

TITLE XI LOAN GUARANTEE PROGRAM

Maritime Administration

Report Number: CR-2004-095

Date Issued: September 28, 2004




Memorandum

**U.S. Department of
Transportation**

Office of the Secretary
of Transportation
Office of Inspector General

Subject: **ACTION:** Report on the Follow-up Audit of the Title XI Loan Guarantee Program
Maritime Administration
Report No. CR-2004-095

Date: September 28, 2004

From: Alexis M. Stefani 
Principal Assistant Inspector General
for Auditing and Evaluation

Reply to
Attn. of: JA-50

To: Maritime Administrator

This final report presents the results of our follow-up audit of the Maritime Administration's (MARAD) Title XI Loan Guarantee Program. We initiated this follow-up audit as a result of the Emergency Wartime Supplemental Appropriation passed by Congress on April 16, 2003.¹ The bill provided \$25 million for the costs of new Title XI loan guarantees that will remain available until September 30, 2005. However, Congress prohibited MARAD from obligating or expending these funds "... until the Department of Transportation Inspector General certifies to the House and Senate Committees on Appropriations that the recommendations of report CR-2003-031² have been implemented to his satisfaction."

Our prior audit of the Title XI Loan Guarantee Program was conducted at the request of Congress following vessel and shipyard owner bankruptcies and defaults of nine Title XI loans from February 1998 to March 2002 totaling approximately \$490 million. There were \$2 billion of Title XI defaults in the late 1980s. MARAD's Title XI loan guarantee portfolio totaled about \$3.6 billion as of June 30, 2004, with another \$1.4 billion in pending loan guarantee applications.

The objectives of this follow-up audit were to verify that MARAD has developed and implemented adequate procedures to effectively address each of the five

¹ Making Emergency Wartime Supplemental Appropriations for the Fiscal Year 2003, Public Law 108-11.

² OIG Audit Report Number CR-2003-031, "Title XI Loan Guarantee Program," March 27, 2003. OIG reports can be accessed on our website: www.oig.dot.gov.

recommendations in our March 2003 report. The report recommended that MARAD:

- **Risk Mitigation.** 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.
- **External Review Process.** 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.
- **Financial Monitoring.** 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.
- **Asset Monitoring.** Establish a formal process for continuously monitoring the physical condition of guaranteed assets over the term of the loan guarantee.
- **Defaulted Asset Monitoring.** Develop an improved process for monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.

Our scope and methodology are described in detail in Exhibit A, and the activities visited or contacted are listed in Exhibit B.

RESULTS IN BRIEF

MARAD has developed policies and procedures that address each of the five recommendations from our March 2003 audit report in a satisfactory manner. However, in verifying the development of these policies and procedures, we note that MARAD still has considerable work to do. Establishing good procedures is just the first step, fully implementing them is another. While MARAD has worked to get satisfactory procedures in place, the proof will be in the follow through and implementation with respect to specific loan guarantee applications. Therefore, we will conduct a follow-up audit of this implementation at a date still to be determined. Strong leadership and staff committed to implementing the strengthened procedures are critical to realize the intended benefits and reduce the risk profile of the Title XI loan guarantee portfolio.

During this audit, three issues came to our attention that need to be fixed to ensure that the full intent of the recommendations from our March 2003 report are addressed. We found that MARAD was not sufficiently enforcing the reserve requirements established to mitigate the risks of noncompliant loans.

Furthermore, the system MARAD developed to monitor the Title XI portfolio is antiquated and rudimentary. This is of considerable importance because MARAD has determined that over 25 percent of its \$3.6 billion portfolio is at an elevated risk of default. Consequently, we made three new recommendations to enhance management of the Title XI program. Our certification of the adequacy of MARAD's implementation, as required by the Congress, was contingent upon a satisfactory written response from MARAD that would include an action plan with steps and milestones to address these new recommendations. Subsequently, MARAD provided a written response (see Appendix) that satisfactorily addressed the intent of the recommendations.

MARAD's Actions in Response to March 2003 Audit Report

The following is a summary of MARAD's actions in response to our March 2003 audit report.

Risk Mitigation. MARAD strengthened its procedures for review and approval of new loan guarantee applications. For any waivers or modifications to the standard loan approval criteria, MARAD performs a risk analysis and determines whether compensating measures are available or necessary, as set forth in the governing Title XI regulation.³ Once this review is completed, MARAD presents the results of its analysis of the application to the Department of Transportation Credit Council (Credit Council).⁴ The Credit Council assesses the financial viability of the application and its consistency with Departmental credit policies, Federal requirements, and DOT regulations on credit assistance. The Credit Council will provide a recommendation to the Maritime Administrator for consideration in approving or disapproving the application.

External Review Process. Regarding the establishment of an external review process, MARAD originally required that *all* new and pending applications would undergo an external review before approval, as a supplement to MARAD's internal review process. As a result of subsequent reauthorization legislation, MARAD and the Credit Council are working on a revision to this requirement. MARAD has suggested general guidelines that would require external reviews for applications from companies for start-up operations; for starting a new service, applying new technologies, or employing more complex finance transactions; and for large dollar transactions that represent a significant portion of the potential borrower's debt. In the interim, until this revision is complete, MARAD will seek Credit Council concurrence for any application that MARAD believes *does not* require an external review.

³ Putting Customers First in the Title XI Program, 46 C.F.R. §298.13 (2000).

⁴ Department of Transportation Order 2301.1, "Establishment of the Department of Transportation Credit Council," June 10, 2004.

Financial Monitoring. By far, the most difficult area for MARAD to address was the establishment of a formal process for monitoring the financial condition of its Title XI portfolio companies. The process includes establishing an administrative file for each portfolio company and assigning an analyst to monitor each file. MARAD also established a requirement for more frequent and timely financial reporting for new Title XI loan guarantees.

MARAD re-established a “Credit Watch” process. The Credit Watch is a monitoring system primarily for those companies experiencing some form of financial difficulty. MARAD established criteria to determine the conditions that warrant inclusion on Credit Watch and more detailed and timely analyses are to be performed on these companies. MARAD assigns Credit Watch companies to one of three categories, depending upon a company’s relative risk: “high” (risk of default within 1 year), “medium” (risk of default within 2 years) and “low” (risk of default within 3 years). As of June 30, 2004, MARAD placed 25 of its 70 borrowers on Credit Watch (high risk – 9 borrowers; medium risk – 8 borrowers; low risk – 8 borrowers). These borrowers had outstanding loan guarantees valued at more than \$935 million, or approximately 26 percent of the more than \$3.6 billion total Title XI loan guarantee portfolio. The nine borrowers considered high risk accounted for \$563 million in outstanding loan guarantees.

