Office of Inspector General
Export-Import Bank
of the United States

Inspection of EXIM's 2014 Transaction with Kenya Airways

September 26, 2018
OIG-INS-18-01

The Export -Import Bank of the United States (EXIM or the Bank) is the official export credit agency of the United States. EXIM is an independent, self-sustaining executive agency and a wholly-owned U.S. government corporation. The Bank's mission is to support jobs in the United States by facilitating the export of U.S. goods and services. EXIM provides competitive export financing and ensures a level playing field for U.S. exports in the global marketplace.

The Office of Inspector General (OIG), an independent office within EXIM, was statutorily created in 2002 and organized in 2007. The mission of the OIG is to conduct and supervise audits, investigations, inspections, and evaluations related to agency programs and operations; provide leadership and coordination as well as recommend policies that will promote economy, efficiency, and effectiveness in such programs and operations; and prevent and detect fraud, waste, abuse, and mismanagement.

This inspection was conducted in accordance with the 2012 Quality Standards for Inspection and Evaluation as defined by the Council of Inspectors General on Integrity and Efficiency. This report does not constitute a Government audit and therefore, it was not conducted following the Generally Accepted Government Auditing Standards (GAGAS).

To: David Sena, Senior Vice President, Office of Board Authorized Finance

From: Jennifer Fain, Acting Assistant Inspector General, Audits and Evaluations

Subject: Inspection of EXIM's 2014 Transaction with Kenya Airways AP088412XX, XA, XB, and PC088413XX

Date: September 26, 2018

Attached please find the final inspection report on the Inspection of EXIM's 2014 Transaction with Kenya Airways. The report outlines two recommendations for corrective action. On September 21, 2018, EXIM provided its management response to a draft of this report agreeing with the recommendations. We consider management's corrective actions to be responsive. The recommendations will be closed upon completion and verification of the implementation of those recommendations.

We appreciate the courtesies and cooperation extended to us during the inspection. If you have questions or comments regarding the final report, please contact me at (202) 565-3439.

cc: Jeffrey Gerrish, Acting President and Chairman
Jeffrey Goettman, Executive Vice President and Chief Operating Officer
Kevin Turner, Senior Vice President and General Counsel
Margaux Matter, Senior Vice President and Chief of Staff
Kenneth Tinsley, Senior Vice President and Chief Risk Officer
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Attachment: Inspection of EXIM's 2014 Transaction with Kenya Airways AP088412XX, XA, XB, and PC088413XX

Executive Summary

Inspection Report on Kenya Airways
OIG-INS-18-01, September 2018

Why We Did This Inspection

We completed an inspection of EXIM's Kenya Airways (KQ) financing to ascertain the adequacy of the Bank's due diligence, risk assessment, transaction structuring, and policy compliance. At the time of our review, the KQ financing constituted the largest non-sovereign aircraft credit on the Bank's Watch List and the first restructuring of an EXIM-financed aircraft transaction in recent years.

What We Recommend

We made two recommendations to improve the Transportation Division's credit review process:

1. Update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records (e.g., Board Memo).
2. Revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11. This would include updating related policies and procedures.

What We Found

The KQ transaction comprised an $821.4 million comprehensive guarantee to support Kenya Airway's purchase of seven aircraft and a spare engine in 2014. Additional aircraft were purchased using private sector financing. KQ's aircraft purchases were part of a broader strategy to expand and modernize its existing fleet and were largely debt financed. The resulting increase in KQ's financial leverage, coupled with increased competition and adverse events precipitated the need for KQ to restructure its debt and lease obligations in 2017.

We found that EXIM generally conducted sufficient due diligence, assessed risk, and adequately structured the transaction in accordance with Bank policies and procedures. The Bank also effectively monitored KQ's performance from transaction approval in March 2014 through the end of the restructuring period in November 2017.

EXIM successfully restructured the KQ transaction. However, the Bank can more fully document the analysis of projected financial results and assumptions when establishing the ability of the borrower to repay its debt. While EXIM was able to successfully restructure this deal and protect the interests of the U.S. Government, more fully documenting the analysis of projected financial results and assumptions when establishing the borrower's ability to repay will provide greater transparency to the origination process and help to better inform decisions.

Lastly, we found that the Bank can improve the transportation origination risk rating model to address limitations in the scale used to determine the final Budget Cost Level (BCL) risk rating for a transaction. We made two recommendations to address identified areas of improvement.

For additional information, contact the Office of Inspector General at (202) 565-3908 or visit www.exim.gov/about/oig

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ABBREVIATIONS AND GLOSSARY

Term	Description
ASU	The 2011 Aircraft Sector Understanding provides a framework for the predictable, consistent, and transparent use of officially supported export credits. The 2011 ASU levels the playing field across the global aviation industry among manufacturers, airlines, and export credit agencies.
Bank or EXIM	Export-Import Bank of the United States
BCL or Risk Rating	The Budget Cost Level is a risk rating system of EXIM that rates a transaction on a sliding scale of 1 (low risk) to 11 (high risk). The BCL rating determines loss reserves allocated by the Bank for a transaction.
Board	The Board of Directors, EXIM, is responsible for approving all medium and long-term transactions of more than $10 million or exceeding seven years repayment.
Board Memo	A memorandum submitted to the EXIM Board as part of the process for approving a transaction for Bank support.
Cape Town Convention	The Cape Town Convention on International Interests in Mobile Equipment is an international treaty that standardizes transactions involving movable property, such as aircraft, rail, and space equipment. The treaty includes international standards for sale contract registration, security interests, and leases.
CAGR	Compound Annual Growth Rate
DSCR	Debt Service Coverage Ratio, as calculated by TD and TPMD, is EBITDAR/(interest expense, lease rental, and principal payments on debt)
EBITDAR	Earnings Before Interest, Tax, Depreciation, Amortization, and Rent
ECA	Export Credit Agency
Final Commitment	A final commitment is an authorization of financing by EXIM.
FY	Fiscal Year
GoK	Government of Kenya
Investment Grade	Issuer ratings above BBB or Baa, which ranges from ‘extremely strong capacity to meet financial commitments’ (AAA or Aaa) down to ‘adequate capacity to meet financial commitments but more subject to adverse economic conditions’ (BBB or Baa). Investment grade bonds are judged by the rating agency as likely enough to meet payment obligations.
KLM	KLM Royal Dutch Airlines
KQ	Kenya Airways PLC, formerly Kenya Airways Limited
Loan Manual	EXIM’s Loan, Guarantee and Insurance Manual, which sets forth the policies and procedures for due diligence, structuring and asset management of Bank transactions.
Obligor	The Borrower, an entity that is legally obligated to repay the EXIM financing.
OECD	Organisation for Economic Co-operation and Development
OIG	Office of Inspector General, EXIM

Term	Description
Operative Date	The date that a transaction has satisfied all conditions precedent and is available for funding.
Preliminary Commitment	A Preliminary Commitment is an offer of EXIM financing subject to the award of the export contract and the Bank's review of a Final Commitment application. Preliminary Commitments are most commonly used in aircraft transactions when the purchaser has not yet made a purchase decision or when the transaction involves multiple deliveries.
PSOR	The primary source of repayment is the entity which EXIM will primarily rely upon for repayment of the direct or guaranteed loan.
TD	Transportation Division, EXIM
TPMD	Transportation Portfolio Management Division, EXIM
Watch List	A list of EXIM transactions that the Bank has determined represents a low to moderate likelihood of impairment.

