on the project progressed, rather than releasing the entire loan proceeds up front.

Better monitoring of the shipbuilding and financial operations of the AMCV subsidiaries would likely have alerted MARAD to AMCV's growing financial problems, allowing it to take action prior to the defaults. With the guarantee approval for the *Columbia Queen*, MARAD allowed AMCV's annual debt service to increase by \$3 million even though the company's financial statements indicated a net loss for the previous year of over \$10 million. AMCV's

¹¹ 46 CFR 298.13 (i)

cumulative debt service was estimated to be \$12 million every 6 months, yet no part of the approval package indicates MARAD reviewed the impact of this growing debt service on AMCV's ability to guarantee or pay its subsidiaries' debts.

MARAD's loan guarantees with the AMCV subsidiaries had no established agreements, protocols, or requirements on how to secure and maintain the vessels after default. The loan guarantees did not specify which party in the guarantee security agreement was responsible for specific actions and the timeframes in which protective actions needed to be taken. Security of the onboard inventory from theft and pilferage was minimal for all the vessels MARAD acquired through the AMCV default. It was only after our audit documented the initial signs of mildew, the lack of security, and the manner of laying-up the vessels, that MARAD took action to secure them.

CONCLUSIONS

To improve MARAD's administration and oversight of the Program, MARAD needs to limit losses to the Federal Government through:

- More effective oversight of the Program's loan application review and approval process, including compensating provisions and collateral;
- More rigorous financial oversight of borrowers during the term of the loan guarantee;
- Better monitoring and protection of vessels and shipyards while under a loan guarantee; and
- More effective stewardship of foreclosed assets.

RECOMMENDATIONS

We recommend that the Maritime Administrator:

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; and
5. Develop an improved process for monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On February 25, 2003, MARAD provided comments (see Appendix) on our February 5, 2003 draft report. Those comments were incorporated into our final report, where appropriate. The Maritime Administrator stated MARAD was in agreement with our overall recommendations, which reflect sound business practices.

MARAD's proposed actions address the intent of our recommendations. MARAD agreed that a rigorous analysis of the risks from modifying loan approval criteria and use of compensating provisions are necessary and it will continue to include these in its assessment of loan guarantee applications. MARAD will immediately undertake efforts to see if additional collateral or other measures can or must be provided for future loan guarantees, if necessary to mitigate the risk of default. We note that MARAD has stated, in the past, it has been subjected to political pressure to approve loan guarantees its internal analyses indicated were not financially sound.

MARAD also agreed that an external review is desirable. MARAD has already had several meetings with an outside financial advisor who has performed analyses for the Export-Import Bank. MARAD is currently seeking the legislative authority to implement the use of such financial advisors, to be funded by the prospective borrower. MARAD expects to develop requirements for an external review process appropriate for its Title XI projects within 3 months.

In addition, within the same time period, MARAD will implement a formal process for review of semi-annual and annual Title XI financial statements. MARAD also plans to develop a “credit watch” report for the use of senior agency management to regularly track the financial status of Title XI borrowers and thereby determine at an early stage which companies may be experiencing financial difficulties.

Furthermore, MARAD will develop a reporting system to obtain relevant information from the class society (an entity designated by governments to oversee construction of vessels) during the vessel construction period and from the Coast Guard, the class society, and insurance companies over the term of the loan guarantee after the assets are completed and put into service.

Within 3 months, MARAD also intends to complete a review of its procedures for maintaining defaulted assets to see where improvements can be made. As part of this process, we would encourage MARAD to develop procedures that will not only be effective in maintaining such assets, but will take into account the relative costs involved. For example, in regard to the AMCV bankruptcy, we noted MARAD spent more than \$2 million to secure a 50-year-old vessel, the *S.S. Independence*, which only had scrap value. MARAD shipped this vessel from Hawaii back to California and put it in “mothballs.”

MARAD is cognizant of the need for improved oversight of the Title XI Program and is in agreement with our five recommendations for improving oversight. We note your commitment to tightening the controls over the approval of loan guarantees and taking more timely action to recover the maximum amount possible from foreclosed assets in the event of loan defaults. These actions, when implemented, will go a long way toward improving the operation and efficiency of the Title XI Program.

