



**U.S. Department of the Interior
Office of Inspector General**

AUDIT REPORT

**MARSHALL ISLANDS DEVELOPMENT BANK,
REPUBLIC OF THE MARSHALL ISLANDS**

**REPORT NO. 99-I-952
SEPTEMBER 1999**



N-IN-MAR-003-99-R

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL,
Washington, DC. 20240

SEP 30 1999

Mr. Donald Capelle
Chairman, Board of Directors
Marshall Islands Development Bank
Post Office Box 1048
Republic of the Marshall Islands
Majuro, MH 96960

Subject: Audit Report on the Marshall Islands Development Bank, Republic of the
Marshall Islands (No. 99-I-952)

Dear Mr. Capelle:

This report presents the results of our review of the operations of the Marshall Islands Development Bank of the Republic of the Marshall Islands. The objective of our audit was to determine whether (1) Compact Section 111 and 211 funds were used efficiently and effectively in accordance with the intent of the Compact and (2) loans and interest receivables were properly accounted for and effectively collected. The audit was requested by the U.S. Ambassador to the Republic of the Marshall Islands.

We concluded that the Marshall Islands Development Bank did not comply with provisions of the Compact of Free Association, Federal and Republic laws, Bank policies and guidelines, and operating procedures applicable to the Bank's operations and the use of funds provided by the United States. Specifically, we found that:

- The Bank used funds provided by the Compact to issue commercial loans to businesses and government entities without adequate assurances that the purposes of the loans conformed to official economic development plans and that the loans could be and would be repaid.

- Although the Bank made good faith attempts to collect its delinquent loans, the Bank did not (1) use all available collection methods; (2) prepare, collect, and maintain loan records necessary to ensure that loan collateral was protected and that loan files were complete and current; and (3) ensure that management fees were charged on all properties the Bank managed for delinquent borrowers.

- The Bank combined loans funded by the United States under the former Trust Territories Economic Development Loan Fund with loans funded by the Republic. Therefore, the Economic Development Loan Fund loans lost their identity as United States-sourced funds.

These conditions occurred because the Bank (1) issued loans, according to the Bank's Chairman of the Board and the Managing Director, based on political considerations and without adequate financial analyses of the projects' financial viability and the borrowers' ability to repay; (2) was reluctant to seize loan collateral and believed that cooperative efforts with the borrowers would resolve delinquency problems; and (3) did not ensure that loan files included the history of Bank actions on the loans and all required documents because loan personnel were not adequately trained and supervised and devoted significant time to managing returned property. Further, the Bank did not collect management fees because Bank officials had not realized the time and related costs involved in managing smaller properties on behalf of delinquent borrowers. Finally, the Bank did not follow requirements to separately account for and control Economic Development Loan Fund accounts because they were not aware of the requirements when the Bank assumed outstanding accounts from its predecessor bank.

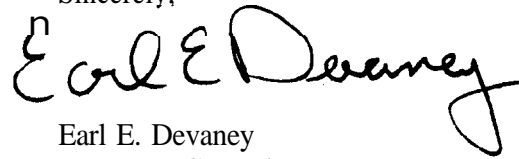
As a result, potential Bank revenue from outstanding loans totaling \$6.8 million appears to be uncollectible, and loans of another \$6.9 million may become uncollectible. The unavailability of this \$13.7 million has prevented the Bank from issuing new commercial loans from Compact funds since July 1996 and from meeting its legally mandated purpose to "promote the development and expansion of the economy of the Marshall Islands." Also, because of ineffective collection enforcement, additional loans totaling \$838,000 appear to be uncollectible, and loans of another \$3.3 million may become uncollectible. The Bank also lost an estimated \$7,500 by not charging management fees. Further, (1) payments totaling \$214,938 received on Economic Development Loan Fund loans were deposited into the Bank's local revenue accounts and (2) loan balances and loan payments totaling \$167,950 were transferred to and/or combined with loans from other financing sources and were not available for new loans to be made pursuant to the established purposes of the Economic Development Loan Fund. We made 11 recommendations to you, as the Chairman of the Bank's Board of Directors, to correct the deficiencies identified.

Based on your August 27, 1999, response (Appendix 3) to the draft report, we consider Recommendations A.4, B.4, and B.5 resolved and implemented and Recommendations A.2, A.3, B.1, and B.3 resolved but not implemented. Accordingly, the unimplemented recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. Also based on the response, we consider Recommendations C.1 and C.2 unresolved and request additional information for Recommendations A.1 and B.2 (see Appendix 4).

Section 5(a) of the Inspector General Act (Public Law 95-452, as amended) requires the Office of Inspector General to list this report in its semiannual report to the Congress. Therefore, please provide a response, as required by Public Law 97-357, to this report by November 10, 1999. The response should be addressed to our Pacific Field Office, 4 15 Chalan San Antonio, Baltej Pavilion - Suite 306, Tamuning, Guam 96911. The response should provide the information requested in Appendix 4.

We appreciate the assistance provided by the staff and management of the Development Bank during the conduct of our audit.

Sincerely,

A handwritten signature in black ink that reads "Earl E. Devaney". The signature is written in a cursive style with a large, prominent "E" at the beginning.

Earl E. Devaney
Inspector General

cc: President, Republic of the Marshall Islands
Managing Director, Marshall Islands Development Bank

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INTRODUCTION

BACKGROUND

The Republic of the Marshall Islands Public Law 1988- 1 (codified as Title 10, Chapter 8, of the Marshall Islands Revised Code) established the Marshall Islands Development Bank effective March 17, 1988. Section 8 10(1) of the Revised Code states, "The functions of the Bank shall be to promote the development and expansion of the economy of the Marshall Islands in order to improve the standard of living of the people by adopting strategies that will develop and mobilize the human, natural, capital, technical entrepreneurial and other resources of the country." Section 8 11 of the Revised Code states that the Bank has the power to provide financial assistance "by extending loans to enterprises; by guaranteeing. . . the payment of money . . . [and] by making equity investments in enterprises." Section 8 11 also states that the Bank has the power to provide nonfinancial assistance to enterprises operating in the Marshall Islands "by taking the initiative in the identification of investment opportunities, the undertaking of feasibility studies, the promotion and formation of new enterprises, as well as the expansion of existing enterprises with the objective of enlarging the economic base of the country" and "by managing or taking part in the management of, supervision, or conduct of the business of enterprises."

Title 10, Sections 807 and 808, of the Revised Code states that the Cabinet of the Republic of the Marshall Islands will appoint the members of the Bank's Board of Directors, nominate the Chairman of the Board, and appoint the Bank's Managing Director. Title 10 of the Revised Code was amended in 1993 to reduce the "exceptional degree of direction" that the Republic of the Marshall Islands Government provided over the Bank's operations by removing the requirements that (1) the Bank's Board should "serve at the pleasure of the Cabinet," (2) amendments of the Bank's By-Laws should be approved by the Cabinet, and (3) the Bank's policies and guidelines also should be approved by the Cabinet.

