

NOW IS THE TIME TO REVISIT THE 50-YEAR RELATIONSHIP BETWEEN THE EX-IM BANK AND PEFCO

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Request to Renew Partnership with Private Export Funding Corporation (PEFCO)

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I appreciate the opportunity to submit a comment to the Export-Import (Ex-Im) Bank in response to its request for comments regarding possible benefits or costs of continuing its relationship with the Private Export Funding Corporation (PEFCO). The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group.

Late in 2019, as the Ex-Im Bank's charter was close to expiring, Ex-Im Bank Chair Kimberly Reed was in the process of reforming the Ex-Im Bank in line with commitments that she had made during her Senate confirmation hearing. In October, when Reed's reform campaign appeared to be in full swing, in a comment submitted to the agency, I raised concerns about an Ex-Im Bank board of directors approval of \$2 billion in debt issuance for PEFCO.¹

PEFCO was created by the Ex-Im Bank in 1970 to buy loans that exist on the books of private lenders but are guaranteed by the Ex-Im Bank. As I noted at the time, the Ex-Im Bank's ongoing support for PEFCO is utterly inconsistent with Reed's commitment to the principle of additionality; that is, ensuring that the Ex-Im Bank adds value that wouldn't exist absent its intervention. It seems also at odds with her commitment to transparency: PEFCO has been around for 50 years, and during that time, the entity hasn't been reviewed at all. Considering that it increases taxpayers' liability and doesn't require congressional oversight, this is extremely troubling. I also noted that PEFCO actually *reduces* the risk-taking role of the commercial banking

1. Veronique de Rugy, "Comments on the Ex-Im Bank's Proposed Additionality Criteria" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, October 25, 2019).

market. Finally, I pointed out that PEFCO's private shareholders include the same financial institutions that were selling their Ex-Im-Bank-guaranteed loans to PEFCO and also the large exporters whose buyers received Ex-Im-Bank-guaranteed loans.

Since that time, there have been a few disconcerting developments relating both to Reed's commitment on additionality and to the future of PEFCO itself. First, in May 2020, the Ex-Im Bank board of directors approved a new additionality checklist that left the additionality policy largely substantively unreformed.² Then, in late July, the Ex-Im Bank made public its intent to renew PEFCO's operating authority (which is set to expire at the end of 2020) as well as increase the level of taxpayer-backed guarantees for the interest payments that PEFCO owes on its debt issuances. In retrospect, it appears that the release in May of the Ex-Im Bank's underwhelming additionality checklist was a harbinger of its intention to renew and expand its support for PEFCO.

In considering the future of PEFCO, it is important to consider the following:

- PEFCO is largely not concerned with small businesses: the share of PEFCO's loans benefiting small businesses is less than 4 percent.
- PEFCO was created to serve the Ex-Im Bank's politically connected beneficiaries, and there is no better-connected beneficiary of the Ex-Im Bank's activities than Boeing. The result is that 86 percent of PEFCO's portfolio has to do with aircraft.
- PEFCO's actions accomplish the reverse of its express objective: risk-taking commercial banks are crowded out of a normal risk-taking role. The crowding out reduces commercial lenders to playing the role of originator of government loans.
- PEFCO is a monopoly: the Ex-Im Bank has granted PEFCO an exclusive benefit. It has also granted PEFCO an exclusive right to have the interest payments that PEFCO owes on its secured notes guaranteed by the Ex-Im Bank.
- Under no circumstances should PEFCO be reauthorized for another 25 years.

PEFCO IS A GIFT TO SPECIAL INTERESTS

To understand why PEFCO is so problematic, it is important first to understand what PEFCO actually does. Established by Ex-Im Bank in 1970 and operating since then under successive 25-year mandates, PEFCO is a privately owned entity that uses the proceeds of its secured-notes debt issuances to purchase 100 percent Ex-Im-Bank-guaranteed loans from commercial banks. These loans serve as collateral for the secured notes that PEFCO issues to buy the loans, which retain the Ex-Im Bank guarantee when they pass from the commercial banks to PEFCO's own books. As spelled out in PEFCO's 2019 annual report, PEFCO is entitled to kick back to the Ex-Im Bank any loan that goes bad, while retaining the good loans: "While defaulted loans must and will be assigned to Ex-Im Bank upon its payment of a claim, performing loans are held by PEFCO in its portfolio to maturity."³

Moreover, the interest payments that PEFCO owes on its secured notes are also guaranteed by the Ex-Im Bank. In short, while ostensibly a privately owned entity, PEFCO is so wrapped in taxpayer-backed guarantees that its shareholders literally cannot lose. Additionally, as no other

2. Veronique de Rugy, "The Ex-Im Bank Is Still the Bank of Boeing," *Daily Economy*, American Institute for Economic Research, June 22, 2020.