INTRODUCTION

We completed an inspection of the Export-Import Bank of the United States (EXIM or the Bank) 2014 Kenya Airways (KQ) transaction (AP088412XX, XA, and XB).[1] The objective of the inspection was to ascertain the adequacy of the Bank's due diligence, risk assessment, transaction structuring, and policy compliance as it relates to the transaction. We initiated the review as part of our annual work plan. Several factors motivated this inspection. It was the first Office of Inspector General (OIG) inspection of an EXIM aircraft transaction and it represents the first restructuring of an EXIM-supported aircraft transaction in recent years. The obligor was also the largest non-sovereign aircraft credit on the Bank's Watch List at the time of selection for inspection.

SCOPE AND METHODOLOGY

To achieve our objective, we employed a combination of qualitative and quantitative techniques as part of our review of the 2014 KQ transaction including a review of financial and legal documentation; review of internal procedures and policies; interviews of EXIM staff and external parties; and research of laws, rules, regulations, and industry practices. The inspection was performed in Washington, DC, with a site visit to London, UK and Nairobi, Kenya in January 2018 to interview transaction participants. A detailed summary of the inspection methodology and a summary of prior reports is provided in Appendix B of this report.

Points of Inquiry

The following points of inquiry directed our focus and helped to guide our inspection.

POINT OF INQUIRY 1: Did the Bank conduct sufficient due diligence, assess risk, and adequately structure the transaction at origination?

POINT OF INQUIRY 2: Did the Bank effectively monitor obligor performance post origination?

POINT OF INQUIRY 3: Did the Bank effectively manage the restructuring process?

We conducted this inspection from July 2017 to September 2018 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of Inspectors General on Integrity and Efficiency.[2] We believe that the evidence obtained provides a reasonable basis for the findings and conclusions in this report.

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[1] The 2014 KQ transaction was comprised of four sub-transactions: a Final Commitment for a comprehensive guarantee of three sub-transactions (AP088412XX, XA, and XB), and a Preliminary Commitment for a comprehensive guarantee of one sub-transaction (PC088413XX). The Preliminary Commitment was later withdrawn by EXIM.

[2] *See* https://www.ignet.gov/sites/default/files/files/committees/inspect-eval/iestds12r.pdf.

BACKGROUND

EXIM Aircraft Portfolio

Comprised of wide and narrow-body aircraft, business jets and helicopters, the total exposure of EXIM's aircraft portfolio represented 48.6 percent of the Bank's $69.5 billion portfolio as of December 31, 2017.[3] Transactions within the portfolio are primarily structured as asset-based with EXIM guarantees to lenders who finance the purchase of the aircraft. The Bank maintains a first-priority security interest in the aircraft as collateral throughout the life of the transaction, and can exercise remedies if needed. An example of a remedy includes the repossession and subsequent disposition of the aircraft.

Over time, the size of the aircraft portfolio has shifted with market conditions such as the 2007-2009 world recession where EXIM's financing of aircraft increased. For example, the Bank financed 27-30 percent of an aircraft manufacturer's deliveries between 2009 and 2012.[4] The percentage decreased to 17 percent after 2012 and was down to 4 percent in 2015 due to improved market conditions for aircraft financings.[5] Congressional actions have also contributed to a decrease in the size of the aircraft portfolio. The 2015 lapse in EXIM's authority and the ongoing lack of a quorum on its Board of Directors (Board) has furthered the decrease in the size of the aircraft portfolio.[6] Since July 20, 2015, the lack of a Board quorum has precluded EXIM staff from presenting medium and long-term transactions over $10 million for Board approval.

As of December 31, 2017, the Bank's estimated value of aircraft collateral in the portfolio exceeded the value of aircraft exposure by 40 percent.[7] The default rate for EXIM's aircraft portfolio was 0.009 percent.[8]

African Market and Outlook

Although Africa is the second most populated continent, the African aviation market currently accounts for only 3 percent of the world's air traffic.[9] Africa was the weakest performing region in the world in terms of profitability with a net post-tax loss of $100

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[3] *See* EXIM's *Portfolio Risk Management Report*, dated December 2017.

[4] *See* (b) (4)

[5] *Ibid.*

[6] *See* https://www.wsj.com/articles/white-house-in-shift-pushes-to-revive-u-s-export-import-bank-1528968601.

[7] *Supra* note 3. To reduce portfolio risk, EXIM co-finances (i.e., reinsures) with other export credit agencies. As of September 30, 2017, EXIM's total outstanding exposure for its portfolio was $69.1 billion. Of this exposure, $4.1 billion (5.9 percent) of risk for transactions authorized between fiscal years 2005 and 2015 was reinsured. These risk sharing agreements were primarily in transactions involving wide-body aircraft.

[8] EXIM's *Default Rate Report*, dated December 2017.

[9] *See* https://businesstech.co.za/news/general/85952/the-biggest-airlines-in-africa/.

million in 2017.[10] In 2018, the region is expected to support demand growth of 8 percent, capacity expansion of 7.5 percent, and a similar projected net post-tax loss of $100 million.[11]

2014 Transaction with Kenya Airways

Obligor History

Founded in 1977, KQ is the national flag carrier of Kenya and is based at Jomo Kenyatta International Airport (JKIA) in Nairobi, Kenya. The principal activities of KQ are the international, regional, and domestic carriage of passengers and cargo by air, the provision of ground handling services to other airlines, and the handling of import and export cargo.

At the time of this report, the Government of Kenya (GoK) is KQ's largest shareholder with a 48.9 percent interest in the carrier. KQ's longstanding strategic partnership since 1995 with KLM Royal Dutch Airlines (KLM) created a worldwide network of joint services. Both KLM and KQ are members of the SkyTeam Global Airline Alliance, which also includes Delta Airlines and Air France among the 19 airline members. KQ is currently the only SkyTeam member located in Africa.[12]

KQ operates 59 intracontinental flights and international routes to six destinations in the Middle East and Asia, and three destinations in Europe. The airline's portfolio also includes two wholly owned subsidiaries, a low-cost Africa-only carrier, JamboJet and African Cargo Handling Limited. KQ is Africa's sixth largest airline in total aircraft fleet, with 36 aircraft currently in service.[13] KQ is the third largest airline in sub-Saharan Africa behind South African Airways and Ethiopian Airways with 4.5 million passengers flown in fiscal year (FY) 2017.[14]

Transaction Description

In 2007, KQ ordered (b) (4) and submitted an application to EXIM for financing support. (b) (4)
The Bank reviewed KQ's application and subsequently issued a Preliminary Commitment—an offer of EXIM financing subject to the award of the export contract and the Bank's review of a Final Commitment application. (b) (4)
EXIM's Preliminary Commitment expired in August 2007. Therefore, KQ was required to resubmit a request to the Bank for financing support.

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10 *See* http://www.iata.org/pressroom/pr/Pages/2017-12-05-01.aspx.

11 *Ibid.*

12 EXIM's KQ Board Memo, dated January 2014.

13 *See* https://centreforaviation.com/insights/analysis/ethiopian-airlines-2015-outlook-more-rapid-expansion-as-it-becomes-africas-largest-airline-204559 and KQ Annual Report FY2017 available at https://corporate.kenya-airways.com/investors-and-shareholders/annual-reports/en/.

14 See KQ Annual Report FY 2017 available at https://corporate.kenya-airways.com/investors-and-shareholders/annual-reports/en/.