As of November 30, 1998, the Bank had received funding of about \$17.5 million from the United States for economic loan programs. These funds were primarily from Sections 111 and 2 11 of the Compact of Free Association between the United States and the Republic of the Marshall Islands, which became effective on October 2 1, 1986. Although the Marshall Islands Development Authority initially had responsibility for \$10 million provided for the

'The 1993 amendments were based on a 1992 report entitled "Institutional Strengthening of the Marshall Islands Development Bank," issued by an Australian planning and training consultant firm. The report stated, "The MIDB [Marshall Islands Development Bank] Act allows for an exceptional degree of direction by [the] Government [of the Marshall Islands]. Government intervention is pervasive and dominates the Bank's lending program. At the same time, the relationship with Government inhibits MIDB from exercising its developmental role and its commercial judgement. MIDB has no real prospect of developing as a [development financing institution] unless it is allowed to operate at arms length from Government. The MIDB Board has approved revisions to the MIDB Act drafted by the consultants. The revisions provide the necessary framework for MIDB's development along the lines of other [development financing institutions]. No change to the By-laws is considered necessary. It is recommended that: the MIDB Act be amended as a pre-requisite to any real reform of the Bank. "

Compact Section 111 Investment Development Fund, the Bank's enabling legislation transferred responsibility for these funds to the Bank. Additionally, in 1992 the Republic initially loaned, and later granted to the Bank as contributed capital, \$5 million received from revenue bonds that were secured by Compact Section 211 funds. The Bank funded its operating expenses from interest earnings and loan origination fees.

The single audit report of the Marshall Islands Development Bank for fiscal year 1997 stated that, as of December 31, 1997, the Bank had loans receivable totaling \$17.8 million and a related allowance for doubtful accounts of \$12 million, which resulted in net loans receivable of \$5.8 million. The single audit report also stated that the Bank had contributed capital of \$17.5 million and an accumulated unreserved retained earnings deficit of \$10.4 million. Finally, the Bank reported calendar year 1997 interest income of \$1 million and an operating loss of \$722,000, which was an increase from the calendar year 1996 operating loss of \$517,000.

The Bank's fiscal year 1999 operating budget totaled \$649,518, including \$92,416 for the salaries and related costs of six Bank employees who were assigned to two loan programs administered by the Majuro Office, Rural Development, U.S. Department of Agriculture. As of November 30, 1998, the Bank had 16 employees, excluding the employees at Rural Development, as follows: 1 secretary, 7 loan officers, 6 accounting personnel, a Finance Manager, and a Managing Director.

OBJECTIVE AND SCOPE

The objective of the audit was to determine whether (1) Compact Section 111 and 211 funds were used efficiently and effectively in accordance with the intent of the Compact and (2) loans and interest receivables were properly accounted for and effectively collected. The scope of our review initially included all Compact-funded loans issued and administered during fiscal years 1997 and 1998 but was expanded to include loans made from Economic Development Loan Fund monies provided by the Trust Territory of the Pacific Islands and the entire portfolio of commercial loans managed and/or issued by the Bank from Compact funds. These changes were made because the Bank's loan records did not adequately summarize the history and status of loans during our initial audit period and because Republic government decisions made during the years immediately following the Bank's creation in 1988 negatively impacted the current availability of funds for commercial development loans.

To obtain information on the processing, administration, and collection of loans, we interviewed officials and/or reviewed loan records at the Majuro offices of the Marshall Islands Development Bank, Ministry of Foreign Affairs, and Auditor General; the United States Embassy; an independent public accounting firm; the Majuro Office, Rural Development, U.S. Department of Agriculture; and two attorneys in private practice who had performed services for the Bank. We also interviewed officials of the Western Pacific Region, Rural Development, U.S. Department of Agriculture, located at Hagatna, Guam.

Our review was made, as applicable, in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances.

As part of the audit, we evaluated the system of internal controls related to the financial and operational management of the Marshall Islands Development Bank to the extent that we considered necessary to accomplish the audit objective. Based on our review, we identified internal control weaknesses in the areas of issuing commercial loans, accounting for outstanding loans, protecting loan collateral, collecting delinquent loans, and complying with a special accounting agreement. These weaknesses are discussed in the Findings and Recommendations section of this report. Our recommendations, if implemented, should improve the internal controls in these areas.

PRIOR AUDIT COVERAGE

During the past 5 years, neither the U.S. General Accounting Office, the Auditor General of the Republic of the Marshall Islands, nor the Office of Inspector General has issued any audit reports on the Marshall Islands Development Bank. However, an independent public accounting firm issued single audit reports on the Republic of the Marshall Islands, which included the Bank's financial statements and the results of audit tests *on* the Bank's operations, for fiscal years 1995, 1996, and 1997. The single audit report for fiscal year 1997 identified six financial statement findings. Specifically, the report stated that (1) the Bank's accounting was based on the source of funding rather than on the type of loan by industry; (2) minutes for 7 of 14 Board meetings were not documented as approved by the Board; (3) initial credit checks and quality control procedures were not performed on all prospective loan customers and their requested loan amounts; (4) subsidiary loan ledgers did not facilitate accounting and reporting on the Bank's loan portfolio; (5) loans receivable were not periodically reviewed for collectibility and assessed for loan losses; and (6) interest income and receivables were not updated on a regular basis during the year, resulting in an erroneous \$136,605 year-end journal entry. We found that these conditions still existed during our review.

FINDINGS AND RECOMMENDATIONS

A. ISSUANCE OF COMMERCIAL LOANS

The Marshall Islands Development Bank used funds provided by the Compact of Free Association to issue commercial loans to businesses and government entities without adequate assurances that the purposes of the loans were in conformance with official economic development plans and that the loans could be and would be repaid. These conditions were contrary to the Compact's terms and to the **Bank's** enabling legislation and operating procedures. These deficiencies occurred because the Bank issued loans, according to the Bank's Chairman of the Board and the Managing Director, based on political considerations and without adequate financial analyses of the projects' financial viability and the borrowers' ability to repay. As a result, as of November 30, 1998, principal and accrued interest on delinquent loans totaling almost \$6.8 million appear to be uncollectible, and an additional \$6.9 million may become uncollectible (see Appendix 1). In addition, the unavailability of the \$13.7 million represented by these delinquent loans has prevented the **Bank** from issuing new commercial loans from Compact funds since July 1996 and from meeting its legally mandated purpose to "promote the development and expansion of the economy of the Marshall Islands."

Loan Policy

Section 21 l(b) of the Compact of Free Association states, "The annual expenditure of the grant amounts specified for the capital account in Section 211 (a) ... shall be in accordance with the **official** overall economic development plans provided by those Governments [of the Compact States] and concurred in by the Government of the United States." In addition, the implementing agreement for Compact funds provided under Section 111 (c) of U.S. Public Law 99-239, Article II, paragraph 6, states, "The Fund is intended to further close economic and commercial relations between the United States and the Marshall Islands, to encourage investment and productive participation in economic development in the Marshall Islands by citizens and commercial enterprises of the United States and the Marshall Islands, particularly through joint ventures between United States and Marshall Islands citizens and commercial enterprises, ... and to encourage the private sector employment and training of citizens of the Marshall Islands and the productive utilization of the natural resources, manpower resources, and other resources of the Marshall Islands."

