

COMMENTS ON THE EX-IM BANK'S PROPOSED ADDITIONALITY CRITERIA

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Agency: Export-Import Bank of the United States

Comment Period Opens: September 9, 2019

Comment Period Closes: October 23, 2019

Date Submitted: October 23, 2019

Docket No. 2019-6019

With the extension to October 23 of the deadline for public comment on the Export-Import (Ex-Im) Bank of the United States' proposed guidelines for determining additionality for medium- and long-term transactions, I request the opportunity to supplement the comments that I submitted on October 9, 2019.

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. These comments, therefore, do not represent the views of any particular affected party or special interest group. Rather, they are intended to help the Ex-Im Bank achieve meaningful reform.

In my initial submission on additionality, I requested that the Ex-Im Bank disclose the \$40 billion pipeline of deals that it claims has been awaiting Ex-Im Bank board of directors approval for financing that ostensibly is not available in the private market. I have been tracking the board's activity on the presumption that the projects on the board's agenda are drawn from that \$40 billion list.

- One upcoming deal that stands out is a proposed loan to El Al Israel Airlines, which is up for a vote at a board meeting on October 31. (The board meeting is closed to the public, so most people will not be able to observe the deliberations.) During the lapse in the Ex-Im Bank board's quorum in 2015–2019, however, El Al successfully financed its Boeing acquisitions through the commercial market.
- Also, on an October 10, 2019, meeting, the Ex-Im Bank board of directors approved a maximum issuance of \$2 billion in secured notes for the Private Export Funding Corporation (PEFCO), an entity created by the Ex-Im Bank nearly a half century ago to trade in the Ex-Im Bank's taxpayer-backed loan guarantees, reduce the risk-taking role of the commercial banking market, and pay dividends to its private shareholders that happen to be the same

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financial institutions and large exporters whose borrowers are the beneficiaries of the Ex-Im Bank's taxpayer-backed guarantees.

If Ex-Im Bank board actions such as these are indicative of the Ex-Im Bank's lending strategy going forward, then they offer a stark warning about the limit of the willingness to deliver on the commitments made by Ex-Im Bank President Kimberly Reed to Senator Pat Toomey during her confirmation hearing.¹ As of this writing, the El Al project has not yet gone to the board of directors, so there is still hope of a sensible (i.e., market-driven) outcome in that case. However, the board's decision on October 10 to approve a \$2 billion guarantee to revive the operations of PEFCO and restore its floating rate authorities warrants some analysis.

PEFCO AND ADDITIONALITY

According to the Ex-Im Bank's press release following the board approval of the PEFCO guarantee, the board's decisions

restore EXIM and PEFCO's public-private partnership, which was first established in 1971, but temporarily lapsed due to a lack of EXIM's board quorum, and increase the amount of private capital in EXIM's transactions in support of U.S. exports on longer repayment terms.²

An examination of PEFCO's most recent annual report reveals a privately owned yet taxpayer-supported entity that pays dividends to its shareholders on the basis of its main business, which is to buy Ex-Im-Bank-guaranteed loans.³ As PEFCO's annual report explains, the private company buys Ex-Im-Bank-guaranteed loans (which are taxpayer-backed assets) from the banks that originate the loans. The report notes that "PEFCO will only purchase the amount covered by the EXIM Bank guarantee, and not the uncovered portion."⁴ PEFCO issues secured notes to raise financing to acquire the Ex-Im-Bank-guaranteed loans, with principal repayments collateralized by pledged assets that carry an Ex-Im Bank guarantee. If PEFCO fails to pay interest on the secured notes, taxpayers (through the Ex-Im Bank) are on the hook for the interest payments.⁵ Since its inception, PEFCO has issued \$17.6 billion in secured notes, of which \$4.3 billion of principal was outstanding at the end of fiscal year 2018.

PEFCO's business model generates no additionality in exchange for Ex-Im Bank guarantees and actually *diminishes* the role of commercial lenders in the market. The following sections elaborate the reasons why.

¹ During Reed's confirmation hearing, Sen. Toomey asked her to confirm the following commitments: (1) improve the transparency at the bank; (2) improve protection for domestic companies from economic harm that might arise from the Ex-Im Bank financing their foreign competitors; (3) ensure that the Ex-Im Bank is not crowding out private financing options that would otherwise be available; (4) work with the committee to meet the statutory requirement that the United States negotiate a reduction in global export credit authorities; (5) work with Sen. Toomey and other members of his committee to strengthen taxpayers' protections against losses from deals that go badly; and (6) work with Sen. Toomey and his committee to crack down on bad actors, whether they are employees of the bank or its customers who should not be dealing with the bank. Reed responded "yes" to all of these questions.

² Export-Import Bank of the United States, "EXIM Board of Directors Reviews Progress in Supporting U.S. Minority- and Women-Owned Business-Related Exports and Jobs; 625 MWOB Transactions Support \$454 Million in FY 2018," press release, October 10, 2019, <https://www.exim.gov/news/exim-board-directors-reviews-progress-supporting-minority-and-women-owned-business-related>.

³ PEFCO, *America's Export Business: Remaining True to Our Mission*, 2018.