In January 2014, KQ requested a Final Commitment for a comprehensive guarantee in the amount of $821.4 million to support the export of (b) (4) .[15] According to the agreement, the manufacturer agreed to deliver all aircraft and engines between March 2014 and October 2014. KQ also requested a Preliminary Commitment for a comprehensive guarantee in the amount of $337.7 million to support the export of (b) (4) .

On March 13, 2014, EXIM's Board approved both the Final Commitment and the Preliminary Commitment.[16] Ultimately, the Bank did not convert the Preliminary Commitment for the three additional aircraft to a Final Commitment (b) (4)

Transaction Structure

As a standard asset-based financing without a sovereign guarantee, the 2014 KQ transaction was structured using a special purpose company (SPC) and finance lease. Figure 1 below includes an illustration of an EXIM finance lease structure for aircraft transactions.[17] As the SPC, Tsavo Aircraft Financing LLC (Tsavo) as obligor owns and leases the EXIM guaranteed aircraft to KQ pursuant to 12-year asset-backed finance leases with straight-line amortization. The primary source of repayment (PSOR) for the transaction is the cash flow generation of the Lessee, KQ, which makes lease payments to the borrower Lessor, Tsavo. The secondary or supporting source of repayment is the residual value of the secured aircraft as measured by the loan to value ratio.

JP Morgan Chase and Citigroup Global Markets, Inc. were the EXIM guaranteed lenders under the 2014 transaction. Wells Fargo Bank served as the security trustee of the EXIM guarantee. The African Export-Import Bank provided subordinated financing for the portion of the aircraft price and acquisition fees not supported by the EXIM guaranteed financing.

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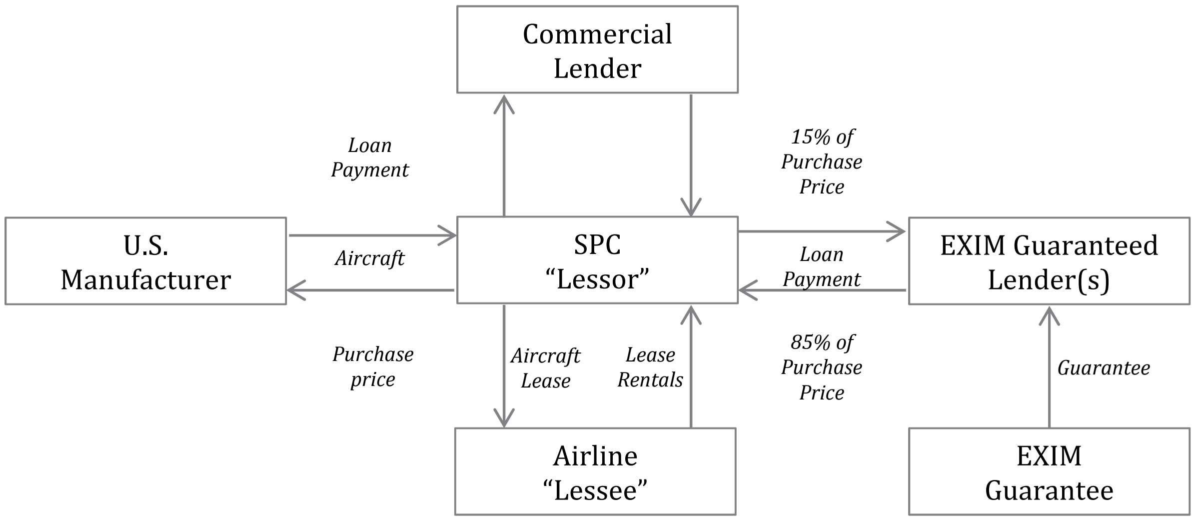
15 (b) (4) percent of each (b) (4) aircraft and (b percent of each (b) (4) aircraft financed under the Final Commitment for KQ was co-financed (i.e., reinsured) by (b) (4) thereby reducing EXIM's exposure by approximately (b) (4)

16 *See* https://www.exim.gov/news/minutes/board-meeting-minutes-2014-03-13.

17 *See* https://www.exim.gov/what-we-do/loan-guarantee/transportation/finance-lease-structure.

Figure 1: EXIM Finance Lease Structure



Source: EXIM

Transaction Closing

KQ received the aircraft approved under the 2014 transaction over a series of eight months, beginning in March 2014. As each aircraft became available for delivery, a separate closing was held, beginning with the first closing on March 31, 2014, and ending with the final closing on October 17, 2014. KQ subsequently drew down on the facility approved by the EXIM Board to fund the purchase of the aircraft. The facility was fully drawn down by October 2014.

Obligor History: Post Closing

(b) (4)

Lease payments were scheduled to be paid 90 days in advance of the corresponding loan payments. (b) (4)

Less than a year after the final closing, KQ restructured its operations and capital structure to reduce leverage and increase liquidity. In 2016, KQ announced the effort known as "Operation Pride" to restructure its operations. On November 2017, KQ announced that all major stakeholders, including EXIM, also agreed to a capital restructuring effort known as "Project Safari."

Financial Distress and Restructuring

Factors Contributing to KQ's Financial Distress

Several factors contributed to KQ's deteriorating financial condition and the need to restructure operations and financial obligations. Specifically, the airline experienced a significant increase in debt and lease obligations coupled with lower than expected revenue growth and higher than expected costs. KQ's obligations quadrupled from $580.8

million in 2012 to $2,488.5 million in 2016 to finance the fleet modernization and expansion.[18] In describing the airline's difficult financial condition, KQ's Chairman confirmed that "the overall level of debt of the Company has become unsustainably high" and that "a return to profitability for investors based on the current balance sheet structure would be exceptionally challenging, and highly unlikely to occur."[19]

Although KQ projected that operating revenue would increase (b) (4) , the airline experienced relatively flat revenue and higher than expected costs. (b) (4) The decrease in revenues was attributed to various external factors such as: increased competition, acts of terrorism in Africa, government imposed travel warnings, and other crises, (b) (4) all of which delayed the airline's ability to fully execute its operational business plan. (b) (4) [20]

KQ's Operations Restructuring Plan

In 2016, KQ embarked on "Operation Pride," a program to improve company profitability through revenue enhancement, cost reduction business model revisions, and capital structure optimization.[21] Under Operation Pride, KQ sold assets; reduced staff and routes; replaced executive positions; and updated processes for risk, pricing, and revenue management.[22]

KQ's Capital Restructuring Plan

KQ also embarked on a recapitalization and financial restructuring plan, known as "Project Safari," to better position the airline for long-term sustainability. On July 16, 2017, KQ publically announced plans to restructure the company and proposed a series of inter-conditional transactions in an attempt to improve the viability of the airline's capital

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[18] *See* KQ's Annual Reports and Financial Statements for years ending March 31, 2012 and March 31, 2016, at https://corporate.kenya-airways.com/investors-and-shareholders/annual-reports/en/.

[19] *See* KQ's 2017 Circular to Shareholders at https://www.kenya-airways.com/uploadedFiles/Content/About_Us/Investor_Information/Project%20Safari_Shareholders%20Circular%20(Approved%20Version).pdf.

[20] *Supra* note 12 and August 2016 Restructuring Consultant Report.

[21] *See* https://www.kenya-airways.com/uploadedFiles/Content/About_Us/Investor_Information/Investor-Briefing-21-July-2016.PDF.