Title 10, Section 8 10(1), of the Marshall Islands Revised Code states, "The [Marshall Islands Development] Bank's activities shall be designed to strengthen the nation's economic base, increase employment and production, improve standards of housing, promote exports, and reduce the country's dependence on imports and foreign aid." Section 8 1 O(2) of the Revised Code states, "In carrying out its functions the Bank shall have due regard for the general economic policies and plans of the Government of the Marshall Islands and to the general objectives of the Investment Development Fund." Section 8 12 of the Revised Code further states, "The [Bank's] Policies and Guidelines will be made public and will be strictly adhered to."

Paragraph 5 of the Bank's Policies and Guidelines (adopted by the Republic's Cabinet on April 13, 1989) states, "As a development finance institution, the Bank will carry out its operations according to sound commercial, banking practice." Paragraph 7 of the Guidelines states, "The Bank will provide financial assistance to those projects, which on the basis of its own analysis, are assessed as technically feasible, economically justifiable, financially viable and profitable." Further, Paragraph 10 of the Guidelines states, "In order to reduce the concentration of risk, the Bank will seek, as far as possible, to diversify its portfolio by sectors of operation and by avoiding inappropriately large investment in any one project. As a general rule, no loan or guarantee provided by the Bank to any single borrower, or equity participation in any single enterprise shall exceed ten percent (10%) in aggregate of the net worth of the Bank, however, this general rule will be exercised at the discretion of the Board."

Political Considerations

Section 16 of the Constitution of the Republic of the Marshall Islands, which became effective on May 1, 1979, states, "The Government of the Republic of the Marshall Islands recognizes the right of the people to responsible and ethical government and the obligation to take every step reasonable and necessary to conduct government in accordance with a comprehensive code of ethics." The Republic's Ethics in Government Act of 1993 (codified at Title 3, Chapter 17, of the Marshall Islands Revised Code) became effective on September 21, 1993. Title 3, Section 1704(5), of the Revised Code states, "Public officials and Government employees shall not use public office for private gain." Section 1704(12) states, "Public officials and Government employees shall endeavor to avoid any actions creating the appearance that they are violating the law or ethical standards set forth in this Chapter." Prior to September 1993, the Republic did not have a comprehensive code of ethics.

The Bank had 48 commercial loans (originally totaling \$18.5 million) that were funded by Compact Section 111 and 21 l(b) funds and administered by the Bank. Of those 48 loans, we reviewed a judgmental sample of 21 loans² (originally totaling \$14 million) that had outstanding balances, including accrued interest, totaling \$13.6 million as of November 30, 1998. We evaluated the status of the 21 loans and the financial/economic basis for approval of the loans, including the purpose of each loan as it related to the two 5-year official economic development plans issued by the Republic for the periods during which the loans were approved. Of the 21 loans reviewed, 1 loan was current, 18 loans were delinquent an average of 46.3 months, and 2 loans (which had been delinquent) were exchanged for common stock of the borrowing organization.

²The 21 loans that we reviewed included 2 loans made to Air Marshall Islands (a government-owned airline) that were subsequently exchanged for common stock of the airline. If the two loans had not been exchanged for common stock, they would have had outstanding balances totaling \$4.3 million as of November 30, 1998. Because the Bank's audited financial statements for 1997 reported the airline's stock as having no value, we included the \$4.3 million that would have been outstanding on the loans as "Lost Revenues" in Table 1 and as "Unrealized Revenues" in Appendix 1.

Based on our review of documents in the loan files and discussions about the loans with the Bank's Chairman of the Board and Managing Director, we noted, for 17 loans (11 to business organizations and 6 to government entities), that they had been issued as follows: 11 loans (5 loans to businesses and 6 to government entities) were issued based on the direct or indirect direction from government officials, 3 loans were issued to businesses owned by relatives of senior-level government officials, and 3 loans were issued to businesses owned by elected government officials. At least 3 of the 17 loans were made for purposes that were not clearly within the scope and intent of the Republic's 5-year economic development plans. The Chairman of the Board and the Managing Director stated that "the Bank issued some loans based on political direction and influence" and that such loans "may not have been made under normal circumstances." As a result of issuing loans without performing thorough financial analyses, requiring additional collateral or other guarantees, and complying with the Bank's lending guidelines, the Bank, as of November 30, 1998, appears to have lost \$6,621,645 on seven of the loans and is at risk of losing an additional \$6,442,610 in potential revenues on three other loans. In addition, for six of the seven remaining loans, revenues were also lost or at risk because the Bank's inadequate collection efforts allowed the loans to become delinquent (see "Collection Practices" in Finding B). The 17 loans and lost or potentially lost revenues are detailed in Table 1.

Table 1. Questionable Loans

<u>Purpose of Loan</u>	<u>Date Loan Signed</u>	<u>Original Loan Amount</u>	<u>Principal Amount Paid</u>	<u>Nov. 1998 Outstanding Balance</u>	<u>Lost Revenues</u>	<u>Potential Lost Revenues</u>
Loans to Businesses:						
Rental Housing	11/24/89	\$631,025	\$15,913	\$615,112	0	0
Hotel	01/12/90	123,174	120,385	126,235 *	0	0
Fishing	10/02/90	132,000	0	208,021	0	0
Entertainment Complex	10/11/90	3,140,29	0	439,680	0	0
Office Building	01/04/91	4,913,549	0	6,032,124	0	\$6,032,124
Fishing	05/27/92	450,000	0	649,193	\$349,193	0
Manufacturing	07/24/92	101,754	6,331	101,442	0	0
Entertainment Complex	06/09/93	1,103,769	23,658	1,218,346	0	0
Fishing	06/28/93	188,000	0	254,323	254,323	0
Fishing	07/09/93	65,474	0	84,360	84,360	0
Rental Housing	01/20/94	232,976		257,539		0
Subtotal		<u>\$8,255,750</u>	<u>\$166,281</u>	<u>\$9,986,375</u>	<u>\$687.87</u>	<u>\$6,032,124</u>
Loans to Government Related Entities:						
Fishing Partnership	06/15/88	\$1,000,000	0	\$1,835,467	\$1,557,677	0
Fishing Partnership	01/27/89	178,331	\$81,050	145,795	123,595	0
Air Marshall Islands	03/15/91	933,321	0	**	1,350,809	0
						0
Development Authority	04/20/93	2,006,000	0	\$222,851	2,901,688	\$222,851
Majuro Government	06/13/95	208,522	18,270	219,660	0	187,635
Subtotal		<u>\$4,505,174</u>	<u>\$99,320</u>	<u>\$2,423,773</u>	<u>\$5,933,769</u>	<u>\$410,486</u>
Total		<u>\$12,760,924</u>	<u>\$265,607</u>	<u>\$12,410,148</u>	<u>\$6,621,645</u>	<u>\$6,442,610</u>

*On May 30, 1996, the Bank combined this loan with the \$97,994 balance of an earlier delinquent loan for the same hotel project

**On May 31, 1995, the Bank exchanged the two loans for common stock of the airline. The amounts shown as "Lost Revenues" are the amounts that would have been outstanding, including accrued interest, if the loans had not been exchanged for stock.

