United States General Accounting Office 136242

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m.
EST
Wednesday
July 6, 1988

FOREIGN AID

Observations on the Overseas Private Investment Corporation

Statement of
Nancy R. Kingsbury, Associate Director
National Security and International
Affairs Division
Before the
Committee on Foreign Relations

136242

042611/136242

GAO/T-NSIAD-88-37

OBSERVATIONS ON THE OVERSEAS PRIVATE INVESTMENT CORPORATION

SUMMARY OF STATEMENT BY
NANCY R. KINGSBURY, ASSOCIATE DIRECTOR
NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

In May 1987, GAO reported on OPIC's methodology and procedures for screening and monitoring projects, and we analyzed the direct trade and employment effects of selected OPIC projects which were ongoing in 1985. This analysis was conducted in response to a requirement in the Overseas Private Investment Corporation Amendments Act of 1985 (Public Law 99-204). We identified a number of weaknesses in OPIC's screening and monitoring procedures, and recommended several improvements in those procedures, including more direct estimates and reporting of positive and negative economic effects of projects, separate from any possible alternatives, and more comprehensive monitoring of ongoing projects to ensure that continuing economic effects are accurately assessed and provision is made to reconsider continuing support to a project if projected impacts on U.S. trade and employment change inappropriately from anticipated projections. In our analysis of the direct employment effects of selected OPIC projects, we found that some OPIC-assisted projects had direct negative effects on U.S. trade, and potentially negative effects on U.S. employment. Because we found that OPIC reported only on the net impact of its projects, including both positive and negative impacts, as well as the offsetting effects of alternative assumptions about economic activity that might occur in the absence of the project, we recommended that OPIC report separately to the Congress on these impacts and assumptions. OPIC disagreed with our assessment of their methodologies and procedures, and with the methodology we used in our analysis, and declined to adopt most of our recommendations.

OPIC also conducted a study of trade and employment effects of its projects, as mandated by the OPIC Amendments Act. The study's principal finding was that OPIC-insured projects have a significant positive impact on domestic U.S. employment. This finding differed from GAO's finding that the projects we examined had a net potentially negative effect on employment in the United States. We believe that most of the differences in results leading to these opposing conclusions are accounted for by differences in analytic methodologies, most importantly the fact that OPIC calculated net employment effects, taking into account assumptions about foreign economic activity which might have occurred in the absence of the OPIC-assisted project. GAO did not include such alternative assumptions, because we believe there is no reasonable methodology for considering such assumptions after a project has been implemented. However, we believe that the fact that this basic difference in approach accounted for essentially opposing conclusions in the OPIC and GAO studies further reinforces our recommendation that OPIC report separately on the direct impacts, and the nature and magnitude of alternative assumptions, so that policymakers can independently assesses the validity of OPIC's estimates of its activities on U.S. trade and employment.

In May 1988, we reported on our review of the adequacy of OPIC procedures for approving and monitoring direct loans, and the completeness of its loan documentation. We examined five loans, and found that OPIC's review of the loan applications prior to approval was adequate, except for its review of credit risk on two loans. We also identified one weakness in project monitoring after approval. Our review of OPIC's loan management process tended to confirm the findings of an independent review of those procedures contracted for by OPIC after the loans we examined had been approved. OPIC management agreed with and is implementing the independent study's recommendations, and we believe that those recommendations, when completed, should correct specific weaknesses in approval and monitoring procedures identified in our review of the individual loans. However, our report contains specific recommendations for modifications to the actions OPIC is taking which we believe would further improve management of the loan programs. OPIC agreed with the thrust of these recommendations, which involve strengthening credit analysis procedures and the independence of post-disbursement oversight.

INTRODUCTION

Mr. Chairman and Members of the Committee:

I am pleased to appear before the Committee this morning to discuss the results of GAO's work related to the Overseas Private Investment Corporation (OPIC). During the past 2 years, we have completed two assignments at OPIC. In May 1987, we issued a report on the direct impact of selected OPIC projects on employment in the United States and on the methodologies used by OPIC for determining, evaluating, and quantifying the U.S. employment effects of OPIC projects. This work was required by the Overseas Private Investment Corporation Amendments Act of 1985 (Public Law 99-204). More recently, in May 1988, in response to a request from the Chairmen of the Senate Foreign Relations Subcommittees on International Economic Policy, Trade, Oceans and Environment, and on Terrorism,, Narcotics, and International Operations, we reported on the adequacy of OPIC's loan approval and monitoring procedures, and the completeness of its loan documentation.