⁴ PEFCO, *America's Export Business*, 11.

⁵ PEFCO, 18.

PEFCO'S PORTFOLIO IS HEAVILY CONCENTRATED IN THE AIRCRAFT SECTOR, WHERE PRIVATE CAPITAL IS ABUNDANT

PEFCO's loan portfolio, like the Ex-Im Bank's, has a high concentration in aircraft. In 2018, 86 percent of its \$4.842 billion in outstanding loans by product consisted of aircraft,⁶ whereas only 5 percent consisted of small business loans.⁷ Moreover, roughly half of PEFCO's outstanding loans are to borrowers in Organisation for Economic Co-operation and Development countries, where commercial finance is readily available.⁸ Notwithstanding Ex-Im Bank President Reed's commitment to strengthen Ex-Im Bank additionality, the Ex-Im Bank has turned back to financing PEFCO, an entity that demonstrates a high concentration of loans where government support is not needed.

THE EX-IM BANK EXPANDED PEFCO'S CAPABILITIES DURING THE GLOBAL FINANCIAL CRISIS BUT FAILED TO SCALE THEM BACK WHEN GLOBAL ECONOMIC CONDITIONS RETURNED TO NORMAL

According to PEFCO's annual report, restrictions on PEFCO's ability to purchase Ex-Im-Bank-guaranteed floating-rate loans were eliminated in 2009. Since that time, PEFCO has been "free to purchase both floating and fixed-rate long-term loans for which EXIM Bank gave its guarantee commitment without restriction."⁹ Then, in 2013, the Ex-Im Bank again expanded PEFCO, this time by establishing a secondary market long-term loan purchase program to allow private lenders to offload their Ex-Im-Bank-guaranteed loans to PEFCO.¹⁰ While a temporary expansion of PEFCO's role may have been justified in 2009, given the global financial crisis, PEFCO's role in the market was allowed to expand even as global markets recovered, crowding out the risk-taking of commercial lenders.

PEFCO'S BUSINESS MODEL CREATES MORAL HAZARD, NOT ADDITIONALITY

PEFCO's annual report notes that its "stock is owned by 26 commercial banks, one financial services company, and six industrial companies."¹¹ The largest shareowner, JPMorgan Chase, owns around 2,900 shares, for a roughly 17 percent stake in PEFCO, while the largest owner among the industrial companies is Boeing, which owns around 1,400 shares, for an 8 percent stake. JP Morgan Chase and the other banks that are shareholders in PEFCO are also the institutions from which PEFCO buys Ex-Im-Bank-guaranteed loans, while shareholder Boeing uses more Ex-Im Bank support to finance its planes than any other exporter. In short, PEFCO's shareholders not only benefit directly from Ex-Im Bank guarantees to their borrowers, they also collect a dividend from PEFCO's business of trading in these guarantees. PEFCO had to suspend the payment of the shareholder dividend in 2016, 2017, and 2018 on account of the lapse in the quorum of the Ex-Im Bank's board. Following the Ex-Im Bank board's recent approval of the \$2 billion guarantee, dividends will probably start flowing to PEFCO's shareholders again.

PEFCO's annual report also details the incentives for PEFCO and commercial lenders to transfer risk to the government. The following pertains to PEFCO:

⁶ PEFCO, 6.

⁷ PEFCO, 6.

⁸ PEFCO, 6.

⁹ PEFCO, 11.

¹⁰ PEFCO, 11.

¹¹ PEFCO, 59.

PEFCO relies upon this U.S. government support and does not make evaluations of credit risks, appraisals of economic conditions in foreign countries, or reviews of other factors affecting collectability of its loans.¹²

And the following pertains to commercial lenders:

Lenders are also able to obtain commitments from PEFCO to purchase loans in the future (in advance of disbursement of such loan by the originating lender).¹³

In short, PEFCO does not need to perform its own risk analysis on loans because it has Ex-Im Bank backing (which itself is backstopped by taxpayers), while lenders that originate Ex-Im-Bank-guaranteed loans do not have to carry the loans on their books, since PEFCO steps in to do so.

RECOMMENDATION

According to PEFCO's annual report,¹⁴ the 1971 Guarantee and Credit Agreement that created PEFCO was scheduled to terminate in 1995 but instead was extended by the Ex-Im Bank for another 25 years. Although the agreement between the Ex-Im Bank and PEFCO is scheduled to expire on December 31, 2020, the Ex-Im Bank's recent \$2 billion commitment to PEFCO suggests that the Ex-Im Bank is not ready to end this 48-year relationship. Considering that PEFCO reduces the role of private lenders in the market, transfers that risk from the private market to taxpayers, and focuses on sectors and markets where commercial financing is readily available—all while paying dividends to well-connected shareholders—continued Ex-Im Bank support for PEFCO is contrary to the Ex-Im Bank's purported commitments to reform. If nothing else, Congress should protect the interest of US taxpayers, who are the Ex-Im Bank's shareholders, and should make the unwinding of PEFCO a condition of Ex-Im Bank reauthorization.

¹² PEFCO, 9.

¹³ PEFCO, 10.

¹⁴ PEFCO, 20.