[22] *See* https://www.kenya-airways.com/uploadedFiles/Content/About_Us/Investor_Information/Book%20KQ%2010996%20Annual%20Report_Website.pdf.

structure.[23] On November 16, 2017, KQ announced that it had completed the following steps as part of the restructuring program:[24]

- <u>Debt Reduction and Equity Conversion</u>: Reduced KQ's gross debt by converting subordinated debts, including GoK and local Kenyan Bank loans, to equity with the ability to convert an additional US $75 million of further indebtedness to equity in the future.[25]

- <u>Lessor Repayment Schedule Restructuring</u>: Provided cash flow relief of US $360 million by restructuring the timing of repayment due to operating and financing lessors, (b) (4) . The restructuring of lessor repayment schedules would be accomplished by deferring financing lease payments of US $189 million and operating lease payments of US $171 million (b) (4) .[26]

- <u>GoK Support</u>: The GoK agreed to the following provisions: (i) the issuance of a US $525 million sovereign guarantee to EXIM; and (ii) the issuance of a US $225 million sovereign guarantee to the Kenyan Banks that agreed to convert their loans to equity and provide US $175 million in new loan facilities for KQ operations backed by the GoK's sovereign guarantee. (b) (4)

  [7]

- <u>Other</u>: KLM committed to support KQ through in-kind contributions of non-cash assets in exchange for new shares. Existing shareholders have the opportunity to buy more KQ shares. KQ introduced an employee stock option plan to qualifying employees.[28]

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[23] *Supra* note 19.

[24] *See* https://www.kenya-airways.com/uploadedFiles/Content/About_Us/Investor_Information/Public%20Announcement%20completion%20of%20the%20restructuring.pdf.

[25] *Ibid.*

[26] *Supra* note 19.

[27] *Supra* notes 19 and 24.

[28] *Supra* note 24.

RESULTS IN BRIEF

We completed an inspection of EXIM's 2014 KQ transaction, a comprehensive guarantee in the amount of $821.4 million to support the export of (b) (4) The objective of the inspection was to ascertain the adequacy of the Bank's due diligence, risk assessment, transaction structuring, and policy compliance as it relates to the transaction. We found that EXIM generally conducted sufficient due diligence, assessed risk, and adequately structured the transaction in accordance with Bank policies and procedures. The Bank also effectively monitored KQ's performance from transaction approval in March 2014 through the end of the restructuring period in November 2017.

EXIM successfully restructured the KQ transaction. However, the Bank can more fully document its analysis of projected financial results and assumptions when establishing the ability of the borrower to repay its debt. Lastly, we found that the Bank can improve the transportation origination risk rating model to address limitations in the scale used to determine the final Budget Cost Level (BCL) risk rating for a transaction. We made two recommendations to address identified areas of improvement.

POINT OF INQUIRY 1: Did the Bank conduct sufficient due diligence, assess risk, and adequately structure the transaction at origination?

Applicable Standards

1. EXIM policies and procedures for origination and restructuring:
   a. Chapter 7 *Standard Long-Term Preliminary Commitments and Final Commitments* of EXIM's Loan, Guarantee and Insurance Manual (Loan Manual), dated January 2013;
   b. Chapter 13 *Aircraft Finance* of the Loan Manual, dated January 2013;
   c. Transportation Division's "*Tools" in Ex-Im Bank's Aircraft "Toolbox"* memorandum (Toolbox Memo), dated 2002; and
   d. Transportation Division's *Risk Assessment System for Ex-Im Bank Supported Large Aircraft Transactions* (Risk Assessment), dated June 1997.
2. Federal guidance on internal controls outlined in the General Accountability Office's (GAO's) *Standards for Internal Controls for the Federal Government,* dated November 1999;[29] and the Office of Management and Budget's (OMB) Circular A-123 Revised, *Management's Responsibility for Internal Controls*, dated December 21, 2004.[30]
3. International agreements and protocol for aircraft financings:

[29] *See* https://www.gao.gov/assets/80/76455.pdf.

[30] *See* https://obamawhitehouse.archives.gov/sites/default/files/omb/assets/omb/circulars/a123/a123_rev.pdf.

a. Organisation for Economic Co-operation and Development's (OECD) *Sector Understanding on Export Credits for Civil Aircraft* (2011 ASU), August 2011,[31] OECD's *Sector Understanding on Export Credits for Civil Aircraft* (2007 ASU), July 2007,[32] and OECD's *Large Aircraft Sector Understanding* (1986 LASU); and

b. Cape Town Convention on International Interests in Mobile Equipment.[33]

4. Credit agency risk rating criteria for airlines.[34]

EXIM Policies and Procedures

Origination and Structuring

Section 2(b)(1) of EXIM's Charter requires the establishment of reasonable assurance of repayment for all transactions authorized.[35] The Bank implements the statutory requirement in part by conducting a risk assessment process for aircraft transactions. According to Chapter 13 of EXIM's Loan Manual, "the objective of the risk assessment process is to establish a reasonable assurance of repayment for the transaction (b) (4) The Loan Manual states, "[t]he assessment of aircraft collateral is an important consideration for asset-based transactions (b) (4)

In accordance with Chapter 7 of the Loan Manual, the Transportation Division (TD) loan officer performs a risk assessment and due diligence to establish reasonable assurance of repayment. The risk assessment process includes consideration of the country risk rating; analysis of the borrower's operations, financial statements analysis, projected financial results, and collateral analysis; and a review of qualitative factors. The analysis of (b) (4) for example, aids in the establishment of the borrower's ability to service debt and obtain financing from external sources.

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31 *See Sector Understanding on Export Credits for Civil Aircraft*, 1 September 2011, available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/asu(2011)1&doclanguage=en.

32 *See Sector Understanding on Export Credits for Civil Aircraft*, 27 July 2007, http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/pg(2007)4/FINAL&doclanguage=en.

33 *See Convention on International Interests in Mobile Equipment*, dated June 9, 2017, available at *http://www.unidroit.org/instruments/security-interests/cape-town-convention.*

34 *See Key Credit Factors: Criteria for Rating the Airline Industry* available at https://www.standardandpoors.com/ and *Global Passenger Airlines,* available at https://www.moodys.com/.

35 *See The Charter of the Export-Import Bank of the United States* at https://www.exim.gov/sites/default/files/2015_Charter_-_Final_As_Codified_-_02-29-2016.pdf.

An aircraft risk rating scoring sheet is completed by the TD loan officer for the transaction to determine the overall BCL risk rating based on defined qualitative and quantitative factors such as industry position, regulatory environment, financial flexibility, EBITDAR margin, and Debt to Net Worth.[36] Each factor is risk rated on a scale of 1 (least risk) to 8 (most risk). For each risk rating level, definitions and ranges are provided for the qualitative and quantitative factors, respectively. The factors are averaged to arrive at a composite score. Structural and collateral enhancements can be considered to enhance the composite score in determining the final BCL risk rating for the transaction. The results of the risk assessment and due diligence are presented in a Board Memo that is submitted to EXIM's Board for consideration and approval.

Structuring

EXIM-supported aircraft financings are generally structured as asset-backed with a finance lease. According to the Toolbox Memo, (b) (4) serves to "... to enhance the creditworthiness of the transaction and enable Ex-Im Bank to conclude that a 'reasonable assurance of repayment' exists." Asset-based financing allows the obligor to use collateral to improve the overall credit profile and financing terms of the transaction. The Bank uses cross collateral and cross default provisions when structuring aircraft transactions with the same borrower. The Toolbox Memo provides options that allow for flexibility in structuring transactions so that risk is reduced to an acceptable level. Example tools available for structuring aircraft financings include the use of a special purpose vehicle (e.g., Special Purpose Company or SPC) and financing lease structure, a first priority mortgage and security interest, cross collateralization, and sovereign guarantee.