During our review, we observed that MARAD’s analysts were, in many cases, 6 months or more behind in performing analyses of borrowers’ financial statements. Timelier financial monitoring will continue to be a challenge for MARAD, especially as new loan guarantees are approved and more frequent reporting requirements are imposed on borrowers and their affiliates. MARAD must focus its efforts on catching up with financial analyses of the borrowers in its current portfolio before expending significant resources on new loan guarantee applications.

Asset Monitoring. Regarding our recommendation to more closely monitor the physical condition of guaranteed assets, MARAD established a more formal process to monitor whether or not a company is current with respect to its marine insurance, classification, Coast Guard inspection, and other required certifications related to the physical condition of vessels. Additionally, following private sector practices, future Title XI transactions will give MARAD the right to select an independent entity to inspect the vessel or shipyard on an annual basis at the company’s expense if the company is not meeting its financial tests. MARAD will use this inspection right if there is concern that the owner is not adequately maintaining the vessel or shipyard.

Defaulted Asset Monitoring. MARAD also developed a better process for documenting the actions taken with respect to seized assets and to maximize

recoveries from their disposal. When appropriate, MARAD obtains the services of marine consultants to assist in conducting appraisals, surveys, and market analyses for the disposition of foreclosed assets. In addition, MARAD now requires monthly written reports on custodial activities and asset condition as another means of monitoring the condition of the vessels in its possession. At the time of our review, three vessels (Cape May Light, Cape Cod Light, and Columbia Queen) remained in MARAD's possession as a result of the foreclosure process. MARAD has appointed a technical representative to monitor each vessel and has contracted with outside parties to ensure that the vessels receive appropriate maintenance and security measures.

Three New Areas Requiring Management Attention

Over the course of this audit, we observed three areas that require management attention. In our opinion, the March 2003 report recommendations cannot be fully implemented unless each of these issues is addressed. In its September 3, 2004 response (see Appendix), MARAD has promised to implement actions to address these recommendations in a timely fashion.

Fully Fund Reserve Fund Requirements and Enforce Financial Agreements.

First, we observed that MARAD has not been enforcing key provisions of the Title XI Reserve Fund and Financial Agreement (RFFA), an important instrument in the Title XI closing documentation. The RFFA establishes financial tests and covenants that borrowers are required to meet as well as financial reporting requirements and obligatory corporate officer certifications. Importantly, the RFFA also establishes the Title XI Reserve Fund, a type of escrow account formed at closing that borrowers make payments into each year that they do not meet certain financial tests. The Reserve Fund provides MARAD with additional security over the life of the loan guarantee in case the borrower runs into financial difficulty.

We noted that some companies were not submitting the required certifications, and/or not making the required deposits into their Reserve Fund. MARAD's actions to address these violations were generally not timely and were ineffective. Furthermore, MARAD does not have a system in place to track the required balances in the Reserve Funds and was unable to provide this information during the course of our audit.

In a judgmental sample of 24 Title XI companies, only 2 of 9 companies that were required to make Reserve Fund deposits actually had. Each of the other seven omissions are events of default in accordance with the terms of the Title XI agreements and give rise to various legal remedies, including the Government's right to seize the guaranteed assets. MARAD's failure to enforce the RFFA over the term of loan guarantees, particularly ensuring that all required deposits are

made into the Reserve Fund, makes it an ineffective means to protect the Government's financial interests. As a result, we are recommending that MARAD (1) perform a full accounting of each borrower's Reserve Fund and (2) require all borrowers to cure any defaults under the requirements of their Reserve Fund and Financial Agreements, including full funding of Reserve Funds.

Establish Effective Default Management. Second, in June 2003, the United States Government Accountability Office (GAO) issued a report titled "Weaknesses Identified in Management of the Title XI Loan Guarantee Program." In the report, GAO recommended that MARAD establish a clear separation of duties to provide a system of checks and balances for key lending functions, including loan guarantee application approvals, financial monitoring, and disposition of foreclosed assets. Currently, these key lending functions remain principally within the responsibility of the same MARAD employees.

The creation of the Credit Council will help in providing checks and balances to the initial approvals of loan guarantee applications as well as approvals of significant post-closing waivers and modifications. However, we remain concerned about MARAD's ability to effectively address troubled loans.

In a recent case, a borrower requested a waiver from MARAD to defer principal payments due on its two Title XI vessels. The borrower was in default of several conditions of its RFFA, including \$1 million in arrears on required Reserve Fund deposits. Nonetheless, MARAD was prepared to grant the waiver request without having acquired essential financial information and fully understanding the borrower's financial situation. For example, MARAD did not obtain the independent auditor's opinion of the borrower's most recent audited financial statements. The Credit Council, as part of its review of the requested waiver, assembled a list of due diligence questions that were forwarded to the borrower, including questions previously sent to the company by MARAD. Instead of providing the requested financial information, the borrower dropped its waiver request and made the required principal payment.

Because of the magnitude of dollars involved and the specialized set of skills required to effectively resolve complex financial situations, we are recommending that MARAD, in coordination with the 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.

Acquire Suitable Financial Monitoring Software. Third, MARAD's financial monitoring system is rudimentary. It relies heavily on non-electronic analyses, and is cumbersome for updating and fully documenting pertinent events. This

antiquated system is inadequate to effectively manage any financial portfolio, let alone one the size of MARAD's \$3.6 billion Title XI program. Developing a computerized database system is essential for MARAD to assess efficiently and timely the financial condition of the companies in its portfolio and to track trends in these companies' finances and operations.

In February 2004, the MARAD Administrator acknowledged this deficiency and agreed to task internal MARAD information systems personnel as well as retain outside consultants to develop a computer-based financial monitoring system. Because little progress has been achieved on this commitment this year, we are recommending that MARAD, 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.

MARAD's Response to New Recommendations

On September 3, 2004, MARAD set forth its action plan with milestones for satisfying the new recommendations (see Appendix). The following summarizes MARAD's implementation commitment.

Fully Fund Reserve Fund Requirements and Enforce Financial Agreements. MARAD has established a plan to review each company's Reserve Fund requirements and other significant defaults. MARAD has promised to complete these reviews for all companies on the Credit Watch by December 31, 2004, and anticipates completing the reviews for the remaining Title XI borrowers by March 1, 2005. Once these reviews are completed, MARAD has promised to take the necessary actions, utilizing all remedies available, to cure any defaults.

Establish Effective Default Management. In coordination with the Credit Council, MARAD will work with staff representing the other credit programs within the Department of Transportation to develop a statement of work for advisors outside of MARAD and the funding options for such advisors. MARAD anticipates that a detailed action plan to secure access to advisors outside MARAD with the requisite capacity and technical sophistication to negotiate solutions to distressed loans can be developed by mid-December 2004.