BACKGROUND

OPIC is a U.S. government agency established in 1971 to encourage and facilitate private U.S. investment in developing countries by providing political risk insurance and direct loans and loan guaranties. OPIC seeks to complement the development assistance objectives of the United States while supporting U.S. economic interests. Amendments to the Foreign Assistance Act of 1961 direct OPIC to decline assistance to proposed overseas investments if OPIC determines that these investments are likely to have significantly adverse impacts on U.S. employment.

Since beginning operations in 1971, OPIC has issued over $30 billion in political risk insurance and more than $1 billion in direct loan and guaranty commitments. In fiscal year 1987, OPIC issued $1.8 billion in insurance coverage for 144 investment projects and about $226 million in loans and guaranties for 31 projects. The 1987 OPIC-assisted investment projects were located in 41 countries.

IMPACT OF OPIC ACTIVITIES ON U.S. EMPLOYMENT

In February 1986, we undertook a study to examine the impact of OPIC's programs on employment in the United States. Specifically, our objectives were to examine (1) the effect on employment in the United States of selected OPIC projects; (2) OPIC's methodology for determining, evaluating and quantifying the effects of its proposed projects on U.S. employment (project screening); and (3) OPIC's methodology for determining whether on-going projects are benefitting U.S. employment as anticipated in initial applications (project monitoring). Our analysis of selected projects found that overall the projects had direct negative effects on U.S. trade and potentially negative effects on U.S. employment, as discussed further below.

We found weaknesses in OPIC's procedures for screening projects which limited OPIC's ability to screen out projects that could have an adverse impact on the United States. For example, our evaluation showed that OPIC had not developed formal guidance and criteria for evaluating projects, and inadequate documentation made it impossible to determine if the expected economic effects of the projects on U.S. trade and employment were being systematically and accurately analyzed. We also found problems with OPIC's project monitoring procedures, including insufficient analysis and use of monitoring data, a lack of on-site verification of monitoring data, and lack of criteria to determine the appropriateness of and circumstances for discontinuing assistance to future projects found (through monitoring) to have adverse effects on the U.S. economy.

We made a number of recommendations for improvements in OPIC's screening and monitoring procedures. Specifically, we recommended that OPIC develop formal policies and a comprehensive system for screening and monitoring the economic effects on the United States of OPIC-assisted projects, including methodology that more clearly and accurately (1) estimated the direct economic effects of projects being considered for assistance (separate from any possible alternatives), (2) calculated the actual effects of ongoing projects on the economy of the United States, and (3) included appropriate procedures and treatment for identifying project characteristics and measuring impacts, such as for start-up and operating procurements and parameters for identifying "significant" adverse impact.

OPIC disagreed with our conclusions and recommendations, presented extensive arguments in rebuttal to our findings and conclusions, and stated that no changes were needed in its. We considered OPIC's comments in detail in our final report and concluded that our conclusions and recommendations were valid.

In reviewing OPIC's methodology for determining the impact of its projects on U.S. employment, we observed that the results of its analyses may be misleading because the methodology frequently permits estimated negative effects of a project to be cancelled or offset by the positive effects of alternative trade activities which it assumes would occur if the OPIC project is not, or had not been, funded.

It is prudent for OPIC, in its initial analyses of proposed overseas projects, to make certain assumptions concerning the possible effects of a project, and of alternatives to the project. For example, OPIC may assume that if it does not assist a proposed U.S. investor project, the goods of a hypothetical foreign competitor would replace U.S. domestic production and displace U.S. sales to other countries. This assumption provides a basis to estimate positive effects which may offset adverse direct effects of the project on U.S. trade and employment. While it may be appropriate to consider such alternative assumptions when the initial project decision is made, we believe that the use of results from such alternative assumptions in OPIC's monitoring and reports on the continuing effects of the projects in operation, without clear reporting of the separate impact of these assumptions, may be misleading.

For example, in one case OPIC calculated and reported that a project would generate 104 employee-years of employment in the United States annually. This observation, however, obscured the underlying analysis which estimated first that the project would result in a direct annual employment loss of 94 employee years. OPIC then assumed that, in the absence of the project, an alternative foreign competitor would produce imports to the United States which would result in a greater loss of 198 employee-years of employment. OPIC's analysis assumed that the OPIC-assisted project would completely prevent or displace this job loss. Thus, by subtracting from the direct negative impact of the project (-94 employee-years) this assumed alternative impact (-198 employee years), OPIC concluded that the project would have a net positive impact of 104 employee years, that is (-94) - (-198) equals +104. An observer is thus left with the impression that the project is likely to have a positive employment impact, when it is expected to have a negative impact. While this analysis may have provided a reasonable basis to make the initial funding decision, the continued use of assumptions about alternative trade flows and employment impacts to offset direct project effects in reporting the annual impact of ongoing projects is not, in our view, appropriate.

