



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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MAY 16 1977

The Honorable Jack Brooks
Chairman, Committee on Government
Operations
House of Representatives



Dear Mr. Chairman:

In response to your August 2, 1976, request and subsequent agreements with your office, we reviewed certain aspects of the Maritime Administration's (Agency's) administration of the title XI Federal Ship Financing Program. This report supplements the information provided in the September 17, 1976, and January 25, 1977, briefings to your office.

At the first briefing we addressed the Agency's guaranteed financing of eight liquified natural gas carriers being built by General Dynamics for use by various corporations related to Burmah Oil, a British corporation. We informed your office concerning relationships among the involved parties and the chronological sequence of events pertinent to the guarantee application and approval process. We also advised your office that based on the Agency information we reviewed, the legal requirements for title XI financing for the eight vessels appeared to have been met.

At the second briefing we addressed the following specific issues of concern by your office regarding the title XI program:

- The role of leverage leasing.
- Foreign involvement.
- The cost to the Government.
- Benefits to ship owners.

We also presented the results of our preliminary work concerning the effectiveness and administration of the title XI program.

We informed your office that the Agency has been successful in increasing the amount of title XI coverage while keeping the number of defaults at a minimum. Its overall administration of the program was generally satisfactory, although we identified certain management weaknesses and other aspects needing attention. Your office requested that we further

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examine these matters and provide a written report on our findings. These matters are summarized below and presented in more detail in the following sections.

- Program income is being reduced because of late guarantee fee collection (\$47,000 for the 12 month period ended January 31, 1977).
- Required annual recertifications that vessels are owned and operated by U.S. citizens are not being submitted in all cases.
- Because demand for guarantees exceeds the authorized ceiling, the Agency limits its refinancing guarantees to only those applications involving a reasonable amount of new vessel construction or where the applicants' financial viability depends directly on the refinancing.
- Delays in processing applications cause applicants to incur excess interest costs and preclude title XI's full contribution to the Merchant Marine Act.
- Title XI documentation requirements could be improved and are a disincentive to applicants.

Our review was limited to an examination of certain management weaknesses and other aspects of the program needing attention which we identified in our preliminary survey work and presented in our January 25, 1977, briefing. Our work was performed at Agency headquarters, Washington, D.C. We examined policies, procedures, and practices; reviewed agency records; and interviewed agency officials. In addition, we contacted several attorneys representing title XI applicants.

BACKGROUND

The Federal Ship Financing Program was established pursuant to title XI of the Merchant Marine Act of 1936 (46 U.S.C. 1271-1281) as amended. This program provides for a full Government faith and credit guarantee of debt obligations issued by citizen shipowners for the purpose of financing or refinancing U.S. flag vessels.

The primary purpose of the program is to promote the growth and modernization of the U.S. merchant marine. It enables eligible vessel owners to obtain long-term financing at interest rates comparable to those available to financially strong, AAA-rated corporations. Title XI applicants pay an

investigation fee for the initial guarantee approval and an annual guarantee fee payable in advance. The fees are deposited into an Agency-administered revolving fund and are used to pay the administrative costs of the program and cover any losses due to defaults.

As of December 31, 1976, the program had more than 400 contracts guaranteeing over 4,500 vessels. Outstanding commitments and guarantees totaled approximately \$5.3 billion. Title XI has been self-supporting because fee and interest income to the revolving fund have far exceeded program administration costs and losses from defaults. To date there have been 10 defaults under the program totaling a net loss of \$14.6 million. As of December 31, 1976, the revolving fund had a balance of about \$115 million.

FEE COLLECTION DELAYS REDUCE PROGRAM INCOME

Participants in title XI pay an annual fee into the Agency's revolving fund in return for the Government's financing guarantee. If the fee is not paid when due and remains unpaid for 5 days, the Agency can either informally remind the company of its nonpayment, or the Secretary of Commerce can issue a formal notice of default. The latter obliges the Secretary to repay bondholders and take possession of the vessel. In the program's 39-year history, this has never happened; moreover, because of the many cases of literal default (guarantee fee payments 5 days overdue), the Agency does not consider this a practical alternative. We believe the present policy, which consists of both waiving security defaults and not penalizing companies for late payments, is unacceptable.

For the period February 1976 through January 1977, we reviewed the timeliness of all guarantee fee payments. We found that late payments were made for 199, or 46 percent, of the 429 title XI contracts in force. The length of the delays ranged from 1 to 99 days. One hundred six, or 53 percent, of all delayed payments were more than 5 days late and could have been declared security defaults; 47 payments were a month or more late.

Using a 6.77-percent interest rate (weighted average annual interest rate on title XI revolving fund investments as of July 31, 1976), we calculated interest income of over \$47,000 lost to the revolving fund because of late payments during the 12-month period ended January 1977.