ACTION REQUIRED

In accordance with Department of Transportation Order 8000.1C, we request that you provide milestones for implementing intended actions for recommendations 1 and 4 within 30 days.

We appreciate the courtesies and cooperation of MARAD representatives during this audit. If you have any questions concerning this report, please call me at (202) 366-1959, or Mark R. Dayton, Assistant Inspector General for Competition and Economic Analysis, at (202) 366-9970.

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EXHIBIT A. SCOPE, METHODOLOGY, AND PRIOR AUDIT COVERAGE

We conducted the audit between November 2001 and January 2003 in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

To determine the status and historical trends of loan guarantees, as well as policies and procedures for the Title XI Program, we interviewed personnel from various MARAD organizations to discuss and obtain copies of the policies, procedures, regulations, and internal controls for the Title XI Program. We also interviewed various government and industry specialists.

We determined what loan guarantees had been approved and analyzed information in the case files in accordance with Code of Federal Regulation (46 CFR 298) requirements. We determined whether the application packages and their approvals complied with the CFR. We also determined whether MARAD used and complied with the requirements and recommendations outlined in the Office of Management and Budget Circulars A-123 and A-129, for the administration and management of the Federal guaranteed loan programs. Additionally, we reviewed what internal controls existed to ensure the policies and procedures prevented fraud, waste, abuse, mismanagement or misappropriation of Federal funds. Finally, we analyzed all 9 recently defaulted loans and a stratified random sample of 33 of the remaining loans in MARAD's portfolio. Therefore, as of April 1, 2002, we analyzed 42 loan guarantees valued at about \$1.6 billion out of a universe of 100 loan guarantees, totaling about \$5.6 billion.

Our review of AMCV included an in-depth review of the loan applications of its subsidiaries. Additionally, we reviewed the AMCV Securities and Exchange Commission filings for the last 5 years. Finally, we visited the foreclosed AMCV assets in Jacksonville, Florida; Pascagoula, Mississippi; and New Orleans, Louisiana.

Prior Audit Coverage

The OIG issued three reports concerning MARAD's Title XI loan guarantee to Massachusetts Heavy Industries prior to its default in February 2000.¹² In these reports, we identified management weaknesses and made recommendations to MARAD to strengthen its loan guarantee program.

¹² Report MA-1998-048, "Management Advisory on Massachusetts Heavy Industries, Inc., Title XI Loan Guarantee," December 17, 1997; Report MA-1999-115, "Massachusetts Heavy Industries, Inc., Title XI Loan Guarantee," July 20, 1999; and Report MA-1999-127, "Status Update Massachusetts Heavy Industries, Inc. Title XI Loan Guarantee," September 15, 1999.

EXHIBIT B. ACTIVITIES VISITED OR CONTACTED

MARITIME ADMINISTRATION

Office of the Maritime Administrator

Office of Chief Counsel

Office of Accounting

Office of Statistical and Economic Analysis

Office of Financial and Rate Approvals

Associate Administrator for Shipbuilding

Office of Shipbuilding and Marine Technology

Division of Ship Design and Engineering Services

Division of Advanced Technology

Division of Support Activities

Office of Ship Financing

Office of Insurance and Shipping Analysis

Division of Shipping Analysis

Division of Marine Insurance

OTHER ACTIVITIES

U.S. Department of Justice

U.S. Department of the Treasury

Atlantic Marine Shipyard, Jacksonville, FL

Northrop Grumman, Ingalls Shipyard, Pascagoula, MS

Delta Steamship Lines, New Orleans, LA

Export-Import Bank of the United States

U.S. Bankruptcy Court, Wilmington, DE

J.P. Morgan Chase Bank of Manhattan

General Accounting Office

Citibank

Deutsche Bank Securities Inc.

EXHIBIT C. MAJOR CONTRIBUTORS TO THIS REPORT

THE FOLLOWING INDIVIDUALS CONTRIBUTED TO THIS REPORT.