Federal Guidance on Internal Controls

As prescribed in OMB Circular A-123, *Management's Responsibility for Internal Control*, EXIM "management has a fundamental responsibility to develop and maintain effective internal control."[37] Internal control is a process effected by EXIM's Board of Directors and management, designed to provide reasonable assurance about the achievement of the Bank's mission and objectives in regard to effectiveness and efficiency of operations, reliability of financial reporting, and compliance with laws and regulations. As stated in the GAO's *Standards for Internal Control in the Federal Government*, "control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives ... [and] ... [t]hey help ensure that actions are taken to address risks."[38]

Management is responsible for designing control activities to achieve an entity's objectives and to respond to risks in its internal control system. A common control activity identified in the GAO standards is "appropriate documentation of transactions and internal control."[39]

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[36] EBITDAR margin is Earnings Before Interest, Tax, Depreciation, Amortization, and Rent as a percentage of total revenue. Debt to Net Worth is a ratio showing a firm's ability to measure its existing debt against total equity.

[37] *Supra* note 30.

[38] *Supra* note 29.

[39] *Ibid.*

Specifically, the standards state that, "Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained."[40]

International Agreements and Protocol

Aircraft Sector Understanding

The OECD's 2011 ASU, a non-binding agreement amongst participants, provides a standardized framework for the use of officially supported export credits for the sale or lease of aircraft. The ASU's standardized framework provides export credit agencies (ECAs) with uniform financing rules so that purchasers select transactions based on product-quality and not the terms offered by ECAs. The ASU establishes the range of financial terms and conditions that ECAs may offer when financing the export of civil aircraft. The ASU highlights include standardization of obligor rating, transaction pricing, and risk mitigation techniques. The ASU has been renegotiated and replaced two times.

Cape Town Convention

The 2001 Cape Town Convention established an international legal framework for the creation, protection, enforcement, perfection, and priority of interests in aircraft (i.e., the "Aircraft Protocol") in 2006.[41] The creation of international standards for transportation equipment registration and legal remedies for default, including repossession, was modeled on modern asset-based finance practices and provides proper recourse to creditors in countries with laws that would otherwise not be creditor-friendly. As of 2017, seventy-three Contracting States and one Regional Economic Integration Organisation (i.e., the European Union), including many countries in which EXIM has completed aircraft financings, have ratified the Aircraft Protocol.[42]

Credit Agency Criteria[43]

The airline industry is a cyclical and capital-intensive sector that is vulnerable to exogenous shocks (e.g., increase in cost of fuel, inflation). In addition to macroeconomic and sector-based risks, an airline carrier's credit profile is determined by company specific qualitative and quantitative factors:

- Qualitative factors include an airline carrier's competitive strength, business mix, operating structure, and fleet/maintenance characteristics; and
- Quantitative or financial metrics typically address the airline carrier's operating margins, free cash flow, capital structure, and liquidity.

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[40] *Ibid.*

[41] *Supra* note 33.

[42] *See* Aircraft Protocol Status, available at http://www.unidroit.org/status-2001capetown-aircraft.

[43] *Supra* note 34.

Finding 1: EXIM generally conducted sufficient due diligence, assessed risk, and adequately structured the KQ transaction. However, the Bank can more fully describe its analysis of borrower projected financial results and assumptions and improve the transportation risk rating model used at origination.

EXIM generally conducted sufficient due diligence, assessed risk and adequately structured the 2014 KQ transaction at origination. In accordance with Bank policies and procedures, TD staff identified and disclosed key transaction risks in the Board Memorandum including sector and event-specific risks, increased competition, higher debt levels, and rising operating costs. As a standard asset-based financing, the KQ transaction was appropriately structured using an SPC and finance lease agreement. To reduce risk to an acceptable level, the Bank structured the financing to require, for example, quarterly rather than semi-annual repayment, a first priority mortgage and security interest in the aircraft, cross-collateralization with past and future Bank supported aircraft, and advanced lease payments by the airline to the SPC. In an effort to further reduce risk EXIM also authorized the use of the "sale and leaseback option" of the fleet which would enable KQ to access funds and reduce the Bank's exposure to the airline. We also determined that the KQ transaction structure complied with international agreements and protected EXIM's security interests in the aircraft and engines through the use of a bankruptcy remote structure. Lastly, the KQ transaction was sufficiently collateralized. As of May 2017, the total value of collateral of the financed aircraft exceeded the value of EXIM loans by approximately 18 percent.[44]

Finding 1A: Documentation of EXIM's assessment of borrower projected financial results should be improved.

Notwithstanding the above, we found that EXIM can improve its documentation of the analysis of projected financial results and assumptions when establishing the ability of the borrower to repay its debt. Less than a year after the final closing of the 2014 EXIM transaction, KQ restructured its operations and financial obligations.[45] This development, which was influenced in part by the known risks disclosed in the Board Memo, demonstrates the need for the Bank to better account for its analysis within the transaction documentation. Improved documentation of the Bank's analysis will provide greater transparency to the origination process and help to better inform decisions.

Pursuant to TD's Risk Assessment policy and procedures, "the projections must be based on conservative, reasonable assumptions in order to be considered valid, and the loan officer should be able to fully explain and defend any marked upward swing in the projected data elements in comparison to the historical results." In accordance with Chapter 13 of EXIM's Loan Manual, "an analysis of projected financial results assists in determining the borrower's capacity to repay amortizing indebtedness and its ability to raise external financing. (b) (4)

[44] EXIM's *Annual Risk Rating Report*, August 2017.

[45] *See* Finding 3 of this report for a discussion of the restructuring of the 2014 KQ transaction.

(b) (4)

To assess EXIM's analysis and due diligence for the KQ transaction, we reviewed supporting documentation for the risk assessment, such as the projected financial results and assumptions, provided in Information Memos and disclosed in the Board Memo covering the period FY 2014 to FY 2018. We also reviewed actual financial results presented in KQ's Information Memos and Annual Reports for the period FY 2011 to FY 2017.[46]

Based on our review, and confirmed by EXIM, we determined that several factors contributed to KQ's deteriorating financial condition and the need to restructure operations and financial obligations in less than a year of the final closing for the 2014 EXIM transaction. (b) (4)

Lastly, various external factors such as increased competition, acts of terrorism in Africa, government imposed travel warnings, and other crises further precipitated KQ's deteriorating financial condition. The results of our review are included in Appendix C of this report.

In our review of the supporting documentation, we found that EXIM can more fully document its analysis of projected financials and assumptions used to establish KQ's ability to repay its debt. For example, the Bank's documentation did not fully describe how the sector and event-driven issues (b) (4) might impact KQ's ability to repay its debt. Nor did it describe alternative outcomes or adjust for risk that may impact KQ's ability to service debt obligations.

Absent a complete record of the TD loan officer's risk assessment and due diligence to establish reasonable assurance of repayment, increases the risk that not all relevant information was considered. Further, by not having a complete record it makes it difficult for the Bank when asked to provide a basis for the decisions it made in authorizing the transaction. While EXIM was able to successfully restructure this deal and protect the interests of the U.S. Government, more fully documenting the analysis of projected financial results and assumptions when establishing the borrower's ability to repay will provide greater transparency to the origination process and help to better inform decisions.

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[46] The Board Memo contained actual financial results covering FY 2011 through six months ended September 30, 2013.

Finding 1B: EXIM's transportation origination risk rating model can be improved.