3. Private Export Funding Corporation, *2019 Annual Report*, 2019, 11.

private entity enjoys the benefits that PEFECO receives from the Ex-Im Bank, PEFECO effectively is an Ex-Im-Bank-guaranteed monopoly, and it has operated as such for 50 years.

Who are the PEFECO shareholders benefiting from this exclusive arrangement with the Ex-Im Bank? According to PEFECO's 2019 annual report, "PEFECO's stock is owned by 26 commercial banks, one financial services company, and six industrial companies."⁴ These institutions include both US and foreign-owned banks such as Citibank, Deutsche Bank, HSBC, JPMorgan Chase, Societe Generale, UBS, and Wells Fargo. Such institutions also happen to be the same commercial lenders that are selling their Ex-Im-Bank-guaranteed loans to PEFECO. *In short, PEFECO's customers are also its owners.*

Banks are not PEFECO's only shareholders. In addition, PEFECO's shareholders include some large corporate exporters that account for a big share of Ex-Im-Bank-supported transactions: e.g., Boeing (aircraft), GE and Raytheon-owned United Technologies (aircraft engines), KBR (oil and gas), and ABB (electricity). Boeing's senior vice president of finance and treasurer even sits on PEFECO's board of directors. Not unexpectedly, the aircraft sector accounts for 86 percent of the underlying assets of the Ex-Im-Bank-guaranteed loans acquired by PEFECO, with the energy sector accounting for another 9 percent.⁵

Furthermore, PEFECO is also permitted to pay dividends to its commercial shareholders. The amount has never been great (e.g., a total payout to all shareholders of \$516,000 in 2014),⁶ and no dividend has been paid since 2015,⁷ when the Ex-Im Bank's lack of a board quorum crimped PEFECO's profitability. Nevertheless, it is worth questioning why an entity whose shareholders have no capital at risk should be allowed to pay dividends under any circumstances.

PEFECO CROWDS OUT THE PRIVATE SECTOR

The exclusivity of the benefits that the Ex-Im Bank provides to PEFECO should be enough to prompt its board of directors to reconsider another renewal of the 1971 guarantee agreement between the Ex-Im Bank and PEFECO. Beyond the issue of exclusivity, PEFECO's acquisition of loans guaranteed by the Ex-Im-Bank eliminates commercial lenders' incentives to take even a minimal amount of risk in export finance. As suggested in PEFECO's 2018 annual report, the Ex-Im Bank's expansion of PEFECO's mandate since the 2007–2008 global financial crisis has actually increased PEFECO's role in the market vis-à-vis commercial lenders:

Moreover, by 2009 agreement with Ex-Im Bank, PEFECO is no longer limited to purchasing floating-rate loans in connection with "environmental" transactions, small business exporters and sub-Saharan borrowers. PEFECO is now free to purchase both floating and fixed-rate long-term loans for which Ex-Im Bank gave its guarantee commitment without restriction.

In fiscal year 2013, PEFECO developed with Ex-Im Bank the Secondary Market Long-term Loan Purchase Program . . . to facilitate the development of an active secondary market in long-term guaranteed loans.⁸

4. Private Export Funding Corporation, *2019 Annual Report*, 70.

5. Author's calculations based on Private Export Funding Corporation, *2019 Annual Report*, 6.

6. Private Export Funding Corporation, *2018 Annual Report*, 2018, 54.

7. Annual PEFECO reports for 2015, 2016, 2017, 2018, and 2019 all state that no dividends have been paid.

8. Private Export Funding Corporation, *2018 Annual Report*, 11.

While the financial crisis may have helped justify a temporary expansion of PEFCO's role in 2009, PEFCO's expanded role in the market continued after 2009, even as global markets recovered, effectively crowding out commercial lenders.