Acquire Suitable Financial Monitoring Software. MARAD has been advised by the Office of the Secretary that the Department wants to implement a monitoring system that can be used by all of the Department credit programs for purposes of efficiency and consistency. MARAD has set forth a three phase action plan consisting of: (1) developing a requirements definition and analysis of alternatives; (2) developing a solutions definition; and (3) acquiring and implementing the selected system. MARAD has set milestones to complete the

first and second phase of the project by March 2005 and an additional 18 months for the acquisition and implementation of the system.

BACKGROUND

Title XI of the Merchant Marine Act of 1936 established the Federal Ship Financing Guarantee Program to assist private companies in obtaining financing for the construction of ships or 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.

The primary purpose of the Title XI Loan Guarantee Program is to promote the growth and modernization of the U.S. merchant marine and U.S. shipyards. The Title XI Loan Guarantee Program enables owners of eligible vessels and eligible shipyards to obtain long-term financing with attractive terms. Vessels financed using loan guarantees include double-hull oil tankers, passenger ferries, cruise ships, and offshore drilling rigs. In the late 1980s, MARAD paid out approximately \$2 billion in guarantees to cover 129 loan defaults. In the 5 years following the implementation of the Credit Reform Act of 1990⁵ (Fiscal Years 1993 through 1997), only three loans, totaling approximately \$12 million, defaulted. In contrast, from February 1998 to March 2002, nine Title XI loans, totaling approximately \$490 million, defaulted.

As a result of the increase in the number of and amount of defaulted loans, the Ranking Member, Senate Committee on Commerce, Science and Transportation, and the Chairman, Subcommittee on Commerce, Justice, State and Judiciary of the House Committee on Appropriations requested that the Office of Inspector General (OIG) conduct an audit of MARAD's Title XI Loan Guarantee Program. The March 27, 2003 audit report identified a number of areas in which MARAD could improve its practices, limit the risk of default, and reduce losses to the Government. Subsequently, the OIG has been reviewing MARAD's progress as it both establishes its procedures to address the report recommendations and ensures that they are implemented.

As of June 30, 2004, MARAD's Title XI loan guarantee portfolio totaled approximately \$3.6 billion. Of that amount, \$3.5 billion represents loan guarantees (that is, construction loans and mortgage loans) that had already been made, and \$106 million were commitments for future guarantees. Additionally, as

⁵ Public Law 101-508.

of the most recent update in August 2004, MARAD had 11 pending applications, valued at about \$1.4 billion (the original amount of the loan). Utilizing a risk factor of 6.21 percent,⁶ the \$25 million supplemental appropriation could provide up to \$400 million in new loan guarantees.

RESULTS AND RECOMMENDATIONS

MARAD has developed policies and procedures that address each of the five recommendations from our March 2003 audit report in a satisfactory manner. However, in verifying the development of these policies and procedures, we note that MARAD still has considerable work to do. Establishing good procedures is just the first step, fully implementing them is another. While MARAD has worked to get satisfactory procedures in place, the proof will be in the follow through and implementation with respect to specific loan guarantee applications. Therefore, we will conduct a follow-up audit of this implementation at a date still to be determined. Strong leadership and staff committed to implementing the strengthened procedures are critical to realize the intended benefits and reduce the risk profile of the Title XI loan guarantee portfolio.

During this audit, three issues came to our attention that need to be fixed to ensure that the full intent of the recommendations from our March 2003 report are addressed. We found that MARAD was not sufficiently enforcing the reserve requirements established to mitigate the risks of noncompliant loans. Furthermore, the system MARAD developed to monitor the Title XI portfolio is antiquated and rudimentary. This is of considerable importance because MARAD has determined that over 25 percent of its \$3.6 billion portfolio is at an elevated risk of default. Consequently, we made three new recommendations to enhance management of the Title XI program. Our certification of the adequacy of MARAD's implementation, as required by the Congress, was contingent upon a satisfactory written response from MARAD that would include an action plan with steps and milestones to address these new recommendations. Subsequently, MARAD provided a written response (see Appendix) that satisfactorily addressed the intent of the recommendations.

The following discusses MARAD's actions in response to our March 2003 recommendations.

⁶ Credit subsidy rate presented by the Maritime Administrator in testimony before the Senate Committee on Commerce, Science, and Transportation on the Title XI Loan Guarantee Program, June 5, 2003.

March 2003 Recommendation 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.”

In response to this recommendation, MARAD updated and strengthened its procedures for review and approval of loan guarantee applications. For any waivers or modifications to the standard loan approval criteria, MARAD will perform a risk analysis and determine whether compensating controls are available or necessary, as set forth in the governing Title XI regulation.⁷ MARAD will ensure that results from the completed analysis are documented in the administrative file and include, at a minimum the (1) modification or waiver, (2) compensating controls being required as consideration for the waiver or modification, and (3) how the Government’s interest is still adequately secured. Once this review is completed, MARAD presents the results of its analysis of the application to the Credit Council. The Credit Council assesses the financial viability of the application and its consistency with Departmental credit policies, Federal requirements, and DOT regulations on credit assistance. The Credit Council will provide a recommendation to the Maritime Administrator for consideration in approving or disapproving the application.

MARAD’s updated procedures were in place for the two loan guarantee applications approved since June 2003. The first, Lake Express LLC, applied for a \$14.5 million Title XI loan guarantee in December 2002 for mortgage period financing of a high-speed ferry to provide service on Lake Michigan between Milwaukee, Wisconsin, and Muskegon, Michigan. The Lake Express application did not require any material modifications to the loan guarantee approval criteria.

The second was a \$143.8 million loan guarantee application for Totem Ocean Trailer Express, Inc. (Totem). Totem applied for a Title XI loan guarantee in January 2003 to build a replacement vessel for its Alaska trade. In this case, Totem requested modifications to allow larger dividends to its shareholders, and an amendment to the working capital definition to include receivables and credit facilities not normally incorporated.

After performing a risk analysis, MARAD imposed compensating provisions to mitigate the increased risks introduced by approving the modifications. Specifically, Totem’s parent company, Saltchuk Resources, Inc., will provide both a guarantee for the loan as well as enter into the Title XI RFFA. Doing so subjects the parent company to the loan guarantee’s financial tests and covenants as well. Additionally, the statutory leverage requirement of 2:1 will be tightened to 1.75:1,

⁷ Putting Customers First in the Title XI Program, 46 C.F.R. §298.13 (2000).

thus decreasing the amount of debt the company could issue relative to the equity available. MARAD was also granted a second mortgage on Totem's three existing vessels, a cross default provision allowing MARAD to declare a default if Saltchuk is in violation of its private sector debt, and Totem's existing Title XI financing will be modified to comply with this more restrictive transaction. The Maritime Administrator approved the Title XI loan guarantee commitment in October 2003 with the concurrence of OST (the Credit Council was not formally established until June 2004). In our view, the compensating provisions addressed the risks introduced by approving the modifications.