The details of 7 of the 17 loans listed in Table 1 are discussed as follows:

- Air Marshall Islands. One loan issued by the Bank on March 15, 1991, was for \$850,000³ and another loan issued on April 1, 1992, was for \$2 million to provide operational funding to Air Marshall Islands, a 100 percent Republic-owned and Republic-controlled corporation. Neither of the Republic's two 5-year economic development plans made reference to providing economic development funding for the establishment of air service, either within the Republic or internationally. According to the Bank's Managing Director, the Cabinet directed that the Bank lend the money to the airline for "operating funds." Additionally, the loans were approved by the Cabinet, although that function was normally performed by the Bank's Board of Directors. The airline did not make any payments on the loans, and on May 31, 1995, the Bank⁴ exchanged the two unpaid loans (which were more than 3 years delinquent at the time and had outstanding balances totaling \$3,488,000, including accrued interest) for common stock in the airline. The Bank's 1997 audited financial statements reported that the stock had no market value, and the Bank's Managing Director described the stock as "worthless." Based on the airline's financial statements, we determined that the airline had not made a profit in at least 8 years⁵ and, as of September 30, 1997, had an accumulated deficit of \$13.4 million. In addition, all of the airline's stock was held by government entities. We also noted that although the Bank owned about 30 percent of the airline's outstanding stock, the Bank did not have a representative on the airline's Board of Directors, which was controlled by the Republic's government. Based on the foregoing, we believe that the Bank may have lost revenues of \$4,252,497 represented by the original loan amounts and the accrued interest through November 30, 1998.

- Office Building Project. On December 27, 1990, the Bank's Board of Directors approved a loan application from a **Marshallese/Korean** partnership for \$2.3 million to build a 5-story office building near the Republic's Capitol Building, although this type of project was not included in the Republic's two 5-year economic development plans. The Bank initially issued a loan of \$850,000 on January 4, 1991, then increased the loan amount by \$1,450,000 on February 26, 1991; by \$962,525 on June 14, 1991; by \$1,262,391 on December 7, 1993; and by \$388,633 on December 31, 1994. The final loan amount was \$4,913,549. As of November 30, 1998, the borrower had not made any payments against the loan principal, and the outstanding balance, including accrued interest, was \$6,032,124.

The initial loan and the subsequent loan increases were approved by the Republic's Cabinet, even though the Bank's Managing Director, in a May 20, 1991, letter to the Marshallese

³The amount of this loan was subsequently increased to \$933,321 by the capitalization of accrued interest totaling \$83,321.

⁴The exchange with the Bank was initiated in August 1994 by the airline's Board of Directors, which included the Republic's now-deceased President and three Cabinet ministers. The exchange reduced the airline's outstanding debt by \$3.5 million and increased its equity by the same amount.

⁵The airline reported a fiscal year 1997 operating loss of \$2.9 million, with total operating revenues of \$7.7 million.

partner, stated that the Bank could not approve the partnership's May 8, 1991, "request for additional funding, because the Board has already exceeded its given authority." In response to a subsequent request for an increase of the loan amount, the Bank's Managing Director prepared a discussion paper for the November 1, 1991, meeting of the Bank's Board of Directors. In the discussion paper, the Managing Director stated, "In the case [of this loan], it is unfortunate that [the Marshall Islands Development Bank] never had the option to significantly spread its risk. ... if the additional loan is approved, then some 36% of Bank assets will be at risk Such an inordinate risk is not normally acceptable to any lending institution - responsible either to a Government or private stockholders - if it aspires to be an ongoing and commercially oriented organization with a worthwhile future contribution to make." As stated previously, the Bank's lending guidelines limited individual loans to 10 percent of the Bank's assets. As of December 31, 1997, this one loan represented about 28 percent of the Bank's total contributed capital. Both the Bank's Chairman of the Board and the Managing Director stated that this loan was based on "political direction and influence" and "may not have been made under normal circumstances."

On December 31, 1994, the Marshallese partner, whose partnership included relatives of the Republic's recently deceased President, assumed the entire loan and ownership of the building. On August 3, 1995, the borrower signed a management agreement that "let the Bank manage. . . the 'Building' for as long as is required to pay off the ... loan." However, the Bank's records indicated that the building's revenues were insufficient to pay off the loan and that outstanding interest on the loan had increased by \$647,667 from August 1, 1995, to November 30, 1998. As of November 30, 1998, more than 7 years after receiving the loan, the borrower had not made any payments on the loan principal.

- Fishing and Entertainment Projects. During the period of September 1991 through September 1993, the Bank released a total of \$1,017,503 for four loans to the same business entity. An October 11, 1990, loan of \$314,029 was for the renovation of an apartment/restaurant/bar building. A May 27, 1992, loan of \$450,000 was for the purchase of a fishing boat. A June 28, 1993, loan of \$188,000 was for the purchase of a second fishing boat. A July 9, 1993, loan of \$65,474 was to finance commercial fishing operations. One of the two owners of the business was a relative of a former Republic President. Although the purposes of three of the four loans were to establish a commercial fishing business, which met the objectives of the Republic's 5-year economic development plans, according to the Bank's Senior Loan Officer and correspondence in the loan files, the borrowers did not have commercial fishing experience. The Bank's Chairman of the Board and the Managing Director both stated that these loans resulted from "political direction and influence" and "may not have been made under normal circumstances." As of November 30, 1998, the borrowers had not made any payments on the principal amounts, and the outstanding balance, including accrued interest, was \$1,427,556.

In summary, the Bank's Chairman of the Board and the Managing Director both stated that the Republic's Cabinet had direct control over the Bank's operations until August 1993, when the Bank's enabling legislation was amended to remove the Cabinet's direct authority over the Bank (see footnote 1). The two Bank officials also confirmed that decisions about major loans had been made either directly or indirectly by the Cabinet and did not always

appear to be based on the borrowers' ability to repay the loans. The officials also stated that, even after passage of legislation reducing the Cabinet's control over the Bank's operations, the **Bank** was subject to some political influence. We noted, for example, that five of the six Bank Directors were government officials. Therefore, to preclude the potential for political influence, we believe that the Bank's Board of Directors should be composed of a more equal mixture of government officials and private business representatives. In addition, the Board should be given the sole authority for approving loans and should be required to clearly document any financial risks involved in the issuance of loans.

