Creative Finance: Options for Security Assistance

By

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The U.S. defense industry faces a disadvantage in the international market because of an inability to offer customers competitive export financing. Government financing, in the form of Foreign Military Sales credits (i.e., loans and grants), is declining and commercial lenders are not filling the void.

Defense exports, comprising roughly 10 percent of the Defense Department's procurement budget over the last three years, have had significant economic benefits. These exports have lowered weapons costs by increasing production runs and spreading indirect costs over a larger business base. If defense exports continue to decline, the defense industrial base will be adversely affected, particular in a time of decreasing Defense Department procurement.

ECONOMIC EFFECTS OF FINANCING SHORTFALL

It is virtually impossible to empirically demonstrate the impact of the commercial financing shortfall on foreign sales. However, an informal survey of some of the largest U.S. exporters of defense products indicates that lack of finance is closing off certain markets to U.S. products. In particular, U.S. industry is losing the ability to sell to "middle income" countries that have difficulty paying in cash and which receive no U.S. military assistance. Most U.S. commercial lenders are reluctant to finance sales to countries such as Brazil, India, Venezuela, Indonesia, Thailand, South Korea, Spain, Morocco, Egypt, and Pakistan, or even NATO countries without some form of U.S. government backing.

Aerospace manufacturers report losing over $1 billion in sales alone in Central and South America to French and British manufacturers in the last five years, in part because of the attractive financing terms offered by their competitors. Companies are facing a similar situation in East Asia. One aircraft company is now competing against the Soviet Union for sales to a country in East Asia. According to the firm, the Soviets are offering financing terms the U.S. company cannot match.

A disturbing long-term affect of the financing situation is that companies are considering performing more research, development, and production through overseas subsidiaries or partners. Two major defense contractors have already decided to perform more work in Canada, which make exports from these companies' Canadian subsidiaries eligible for financing from Canada's Export Development Corporation. Other major defense exporters will likely be taking similar steps in countries such as the United Kingdom, which again provides substantial export assistance. The net result of this process could be a loss of U.S. jobs and a continued erosion of the defense industrial base.

EXPORT ASSISTANCE PROGRAMS IN NATO COUNTRIES

European governments generally regard defense exports as but one component of their entire commercial export picture. Little distinction is made between defense and commercial exports, and both receive equal treatment in the country's export assistance programs. These programs include: Canada–The Export Development Corporation; France–COFACE; Germany–Kreditversicherungs A/G (Hermes) and Allgemeine Kreditversicherungs Aktiengesselschaft (AKA); Japan–The Eximbank of Japan; and the United Kingdom–The Export Credit Guarantee Department.

By contrast, the Export/Import Bank of the U.S. (Eximbank) is prohibited by law from supplying credits to developing countries for defense products, and by policy it does not offer export credits for such products to any country. It should be noted that the recently passed drug bill [i.e., the 1988 *Anti-Drug Abuse Act*, P.L. 100-690], however, authorizes the Eximbank to finance sales of defense equipment related to "anti-narcotics" purposes. [Editor's note: On 20 July 1989, the Eximbank announced it would provide a guarantee for $170 million of a total $200 million foreign military sale to Columbia of military equipment for use by the Colombian armed forces in combatting drug trafficking. This is the first such FMS case to receive an Eximbank guarantee, and reportedly includes the sale of 20 UH-1 Huey helicopters, 5 UH-60 Blackhawk helicopters, 13 river patrol boats, radar command equipment, jeeps, fuel trucks, ammunition, and other defense articles.]

Britain provides formal assistance to its defense industry through the Defence Export Services Organisation (DESO), which provides personnel to its overseas embassy staff. The function of DESO personnel is to encourage customers to purchase British defense equipment. When commercial sales are consummated, the British government guaranties a high percentage of the commercial financing against non-payment through its Export Credit Guarantee Department.

Other countries' export assistance agencies provide similar support for their industries, with *no* distinction made between military and non-military goods. This aggressive support has played a role in increased sales for European suppliers.

ORDERS OF U.S. EQUIPMENT DOWN

Foreign sales of U.S. defense equipment have declined four years in a row, with the U.S. market share declining from over 25 percent in 1983 to roughly 18 percent in 1986 when sales of U.S. defense equipment dropped to their lowest level since 1981. Another indicator of the drop in U.S. orders is the balance of defense trade with NATO countries over the last 10 years, which has fallen from 9:1 to roughly 1.4:1. The trend in new orders for U.S. equipment since 1980 is shown in Table 1.

This decline has contributed to the nation's trade imbalance, cost thousands of jobs in the defense industry, reduced R&D funds available for defense and civilian products, and most significantly, has caused some major companies to cut back overseas marketing efforts.