To validate EXIM's assessment of risk for KQ, we reviewed the aircraft risk rating scoring sheet completed by the TD loan officer. Although we observed no anomalies in the completion of the sheet for KQ, we identified limitations in the scale used to determine the final BCL risk rating for the transaction. Specifically, the transportation risk rating model utilized at origination does not use the same BCL scale that is used by the Bank for risk rating non-transportation transactions. Instead of using a scale of 1 (low risk) to 11(high risk), the transportation risk rating model uses a risk rating scale of 1 (least risk) to 8 (most risk) to risk rate each factor at origination. As a result, the rating scale limits an unsecured transportation transaction rating to a BCL 8 even in those cases when the borrower's actual credit metrics may fall into a higher risk category, such as a BCL 9 to 11.

To illustrate, the risk rating scoring sheet for the KQ transaction scored (b) (4)

In discussions, EXIM staff acknowledged the rating scale limitations of the transportation risk rating model used at origination. Bank staff noted, however, that (b) (4)

The rating scale limitation also differs from the practices observed by the credit rating agencies. For example, the BCL 1 to 8 scale used by the Bank for transportation transactions is equivalent to Moody's rating range of Aa1 to B3. However, under Moody's airline rating system, qualitative and quantitative factors can be rated within a broader range, equivalent to EXIM's risk rating scale of BCL 1 to 11. By limiting initial sub-scores at origination to a scale of BCL 1 to 8, EXIM precludes transportation transactions from rating any sub-component above 8 (i.e., a 9 to 11). As a result, the overall risk level for a transaction can never be higher than a BCL 8 under the current transportation risk rating model for origination. Therefore, the risk rating for a transportation transaction at origination may not fully reflect the associated risk.

RECOMMENDATIONS

We recommend that the Senior Vice President, Office of Board Authorized Finance:

1. Update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records (e.g., Board Memo).
2. Revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11. This would include updating related policies and procedures.

Management Response:

See Appendix A, Management Response and OIG Evaluation.

POINT OF INQUIRY 2: Did the Bank effectively monitor obligor performance post origination?

Applicable Standards

1. EXIM policies and procedures for post-operative monitoring:
    a. Chapter 13 *Aircraft Finance* of the Loan Manual, dated January 2013;
    b. Chapter 22 *Post Operative Monitoring* of the Loan Manual, dated January 2013;
    c. TPMD Policy Manual (Manual), undated; and
    d. EXIM's *Enhanced Monitoring Management Policy*, 2016.
    e. EXIM's *Watch List Credit Policy*, 2016

EXIM Policies and Procedures

Credit Transfer Policy

An aircraft transaction is transferred from the Transportation Division (TD) to the Transportation Portfolio Monitoring Division (TPMD) once it is approved by the Board and made operative; all transaction pre-closing requirements, such as Condition Precedents to Closing, have been resolved; and the transaction has been fully disbursed. At transfer, TD turns over to TPMD all applicable information, such as the disbursement memorandum and closing documents.

EXIM Aircraft Post-Operative Monitoring Procedures

The primary document that outlines the Bank's policies and procedures for proactive management is the TPMD Policy Manual. The Manual focuses on monitoring the financial condition of the various obligors, maintenance, and condition of the mortgaged collateral and actively managing post-operative matters such as amendments, waivers, consents, and restructurings. The Manual is reviewed annually and updated as needed. Once a credit is transferred from TD, it is managed and monitored by TPMD. An obligor's rating and the rationale supporting a rating is documented in a TPMD risk rating report on an annual and as needed basis. The risk rating report includes a monitoring plan; character, reputational, and transaction integrity results; and documentation to support the rating rationale. TPMD is also responsible for monitoring the use, maintenance, and condition of the collateral and managing transaction amendments, waivers, consents, and, if necessary, restructurings.

EXIM Watch List Credit Policy

An approved transaction is subject to review under the Bank's ongoing monitoring of its portfolio of credits. As part of this process, the Office of the Chief Financial Officer (OCFO) conducts monthly exposure reviews. The Watch List, included in EXIM's internal portfolio risk management report, documents credits in the Bank's portfolio where the borrower's ability to service repayment could be affected. This list is broken into three parts: Projects and Corporates, Working Capital, and Transportation.[47] The events or situations experienced by these credits are of a political, commercial, operational and/or technical nature. A briefing is presented by leadership from the division directly responsible for a credit on the Watch List to the President of the Bank and other senior management regarding the risks associated with the credit. A borrower can be removed from the Watch List when a course of action is agreed upon, enacted, and the situation is remedied.

EXIM Enhanced Monitoring Policy

TPMD conducts enhanced monitoring when the Bank deems a transaction high-risk. A high-risk credit is a transaction that contains a BCL rating of (b) (4) and/or is deemed to be high risk due to (b) (4) These transactions, per policy, require an enhanced monitoring plan (EMP) that may be temporary or long-term. Circumstances that may trigger an EMP can be borrower-specific (e.g., missed payment) or non-borrower-specific (e.g., political violence).

Once the transaction has been identified and confirmed eligible for enhanced monitoring, the Vice President (VP) of the division directly responsible for the transaction selects a cross-divisional team to formulate an enhanced monitoring strategy for the transaction going forward. Examples of underlying strategies are site visits, asset inspections, retention of expert consultants, accelerated/enhanced production of financial statements and/or stress tests. Depending on the nature of the transaction, the team may consist of representation from various Bank divisions under the Office of Board Authorized Finance, the Office of General Counsel, and outside advisors. The team is responsible for the implementation of the strategy, and periodic reevaluation of the transaction going forward. Updates are given to senior level management via a weekly Monitored Credit Meeting.

Finding 2: EXIM effectively monitored KQ performance in accordance with Bank policies and procedures.

We found that EXIM effectively monitored KQ performance in accordance with Bank policies and procedures from transaction approval in March 2014 through the end of the restructuring period in November 2017. Specifically, we confirmed compliance in the areas below and the results were as follows:

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[47] EXIM's *Major Delinquent Debt, Impaired Credits & Watch List* as of June 2016.

Evidence of EXIM monitoring using the internal Bank Watch List

In accordance with the TPMD Policy Manual, (b) (4)

[48] (b) (4)

Adherence to enhanced monitoring procedures

According to EXIM's Enhanced Monitoring Management Policy, TPMD conducts enhanced monitoring when the Bank deems a transaction high-risk. TPMD worked with KQ to restructure the transaction and placed the transaction under enhanced monitoring procedures. EXIM recognized that the transaction warranted closer monitoring in early 2015, and per enhanced monitoring guidelines, the Bank wanted additional divisions to monitor the credit developments. The transaction was subject to an EMP which aligned with the Bank's downgrade of the transaction's risk rating from a (b) (4) to a (b) (4) in 2015.

Re-rating of transaction through TPMD monitoring

According to the TPMD Policy Manual, an obligor's risk rating and the rationale supporting ratings are documented in a TPMD risk rating report on an annual or as needed basis. In August 2015, EXIM downgraded the KQ transaction from a (b) (4) to a (b) (4) due to the obligor's deteriorating financial status and credit. To assess the airline's ability to access liquidity, the Bank's 2015 annual risk rating report included a review of the portfolio and the value of collateral, land and potential lease-backs. Furthermore, as a result of the downgrade, the Bank sent an aircraft inspection team to inspect the EXIM-financed fleet. The results of the inspections were documented in the Bank's 2017 annual risk rating report.