Accordingly, we recommended that, in OPIC's annual reports to the Congress on newly approved or ongoing projects, the agency should (1) report aggregate positive trade and employment effects on the United States separately from aggregate results of projects with expected negative impacts, and (2) report separately the economic effects on the United States of any alternatives and assumptions considered in OPIC's analyses.

OPIC disagreed with this recommendation, stating that it believed that its reports presented fair assessments of project benefits. Although OPIC now provides some additional detail and information in its annual Development Report such as the number of projects with positive and neutral employment impacts, the data continue to reflect the net impact of the direct effect on U.S. employment of projects' trade flows with the United States, offset by the estimated effect of the alternative assumptions against which these direct effects are measured. For example, the 1987 Development Report estimates that, during the first 5 years of operation, net imports to the U.S. resulting from OPIC projects will be $104 million (a small negative trade effect). Our analysis of additional information in the Development Report suggests that project shipments to the United States are estimated to be a much larger $615 million. However, this larger negative estimate is apparently offset by an assumption that, in the absence of these OPIC approved projects, $511 million of similar goods would be shipped to the United States by competing foreign firms. The reported estimate for net imports is the difference of these two figures. We have not analyzed the individual projects and thus cannot comment on the reasonableness of the alternative assumptions. Policymakers should then be in a better position to be clearly informed that a baseline is being used, its magnitude, and the underlying assumptions used in its construction. Only then can policymakers independently consider the reasonableness of OPIC's reported trade and employment effects.

OPIC'S ANALYSIS OF EMPLOYMENT EFFECTS

The OPIC Amendments Act of 1985 also required OPIC to conduct a study of effects of its insured projects on U.S. employment. The OPIC report was based on a study conducted by Arthur Young and Company, and OPIC. The study's principal finding was that "OPIC insured projects have a significant positive impact on domestic U.S. employment." This finding differed from GAO's finding that the 1985 operations of projects that OPIC had approved in 1981 and

1982 had a net potentially negative direct effect on employment in the United States.

There are similarities between the GAO and OPIC studies in the data used for analysis and the data collection methods. Both studies used a questionnaire survey of policyholders to collect financial data about the projects, and both collected similar data including project procurement from the United States, direct and indirect sales to the United States, and sales to the host and third world countries. However, the underlying approach used to calculate project impact in the United States differed between the GAO and OPIC studies in at least two respects.

First, GAO separated the project impact into the positive effect of initial (one-time) procurement needed to start the project and the project's annual operating impact which might continue for many years. The OPIC study sometimes combined project initial procurement with the project's operating impact. Since initial procurement tends to involve substantial exports of such items as construction supplies from the United States, usually a large positive effect, considering one-time start-up activities separately from operating activities is necessary to provide an accurate picture of continuing project effects.

Second, GAO calculated the direct trade and employment effects in 1985 of projects that had been approved 3 or 4 years earlier, and did not consider what might have happened had the project not been approved, because we do not believe there is a reasonable methodology for assuming the effects of some alternative scenario after a project has been implemented. We believe OPIC calculated a project's employment impact by first using the direct trade effects similar to GAO's calculation, and then used a baseline scenario that estimated an alternative assumption of what might have happened if the OPIC insured project had not been implemented.

Other differences exist between the two studies. For example, different procedures were used for selecting the projects examined. In addition, it is not clear whether OPIC's project analyses were corrected for differences between data presented in the initial project questionnaire and data actually obtained from review of project site records. We found that data in initial applications and corporate headquarters responses to our questionnaires were sometimes significantly different from actual records available from examination of project operations. However, these differences do not appear to be significant in the outcomes of the two studies. Whether the study included the effects of alternative assumptions accounts for most of the differences in findings between the two studies.

We do not believe it is necessary to resolve the disagreement about whether alternative assumptions should be used in reporting the impact of OPIC projects. However, the fact that GAO and OPIC used similar data, but arrived at fundamentally different conclusions principally because the OPIC study offset direct trade and employment effects with estimated effects of assumed alternative scenarios, reinforces our recommendation that assumptions and the magnitude of the assumptions used in calculating employment impact should be presented separately in OPIC reports and analyses. Without clear disclosure of these analytical assumptions, policymakers do not have comprehensive oversight of OPIC's program to stimulate private investment in developing countries.