There are a variety of reasons for this trend. The number of suppliers has grown dramatically, and the market is undergoing a structural shift, with more customers interested in manufacturing know-how and technology transfer than in purchases of end-items. It should be noted that many countries made major aircraft purchases in the late 1970s and early 1980s, which were in part responsible for the high level of sales during that period. Increased Congressional involvement in the arms transfer process also has led to a decline in sales to moderate Arab states in the Middle East, notably Jordan and Saudi Arabia. Finally, the decline in available military assistance funds to finance arms purchases by overseas allies has contributed to the situation.

TABLE 1

U.S. Arms Transfers
Fiscal Years 1980-1988
(Dollars in Millions)

Year	I Total FMS Agreements *	II FMS Construction Agreements	III Total Commercial Deliveries ***
1980	$14,106	($1,596)	$1,968
1981	7,403	(882)	2,198
1982	17,435	(86)	1,801
1983	14,872	(22)	3,974
1984	13,886	(305)	3,756
1985	11,837	(924)	5,646
1986	6,927	(69)	4,268
1987	7,134	(143)	4,477
1988	12,476 **	(257)	5,031

* Column I, "Total FMS Agreements," includes both Foreign Military Sales and Foreign Military Construction Sales, the latter which is shown separately in Column II. Source: *Defense Security Assistance Agency, Foreign Military Sales, Foreign Military Construction Sales, and Military Assistance Facts, As of September 30, 1988*, (i.e., "DSAA Fact Book"), pp. 2-3 and 10-11.

** The $5,612 million increase from FY 1987 to FY 1988 in new FMS agreements is a result of sales of: F/A-18s and associated missiles to Kuwait; F-16s to Israel and Egypt; Aegis air defense system to Japan; and, F-15 attrition aircraft and UH-60 helicopters to Saudi Arabia.

*** Commercial deliveries represent the total dollar value of exports made against direct commercial purchases of munitions-controlled items, as compiled and reported by the State Department's Office of Munition Control and included in the "DSAA Fact Book," *op. cit.*, pp. 42-43.

As shown in Table 2, available FMS financing has been drastically reduced by Congress in an attempt to reach the deficit targets mandated by the Gramm-Rudman-Hollings deficit reduction law.

The result of these budget reductions, from a foreign policy perspective, has been a problem in meeting U.S. security commitments around the globe. One of the examples of this phenomenon is Turkey. By the Defense Department's own estimates, Turkey needs $1.2 billion annually to sustain and modernize its armed forces in order to meet its NATO defense commitment. The U.S. has been limited in its ability to help Turkey to meet these commitments because of the lack of funds and Congressional antipathy.

TABLE 2

Military Assistance Funding, FY 85-89
(FMS and MAP)

Year	$ in Billions	$ Constant
FY85	$5.8	$6.60
FY86	5.7	6.31
FY87	5.0	5.38
FY88	4.8	4.98
FY89	4.7	4.70

A more fundamental problem has been the disproportionate share of the cuts. Funding for Israel and Egypt has remained constant, while other areas of the world have been cut by as much as 70 percent. These two countries now absorb over 70 percent of all foreign military sales (FMS) credits. This restriction not only affects U.S. security commitments, it also means that the defense industry has no marketing tool for much of the Third World.

ATTITUDES OF U.S. BANKS TO FINANCING DEFENSE EXPORTS

At this time there are no major U.S. banks willing to finance *all* types of military goods. By contrast, European banks do not share this negative attitude toward their own country's military exports. While U.S. commercial banks have been adverse to financing international military sales, this situation has changed in recent years.

A number of banks are now financially supporting the commercial sale of military products in light of the combined effect of FMS budget cutbacks and shrinking U.S. government procurement exacerbated by the Gramm-Rudman-Hollings deficit reduction bill. First Chicago Trade Finance, which stopped financing military exports a number of years ago, recently started financing military exports. Irving Trust Trade and Finance has similarly activated a positive bank military finance policy. Security Pacific has also begun to pursue military transactions. Chase Manhattan is also now financing some limited defense sales. While still a "thin" market and prone to withdrawal in the face of any serious repercussions, the combined capacity of these banks in trade finance represents an improvement.

There are several reasons why banks have become more interested in financing defense exports—the main one simply being opportunity. Until recently there was little demand for financing U.S. military sales because of U.S. government direct program support. Given this low demand by U.S. defense companies lack of need, lack of knowledge of the subject, and absent request for pressure from U.S. defense companies, U.S. banks understandably had no incentive to change policies or respond more aggressively to the lending opportunities provided by this type of business.