In October 1976, the Agency's Division of Accounts set up a system for tracking delinquent payments. Title XI administrators are now alerted on the due date if the guarantee fee is not received; they then call the delinquent companies. If the payment is not received within a week, it will appear on a weekly list of delinquent payments and weekly telephone reminders will be made to the delinquent company until the payment is received. This new system is only a partial solution to the problem because it merely reduces the length of the delay period, not the number of such delays. For example, of the 115 guarantee fees paid during November 1976 through January 1977, 55 percent were late compared to 46 percent for the year ending January 1977.

As a possible solution to delinquent guarantee fee payments, the Agency is considering penalizing late companies by increasing the guarantee fee rate to the maximum allowed. (The Secretary is authorized to charge an annual fee recomputed annually ranging from 1/2 to 1 percent of the outstanding mortgage balance; the average is currently about 6/10 of 1 percent.) A penalty of some form is needed to deter companies from making late payments.

RECOMMENDATION

We recommend that the Secretary of Commerce, within the limits of the act, have the Agency assess a penalty on companies when payments are overdue.

CITIZENSHIP FOLLOW-UP SYSTEM NEEDED

To be eligible for title XI financing guarantees, vessels must be owned and operated by U.S. citizens. This requirement enables the Federal Government to maintain control over the vessel in case of a national emergency or if needed for national defense purposes. To satisfy this requirement the owners/operators are required to establish their U.S. citizenship, which the Agency verifies, at the time of the guarantee and annually thereafter throughout the life of the mortgage. Failure to satisfy the citizenship requirement is cause for a title XI guarantee default.

Discussions with officials of the Agency's Office of General Counsel, and review of loan guarantee files, indicated that the Agency's initial verifications are satisfactory. However, our review of the loan guarantee files of 22 of the 185 companies required as of September 30, 1976, to submit annual recertifications showed that 11, or 50 percent, did not do so for 1 or more years. Although we did not find evidence

of foreign ownership in these 11 companies, without a follow-up system the potential for foreign ownership exists.

We discussed the lack of recertifications with officials of the Agency's General Counsel and Division of Ship Financing Guarantees. They told us that although they are aware some companies are not submitting the recertifications, they do not know the extent of the problem because they do not have a systematic method for monitoring and reviewing the recertification requirement. These officials attribute not having such a system to lack of resources, including both personnel and automatic data processing equipment. The Assistant Administrator for Maritime Aids advised us that since the Agency's initial efforts in assuring citizenship requirements are substantial, he does not believe a follow-up system is justified, especially considering the resources required.

Without the recertification process, the Agency cannot assure compliance with title XI which requires that owners and operators continue to be U.S. citizens throughout the life of the mortgage guarantee. For this reason we do not believe the Agency is authorized to forgo the recertification process unless they develop some alternate means of assuring compliance with the citizenship requirement. Regarding the resources needed to establish an effective follow-up system, we could find no evidence that any study had been made to determine what procedures to follow and the types and quantity of resources that would be needed.

RECOMMENDATION

In view of the title XI citizenship requirements, we recommend that the Secretary of Commerce direct the Agency to take appropriate actions to comply with the citizenship verification requirement of title XI. We think this is important in view of the growth of the title XI program, the increasing value of individual vessels, and the more frequent use of complex financial arrangements, such as leverage leasing, which involves more parties subject to citizenship certification.

CONGRESS SHOULD BE INFORMED OF
REFINANCING RESTRICTIONS

The Merchant Marine Act of 1936 provides for Agency guarantees of refinancing for existing vessels. Section 1104(a)(4) of the act states, in part,

"* * * the Secretary of Commerce * * * may guarantee * * * payment of the principal of and interest on an obligation which aids in * * * refinancing existing obligations * * *."

Our review of the Agency refinancing policy showed that it, despite its refinancing authority under section 1104(a)(4), limits its approval of refinancing guarantees to only those applications involving a reasonable amount of new vessel construction or where the applicant's financial viability depends directly on the refinancing.

According to the Director, Office of Subsidy Administration, this policy is being followed because the Agency's \$7 billion authorized guarantee ceiling is less than the total demand for title XI guarantees. He said that by guaranteeing refinancing having a reasonable amount of new construction, the Agency can promote work for U.S. shipyards and enhance the capability of the U.S. merchant fleet, both major objectives of the act. He also added that by adopting this policy the Agency can maximize its promotion of the overall goals of the act within its statutory guarantee ceiling.