The Ex-Im Bank also cites banking regulation to justify continuing PEFCO's role in the market, implicitly arguing that the impacts of crisis and of regulation are comparable:

Since the Global Financial Crisis and the emergence of the Basel III regulatory environment, PEFCO's primary role has been to act as a source of liquidity for the commercial market. This crowds the private sector into official export finance and maximizes the competitiveness of EXIM-guaranteed/insured transactions.⁹

The implication that banking regulation (Basel III) significantly constrains the ability of commercial lenders to hold Ex-Im-Bank-guaranteed loans, which already carry a taxpayer-backed guarantee, is absurd on its face. Far from giving the private sector incentives to provide official export finance, PEFCO makes it possible for commercial lenders to decrease their engagement in export finance, potentially reducing their role in loan administration. In fact, during the years that the Ex-Im Bank could not function at its full potential, new lenders entered the market.¹⁰

At the same time, however, commercial lenders are unlikely to complain that PEFCO is crowding them out. After all, they are shareholders of PEFCO and thus the beneficiaries of PEFCO's exclusive relationship with the Ex-Im Bank. But they are effectively still being crowded out. In fact, the effect on society may be worse, since the lenders themselves welcome the subsidy.

MORE ON PEFCO'S LACK OF ADDITIONALITY

Now that the risk of providing loans for exports has shifted from the commercial sector to the taxpayer, one could expect some kind of benefit from a public policy perspective. Based on the portfolio of loans that PEFCO has acquired, however, there does not appear to be such an upside. In particular, the aircraft sector has dominated PEFCO's portfolio for at least the past several years (since well before the economic crisis induced by the COVID-19 pandemic), during which commercial banks were more than willing to lend to Boeing's customers while the Ex-Im Bank was out of the market. Likewise, the regional concentration of the Ex-Im-Bank-guaranteed loans held by PEFCO is weighted heavily toward markets where commercial financing before the current crisis should have been able to meet the needs of exporters. Such markets where PEFCO is concentrated include Australia, Ireland, Italy, Luxembourg, and the United Kingdom. Moreover, 19 percent of PEFCO-held loans are outstanding to China and Hong Kong alone. The Ex-Im Bank's charter contains a new mandate directing the Ex-Im Bank to consult with the US secretary of state to assess whether its loans involving the Chinese government pose risks to the US national interest. Thus, it is reasonable to consider that up to one-fifth of PEFCO's existing portfolio could be deemed to pose risks to the national interest.

Separately, the share of PEFCO's loans benefiting small businesses is less than 4 percent. This compares poorly to the Ex-Im Bank's congressionally mandated target of 25 percent, which will increase to 30 percent next year.

9. Export-Import Bank of the United States, Request to Renew Partnership with Private Export Funding Corporation (PEFCO), 85 Fed. Reg. 45213 (July 27, 2020).

10. Veronique de Rugy and Justin Levanthal, "Ex-Im Bank: A Comparative Analysis of Pre- and Post-Quorum Lending" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 2019).

CONCLUSION

As discussed earlier, PEFCO's assets are Ex-Im-Bank-guaranteed loans acquired through the issuance of secured notes collateralized by those loans, with the Ex-Im Bank also guaranteeing PEFCO's interest payments on the secured notes. Although PEFCO is ostensibly a private institution, its activities incur no risks for itself or its private shareholders. In the 50 years since PEFCO was created, the 1971 guarantee agreement between the Ex-Im Bank and PEFCO has come up for review only once (in 1995). Ahead of the expiration of the guarantee agreement on December 31, 2020, the Ex-Im Bank is not proposing a bidding process or any other transparent mechanism to justify the exclusive benefit that PEFCO and its shareholders receive from the Ex-Im Bank.

In addition, while the Ex-Im Bank has not disclosed the length of the guarantee agreement that it is seeking with PEFCO, one should assume that it is seeking another 25 years. That is far too long. Advocates for PEFCO like to argue that 25 years is necessary for beneficiaries to feel that their investment will be honored. This argument doesn't hold water, since the federal government will honor its guarantee whether or not PEFCO is allowed to issue more debt.

In light of the current economic crisis, some may feel that now is not the time to reconsider or even reform PEFCO. But not even the most pessimistic economic scenarios assume that the current crisis will last 25 years. Assuming that the liquidity argument holds, if the guarantee agreement between the Ex-Im Bank and PEFCO is renewed again, it should be renewed for only one year, at the end of which the need for, or appropriate role of, PEFCO should be revisited in light of prevailing economic conditions. In the meantime, the Ex-Im Bank should review the appropriateness of its exclusive relationship with PEFCO.

In addition, PEFCO should under no circumstances be allowed to pay dividends to its shareholders, since they have zero capital at risk.

Finally, to signal a ceiling on the level of support that US taxpayers will provide to PEFCO's shareholders, the Ex-Im Bank should not expand its guarantee for the interest payments that PEFCO owes on its secured notes, as has been proposed.