Financial Analyses

Regarding methods of safeguarding the Bank's interests, Paragraph 20 of the Bank's Policies and Guidelines states that the Bank "may require the applicant for a loan, guarantee or equity participation that is over \$15,000 to provide a business plan or feasibility study indicating the technical, economic and financial feasibility [of the business]"; Paragraph 24 states that the Bank "shall use its best endeavors to ensure that the financial requirement for the completion and commissioning of the project is covered, including, if appropriate, allowance for cost overruns"; and Paragraph 25 states that the "Bank shall secure its loans or guarantees by appropriate collateral coverage and guarantees from its borrowers in accordance with sound banking practices." Also, Paragraph 34 states, "The Bank shall decide on a scheme for loan repayment which shall be incorporated into the loan agreement. The repayment period of a loan, including a grace period, where appropriate, will be determined taking into account: ... the Bank's own interest to recover principal in as a short a time as possible for the optimum use of its funds to maximize the turnover of its portfolio." In addition, Section 3.2.4 of the Bank's Operating Manual states:

"Financial analysis" refers to the assessment of each and every potential borrower who may come to the Bank for assistance The OBJECTIVES of financial analysis are:

To judge whether an existing enterprise is solvent. ... To assess the ability of the business to prosper and meet its present commitments, PLUS any new [Bank] loan commitments when they fall due. ... To make some judgement of the net (or residual) value of assets that may be available to the Bank as collateral for any loan

The ultimate purpose of astute financial analysis is to ensure REALISTIC BUDGETING which, in turn, will demonstrate whether or not a project has prospects of being commercially viable and thus may warrant a Bank loan. In compiling Bank budgets lending staff must also:

Apply their knowledge of other similar projects. ... Make use of any industry research data that may be available, and certainly judge carefully such things as site/location and management potential.

Despite these requirements and guidelines, the files for only 8 of the 21 commercial loans we reviewed contained financial analyses. These analyses were of varying degrees of complexity and all appeared (based on the absence of Bank-related comments or notations) to have been submitted by the loan applicants. In addition, the eight analyses included what we believe were either unrealistic assumptions or analytical information that was too general to apply to the specific loan requests. Further, none of the 21 loan files included a record of a separate financial analysis by the Bank or a Bank critique of the analyses submitted by the applicants. According to Bank personnel, the Bank did not always perform thorough credit and financial analyses of prospective commercial borrowers and did not document reviews that were performed because management did not require these actions to be taken and had not provided personnel adequate training and supervision to accomplish these tasks. As a result, the Bank's management did not appear to have had access to the information needed to evaluate the prospects for repayment of proposed loans. As a consequence of the Bank not conducting adequate financial analyses to determine the feasibility of proposed projects and the credit worthiness of loan applicants, delinquent loans totaling \$176,256 appeared to be uncollectible and additional loans totaling \$431,004 were also at risk of becoming uncollectible. For example:

- On October 22, 1992, the Bank made the final disbursement for a loan of \$160,632 from Compact funds to a construction company to buy construction equipment and tools necessary to perform on a \$400,000 contract. The Bank had also made a loan of \$398,755 on February 6, 1991, secured by the same contract, to the same company from Republic funds. According to the Bank's Managing Director, the borrower could not repay the second loan because the contract was canceled when the Republic canceled the overall project. However, we question whether the Bank should have made loans to the company in excess of its total projected revenue of \$400,000 from the construction contract. The Bank's file for the second loan contained no financial analysis or other documented analysis that addressed this issue. Although the borrower had paid \$29,216 on the principal of the Compact loan, the last such payment was made on September 1, 1993. As of November 30, 1998, the loan was 63 months delinquent, had an outstanding balance of \$176,256, including accrued interest, and, in our opinion, appeared to be uncollectible.

- On November 13, 1991, the Bank made a loan of \$346,970 to a business operating a small hotel for the purpose of building additional rooms and upgrading the hotel's restaurant and bar. On August 27, 1992, the Bank made another loan of \$351,739 to the business to significantly upgrade the construction quality of the hotel improvements. However, the loan file did not include any indication that the Bank had performed its own financial analysis on either loan but had relied on the borrower's financial projections. Although the first loan appeared reasonable, the Bank did not perform an analysis to determine whether the business could repay the second loan from the same revenues. The second loan increased the monthly loan payment from \$3,833 to \$7,518. This larger monthly payment was reduced by the Bank on January 31, 1996, when it reduced its interest rates to 6.5 percent and, for "a limited time" (which was still in effect as of November 1998), reduced the monthly payment amount to \$5,000. However, as of November 30, 1998, the borrower had not made any principal payments on the second loan and owed \$431,004, including accrued interest. In our opinion, this potential revenue is at risk of loss.

- During the period of November 1989 to August 1997, the Bank made two loans⁶ totaling \$631,025 to an individual to build 10 rental houses. The only financial projections in the loan file were based on what, in our opinion, were unreasonable assumptions by the borrower, such as that all 10 houses would be occupied 100 percent of the time, the project would be completed without any unforeseen delays, and there would be no unexpected construction or operating costs. There was no indication in the file that the loan officer or another Bank official questioned the assumptions, nor was there a financial projection that used assumptions that we believe were more appropriate. Although the borrower assigned all rent collections to the Bank when the Bank renegotiated the loan in August 1997, only 14 months later, on November 30, 1998, the loan was 6 months delinquent and had an outstanding balance of \$615,112.’

Recommendations

We recommend that the Chairman of the Board of Directors, Marshall Islands Development Bank:

1. Request the Board of Directors to revise the Bank’s Policies and Guidelines to require that development loans be granted in conformance with the applicable goals and objectives contained in the Republic’s 5-year economic development plans as a condition of approval.

2. Submit a formal request to the Republic’s Cabinet to amend the Bank’s enabling legislation so that the number of government officials is reduced and the number of private business representatives appointed to the Bank’s Board of Directors is increased and to require formal acknowledgment and approval by the Bank’s Board of Directors of any loan applications subject to possible political influence. In that regard, written statements should be required by voting Board members that they had no conflicts of interest and that they were not aware of any financial risks related to politically influenced loans.

3. Submit a formal request to the Republic’s Cabinet to require that the Board of Directors of Air Marshall Islands include at least one member who represents the Marshall Islands Development Bank.

4. Ensure that the Bank’s Managing Director provides training in financial analysis to the Bank’s Senior Loan Officer, requires that independent financial analyses be performed for all loan applications, and reviews and formally approves such financial analyses.

⁶The loans consisted of the original loan of \$474,169, an additional loan amount of \$64,651, and interest capitalizations of \$18,590 and \$73,615.

‘Although we consider the outstanding balance of \$615,112 on this loan to be at risk of loss, we did not include it in Appendix 1 as part of the monetary impact for Finding A because it is included in the discussion and the monetary impact for Finding B.

Marshall Islands Development Bank Response and Office of Inspector General Reply

In the August 27, 1999, response (Appendix 3) to the draft report from the Bank's Chairman of the Board, the Bank concurred with the four recommendations. Based on the response, we consider Recommendation 4 resolved and implemented and Recommendations 2 and 3 resolved but not implemented and request additional information for Recommendation 1 (see Appendix 4).

Additional Comments on Finding

The Bank stated that information included in one of the three examples of the Bank's inadequate credit analysis (see "Financial Analysis" in this report) was "inaccurate." The Bank also provided information on its position that the loan was adequately secured and that substantial loan payments had been made. Further, the Bank stated that "most of what is said about non compliance with provisions of the Compact ... [and with Federal and Republic laws] ... would have been avoided if the Bank had been given more autonomy and independent [sic] from the start." The Bank further stated that "the Board feels that these [instances of] non compliance could have been minimized, or avoided, if the IDF [Investment Development Fund] Advisory Board, established [by the Compact] had taken a more active role in its capacity as an Advisory Board to the fund." The Bank then stated that the only advice the Advisory Board provided was "for a loan to fund a joint venture fishing project" and that the "project was a failure." Further, the Bank noted that the President of the Republic of the Marshall Islands had sent a letter dated April 26, 1993, to the U.S. Ambassador to the Republic appointing the Republic's representatives to the Advisory Board and requesting appointment of the United States representatives to the Board. The Bank further stated, "Until now no one knows whether the appointments were made or not, as there has not been a meeting of that [Advisory] Board."