March 2003 Recommendation 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 retained independent external reviewers to conduct limited evaluations⁸ of the two loan guarantee applications approved since June 2003 – Lake Express LLC, and Totem.

Regarding the Lake Express application, an independent external financial analyst reviewed the company's business plan and capitalization, and an independent external market analyst reviewed the market research and demand forecast. The financial analyst recommended that several steps be taken to further protect the Government's interests and MARAD agreed to implement these changes, as appropriate. The market analyst raised some concerns about the underlying market research and, as a result, MARAD limited the Government's risk by establishing a firm ceiling on the guarantee amount in the Lake Express commitment letter. On the second application, the external financial analyst for Totem's business plan and capitalization recommended that several steps be taken to further protect the Government's interests. MARAD addressed those issues as well and adopted measures as appropriate.

MARAD's initial policy for obtaining independent external reviews applied to all Title XI loan guarantee applications. On September 8, 2003, the Maritime Administrator delivered an “Action Memorandum to the Secretary” providing the then current status of reforms being undertaken to improve the management of the program. Among other things, MARAD stipulated that *all* new and pending applications would undergo an external review before approval as a supplement to MARAD's internal review process. Subsequently, on November 24, 2003, Congress passed the National Defense Authorization Act for Fiscal Year 2004.⁹

⁸ MARAD cited two reasons for these limited evaluations: (1) the narrow timeframe in which these analyses needed to be performed, and (2) the lack of a defined source of funds to pay for such reviews at the time.

⁹ National Defense Authorization Act for Fiscal Year 2004, Public Law 108-136.

Section 3526 of the Act provided, “The Secretary *may* make a determination that aspects of an application under this title require independent analysis to be conducted by third party experts due to risk factors associated with markets, technology, financial structures, or other risk factors identified by the Secretary.” The Committee Report accompanying the legislation stated, “The conferees intend that the Secretary should not use this authority in routine cases nor where MARAD already has sufficient expertise to assess fully the risk of approving a loan guarantee application.” This section also provided MARAD with a means to collect fees to cover the costs of these independent analyses.

As a result of this legislation, MARAD and the Credit Council are working on a revision to the requirement for external reviews of all Title XI applications. MARAD has suggested general guidelines for procuring external reviews of Title XI applications, to include companies starting a new service, start-up operations, new technologies, more complex finance transactions, and large dollar transactions representing a significant portion of the potential borrower’s debt. Until this revision to the September 8, 2003 action memorandum is finalized, MARAD will seek Credit Council concurrence for any application that MARAD believes *does not* require an external review. Additionally, MARAD’s Office of Ship Financing and Office of Acquisitions have developed a list of qualified entities that can perform external reviews.

March 2003 Recommendation 3: “Establish a formal process for continuously monitoring the financial condition of the borrowers, including requirements for financial reporting over the term of the guarantee as a condition of loan approval.”

In response to our recommendation, MARAD established a formal process to review the financial statements and monitor the financial condition of its Title XI portfolio companies. The process includes establishing an administrative file for each portfolio company and assigning an analyst to monitor each file. The file includes financial statements, a form indicating when the financial statements and other financial reports are due, and a listing of the financial requirements of the loan guarantee. For each due date, MARAD’s analyst prepares a financial statement review (FSR) form. These forms will also be completed for all affiliated companies whose financial condition is relied upon by MARAD (i.e., parent companies providing guarantees for its subsidiary’s Title XI debt). The FSR, composed of basic information on the financial condition of the company, particularly the company’s compliance with the various financial tests included in the Title XI documentation, forms part of the basis for MARAD determining whether or not the company should be placed on “Credit Watch” and why.

The Credit Watch is a monitoring system MARAD developed for those companies experiencing some form of financial difficulty. The Credit Watch is broken down into three categories: category 3 – significant/high risk (risk of default within 1 year); category 2 – moderate/medium risk (risk of default within 2 years); category 1 – minimal/low risk (risk of default within 3 years). MARAD established criteria to determine the conditions that warrant inclusion on Credit Watch and more detailed and timely analyses are to be performed on these borrowers. The criteria include a company’s lack of compliance with any of the financial tests included in the RFFA, a bankruptcy filing, or a company exhibiting deteriorating financial trends. MARAD also places borrowers on Credit Watch during their first 3 years of start-up operations. These criteria are comprehensive and should help identify loans requiring closer monitoring.

In January 2004, MARAD initially placed 26 borrowers on Credit Watch. As of June 30, 2004, 25 borrowers were on Credit Watch with outstanding loan guarantees valued at more than \$935 million or approximately 26 percent of the more than \$3.6 billion Title XI loan guarantee portfolio. A breakdown of the 25 companies is shown in the Table below.

Credit Watch Companies (as of June 30, 2004)				
Risk Category	No. of Companies	Loan Guarantees (\$ in millions)	Percent of Title XI Portfolio \$	Percent of Credit Watch \$
3. High Risk	9	563	15.6	60.2
2. Medium Risk	8	232	6.5	24.8
1. Low Risk	8	140	3.9	15.0
Total	25	\$935	26.0%	100.0%

Source: MARAD’s list of Credit Watch companies

Procedures require that Credit Watch reports be updated when (1) financial statements are received, (2) Title XI debt service payments are made, and (3) developments occur that would either favorably or adversely impact a company’s financial or economic condition. MARAD distributes copies of the Credit Watch reports to the (1) Maritime Administrator, (2) Deputy Maritime Administrator, (3) Chief Counsel, (4) Associate Administrator for Shipbuilding, (5) Chief, Division of Ship Financing Contracts, and (6) Director, Office of Ship Financing.

MARAD's procedures require that the Credit Watch reports be provided to the DOT Chief Financial Officer and General Counsel on a quarterly basis. The Credit Watch reports form the basis for quarterly meetings between the Credit Council and MARAD senior management to discuss the Title XI loan guarantee portfolio and whether or not it is necessary to take any actions to protect the interests of the taxpayer against potential defaults. MARAD also plans to hold these meetings on a case-by-case basis if needed.

MARAD held its first quarterly Credit Watch meeting with senior OST officials in March 2004 (prior to the establishment of the Credit Council). At the meeting, MARAD provided information on the criteria used for the Credit Watch reports and highlighted some of the higher risk projects.