REVIEW OF OPIC LOAN PROGRAM

Recently, we were asked to review the adequacy of OPIC procedures for approving and monitoring direct loans, and the completeness of its loan documentation. In response to that request, we reviewed five individual loans, and OPIC's efforts to improve loan management.

OPIC makes loans to U.S. investors for projects in developing countries to promote social and economic growth. As of March 31, 1988, OPIC had 75 active loans with an outstanding balance of approximately $48.0 million. Thirty of the 75 OPIC loans, or 40 percent, were in delinquent status, that is, in arrears 90 days or more in payment of principal, interest, or both. The delinquent principal was approximately $5.1 million, or

10.6 percent of the $48.0 million outstanding balance, and delinquent interest was $2.3 million.

We reviewed OPIC procedures for approving and monitoring five active loans totalling $8.0 million. The loans, ranging from $150,000 to $6 million, were made to finance projects in five different countries. Two loans were approved in fiscal year 1987, two in fiscal year 1986, and one in fiscal year 1985. We considered several factors in judgementally selecting these loans, including the year approved, project location, and current repayment status. We specifically selected three loans that were in default to determine whether weaknesses in OPIC's loan review process and loan management were contributing factors to the eventual default of each loan.

We found that, for the five loans, OPIC's review of loan applications prior to approval was adequate, except for its review of credit risk on two loans. We identified one weakness in project monitoring after loan approval, specifically that OPIC did not obtain key financial information on the borrower's operating forecast for 1988 as required by the loan agreement. Consequently, OPIC could not monitor project progress by comparing estimated financial operations with actual experience and a potential "early warning system" for identifying possible loan problems was lost. The OPIC files for the five loans were generally well organized and complete. Key documents, such as loan papers recommending loan approval, loan agreements with borrowers, and promissory notes issued by borrowers, were on file.

For two of the loans in default, OPIC did not adequately consider the borrower's financial performance in making loan approval decisions. Specifically, OPIC did not obtain current information on these borrowers' financial condition before loan approval. This information, when obtained, showed that each borrower was experiencing operating losses. If this information had been obtained earlier, it could have been considered by agency management prior to loan approval. Also, for one of these loans, OPIC did not determine whether the borrower had an adequate accounting system.

All of the loans we examined were approved prior to September 1987 when, in response to this Committee's concerns about a particular defaulted OPIC loan, OPIC contracted with Peat Marwick Main and Company, a consulting firm, to review its loan management process. In its January 1988 report to OPIC, Peat Marwick compared OPIC's credit process to a similar process in a large, well-run, commercial bank and commented on the differences.

OPIC emphasizes lending funds to achieve development goals, whereas a commercial bank emphasizes maximum returns and maintaining minimum credit risk. Peat Marwick stated that a number of loans funded by OPIC would be considered credit risks in the commercial banking environment. It reviewed OPIC's credit process in light of the sometimes conflicting goals of enhancing economic development and controlling credit risk.

While recognizing the differences in goals between OPIC and commercial banks, the report identified several areas where OPIC could improve its credit process, including

-- lack of policy guidance on what is an acceptable credit risk, given OPIC's mandate to finance projects in developing countries;

-- insufficient emphasis on analysis of credit risk in reviewing proposed loans;

-- inadequate monitoring of approved loans; and

-- absence of independent oversight on the loan approval and monitoring process.

The weaknesses we identified in the loan management process tended to confirm the findings of the Peat Marwick study. While OPIC reviewed credit risk as well as development, foreign policy, and domestic benefits for proposed projects, it did not have policy guidance in assessing whether these benefits offset the project's credit risk. Also, OPIC did not perform an independent review of the loan approval and monitoring process.

The Peat Marwick report made several recommendations to improve OPIC's loan management process, such as to

-- formulate a policy which provides direction on acceptable credit risk, given OPIC's mandate to finance projects in less developed countries,

-- establish a separate group within the Finance Department to provide credit analysis support to project teams reviewing loan applications and monitoring projects, and

-- establish an independent credit review group to participate in the loan approval process as well as to perform post-disbursement oversight on the agency's loan portfolio.

OPIC management agreed with and is in the process of implementing most of Peat Marwick's recommendations, with a target date of September 30, 1988, for completing action on all recommendations. We believe that the actions initiated by OPIC to implement Peat Marwick's recommendations, when completed, should improve the agency's process for managing the loan program and correct specific weaknesses in approval and monitoring procedures identified in our review of individual loans. However, our report contains specific