The statement that information in one example in the draft was "inaccurate" is incorrect. However, we have revised the example to clarify that (1) we were referring to the date of the final disbursement on the loan (October 22, 1992), not the date on which the loan was signed, and (2) the loan was 63 months delinquent as of November 30, 1998, not as of September 1, 1993.

Regarding the Bank's statement that two additional contracts were used to secure the repayment of the two loans to the borrower, this information was not in the Compact-funded loan file provided to us during the audit, nor was it provided in response to our inquiries for information concerning the Republic-funded loan. Additionally, we did not review the files of Republic-funded loans because the loans did not involve United States-sourced funds. Based on the information provided with the response, we have deleted reference to the delinquency of the Republic-funded loan. However, Bank officials did not mention any other contracts during audit discussions on this loan. If these contracts were used to justify the approval of the Compact-funded loan, this information should have been included in the

Compact-funded loan file and referred to as part of a financial analysis of the loan, which was not performed.

Regarding the financial status of the Compact-funded loan and the Republic-funded loan, the Bank listed seven payments, totaling \$100,396.17, with the inference that these payments were applied to the Compact-funded loan. However, the Bank's accounting records showed that only two payments, totaling \$8,185.62, of the seven payments were applied to the Compact-funded loan. Consequently, the other five payments, totaling \$92,210.55, were apparently applied to the Republic-funded loan. Further, based on the Bank's accounting records as of November 30, 1998, the Compact-funded loan's outstanding principal balance was \$131,416, which, when subtracted from the initial loan amount of \$160,632, results in a total of \$29,216 in principal having been paid on this loan. In addition, according to the Bank's accounting records as of March 12, 1999, the most recent payment the Bank applied to the Compact-funded loan was made on September 1, 1993. Therefore, we still consider the remaining balance of \$176,256, including accrued interest, to be potentially uncollectible.

We have addressed the issue of the Bank's autonomy through Recommendation 2.

Regarding the Investment Development Fund Advisory Board, we do not believe that the Advisory Board had or would have had a significant impact on the issues discussed in the report. According to the Compact, the Advisory Board's duties and responsibilities include providing "advice and guidance" on the evaluation of proposals and recipients of distributions from the Investment Development Fund and assisting in other programs designed to attract investment in the Republic. Also, as noted in the Bank's response, the only advice apparently given by the Board resulted in a "project that was a failure" with related losses of \$1.7 million in principal and interest. Further, regarding the appointment of United States representatives to the Advisory Board, during our audit, we contacted United States, Republic, and private entities in our efforts to obtain records relating to the actions of the Advisory Board and to determine what actions had been taken to appoint United States representatives to the Board in 1993 or subsequent to 1993. We were unsuccessful in obtaining any documentation other than the Republic President's April 26, 1993, letter referred to in the response. However, by December 31, 1993 (the end of the Bank's fiscal year), the Advisory Board would have had few decisions to make on loans because most available funds were committed. As of that date, the Investment Development Fund had 31 loans, totaling \$12.3 million (including unpaid interest), and of that number, 17 (55 percent) loans were delinquent.

B. COLLECTION OF DELINQUENT LOANS

Although the Marshall Islands Development Bank made good faith attempts, it did not collect all delinquent loan amounts. The Bank's operating procedures and borrowers' loan documents specify the responsibilities of the Bank and the borrowers for protecting collateral and collecting delinquent loans. However, the Bank did not (1) use all available collection methods; (2) prepare, collect, and maintain loan records necessary to ensure that loan collateral was protected and that loan files were complete and current; and (3) ensure that management fees were charged to delinquent borrowers for all properties the Bank managed. Also, the Bank's Managing Director said that the Bank was reluctant to seize loan collateral and believed that cooperative efforts with the borrowers would resolve delinquency problems. Further, Bank personnel stated that they were inadequately trained and supervised and that they had to expend too much time managing returned property. Finally, management fees were not generally collected because Bank officials had not realized the time and related costs involved in managing smaller properties. As a result, delinquent loans totaling \$629,631 appear to be uncollectible, and loans totaling another \$3.3 million may become uncollectible because of inadequate collection enforcement. Additionally, delinquent loans totaling \$208,021 appear to be uncollectible because the pledged property was not insured, and potential management fees of about \$7,500 had not been collected. (The monetary impact of the preceding amounts is presented in Appendix 1.) Further, we believe that the Bank's lack of action to aggressively collect delinquent loans may serve as an inducement for other borrowers not to repay their loans or not to repay their loans timely.

Collection Practices

Paragraph 25 of the Bank's Policies and Guidelines states, "The Bank shall secure its loans or guarantees by appropriate collateral coverage and guarantees from its borrowers in accordance with sound banking practices." Section 3.3.2 of the Bank's Operating Manual states:

When arrears do occur, it is most important to quickly identify why, and then complete appropriate and timely action to return the account to current status e.g. obtain the repayment/s, reschedule the repayment/s, rehabilitate the project, or sell off assets. The monitoring and control of arrears, plus the education of borrowers in good credit habits, is a most important part of the role of all Bank lending staff. . . . Arrears may be caused by the client/project when borrowers will not pay or cannot pay.

For client-caused arrears, the Manual continues:

Borrowers who will not pay are those who have sufficient funds to meet the agreed repayments, but choose not to pay. In all such cases, prompt and **firm** action needs to be taken in order to show the borrower that the Bank means to enforce the loan agreement. . . . This type of borrower does not warrant any leniency from the Bank . . . and after two reminders and one warning letter the Bank should proceed to realize upon its securities.

Further, Section 3.3.2.4 of the Manual states:

The accepted basis for classifying the status of delinquent accounts is: ... Two Months up to Three Months - third contact MUST be a Bank visit to the project to undertake a full review and report back, Over Three Months - generally regarded as hard-core arrears with deep seated problems needing careful, consistent, and positive follow-up, Over Twelve Months - non-performing loans where debt recovery is most definitely in doubt. ... Only careful and constant attention to arrears monitoring will maintain proper control of the Bank's loan portfolio, protect [the Bank's] capital, and allow the Bank to continue on with its primary role as a major catalyst for development in [the Republic of the Marshall Islands].

In addition, loan agreements between borrowers and the Bank specify that upon default by the borrowers, the Bank can “take possession of the [loan] collateral or render it unusable; .. Sell or dispose of collateral by sale and pursuant to the law; ... Foreclose on any real property or appropriate personal property in accordance with law; .., and Pursue any and all other remedies available under law or equity to enforce the term of this Loan Agreement.”