There has also been a failure of traditional bank product lines for *Fortune 500* companies. With these companies now accessing the capital markets directly through commercial paper and bonds, banks no longer need to lend to these companies the volume they once did. At the same time, interstate banking and merger and acquisition activities among banks have raised the Return on Capital and Return on Asset Requirements to higher levels. Necessity has thus caused some banks to consider alternatives.

Despite this improvement, however, banks are still reluctant to expose themselves to the credit risks inherent in sales of defense equipment. This perceived risk translates into higher interest rates and up-front costs that make financing terms offered by U.S. companies less attractive than those offered by foreign competitors.

OPTIONS TO STRETCH SECURITY ASSISTANCE FUNDS

The U.S. thus confronts a situation where it seems desirable to find ways to make its military assistance dollars go further. A number of other so-called "creative financing" ideas have been considered, both in and out of government, as a way to increase the buying power of customers without increasing budget authority in the 150 account [i.e., the U.S. budget function which includes annual appropriations for foreign assistance, including FMS loan and grant financing]. The options are: a blend of FMS and commercial financing; a privately financed reinsurance company to reduce bankers' risks; more flexible use of Export-Import Bank guaranties; and a new government guaranty program.

BLEND OF FMS AND COMMERCIAL FINANCING

Only one approach has been formally approved by the Administration and presented on Capitol Hill. Under the plan, a country could be offered a "blend" of FMS and commercial financing. The two loan elements are tied together by an "umbrella agreement," which specifies that loans be repaid on a single repayment schedule. The debtor must repay the loan to a single intermediate institution, which then distributes the funds on a proportionate basis. This means that the debtor is repaying the banks and the U.S. at the same time.

Under provisions of the Brooke amendment, if a country is behind on its payments to the U.S. government by more than one year, the country can receive no further U.S. assistance. Under the combined lending plan, a borrower cannot pay the U.S. government without paying the private institutions. Hence, the commercial banks, while receiving no direct financial guaranty, do receive a *defacto* government guaranty.

The defects of the plan, according to a number of bankers and industry representatives are these: any default must continue for a year before the Brooke Amendment applies, and despite the Brooke Amendment, must be carried on the banks' books in a reserve for bad debt with high Federal Reserve Bank required capital reserves until paid. In most cases, invocation of the Brooke Amendment results in a rescheduling of a debtor's loan, including its private loans, and therefore the banks are not assured of payment in accordance with the original loan schedule. Furthermore, if the prospect of new official assistance decreases, as is the case under the current budget climate, the Brooke Amendment threat diminishes in its effectiveness.

No loans have been signed under this plan, although discussions have taken place with Korea, Thailand, and Spain.

PRIVATELY FINANCED EXPORT ASSISTANCE

Security Export Finance Corporation. This would involve the creation of a privately financed and operated corporation to provide the financial community with guaranties on financing for sales of U.S. defense equipment and services. The corporation, which would be based outside the U.S., would receive financing from member companies. Such a proposal has been advanced by Irving International Trade, Inc.

Trade Underwriting Facility. A Trade Underwriting Facility (TUF) is an exporter owned and driven self-insurance consortium that covers all exports, including military. It would involve the creation of a privately owned and operated insurance corporation providing the financial community, through insurance company subsidiaries, insurance on financing export sales, including defense equipment and services. The corporation would be based in Bermuda and would receive capital from member companies. Such a proposal is currently being advanced by a prominent New York investment firm.

The problem with both these options is that they provide only limited assistance for smaller transactions. As the amount of the guaranty increases, the risks increase to the point where the bank would be forced to add basic points to a loan. This approach would thus place companies in the same noncompetitive situation they are in today.

USE OF EXPORT-IMPORT BANK GUARANTIES

The Exim has authority available that theoretically could be used to guaranty private financing of defense exports. Under present law [Sec. 32, Arms Export Control Act] the Eximbank may not "participate in any extension of credit in connection with any agreement to sell defense articles and defense services entered into with any economically less developed country after June 30, 1968." This prohibition does not apply if the defense articles are being sold in connection with the war on drugs. Exim is also limited from supporting defense exports by its charter. Section 2(b)(7) of Exim's charter restricts the amount [of] funding to support defense sales to 7.5 percent of the total limit on outstanding loans.

In order to use this authority to provide guaranties for military exports to developing countries, Sec 32 of the Arms Export Control Act, would have to be amended. Language could be inserted into the law that might permit the Eximbank to guaranty commercial loans to the Camp David peace accord signatories [i.e., Egypt and Israel] and other countries that would be so designated by the President. Such a list might include Korea, Spain, Thailand, Malaysia, Singapore, and Indonesia.