During our review we confirmed that the Agency's demand for guarantees has exceeded its authorized \$7 billion ceiling. For instance, as of December 31, 1976, guarantees committed and applications on file at the Agency totaled approximately \$7.1 billion. In addition, we confirmed that applications (records are not readily available to show how many) for refinancing have been denied because they did not include what the Agency considers to be a reasonable amount of new construction. According to Agency officials, in addition to the refinancing guarantees denied, their policy could have also discouraged other ship owners from submitting applications for refinancing guarantees. Therefore, the exact effect of the Agency's policy on the U.S. maritime industry is not known.

It appears that the Agency's policy of limiting its approval of refinancing guarantees to only those involving a reasonable amount of new construction or where the applicant's

financial viability depends directly on the refinancing, does not permit it to exercise the full intent of its authority under section 1104(a)(4) of the act. However, if all qualified refinancing applications are accepted and added to the active application backlog, the statutory ceiling for guarantees would be approached more rapidly, thus precluding the acceptance of applications for financing new construction. Faced with this dilemma, the Agency, rather than requesting an increase in its authorized ceiling, chose to adopt its limited refinancing policy.

RECOMMENDATION

We recommend that the Secretary of Commerce inform the Congress that the authorized \$7 billion ceiling is inadequate to cover all guarantee demands and therefore, the Agency has to place restrictions on applications for refinancing guarantees. Further, the Secretary should recommend to the Congress a legislative ceiling for title XI guarantees compatible with both industry and Federal maritime policy needs.

DELAYS IN PROCESSING APPLICATIONS

According to title XI administrators, the processing time of a ship financing guarantee should ideally be about 5 to 6 months. To compare this standard with the Agency's actual time to complete investigation and documentation of its application process, we reviewed the status of the 48 pending title XI applications as of September 30, 1976. (Data was not readily available regarding processing time for completed applications.) We found that 24, or 50 percent, of the applications in process had already exceeded the standard for completion set by Agency officials. The time in process for these 24 applications ranged from 6 to over 18 months and averaged 10.4 months.

Processing delays mean increased costs to title XI applicants

In a January 1977 study, the Agency estimated the processing time from application to issuance of a guarantee to exceed 1 year. Although the study did not identify specific causes of processing delays, it concluded that automating the program would expedite the process. The study also pointed out that, for the year reviewed (October 1975 to September 1976), loan guarantee applicants in total could have saved almost \$10 million in interest costs if the average processing time had been reduced by 3 months. According to the study:

- Most shipowners applying for Government guarantees require financing while their vessels are being constructed.
- Most shipowners receive short-term, relatively high interest rate loans to cover the period before application approval.
- After closing the title XI guarantee transaction, shipowners eliminate their short-term loans and sell Government guaranteed mortgage bonds, thereby reducing their interest costs.

The study concludes that the shorter the processing time at the Agency, the lower the construction period interest expense to shipowners.

Reasons for delays

We discussed the delays in processing guarantee applications with officials of the Offices of Subsidy Administration and Ship Construction. They attributed the problem to

- incomplete materials submitted by the applicants necessitating follow-up at many stages during the investigation phase of processing and
- the Agency's lack of resources, including both personnel and automatic data processing equipment.

The officials elaborated on these matters as follows:

Incomplete materials

Agency officials stated that when applicants submit insufficient or inadequate materials as part of their guarantee applications, the Agency must request additional data--a time-consuming communication process responsible for much of the program's processing delays. Of the 48 active pending applications on hand as of September 30, 1976, 33 had not completed the investigative phase of processing. We reviewed the status of these 33 and found that 15 did not include all the necessary information. Agency officials stated that the types of information needed to complete these applications were evidence of (1) firm charters, (2) completed financing arrangements, and (3) firm construction contracts.

Inadequate resources -

The Chief, Division of Ship Financing Guarantees, stated that turnover among his application examiners, combined with the inflexible personnel ceiling, contributed to delays in application processing. We were also told by officials of the Division of Trade Studies and Statistics and the Office of Ship Construction that, because of personnel shortages in their areas, certain title XI work had to be contracted out to private firms. The work involved two of the most important technical analyses made by the Agency--evaluations of the proposed vessel's economic soundness and its construction. In the past, these types of analyses were performed in-house by the Agency.

Program officials told us that because of the increase in the size of title XI, with its considerable administrative workload, manual recordkeeping was inefficient and was having an adverse impact on the program's ability to process new applications in a timely manner. They said much time was being spent by clerical, as well as professional, personnel in maintaining and using the manual systems. This time could be more productively devoted to reviewing and processing applications and, according to program officials, delays could be avoided if an automated information system was implemented.