In addition to maintaining the FSR and Credit Watch reports in each company's administrative file, MARAD will maintain a copy of these reports in a central file with other reports of all the Title XI companies for tracking purposes. Between September 2003 and February 2004, MARAD prepared an FSR based on each borrower's **December 31, 2002** financial statements. MARAD prepared Credit Watch reports for 26 companies based on their respective **June 30, 2003** financial statements. After our review of MARAD's initial analyses and subsequent discussions, MARAD agreed to make certain improvements to future Credit Watch reports, including more in-depth financial and operational analyses necessary to monitor these loan guarantees. MARAD updated three Credit Watch reports of companies in the "high risk" category with this enhanced analysis using the more recent audited financial statements for the year ended **December 31, 2003**. MARAD intends to apply this more in-depth approach to all 2003 year-end financial submissions as well as future analyses of Credit Watch companies.

To its credit, MARAD established a requirement for more frequent and timely financial reporting for future Title XI loan guarantees. For all new loan guarantees, MARAD requires borrowers to provide officer certified quarterly financial statements (currently semi-annual) within 45 days after the end of the period (currently 90 days) in addition to the audited financial statements 105 days after the end of the fiscal year. Additionally, MARAD now requires any company in the "high-risk" category of the Credit Watch to submit monthly financial statements within 30 days of each month's end. These enhanced reporting requirements have been included in the closing documentation of the two loan guarantees (Lake Express and Totem) approved since June 2003 and will be incorporated in all future loan guarantee transactions.

Furthermore, when a MARAD analyst identifies an action by the borrower or its affiliates that is a breach of any applicable covenant or financial test, the analyst is required to contact the company and document the breach in the company's

administrative file. If the company requests a waiver, any approval must indicate the basis for the approval, any compensating requirements, and an explanation that adequate security exists to mitigate risk.

On June 10, 2004, the Department issued DOT Order 2301.1, "Establishment of the Department of Transportation Credit Council". The Credit Council's primary responsibilities are to provide policy direction; review the financial analysis of proposed projects and significant modifications to existing projects; and review, on a regular basis, the outstanding portfolios of all DOT credit programs. The order also called for the establishment of a Joint Credit Office responsible for conducting the financial analysis of all credit applications in DOT credit programs, including Title XI applications in concert with MARAD and the Office of Budget and Program Performance within OST. Loan guarantee applications will be presented to the Credit Council after MARAD, the Joint Credit Office, and OST Budget have completed their reviews.

The formation of this Credit Council should afford an excellent mechanism to ensure that the procedures developed by MARAD continue to be implemented and provide the intended benefits and risk reduction to the Title XI Loan Guarantee Program. The Credit Council has already reviewed an application for a new Title XI guarantee as well as a borrower's request for a significant modification to an existing Title XI loan guarantee.

March 2003 Recommendation 4: "Establish a formal process for continuously monitoring the physical condition of guaranteed assets over the term of the loan guarantee."

In response to our recommendation, MARAD established a more formal process to monitor whether or not a company is current with respect to its marine insurance, classification, Coast Guard inspection, and other required certifications related to the physical condition of vessels. On a quarterly basis, the Office of Insurance will inform the Office of Ship Financing of any companies not current on their insurance. Similarly, the Office of Ship Operations will advise the Office of Ship Financing of any companies that do not have current classifications and vessel inspections. The first of the quarterly reports for the period ended December 31, 2003, was delivered to the Office of Ship Financing in January 2004. The report noted two confirmations of insurance on Title XI companies that had not been received. According to MARAD's Office of Insurance, both companies provided MARAD with the necessary confirmations within 5 days of the issuance of the report.

MARAD's Office of Insurance maintains a file with insurance record cards for each company. Every month it reviews the file to determine which companies

insurance will expire within 30 days. A reminder letter is sent to each insurance broker or company. To ensure that companies maintain current insurance, the Division of Marine Insurance must certify that each vessel has insurance coverage prior to loan guarantee closings. Further, vessel owners must provide evidence that vessels have received all necessary certifications prior to obtaining insurance coverage.

Additionally, following private sector practices, future Title XI transactions will give MARAD the right to select an independent entity to inspect the vessel or shipyard on an annual basis, at the company's expense, if the company is not meeting its financial tests. MARAD will use this inspection right if there is concern that the owner is not adequately maintaining the vessel or shipyard. We concluded that MARAD's revised procedures were adequate for monitoring the physical condition of guaranteed assets.

March 2003 Recommendation 5: “Develop an improved process for monitoring the physical condition of foreclosed assets and for recovering the maximum amount of funds from their disposal.”

After a thorough review of its existing procedures for monitoring the physical condition of defaulted assets and their disposition, MARAD developed a formal process for documenting the actions taken with respect to seized assets. When appropriate, MARAD obtains the services of marine consultants to assist in conducting appraisals, surveys, and market analyses for the disposition of defaulted assets. MARAD will maintain copies of the consultant reports in the administrative files of the respective companies. In addition, MARAD now requires monthly written reports on custodial activities and asset condition as another means of monitoring the condition of the vessels in its possession.

At the time of our review, three vessels (Cape May Light, Cape Cod Light, and Columbia Queen) remained in MARAD's possession as a result of the foreclosure process. MARAD has appointed a technical representative to monitor each vessel and has contracted with outside parties to ensure that the vessels receive appropriate maintenance and security measures. We performed an on-site visit to two of the vessels and completed a walk through of both accompanied by the custodian. Based on our review of MARAD's files, on-site tour, discussions with the MARAD official responsible for the third vessel, and confirmation that the insurance coverage for each vessel is adequate, we concluded that MARAD is maintaining the vessels satisfactorily. MARAD is exploring its options to dispose of the vessels and expects to sell the assets in the near future.

THREE NEW AREAS REQUIRING MANAGEMENT ATTENTION

Over the course of this audit, we observed three areas that require management attention. The March 2003 report recommendations cannot be fully implemented without each of these issues being addressed. In its response (see Appendix), MARAD has promised to implement actions to address these recommendations in a timely fashion.

Reserve Fund and Financial Agreement

A key instrument in the Title XI closing documentation is the Title XI Reserve Fund and Financial Agreement. This agreement, among other things, establishes financial tests and covenants that the borrowers are required to meet. The RFFA also establishes the Title XI Reserve Fund. The Title XI Reserve Fund is a type of escrow account formed at closing that borrowers make payments into each year they do not meet certain financial tests. Consequently, the Reserve Fund provides MARAD with additional security over the life of the loan guarantee in case the borrower runs into financial difficulty. The RFFA requires companies to provide a statement of an independent certified public accountant that Reserve Fund calculations have been computed in accordance with the agreement (and showing the pertinent calculations) along with the total amount of all deposits required to be made into the fund for that fiscal year as well as an Annual No Default Certificate stating whether or not the company is in default of any condition.