<u>Name</u>	<u>Title</u>
Mark R. Dayton	Assistant Inspector General for Competition and Economic Analysis
Michael E. Goldstein	Program Director
Pamela J. Steele-Nelson	Project Manager
Joseph F. Lenart, Jr.	Analyst
David S. Engelen	Analyst
Christopher T. Brothers	Analyst
Wayne L. White	Auditor
Bernard Fishman	Auditor
Shirley Murphy	Editor
Petra Swartzlander	Statistician

APPENDIX. MANAGEMENT COMMENTS



U.S. Department
of Transportation
**Maritime
Administration**

Memorandum

Subject: Draft Report on Audit of the
Title XI Loan Guarantee Program

FEB 25 2003

From: *William G. Schubert*
Captain William G. Schubert
for Maritime Administrator

To: Mark R. Dayton
Assistant Inspector General
for Competition and Economic Analysis

The Maritime Administration (MARAD) has reviewed your draft report on the audit of the Title XI loan guarantee program. We appreciate the time and effort you and your staff have dedicated to this project and your comments are very useful as we develop measures to improve the oversight and operation of the program. We are in complete agreement with your overall recommendations which reflect sound business practices. However, we would offer a number of comments to the report, which have been made on a section-by-section basis corresponding to the sections of the report.

BACKGROUND

More favorable loan terms are offered to the Title XI applicants than are offered by commercial lenders as a result of the statutory full faith and credit guarantee of the United States. While such terms may be more favorable they do not reflect a greater risk of default. Assuming that MARAD is not prevented from basing its decision to issue the guaranty on economic soundness, the more favorable terms enabled by a government guaranteed loan do not create an inherently higher risk of default. In a number of instances where defaults have occurred, it has been due to political pressure brought upon MARAD to overlook underwriting requirements. For example, the default of the Quincy Shipyard project is directly attributed to the specific direction by Congress for MARAD to approve the guarantee without regard to economic soundness.

RESULTS

The test of economic soundness was first required of MARAD by regulation. Subsequently, the test became part of the statutory framework for Title XI financing. The Federal Credit Reform Act of 1990 (FCRA) established a uniform method for estimating the risk or cost of Government loan and loan guarantee programs and did not refer to the economic soundness requirement.

Table 2 lists three Enron-related companies being operated under bankruptcy protection. None of these companies is in bankruptcy. MARAD and the other project creditors continue to monitor these projects very closely.

MARAD Could Reduce the Risk of Losses Through Compensatory Loan Provisions Such As More Collateral and Higher Equity Contributions

We agree with your suggestion that, as consideration for modifying or waiving financial requirements, MARAD could impose compensating measures such as liens on unencumbered collateral, requiring greater amounts of project equity or having a greater portion of project risk assumed by the applicant's lender. MARAD will continue to explore these options to the extent practicable when evaluating future loan guarantees.

Notwithstanding any modifications MARAD has made to financial requirements, it is likely that the noted projects would have defaulted anyway due to circumstances that could not be foreseen at the time of the guarantee issuance. Financial requirements cannot be waived or modified, pursuant to 46 CFR 298.13(i), unless a determination is made that there is adequate security for the Title XI guarantee, such as reserve funds deposits or parent guarantees which are generally subject to certain financial tests. The vast majority of projects for which modifications of financial requirements have been made have not defaulted.

At closing, SEAREX, Inc., an example of a defaulted loan guarantee, was required to have \$150,000 in working capital, an amount which was greater than the requirement of working capital of at least \$1.

MARAD Would Benefit From External Application Review

We agree that the use of outside financial advisors would be beneficial. To that end, MARAD is seeking legislation in its 2004 authorization to have the authority to engage such financial advisors, at the expense of the prospective borrower. The use of financial advisors would be most appropriate for uniquely complicated projects, to expedite an application where the applicant desires to do so and for such other projects where such advice would be warranted.

Based on our experience, the assessment of a new market is likely to be the area where a financial adviser would be warranted. The experience of the Export-Import Bank provides a useful model for the use of financial advisors as part of a project review.

MARAD Could Better Protect Its Interests Through Improved Oversight of Borrowers Over the Duration of Their Loans

We agree that the financial monitoring process could be improved. To this end we have transferred the oversight responsibility to the Office of Ship Financing which now performs regular assessments of the financial health of each Title XI company. We will

also institute a periodic “credit watch” report for the use of senior agency management which will reveal those Title XI companies experiencing financial difficulties.

Financial covenants requiring certain financial performance levels, such as minimum working capital levels, cash flow requirements, minimum financial ratios, future capital spending constraints and timely financial reporting, are included in the Title XI Reserve Fund and Financial Agreement which is part of the standard Title XI documentation.