Processing problems have been a continuing problem

The factors contributing to delays in title XI application processing--incomplete materials submitted by applicants and a lack of resources--were equally present 5 years ago. In August 1972 a committee, headed by a special assistant to the Assistant Secretary for Maritime Affairs, was formed to study these problems. It found that a lack of staffpower was the greatest single impediment. Other factors identified by the committee included information processing and the need for providing better information to title XI applicants.

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The Merchant Marine Act of 1936, as amended, has been described as

" * * * a comprehensive Congressional inactment designed to foster the development and encourage the maintenance of the United States Merchant Marine."

Title XI contributes to the act's goals by providing an incentive to shipowners to register their vessels in the United States. To the extent delays in processing applications impede or discourage U.S. shipowners from building vessels, or cause these shipowners to incur excess interest charges, the program is not making its fullest contribution to the objectives of the act. We believe the matters discussed in this section of our report have had a negative effect on the Agency's ability to promote the goals of the act in an efficient and effective manner.

RECOMMENDATION

We recommend that the Secretary of Commerce direct the Agency to shorten its inordinately long application process. To accomplish this will require, at a minimum, an examination of (1) staffing requirements, (2) adequacy of written instructions to applicants, and (3) applicability and need for automatic data processing equipment. Shortening the process will better enable the title XI program to meet the intent of the act.

OBSERVATION ON THE TITLE XI DOCUMENTATION PHASE

Applications for financing guarantees must go through two processing phases before they can be approved. The first is the investigation phase in which the applicant's proposal is reviewed for economic soundness and conformity to vessel cost, specification, and operating standards. With an affirmative finding from this phase, the Secretary sends the applicant a letter of commitment allowing him to issue securities to finance his vessel. At this point the second, or documentation, phase begins and with it, according to the Assistant Secretary for Maritime Affairs, the generation of a great deal of burdensome and costly paperwork.

A set of guarantee documents includes many separate agreements, opinions, consents, and other legal instruments. According to the Chief, Ship Financing Guarantee Division, the following is a typical set of title XI commitment documents.

<u>Document number</u>	<u>Document</u>	<u>No. of pages</u>
1	Commitment to Guarantee Obligations	20
2	Schedule X-Schedule of Definitions	10
3A	Appendix I-Underwriting Agreement-Serial Bonds	13
3B	-Underwriting Agreement-Sinking Fund Bonds	17
4	Appendix II-Trust Indenture	9
5	Schedule A-Schedule of Definitions to Trust Indenture	4
6	Exhibit 1-General Provisions incorpo- rated into the Trust Indenture by Reference	20
7A	Exhibit 2(a)-Forms of Serial Bond, Guarantee and Trustee's Authentica- tion Certificate	7
7B	Exhibit 2(b)-Forms of Sinking Fund Bond, Guarantee and Trustee's Au- thentication Certificate	7
8	Exhibit 3-Authorization Agreement	24
9	Appendix III-Security Agreement	
10	Exhibit 1-General Provisions Incor- porated into the Security Agreement by Reference	28
11	Exhibit 2-Form of Secretary's Note	3
12	Exhibit 3-Form of First Preferred Fleet Mortgage	6
13	Exhibit A-Form of Supplement to First Preferred Fleet Mortgage	5
14	Exhibit B-Form of Opinion of Counsel	2
15	Exhibit 4-Construction Contracts	70
16	Exhibit 5-Form of Consent of Ship- builder	3
17	Exhibit 6-Title XI Reserve Fund and Financial Agreement	23
18	Exhibit 7-Form of Management Agree- ment	
19	Appendix IV-Depository Agreement	<u>5</u>
	Total pages of documentation	<u>276</u>

In May 1976 testimony before the House Committee on Merchant Marine and Fisheries, the Assistant Secretary for Maritime Affairs said he is not happy with the paperwork

process and believes a better job could be done. He further stated that large and financially sound companies can afford the expense of paperwork and the attorneys required to handle it, but when these costs are imposed on applicants of financially limited resources, they are discouraged from participating in the program. The Assistant Secretary believes it will take a combined effort by the Agency, ship-owners, and the financial community to decrease the amount of this paperwork.

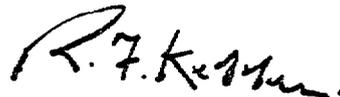
Although our review did not determine the extent of this problem, we discussed its impact with several attorneys who represent title XI applicants and staff members of the Agency's Ship Financing Guarantee Division. Their comments generally confirmed the statements made by the Assistant Secretary.

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As your office requested we have not obtained written comments from the Agency regarding this report. We have, however, presented program officials with an oral statement of facts to which they expressed general agreement.

This report contains recommendations to the Secretary of Commerce. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. We will contact your office in the near future to arrange for release of the report so that the requirements of section 236 can be set in motion.

Sincerely yours,



ACTING Comptroller General
of the United States