Use of EXIM hired aircraft inspections

According to the TPMD Policy Manual, the division is responsible for monitoring the use, maintenance, and condition of the collateral. The Bank engaged an aircraft inspection firm to conduct two initial inspections of the EXIM-financed aircraft. The inspections were conducted to ensure that the Bank's security interest in the aircraft was protected and records were well maintained.

The April 2016 inspection included two aircraft that were financed under the 2014 KQ transaction and two aircraft that were financed under a separate 2005 EXIM-guaranteed facility and cross collateralized with other EXIM financings. (b) (4)

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[48] EXIM documents the performance of a credit when the borrower's ability to service repayment could be affected. Pursuant to OCFO policy, this documentation is included in EXIM's internal portfolio risk management report.

(b) (4) .[49] (b) (4)

A subsequent round of KQ aircraft inspections were conducted in October 2016 on four additional aircraft financed under the 2014 KQ transaction. (b) (4)

RECOMMENDATIONS

OIG does not make any recommendations related to this finding.

POINT OF INQUIRY 3: Did the Bank effectively manage the restructuring process?

Applicable Standards

1. EXIM policies and procedures for restructuring:
    a. TPMD Policy Manual (Manual), undated.

EXIM Guidelines for Restructuring

According to the TPMD Policy Manual, the debt of a transaction may be restructured (b) (4)

[51] TPMD considers restructuring requests on a case by case basis after assessing an obligor's current financial condition, future business prospects, and fleet

[49] The 2005 aircraft have been paid in full as of June 2017.

[50] TPMD Policy Manual.

[51] *Ibid.*

collateral value. (b) (4)

[52]

Pursuant to the TPMD Policy Manual, restructurings must be reviewed and approved by the Bank's Board of Directors. As EXIM lacked a quorum on its Board at the time, the restructuring was approved in May 2017 by senior management under special delegation of authority and in accordance with Bank policies and procedures.[53]

Finding 3: EXIM successfully restructured the 2014 KQ transaction in accordance with Bank policies and procedures.

In late 2017, EXIM finalized a successful restructuring of the 2014 KQ transaction. The restructured transaction included the 2014 financing of seven aircraft, and one spare engine. As part of the restructuring, the Bank agreed to a (b) (4)

Based on our analysis, we concluded that EXIM properly disclosed the terms and conditions of the restructuring of the transaction, including the potential risks, to Bank senior leadership. Moreover, EXIM successfully mitigated the disclosed risks. We also observed that the Constitution of Kenya, 2010 (2010 Constitution) supports the terms of the sovereign guarantee by outlining the mechanism for debt repayment to its lenders. In the event that EXIM needs to invoke the guarantee, the terms of the Constitution of Kenya provide a clear repayment process.[54] Specifically, we found the following:

EXIM assessed KQ's financial condition and business prospects as a restructuring candidate in accordance with Bank policies and procedures

EXIM's TPMD Policy Manual states that the TD considers restructuring requests on a case by case basis after assessing an obligor's current financial condition, future business prospects, and fleet collateral value.[55] (b) (4)

Furthermore, the OIG found evidence of the Bank's due diligence. Specifically during restructuring, participants such as representatives from the GoK, legal counsel, and

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[52] *Ibid.*

[53] EXIM's Special Delegation of Authority Board Resolution as of July 16, 2015.

[54] *See* the Constitution of Kenya, 2010 at http://www.kenyalaw.org/lex/actview.xql?actid=Const2010 and the Public Management Finance Management Act, No. 18 of 2012 at http://www.kenyalaw.org/lex//actview.xql?actid=No. 18 of 2012.

[55] *Supra* note 50.

the third-party financial restructuring firm disclosed that the Bank engaged in constant communication throughout the process.

EXIM properly disclosed the risks posed by the restructuring and sought approval

Pursuant to the TPMD Policy Manual, (b) (4)

As EXIM lacked a quorum on its Board at the time, the restructuring was approved in May 2017 by senior management under special delegation of authority and in accordance with Bank policies and procedures.[56] In November 2017, KQ formally announced that all parties, including the GoK, KLM, and various lenders, had agreed to the terms of the restructuring.

We found that the Bank disclosed key risks in the terms and conditions of the restructuring, including key differences between the proposed GoK guarantee and sovereign guarantees that EXIM had accepted in prior transactions. For example, the GoK guarantee is (b) (4)

To address these risks, the Bank's restructuring memorandum outlined a potential remedy for both (b) (4)

EXIM restructured the transaction in accordance with international agreements and Bank policies

The Bank adhered to international agreements and Bank policies and procedures when it restructured the 2014 KQ transaction. The Bank ensured that its interest in the airframes and engines was registered on the International Registry. The Bank further reduced risk by ensuring that it had a perfected security interest in the aircraft and spare engine. It did so by amending the Uniform Commercial Code financing statements to reflect KQ's name change from "Kenya Airways Limited" to "Kenya Airways PLC."

Sovereign guarantee is well supported by Kenyan Authorities and law

According to the TPMD Policy Manual, (b) (4)

e found the sovereign guarantee to be well supported by Kenya law. In interviews with GoK officials, we learned that KQ is viewed as a strategic asset to the Kenyan economy and thus the government was willing to provide a guarantee to ensure its operations. We also confirmed with interview participants that the GoK guarantee is non-discretionary; meaning if the debt is called it must be paid according to Kenya law.

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[56] *Supra* note 53.

The 2010 Constitution offers strong, lender-friendly protections on debt repayment by the GoK. For example, it outlines the procedures within the GoK for repayment of loans and guarantees.[57] The Consolidated Fund, outlined in Article 206 of the Constitution, is the main account for money raised and received for the Kenyan National Government. If KQ were to default on the loan, EXIM could seek repayment directly from the Consolidated Fund without additional actions by the Parliament of Kenya because the sovereign guarantee has already received parliamentary approval for funds distribution from the Kenyan Debt Management Department. We found that the restructuring was successful in ensuring repayment of the EXIM-supported debt.

RECOMMENDATIONS

OIG does not make any recommendations related to this finding.

[57] *See* the Constitution of Kenya, 2010, available at http://www.kenyalaw.org/lex/actview.xql?actid=Const2010.

APPENDIXES

Appendix A: Management Response and OIG Evaluation

EXIM
EXPORT-IMPORT BANK OF THE UNITED STATES

Reducing Risk. Unleashing Opportunity.

September 21, 2018

Parisa Salehi
Acting Inspector General
Office of the Inspector General
Export-Import Bank of the United States
811 Vermont Avenue, NW
Washington, DC 20571

Dear Ms. Salehi,

Thank you for providing the Export-Import Bank of the United States ("EXIM Bank" or "the Bank") management with the Office of the Inspector General's ("OIG") inspection report on "2014 Transaction with Kenya Airways", OIG-INS-18-01, dated September 14, 2018 (the "KQ Inspection"). Management continues to support the OIG's work which complements the Bank's efforts to continually improve its processes. EXIM Bank is proud of the strong and cooperative relationship it has with the OIG.

EXIM Bank recognizes our staff for their excellence in underwriting and monitoring of this transaction. Through its staff the Bank supported U.S. exports and protected U.S. taxpayers. The Bank appreciates the OIG's acknowledgment that EXIM "generally conducted sufficient due diligence, assessed risk, and adequately structured the transaction in accordance with Bank policies and procedures."

EXIM also values that the OIG noted that "EXIM was able to successfully restructure this deal and protect the interests of the U.S. Government" and that "the restructuring was successful in ensuring repayment of the EXIM-supported debt."