Another possibility is to amend the AECA to permit Exim to guaranty commercially financed sales of certain "non-lethal" types of equipment. Such a list might include radar and communications systems, surveillance equipment, utility vehicles, utility aircraft, production equipment, tooling and maintenance equipment, construction equipment, and uniforms and food for the military. Such a list would mean that Exim would not have to support sales of guns, ammunition, tanks, jet fighters, and other "lethal" equipment.

Sales guarantied by Exim would continue to be subject to all the rules governing export controls on defense equipment as required by the AECA, ensuring that only appropriate equipment is funded. The Exim bank also clearly has the resources and methodology to evaluate the credit-worthiness of countries.

A U.S. GOVERNMENT GUARANTY PROGRAM

In its most general outline, this alternative would mean allowing the U.S. to guaranty commercially financed sales of U.S. defense equipment to credit-worthy customers. From the defense and banking industry's perspective, a 100 percent government guaranty would be most attractive, but some percentage less than 100 percent would probably be marketable. Or some kind of "sliding" scale could be established, dependent on credit-worthiness and on the product. This would minimize the bank's risks and as a result significantly lower the cost of such loans to potential customers.

There is precedent for establishing such a program. In the late 1960s and early 1970s, the FMS program operated by making guaranties available to overseas allies. In the mid-1970s, private loan guaranties ceased, and guaranties became linked to the Federal Reserve Bank. The credits carried a U.S. government guaranty, which was backed by the Guaranty Reserve Fund (GRF). The system functioned well until debtor countries started making late payments and the GRF began to run out of money. The situation reached a crisis point in the Fall of 1987, when Congress appropriated $532 million to replenish the GRF over the administration's objections. In the administration's view, the GRF could be simply scored as "lost receipts" and hence not require a Congressional appropriation.

The budget scoring of a 100 percent guaranty program for commercial defense exports is problematic. Under the Budget Act, all appropriations relating to security assistance are "scored," or counted, against budget subsection 150 (the international affairs budget). While Section 24 of the Arms Export Control Act gives the President guaranty authority, the principal amount of the loan guarantied counts against the available security assistance budget authority in accordance with the Congressional Budget Office's interpretation of the Budget Act.

Stated differently, if the U.S. guaranties a $20 loan, it gets counted in the budget as if it was $20 of new budget authority. Thus, any bank funds guarantied by the U.S. government would be scored against the 150 account even if no funds were appropriated for the Guaranty Reserve Fund. It thus makes little fiscal sense for the President to seek authority in the budget submission to extend 100 percent guaranties for commercial defense equipment unless the scoring rules are changed.

The other precedent for a guaranty program is the FMS debt reform plan that was enacted into law in the FY 1988 Continuing Resolution. Under that plan, the U.S. government allows countries to arrange private financing for outstanding amounts owed to the U.S. on past FMS debts. The U.S. will guaranty 90 percent of the privately financed amount. For this partial guaranty program, the scoring issue has been solved, at least in principle. The U.S. guaranty here is treated as a *contingent liability*, which essentially means that none of the guarantied amount is scored against the 150 account. Under the plan, if the countries cannot meet payments to the bankers, the Guaranty Reserve Fund will borrow the money from the Treasury to pay the bankers to the extent necessary.

The advantage of applying this approach for commercially financed sales is that Congress would only have to appropriate a percentage of the guarantied loan. This would make sales to credit-worthy allies more easily consummated. These countries might include Greece, Spain, Portugal, Korea, Thailand, and Israel. Appropriated funds could then be used for direct loans or grants to the "developing world" where banks would be unwilling to take the financial risk without some kind of guaranty.

In determining the scoring approach for the program, it is important that *all* costs and potential liabilities be clear from the outset. Any attempt to "hide" these costs would ensure that the program would never get the support of Congress.

A partial guaranty program could require the establishment of a new reserve fund to guard against possible defaults. Such a fund would require an initial appropriation that would represent a fixed percentage of anticipated sales. As an example, if the fund was capitalized a 10 percent of the outstanding loans, a $200 million appropriation would provide a basis for loans of $2 billion. The percentage of the guaranty could vary with each country, depending on credit worthiness.

One uncertainty of such a program would be a mechanism by which the U.S. government could determine the credit worthiness of a country—a very sensitive political issue. A repeat of the FMS Credit program must be avoided, where loans were made to countries on political grounds with little attention paid to the ability of the countries to meet their debt service obligations. Some kind of interagency consultative process with the Eximbank, and the Treasury and Defense Departments might be a possibility.

In practical terms, it means introducing legislation, which has already been drafted, to establish a program that would extend partial guaranties to commercially financed defense sales. This would help restore the defense Industry's competitiveness in the international marketplace.