During our review, we observed that MARAD was not enforcing key provisions of the RFFA. Some companies were not submitting the required certifications and/or not making the required deposits into the Reserve Fund. Out of a judgmental sample of 24 companies (see Exhibit A), fewer than half of the companies provided MARAD with the requisite Title XI Reserve Fund Net Income documentation. We observed a lack of enforcement as well with the Annual No Default Certificates in that one-third of the sample companies had failed to provide MARAD with the required certificate and less than half of the remaining two-thirds provided it on a timely basis. Additionally, according to MARAD, only two out of nine companies that were required to make Reserve Fund deposits actually had. Each of these failures to comply with the provisions of the RFFA are events of default in accordance with the terms of the Title XI agreements and give rise to various legal remedies, including the Government's right to seize the guaranteed assets.

MARAD's failure to enforce the RFFA over the term of loan guarantees, particularly ensuring that all required deposits are made into the Reserve Fund, makes it an ineffective means to protect the Government's financial interests. As a result, we are recommending that MARAD (1) perform a full accounting of each borrower's Reserve Fund and (2) require all borrowers to cure any defaults under

the requirements of their Reserve Fund and Financial Agreements including full funding of Reserve Funds.

Default Management

In June 2003, the United States Government Accountability Office (GAO) issued a report titled “Weaknesses Identified in Management of the Title XI Loan Guarantee Program.” In the report, GAO recommended that MARAD establish a clear separation of duties to provide a system of checks and balances for key lending functions, including loan guarantee application approvals, financial monitoring, and disposition of foreclosed assets. Currently, these key lending functions remain principally within the responsibility of the same MARAD employees.

The creation of the Credit Council will help in providing checks and balances to the initial approvals of loan guarantee applications as well as approvals of significant post-closing waivers and modifications. However, we remain concerned about MARAD’s ability to effectively address troubled loans.

In a recent case, a borrower requested a waiver from MARAD to defer principal payments due on its two Title XI vessels. The borrower was in default of several conditions of its RFFA, including \$1 million in arrears on required Reserve Fund deposits. Nonetheless, MARAD was prepared to grant the waiver request without having acquired essential financial information and fully understanding the borrower’s financial situation. For example, MARAD did not obtain the independent auditor’s opinion of the borrower’s most recent audited financial statements. The Credit Council, as part of its review of the requested waiver, assembled a list of due diligence questions that were forwarded to the borrower, including questions previously sent to the company by MARAD. Instead of providing the requested financial information, the borrower dropped its waiver request and made the required principal payment.

Because of the magnitude of dollars involved and the specialized set of skills required to effectively resolve complex financial situations, we are recommending that MARAD, in coordination with the 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.

Financial Monitoring Software

MARAD’s financial monitoring system is rudimentary. It relies heavily on non-electronic analyses and is cumbersome for updating and fully documenting pertinent events. This antiquated system is inadequate to effectively manage any

financial portfolio, let alone one the size of MARAD's \$3.6 billion Title XI program. During our audit, we met with officials at the Export-Import Bank of the United States (Ex-Im Bank). The Ex-Im Bank has implemented a robust, sophisticated computerized system to monitor its extensive portfolio. Developing a computerized database system is essential for MARAD to assess efficiently and timely the financial condition of the companies in its portfolio and to track trends in these companies' finances and operations.

In February 2004, the MARAD Administrator acknowledged this deficiency and agreed to task internal MARAD information systems personnel as well as retain outside consultants to develop a computer-based financial monitoring system. Because little progress has been achieved on this commitment this year, we are recommending that MARAD, 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.

RECOMMENDATIONS

We recommend that the Maritime Administrator:

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.

MANAGEMENT COMMENTS

On September 3, 2004, MARAD provided a response (see Appendix) to our August 18, 2004 draft report. The Maritime Administrator stated that MARAD is committed to implementing the three new recommendations and provided an action plan with milestones for satisfying them.

To address the first recommendation, MARAD will send a letter to each borrower by October 1, 2004, requesting certifications regarding required reserve fund

deposits from the inception of each loan. The letter will require a response from each borrower by November 1, 2004. After the responses are received, MARAD will take the necessary actions, utilizing all remedies available, to cure any defaults. MARAD will also review each company's financial statements for any other outstanding defaults that have a substantial adverse financial impact on, or increase the financial risk to MARAD, and aggressively pursue remedies to cure those defaults. MARAD will complete these reviews for all companies on the Credit Watch by December 31, 2004, and anticipates completing the reviews for the remaining Title XI borrowers by March 1, 2005. Prospectively, MARAD will require that all companies comply with each of their obligations set forth in the Title XI documentation; and has committed to take timely and appropriate action to redress any defaults.

To address the second recommendation, MARAD will work with staff representing the other credit programs within the Department of Transportation (the Credit Restructuring Working Group) to develop a statement of work for advisors outside of MARAD and the funding options for such advisors. This issue will be presented to the Department of Transportation Credit Council at its next meeting. MARAD expects the Credit Council to decide on how to proceed by mid-November 2004. A detailed action plan to 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, can be developed by mid-December 2004.

Regarding the third recommendation, MARAD has been advised by the Office of the Secretary that the Department wants to implement a monitoring system that can be used by all of the Department credit programs for purposes of efficiency and consistency. MARAD is currently working with the Department's Chief Information Officer to determine the funding necessary from each operating administration for development of a requirements definition and analysis of alternatives. MARAD anticipates that this will take 120 days and that the funding needed to complete this phase will be obligated prior to the end of the current fiscal year. MARAD has already obligated its share for this phase. MARAD also has developed a preliminary statement of work to be finalized after reaching a full agreement with all members of the Credit Restructuring Working Group. As Title XI loan guarantees make up a major portion of the Department's total credit portfolio, to determine the funding necessary to continue with the project, the Department is investigating means to allow the use of a portion of the \$25 million supplemental wartime appropriation for this purpose. The next phase of the project, expected to take 90 days, will be to develop the method for accomplishing the requirements within the selected alternative. Once this is completed, MARAD expects that the acquisition and implementation of the selected system, in phased incremental software installations, will take approximately 18 months.

OFFICE OF INSPECTOR GENERAL RESPONSE

MARAD's planned actions and milestones are responsive to the intent of our recommendations.

MARAD should place a high priority on meeting the milestones that it has established in its response. Performing a full accounting of each borrower's Reserve Fund, and requiring all borrowers to cure any defaults under the requirements of their Reserve Fund and Financial Agreements, including full funding of Reserve Funds, will significantly reduce the risk of its Title XI portfolio. We also would expect that MARAD will implement the program improvements it developed before expending significant resources on reviewing and approving new loan guarantee applications.