To evaluate the Bank's collection practices, we selected a judgmental sample of 115 of the Bank's 509 recorded loans (see Appendix 2), including loans from each category of the Bank's Federally funded loan programs. The 115 loans had original loan amounts totaling \$15.5 million and, as of November 30, 1998, consisted of 23 paid-off loans and of 92 active loans with outstanding balances totaling \$18.7 million, including accrued interest. Of the 92 outstanding loans, 49 loans, totaling \$18.2 million as of November 30, 1998, were delinquent (32 loans delinquent 1 year or more and 17 loans delinquent less than 1 year). Based on our review of the loan payment history and the age of the loans, we believe that the Bank will not be able to collect amounts due for 34 of the 49 delinquent loans. (The 34 loans consisted of 31⁸ of the 32 loans that were delinquent 1 year or more and 3 of the 17 loans that were delinquent less than 1 year.) However, in Finding A, we questioned the Bank's ability to collect 8 of these 34 loans, with outstanding balances totaling \$8,970,836. Therefore, to avoid duplicate counting, we included in the monetary impact reported in Appendix I only the remaining 26 loans, with uncollectible or potentially uncollectible balances totaling \$3,896,575, as shown in Table 2.

⁸One of the 32 loans was excluded because it appeared to be collectible, even though it had been delinquent for 22 months.

Table 2. Delinquent Loans With Lost or Potential Lost Revenues

<u>Source and Type of Loan</u>	<u>Loans Reviewed</u>	<u>Loans Identified</u>	<u>Original Loan Amount</u>	<u>Nov. 1998 Outstanding Balances</u>	<u>Lost Revenues</u>	<u>Potential Lost Revenues</u>
Compact 111- Investment Development	16	7	\$3,304,378	\$3,749,829	\$439,680	\$2,671,126
Compact 211 - Commercial	5	3	622,697	782,227	0	433,004
Compact 211- Housing	34	4	60,201	55,674	13,475	42,199
Trust Territories - Economic Development	20	12	439,417	297,091	176,476	120,615
USDA - Housing Preservation	36	0	0	0	0	0
USDA - Rural Development	4	0	0	0	0	0
Total	<u>115</u>	<u>26</u>	<u>\$4,426,693</u>	<u>\$4,884,821</u>	<u>\$629,631</u>	<u>\$3,266,944</u>

We reviewed the files for 18 nonhousing loans that were among the 49 delinquent loans and determined that the file for only 1 of the 18 loans included any comments explaining why the loan was delinquent (the file stated “management weaknesses”). In addition, none of the files for the 49 delinquent loans included a financial analysis of the delinquent borrower, a collection plan, or documentation that the Bank had attempted to seize loan collateral or had initiated court action. We asked two attorneys who had worked with the Bank to collect delinquent loans whether the Bank could successfully seize property and/or take other court action to collect delinquent accounts. The attorneys stated that the enforcement of the security agreements would likely be upheld in the Republic’s courts but added that the Bank had never filed a court action to enforce the agreements. The Bank’s Managing Director also stated that the Bank had not taken legal action against delinquent borrowers. By not using all available legal means to collect delinquent loans, the Bank appears to have lost \$629,631 and placed another \$3,266,944 at risk of loss. For example:

- On January 22, 1999, the Bank’s payment agreement (dated January 20, 1998) with one delinquent borrower was, in effect, overturned as a result of a decision by the Marshall Island’s High Court to assign the borrower’s revenues to another creditor. The borrower had originally obtained the loan on October 11, 1990, and, as of November 30, 1998, was 77 months delinquent and had an outstanding balance of \$439,680, including accrued interest. In addition, the borrower had never made a payment on the loan principal. The Bank’s Managing Director stated that the Bank had inadvertently not filed its payment agreement with the Court. Therefore, the Bank’s claim was not recognized by the Court and was overturned when another creditor brought suit against the borrower. In our opinion, the Bank would have increased the probability of recovering all or most of the \$439,680 outstanding balance if it had taken more aggressive actions, such as seizing the secured property.

- By August 1997, the Bank had loaned \$631,025 (including capitalized interest) to an individual to build 10 rental houses (see “Financial Analyses” in Finding A). Although the borrower assigned all rent collections to the Bank when the loan was renegotiated in August 1997, only 15 months later, by November 30, 1998, the loan was 6 months delinquent. Prior to August 1997, rents from four of the rental houses had been assigned to the Bank, but the Bank experienced difficulty in collecting the rents because the borrower or the borrower’s representative would collect the money from tenants and not remit the money to the Bank.

As of February 1, 1999, only 4 of the 10 houses were rented at a total rental income of \$3,000 per month, which was \$2,500 per month less than the \$5,500 monthly loan payment amount. In addition, the Bank attempted to convince the borrower to voluntarily transfer management of the property to the Bank but had not been successful, although it continued to seek to take over the project. Further, based on our site inspection, the wooden houses appeared to be deteriorating and in need of renovation to be desirable rentals. As of November 30, 1998, the loan balance of \$615,112 was outstanding.

Loan Records

Paragraph 5 of the Bank's Policies and Guidelines directs the Bank to "carry out its operations according to sound commercial, banking practice." Section 3.3.6 of the Bank's Operating Manual states that the Bank "has two major information systems: the computerized accounting system and the loans filing system comprised of a separate file for each loan account." Paragraph 3.3.6.2 of the Manual states, "Given the importance of loan files, it is absolutely essential that each one must always be a complete record of all that occurs with a given borrower/loan. ... The loan file should be a record of every single thing that happens." Further, Paragraph 30 of the Bank's Policies and Guidelines states that "the Bank shall require loan applicants to produce insurance policies ... for ... real property improvements," and Subparagraph 30(d) states that "where insurance is required, the premiums shall be paid in full by the borrowers as the standard practice of the Bank." Further, Title 10, Section 13(4), of the Marshall Islands Revised Code states, "In the preparation of the [Bank's] financial statements, adequate and proper provisions shall be made for bad and doubtful debts"

File Documentation. The Bank did not include sufficient documentation in the loan files to support that property used as loan collateral was adequately protected and that required loan processing procedures and collection actions were performed. Based on our review of 21 commercial loan files and 70 housing loan files,⁹ we determined that none of the 91 files included documents providing (1) the entire payment history, delinquency status, and aging of the loans; (2) narrative comments on major loan actions (such as loan amendments and meetings with delinquent borrowers); and (3) evidence of supervisory reviews. In addition, the loan files for neither the 21 commercial loans nor the 34 Compact Section 211 housing loans included documents showing that current insurance coverage existed on the property used for loan collateral. According to Bank loan officers, documentation was not included because they had not received adequate **followup** training on retaining documentation on insurance coverage and the loan files were not subject to routine supervisory monitoring. The Senior Loan Officer also stated that much of his time was devoted to managing returned properties. According to the Bank's Managing Director, many of the housing borrowers could not afford insurance, and the Bank was therefore attempting to include funds to pay for the cost of insurance in the initial amounts of future

⁹We did not perform this review on the 4 U.S. Department of Agriculture Rural Development loans in our sample because the funds on each of these loans had not been disbursed at the time of our audit and on the 20 Trust Territories Economic Development loans in our sample because these loans were issued by the Bank's predecessor bank and did not relate to the Bank's current operations.

loans. As a result, the Bank lost \$208,021 on at least one loan because loan collateral was not insured.