Additionally, EXIM appreciates the OIG's conclusion that "the Bank also effectively monitored KQ's performance from transaction approval in March 2014 through the end of the restructuring period in November 2017" and that EXIM "properly disclosed the terms and conditions of the restructuring of the transaction" and "successfully mitigated the disclosed risks", to include that "the sovereign guarantee is well supported by Kenyan Authorities and law."

The Bank is proud of its efforts resulting in a successful restructuring and appreciates the OIG's recognition of the numerous challenges surrounding it, to include "increased competition, acts of terrorism in Africa, government imposed travel warnings, and other crises, […] (b) (4)
(b) (4)

The Bank continuously strives to improve its policies and practices and agrees to both OIG recommendations issued in this report.

Recommendation 1: that the Senior Vice President, Office of Board Authorized Finance, update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records (e.g., Board Memo).

Management response: Management agrees with this recommendation. EXIM Bank notes that staff conducted a comprehensive analysis of the borrower's financial projections and assumptions but recognizes that it can strengthen its efforts of documenting it more fully in the transaction records. As such EXIM will update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records.

Recommendation 2: that the Senior Vice President, Office of Board Authorized Finance, revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11. This would include updating related policies and procedures.

Management response: Management agrees with this recommendation. EXIM will revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11 and update its guidance accordingly.

We thank the OIG for your efforts to ensure the Bank's policies and procedures continue to improve, as well as the work you do with us to protect EXIM funds from fraud, waste, and abuse. We look forward to strengthening our working relationship and continuing to work closely with the Office of the Inspector General.

Sincerely,

Jeffrey Goettman
Executive Vice President & Chief Operating Officer
Export-Import Bank of the United States

OIG Evaluation

On September 21, 2018, EXIM provided its management response to a draft of this report, agreeing with the two recommendations. The response identified the Bank's actions to address the recommendations. OIG considers the Bank's actions sufficient to resolve the reported recommendations, which will remain open until OIG determines that the agreed upon corrective actions are complete and responsive to the reported recommendations. The Bank's management response to the reported recommendations and OIG's assessment of the response are as follows:

RECOMMENDATION 1

Recommendation 1: Update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records (e.g., Board Memo).

Management Response: Management agrees with this recommendation. EXIM Bank notes that staff conducted a comprehensive analysis of the borrower's financial projections and assumptions but recognizes that it can strengthen its efforts of documenting it more fully in the transaction records. As such EXIM will update policies and procedures to ensure the analysis of the borrower's financial projections and assumptions is fully documented and supported in the transaction records.

Evaluation of Management's Response: Management's actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification that the actions have been implemented.

RECOMMENDATION 2

Recommendation 2: Revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11. This would include updating related policies and procedures.

Management Response: Management agrees with this recommendation. EXIM will revise the transportation origination risk rating model to ensure the final rating outcomes comport to the Bank's BCL risk rating scale of 1 to 11 and update its guidance accordingly.

Evaluation of Management's Response: Management's actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification that the actions have been implemented.

Table 1: Summary of Management's Comments on the Recommendations				
Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date[58]	Resolved: Yes or No[59]	Open or Closed[60]
1	Updates will be made to the Bank's policies and procedures that require the analysis of borrower financial projections and assumptions to be fully documented and supported.	No target completion date provided	Yes	Open
2	Revisions will be made to the Bank's transportation origination risk model to align it with the BCL risk rating scale of 1 to 11. Bank guidance will also be updated.	No target completion date provided	Yes	Open

[58] EXIM OIG has requested target completion dates for each of the outstanding recommendations.

[59] "Resolved" means that (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation; or (2) Management does not concur with the recommendation, but alternate action meets the intent of the recommendation.

[60] Upon determination by the EXIM OIG that the agreed-upon corrective action has been completed and is responsive to the recommendation, the recommendation can be closed.

Appendix B: Inspection Methodology and Prior Reports

Inspection Methodology

During the inspection, we employed a combination of qualitative and quantitative techniques, as well as documentation reviews. We conducted the inspection from July 2017 to September 2018, primarily in Washington, DC, with a site visit to London, UK and Nairobi, Kenya in January 2018. We utilized the following techniques during the research and fieldwork phases of the review:

1. Reviewed the transaction's financial and legal documents, internal and external reports and correspondence related to the transaction.
2. Interviewed Bank staff from TD, TPMD, Office of Board Authorized Finance, and Office of General Counsel.
3. Interviewed external parties including representatives of the borrower/lessee, legal advisor, financial advisor, GoK and U.S. government officials located in Kenya.
4. Reviewed public and open source documents regarding the borrower and the transaction.
5. Conducted onsite interviews with external parties in January 2018 in London, UK and Nairobi, Kenya.

To address transaction specific issues the following was performed:

1. Researched aircraft industry background and trends, including the African aviation market.
2. Researched aircraft finance rating guidance.
3. Researched international agreements and protocol such as the 2011 OECD ASU and the Cape Town Convention.

Prior Reports

EXIM OIG Report (OIG-EV-17-05)

In FY 2017, OIG completed an evaluation of TPMD's risk-rating policies and procedures.[61] The evaluation determined that the division was generally adhering to the risk review and monitoring procedures outlined in current policy guidelines. As part of the evaluation, we compared TPMD's current credit risk review process to leading practices. Although the division's process broadly tracks those practices, we found some areas that should be addressed to ensure alignment. For example, whereas internal guidance provides quantitative metrics to assess key risks, it lacks benchmarks for individual risk factor ratings. Second, we found that a key EXIM credit metric did not align with credit rating

[61] *See* EXIM OIG's *Report on Transportation Portfolio Management Division's Risk Rating Process* (OIG-EV-17-05, dated August 30, 2017) available at https://www.exim.gov/sites/default/files/oig/reports/Final%20TPMD%20%20Report%20-%20Redacted.pdf.

agency practices and that certain aspects of the Bank's qualitative framework resulted in inconsistencies within the rating process. As a result, we concluded that the TPMD risk rating process was susceptible to non-replicability and inaccurate risk rating profiles. In addition, we found that EXIM continues to use different risk rating models for origination and monitoring transportation transactions. Further, EXIM had not established a timeline for implementing recommendations made in the 2015 S&P Capital IQ Risk Solutions evaluation report on the Bank's risk rating model.[62] Lastly, we found that the Bank conducts aircraft inspections on an ad-hoc or as needed basis, and those findings from aircraft inspections were not always fully integrated into TPMD risk rating reports. Our report made three recommendations to strengthen TPMD's risk rating policies and procedures. As of the date of this report, all three recommendations are closed.

[62] S&P Capital IQ Risk Solutions' *Conceptual Soundness and Outcomes Testing Review Report,* dated October 28, 2015.

Appendix C: KQ's Financial Condition – Contributing Factors

(b) (4)

63 (b) (4)

64 (b) (4)

(b) (4)

(b) (4)

(b) (4)

Appendix D: KQ Revenue and Margins – Historical, Projected, and Actual

(b) (4)

Appendix E: KQ Operating Statistics – Historical, Projected, and Actual

(b) (4)

ACKNOWLEDGEMENTS

This report was prepared by the Office of Inspections and Evaluations, Office of Inspector General for the Export-Import Bank of the United States. Several individuals contributed to this report including Daniel Wong, Inspector; Liam Bresnahan, Financial Analyst; Lisa Clark, Paralegal; and Jennifer Fain, Acting Assistant Inspector General for Audits and Evaluations.

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