As mentioned earlier, during our review, we observed that MARAD's analysts were, in many cases, 6 months or more behind in performing analyses of borrowers' financial statements. While we understand that MARAD has only recently initiated the implementation of its financial monitoring system, MARAD nonetheless must focus its efforts on bringing its new system up to date as no responsible lending institution would continue to originate new loan guarantees without having a firm grasp on the financial condition of its existing portfolio.

ACTION REQUIRED

MARAD's planned actions are responsive to the intent of the recommendations. The recommendations are considered resolved subject to follow-up requirements of Department of Transportation Order 8000.1C.

We appreciate the courtesies and cooperation of MARAD representatives during this audit. If you have any questions concerning this report, please contact me at (202) 366-1992 or Mark Dayton, Assistant Inspector General for Competition and Economic Analysis, at (202) 366-9970.

EXHIBIT A. SCOPE AND METHODOLOGY

We conducted this follow-up audit as a result of the Emergency Wartime Supplemental Appropriation passed by Congress on April 16, 2003. The bill included \$25 million to fund Title XI loan guarantees, but made MARAD's access to the funds contingent on certification that the recommendations in the OIG Report Number CR-2003-031 have been implemented to the Inspector General's satisfaction. The scope of this assignment was limited to the review of MARAD's development and implementation of processes and procedures to address the five report recommendations and covered the entire Title XI loan guarantee portfolio including all new and pending applications, loan guarantee commitments, and loan guarantees.

In performing the audit, we made inquiries and reviewed relevant documents, such as company financial statements, MARAD's Financial Statement Reviews, MARAD's Credit Watch reports, Commitments to Guarantee Obligations, Title XI RFFAs, Depository Agreements, and post-closing waivers/modifications. We held meetings with and interviewed MARAD officials to obtain and discuss policies, procedures, regulations, and internal controls relevant to the Title XI Program at MARAD Headquarters and field offices. We met with MARAD's Office of Accounting to determine whether MARAD had received documentation regarding borrower Title XI debt payments and Reserve Fund deposits. We also met with officials from the Export-Import Bank to gain an understanding of how the bank's loan guarantee program could be used as a benchmark in evaluating MARAD's Title XI Loan Guarantee Program and attended a demonstration of their automated financial monitoring system.

To evaluate MARAD's implementation of its financial monitoring process, we reviewed the Financial Statement Reviews and applicable Credit Watch reports for the Title XI portfolio companies that filed December 2002 financial statements with loans outstanding as of September 2003. While our analysis covered the entire Title XI portfolio, we concentrated on the 26 loan guarantees MARAD included in its January 2004 Title XI Credit Watch analysis. We also reviewed MARAD's new procedure of obtaining the concurrence of OST for any substantive post-closing waivers or modifications of existing Title XI loan guarantees (11 companies) identified by MARAD.

We evaluated MARAD's analysis of the Title XI loan guarantee applications and the independent external review processes for both Lake Express LLC and Totem Ocean Trailer Express, Inc. This included an examination of the various reports issued as well as meetings and interviews with the financial and market experts

retained to perform the application reviews. This was followed by meetings with MARAD officials to confirm that the conclusions of the experts were considered.

To assess MARAD's enforcement of its RFFAs, we used a judgmental sampling approach and requested the (1) Title XI Reserve Fund Deposit calculation and (2) Annual No Default Certificates for 24 loan guarantees in the portfolio (approximately one-third of the companies). Our sample included (1) all 15 companies in the "high" and "medium" risk categories of the January 2004 Credit Watch, (2) 5 of the 11 companies in the "low" risk category of the January 2004 Credit Watch, and (3) 4 companies not on Credit Watch.

We met with the Office of Insurance to review the types of insurance coverage (i.e. hull insurance, third party liability, war risk insurance, etc.) and the reporting system for obtaining information from the insurance companies. We reviewed the status of insurance coverage (i.e. insurance binders) on all vessels and shipyard modernization projects in the Title XI Loan Guarantee Program for the companies on Credit Watch. In addition, we reviewed MARAD's proof of insurance for the three vessels held by MARAD through the foreclosure process. We met with the Division of Ship Maintenance regarding the United States Coast Guard inspections and Class Society certifications for the vessels under the Title XI Loan Guarantee Program.

We visited the Kvaerner Shipyard in Philadelphia, Pennsylvania to observe and gain a better understanding of the shipbuilding process. In addition, we visited two of the three vessels obtained through the foreclosure process, the Cape May Light and Cape Cod Light, at the Clay County Port Authority in Green Cove Springs, Florida in order to observe the vessels and determine whether MARAD is satisfactorily monitoring and maintaining the physical condition of its assets. We held a meeting with the regional MARAD staff responsible for ensuring the day-to-day maintenance and safeguarding of the third vessel obtained through the foreclosure process (Columbia Queen).

During the audit, we held numerous meetings with MARAD officials to discuss their progress in establishing and implementing policies and procedures to address our recommendations. In February 2004, we issued a memorandum communicating the current status of our follow-up audit to the Acting Deputy Secretary.

We conducted the audit from June 2003 through August 2004, in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

Exhibit A. Scope and Methodology

EXHIBIT B. ACTIVITIES VISITED OR CONTACTED

We visited or contacted the following organizations.

Maritime Administration Headquarters

Office of the Maritime Administrator
Office of Accounting
Associate Administrator for Shipbuilding
Office of Ship Financing
Office of Insurance and Shipping Analysis
Division of Marine Insurance
Division of Ship Maintenance
Office of the Chief Counsel
Division of Ship Financing Contracts
Division of Management and Organization

Maritime Administration Field Offices

South Atlantic Region, Norfolk, VA
Western Region, San Francisco, CA

Other Activities Visited or Contacted

Export-Import Bank of the United States, Washington, DC
Clay County Port Authority, Green Cove Springs, FL
Kvaerner Shipbuilding, Inc., Philadelphia, PA
American Marine Advisors, Inc., New York, NY

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
Stuart A. Metzger	Program Director
Mitchell Behm	Project Manager
Gary Fishbein	Senior Auditor
Bernard Fishman	Senior Auditor

APPENDIX. MANAGEMENT COMMENTS



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

Memorandum

September 3, 2004

Subject: Draft Report on Follow-Up Audit of Title XI
Loan Guarantee Program

William G. Schubert
From: Captain William G. Schubert
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 results of the follow-up audit of the Title XI loan guarantee program. Although we continue to have concerns with certain statements in the report, we are committed to implementing the three new recommendations in the draft report. Our response below has been limited to our action plan for satisfying those recommendations.

Recommendation 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.

MARAD Accounting.