MARAD also requires additional reserves or collateral when warranted. For example, in certain Enron subsidiary transactions, additional reserves or collateral required by MARAD included a supplemental \$24 million letter of credit, a \$10 million vessel removal guarantee, and mandatory funding of a year’s debt service in the event of failure of a certain financial test.

In the event of loan defaults, the ability of MARAD to take control and custody of defaulted assets quickly is often frustrated by companies seeking the protection of the bankruptcy laws available to them.

MARAD Could Improve Its Return on Foreclosed Assets Through Better Tracking of the Vessels and Property Constructed With Loan Guarantees

MARAD requires that it be provided access to a vessel during construction and MARAD periodically inspects the progress of construction. Construction oversight is also provided by the relevant classification society. After delivery and for the term of the loan guarantee, a vessel is subject to regular Coast Guard inspections, insurance certification, and drydockings and must also be maintained in class. It is through these means that MARAD appropriately monitors and protects assets. Such procedures have demonstrably avoided a diminution of vessel value during the term of our loan guarantees.

When AMCV filed for bankruptcy, MARAD knew the condition and status of the AMCV vessels and took immediate steps to ensure that the vessels were properly laid up. At the time of the AMCV loan defaults, the vessels had already been laid up with MARAD oversight. In each case, a report was made to MARAD headquarters and there continued to be ongoing oversight of the vessels.

The CAPE MAY LIGHT had operated for several months before the bankruptcy filing. The vessel remained at the same port after MARAD took possession, but was moved from one pier to another. There has been no damage to the vessel. The vessel has not deteriorated; it is under dehumidification and subject to constant monitoring under the supervision of a qualified custodian.

AMCV’s Bankruptcy Significantly Affected the Title XI Program, but Does Not Threaten Its Solvency

MARAD performed a cash flow analysis for each AMCV project which indicated that revenues would exceed expenses, including debt service. It is clear that the defaults would have occurred regardless of modifications to the financial requirements because of the subsequent downturn in the cruise industry, exacerbated by the events of September 11, 2001. Similarly, other cruise lines declared bankruptcy at approximately the same time as AMCV.

For each of the AMCV projects there was sufficient basis to modify the financial requirements and the Project America cruise vessels could not have been undertaken without such modifications. These vessels represented a very positive development for the industry since they would have been the first oceangoing cruise vessels built in the United States in half a century. The importance attached to this project is indicated by the special legislation granting the vessels exclusive operating rights in Hawaii (PL 105-56, section 8109). Again, political pressure on MARAD played a major role in the issuance of the loan guarantees.

RECOMMENDATIONS

You have made five recommendations for improvement of MARAD's administration and oversight of the Title XI program. The recommendations and our responses to each follow.

- 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.**

MARAD agrees that such an analysis and compensating provisions are necessary and will continue to include these in its assessment of loan guarantee applications. MARAD will immediately undertake to see if additional collateral or other measures can or must be provided for future loan guarantees, if necessary to mitigate the risk of default.

- 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.**

MARAD agrees that an external review is desirable. We have already had several meetings with an outside financial adviser who has performed analyses for the Export Import Bank and are currently seeking the legislative authority to implement the use of such financial advisors to be paid by the prospective borrower. We expect to develop requirements for an external review process appropriate for MARAD projects within three months.

- 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.**

The Title XI documents require submission of semi-annual and annual financial statements. We will implement within three months a formal process for review of these statements and will also develop a "credit watch " report for the use of senior agency management to track regularly the financial status of Title XI borrowers and thereby determine at an early stage which companies may be experiencing financial difficulties. MARAD will look to see what outside sources may be available to assist in this area.

- 4. Establish a formal process for continuously monitoring the physical condition of guaranteed assets over the term of the loan guarantee.**

MARAD will develop a reporting system to obtain relevant information from the class society during the vessel construction period and from the Coast Guard, the class society and insurance companies over the term of the loan guarantee after the assets are completed and put into service.

- 5. Develop an improved process for monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.**

MARAD will review its procedures for maintaining defaulted assets to see where improvements can be made. This review will be completed in three months.

In conclusion, we thank you for your report and we appreciate the recommendations you have made for program improvement. We would be pleased to meet with you at your convenience to discuss our comments.