MERCATUS CENTER
George Mason University

TESTIMONY

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

Veronique de Rugy
Senior Research Fellow, Mercatus Center at George Mason University

Export-Import Bank of the United States
Meeting of the Board of Directors

August 13, 2020

Late in 2019, as the US Export-Import (Ex-Im) Bank's charter was close to expiring, Ex-Im Bank Chair Kimberly Reed was going through the motions 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, I flagged to readers an Ex-Im board of directors approval of $2 billion in debt issuance for the Private Export Funding Corporation (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 seems to fly in the face of 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. I also noted that PEFCO actually *reduces* the risk-taking role of the commercial banking 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, the Ex-Im Bank board of directors approved a new additionality checklist that appears only to paper over the Ex-Im Bank's existing additionality procedures and leave the policy essentially 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.

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

For more information or to meet with the scholar, contact
Mercatus Outreach, 703-993-4930, mercatusoutreach@mercatus.gmu.edu
Mercatus Center at George Mason University, 3434 Washington Blvd., 4th Floor, Arlington, Virginia 22201

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 EXIM 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. Moreover, as no other private entity enjoys the benefits that PEFCO receives from the Ex-Im Bank, PEFCO effectively is an Ex-Im-Bank-guaranteed monopoly, and it has operated as such for 50 years.

Who are the PEFCO shareholders benefitting from this exclusive arrangement with the Ex-Im Bank? According to PEFCO's 2019 annual report, "PEFCO'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 who are selling their Ex-Im-Bank-guaranteed loans to PEFCO. *In short, PEFCO's customers are also its owners.*

Banks are not PEFCO's only shareholders. In addition, PEFCO'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 PEFCO'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 PEFCO, with the energy sector accounting for another 9 percent.[5]

Although it might seem hard to believe, PEFCO is entitled 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 PEFCO's profitability. However, it is hard to imagine why an entity whose shareholders have zero capital at risk should be allowed to pay dividends under any circumstances.

PEFCO CROWDS OUT THE PRIVATE SECTOR

The exclusivity of the benefits that the Ex-Im Bank provides to PEFCO should be enough to prompt the Ex-Im Bank's board of directors to rethink another renewal of the 1971 guarantee agreement between the Ex-Im Bank and PEFCO. Beyond the issue of exclusivity, PEFCO's acquisition of Ex-Im-Bank-

---

3. Private Export Funding Corporation, *2019 Annual Report*, 2019, 11.
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 PEFCO reports for 2015, 2016, 2017, 2018, and 2019 all state that no dividends have been paid.

guaranteed loans disincentivizes commercial lenders from taking even a minimal amount of risk in export finance. As suggested in PEFCO's 2018 annual report, the Ex-Im Bank's expansion of PEFCO's mandate since the 2008–2009 global financial crisis has actually increased PEFCO's role in the market vis-à-vis commercial lenders:

> Moreover, by 2009 agreement with [Ex-Im Bank], PEFCO is no longer limited to purchasing floating-rate loans in connection with "environmental" transactions, small business exporters and sub-Saharan borrowers. PEFCO 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, PEFCO 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 [Ex-Im-Bank-]guaranteed loans.[8]

While a temporary expansion of PEFCO's role may have been justified in 2009, given the financial crisis, PEFCO's expanded role in the market continued 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-backed loans, which already carry a taxpayer-backed guarantee, is absurd on its face. Far from incentivizing the private sector to participate in official export finance, PEFCO makes it possible for commercial lenders to decrease their engagement in export finance, potentially reducing their role to loan administration. In fact, during the years that the Ex-Im Bank couldn't 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 may be worse, since the lenders themselves welcome the subsidy.

MORE ON PEFCO'S LACK OF ADDITIONALITY

Now that 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

---

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

sector has dominated PEFCO's portfolio at least for the past several years (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 Ex-Im Bank 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 benefitting 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.

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, we should assume that the Ex-Im Bank and PEFCO are seeking another 25 years. That is far too long.

In light of the current economic crisis, some may feel that the now is not the time to reconsider or even reform PEFCO. But not even the most pessimistic economic scenarios contemplate 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.