MARAD will initiate a review of each current Title XI company to determine whether, over the life of their respective Title XI transaction(s), any company has failed to make the required Reserve Fund deposits. To accomplish this, we will send a letter to each current Title XI shipowner requiring that it submit a certification for each year of its loan guarantee as to whether a Reserve Fund deposit was required or not, the amount of deposit due, and the amount actually paid. These letters will be sent by October 1, 2004, with a request that the companies respond by

November 1, 2004. We will pursue the certifications and failure to make Reserve Fund deposits beginning with the companies in the highest risk category on the Credit Watch Report. After the responses are received, we will determine the appropriate course of action to cure any defaults, taking into consideration such factors as the company's current financial condition, years remaining on the guarantee, and the date on which the Reserve Fund deposit(s) should have been made. We will utilize the means discussed later in this section.

We will also review our records to determine whether any Title XI company has failed to file financial statements over the last three calendar years (2001, 2002, 2003). To the extent that additional financial statements are needed, MARAD will demand that the companies provide them by October 15. Finally, we will also review each company's financial statements for the same time period to determine whether it has committed any defaults that have any substantial adverse financial impact on, or increase the financial risk to MARAD, such as impermissible dividends or redemptions of capital.

We will aggressively demand that a company found to be in default rectify any of the above defaults by promptly complying with the requirements imposed by the Title XI documentation. MARAD will require explanations in writing and demand prompt compliance, followed by demands for face to face meetings here in Washington. A failure to redress the default will be met by MARAD taking timely and appropriate enforcement action. Prospectively, we will require that all companies observe each of their obligations under their Title XI documentation.

In response to the five recommendations contained in your March 27, 2003, audit report, MARAD worked with your staff to develop new forms and procedures to implement these recommendations. We believe that following these procedures is an important function. This effort will continue as the staff works on the review of the prior years' financial statements as outlined above, in response to your latest recommendation. The same MARAD staff will also be working with the DOT Credit Council and its staff on various aspects of program administration, including Credit Watch briefings. We anticipate completing the overall financial review for all companies by March 1, 2005. However, in order to ensure that the most problematic companies do not have egregious defaults that increase the financial risk to the Government, MARAD will perform a complete review of the companies on the Credit Watch Report by December 31, 2004.

Appendix. Management Comments

Enforcement Based on Existing Remedies. Enforcement actions, as determined on a case-by-case basis, currently can include:

1. Calling a default and demanding that the Company, among other things, cure the default and amend its Title XI documents to include new, more effective remedial rights for MARAD (see discussion below for more information).
2. MARAD hiring private auditors to review the company's records and complete an outside audit, as a company payable.
3. Reporting the existence of the defaults to applicable credit rating agencies and other members of the shipping industry by the issuance of a public statement from MARAD that the company is in default.
4. Assuming the guaranteed obligations and transferring the vessels and the obligations to another ship owner and commencing available creditor remedies against the company.
5. Seizing the vessels and laying them up or operating them in the name of MARAD to collect the revenue stream.
6. Debarring the Company from other Federal programs, grants, contracts, loans and loan guarantees.
7. Sending a notice to the Indenture Trustee instructing it to call upon the guaranteed obligations and the commencement of all available creditor remedies against the company.
8. Referral for prosecution pursuant to 18 U.S.C. 1001 in the event that the Company has made willful written misrepresentations to MARAD.

MARAD will execute these remedies, as appropriate, to protect the Government's financial and maritime interests, against any existing Title XI company that fails or refuses to comply promptly and in good faith with MARAD's demand that the company cure its defaults.

Enforcement Based on New Remedies.

Effective immediately, each new Title XI guarantee that MARAD issues will add new remedies to the existing Title XI documentation to ensure that, upon a company's default pursuant to the Title XI documents, the Government can immediately employ a full range of creditor remedies

available under the law. These remedies can be put in place in the Title XI documentation without the creation of new statutory or regulatory authority.

As noted above, MARAD will demand that existing defaulters (and all Title XI companies that seek to renegotiate the terms of their current transaction) agree to include these new remedies as part of their existing Title XI documentation.

These new remedies will:

1. Clearly spell out that MARAD may exercise the full range of creditor remedies immediately upon the occurrence of a Default whether or not MARAD has paid under the guarantee or assumed the debt. These remedies will include, for instance, the right to bring suit in law and in equity to obtain compliance even before MARAD has paid out one dollar under its guarantee.
2. Ensure that MARAD is authorized to take immediate steps to protect its interests fully if the Company fails to make its Reserve Fund deposits or any other payment or to take any other action required by the Security Agreement for the benefit of MARAD.
3. Require shareholders of closely held Title XI companies and board members and other key officials of all Title XI companies to be financially responsible, as appropriate, to MARAD if they cause the Title XI Company to violate its Title XI duties.

Recommendation 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.

MARAD will work with the Credit Restructuring Working Group (CRWG) to develop a statement of work for advisors outside of MARAD that could be used for any of the Department's credit programs, including Title XI, and to evaluate the funding options for such advisors. This issue will be presented to the Department of Transportation Credit Council at its next meeting scheduled to occur in September 2004. MARAD will draft a statement of work in conjunction staff representing the other credit programs

within the Department. The CRWG will then present the results of its analysis to the Department of Transportation Credit Council for its decision as to how to proceed. We would expect that this decision could be made by mid-November and that a detailed action plan for implementation of the decision could be developed by mid-December.

Recommendation 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.

The Office of the Secretary has advised that the Department wants to implement a monitoring system that can be used by all the Department credit programs for purposes of efficiency and consistency. The CRWG has already met with MARAD's Chief Information Officer (CIO) and a representative of the Department's CIO to discuss this matter and to determine the funding necessary from each mode for development of a requirements definition and analysis of alternatives. This phase is anticipated to take 120 days. The Department anticipates that the funding needed to complete this phase will be obligated prior to the end of the current fiscal year and MARAD has already obligated its share. The MARAD CIO has already developed a preliminary statement of work for the first phase of the project and will finalize the statement of work after reaching full agreement with all members of the CRWG.

After completion of the first phase described above, the CRWG will determine the funding necessary to continue with the project. If necessary to make funding decisions, the CRWG will ask for guidance from the Department Credit Council. In view of the fact that the number of outstanding Title XI guarantees make up a major portion of the Department's total credit portfolio and recognizing that a portion of the supplemental appropriation will be required to fund a major portion of the project to completion, the Department has begun to investigate means for obtaining appropriations language to allow the use of a portion of the supplemental appropriation for this purpose.

After securing the necessary funding, the next phase of the project will be the solutions definition, expected to take 90 days. In this phase, the method

for accomplishing the requirements within the selected alternative will be developed.

After completion of the first two phases, 18 months will be allowed for the acquisition and implementation of the selected system. The approach will be phased with incremental installations of software.