Specifically, although the Chattel Mortgage Security Agreement used by the Bank required that borrowers carry insurance on collateral used as surety for their bank loans, a 50-foot fishing boat with fishing equipment, which was partially financed by a Bank loan, was not insured and was considered a total loss when it burned about 10 months after the borrower obtained the loan. The Bank's Managing Director stated that during this period, smaller boats could not get insurance in the Republic and that the Bank had required the borrower to include as collateral for this loan a small hotel that was also used as collateral for a separate \$137,000 hotel loan. Although we could not determine the value of the mostly wooden hotel, we determined, based on our site visit, that the hotel was not in operation and needed extensive repairs before any rooms could be rented. As of November 30, 1998, the borrower had not made any payments on the loan and owed a total of \$208,021, including accrued interest. We believe that the Bank should more adequately protect its interests by requiring alternate unpledged collateral for the loans.

Computerized Accounting System. The Bank did not operate a computerized accounting system that was adequate to effectively administer its outstanding loans. A 1997 consultant study funded by the Asian Development Bank discussed the need to correct deficiencies in the Bank's computerized accounting system and made recommendations for improvement. Bank officials said that the recommendations were not implemented because the Bank's management did not agree with the conclusions of the study. However, the Bank's Managing Director and its Finance Manager agreed that the Bank's computerized accounting system was old and needed improvements. As a result, Bank personnel and management and Bank Directors could not readily determine the status of the Bank's loan portfolio to help ensure that personnel initiated appropriate collection actions on delinquent loans. Examples of the Bank's ineffective system of loan administration are as follows:

- The Bank's accounting computer equipment and its local area network configuration were inadequate to provide the processing power needed to summarize the payment history of any loan more than 2 years old, thereby excluding most of the approximately 1,000 (Federal and Republic) loan files, which may include more than 8 years of transactions. Therefore, a loan's complete history could not be provided without extensive manual review.

- The Bank was unable to locate its computerized or manual accounting ledger files for transactions on the 9 outstanding Compact Section 2 11 Bond Proceeds Fund commercial loans for calendar year 1994; 9 outstanding Compact Section 111 Investment Development Fund commercial loans for a 6-month period in 1990; and the 54 Trust Territories Economic Development Loan Fund loans for 1992, 1993, and 1995.

- The Bank relied on its external auditors to perform loan account agings and to adjust loan allowance accounts on an annual basis instead of using the computerized system, performing these reviews periodically during the year, and then providing this periodic delinquency information to its Board of Directors.

Property Management

Paragraph 5 of the Bank's Policies and Guidelines states, "As a development finance institution, the Bank will carry out its operations according to sound commercial, banking practice." The Bank's Senior Loan Officer stated that he was assigned management of the rental properties that had been turned over to the Bank and that managing the properties took a "significant portion" of his time. In our opinion, the Bank should charge the borrowers a percentage of revenues collected from the managed properties to help recover some of the personnel costs incurred. In addition, since the Senior Loan Officer was the lead official responsible for collecting delinquent commercial loans, we believe that the Bank should consider assigning another staff member to manage the returned properties.

As of November 30, 1998, the Bank had entered into management agreements with six delinquent borrowers of either Compact Section 111 Investment Development Loan Funds or former Trust Territories Economic Development Loan Funds to manage the properties that were used to secure the loans until the loans were paid off. With the Bank collecting revenues from the properties and using the revenues to make payments on the delinquent loans, the number of loan delinquencies was decreasing at the time of our audit. However, for five of the six agreements, the Bank had not required the borrowers to reimburse the Bank for its property management costs. We estimated that using a management fee of 10 percent of collected revenues, the Bank could have collected management fees of about \$7,500 during 1998, which would have defrayed some of the Bank's operating expenses.

Recommendations

We recommend that the Chairman of the Board of Directors, Marshall Islands Development Bank, ensure that the Bank's Managing Director:

1. Enforces the loan provisions for seizing loan collateral for loans that are significantly delinquent.
2. Provides **refresher** training in loan file maintenance to all loan personnel and amends the Bank's Policies and Guidelines to require regular supervisory reviews of files on loans that are delinquent.
3. Assigns property management responsibilities to Bank personnel other than loan officers who are responsible for collecting delinquent loans.
4. Performs an assessment of the Bank's computerized systems and develops a plan of action to upgrade the systems to meet the identified needs. Any upgrades should include correcting errors in the loan files (both automated and manual) and providing training on the upgraded systems.
5. Prepares standard wording to be used in all Bank management agreements with borrowers which specifies that monthly charges (such as a percentage of monthly collections)

should be assessed for property management and amends existing management agreements to include such wording.

Marshall Islands Development Bank Response and Office of Inspector General Reply

In the August 27, 1999, response (Appendix 3) to the draft report from the Bank's Chairman of the Board, the Bank concurred with the five recommendations. Based on the response, we consider Recommendations 4 and 5 resolved and implemented and Recommendations 1 and 3 resolved but not implemented and request additional information for Recommendation 2 (see Appendix 4).

C. ECONOMIC DEVELOPMENT LOAN FUND

The Marshall Islands Development Bank combined loans funded by the United States, under the former Trust Territories Economic Development Loan program, with loans funded by the Republic, which resulted in United States-funded loans losing their identity. According to the “Agreement By The Federated States of Micronesia, Republic of the Marshall Islands, Republic of Palau, and Trust Territory of the Pacific Islands To Amend the EDLF [Economic Development Loan Fund] Plan,” which became effective on October 24, 1985, and transferred responsibility for the Economic Development Loan Fund from the Trust Territory of the Pacific Islands to the Republic of the Marshall Islands, the Republic agreed to separately account for Economic Development Loan Funds in a revolving fund. The Bank’s Finance Manager stated that he was not aware of these requirements when the Bank assumed the outstanding Economic Development Loan Fund accounts from its predecessor, the Marshall Islands National Development Bank. As a result, (1) loan payments totaling \$214,938 were deposited into the Bank’s local revenue accounts and (2) loan accounts totaling \$167,950 were transferred to the borrowers’ other related loans that were financed from other sources (see Appendix 1). As a result, these funds were not available for loans that were in compliance with the established purposes of the Economic Development Loan Fund.

U.S. Public Law 88-487 (Pacific Islands Trust Territory - Economic and Social Development), dated August 22, 1964, established a development fund grant for the Trust Territory of the Pacific Islands. The amount of the fund was increased on March 21, 1972, by U.S. Public Law 92-257 (Trust Territory of the Pacific Islands) to a total of \$5 million. Public Law 92-257 was codified in Title 48, Sections 1688 through 1693, of the U.S. Code Annotated. Section 1689 states that the use of the grant depends on the government of the Trust Territory preparing a plan that “shall provide among other things for a revolving fund to make loans or to guarantee loans to private enterprise.” Section 1690 established basic loan and guarantee requirements, and Section 1691 states that the “plan provided for in section 1689 of this title shall set forth such fiscal control and accounting procedures as may be necessary to assure proper disbursement, repayment, and accounting for such funds.” The Agreement reiterated the statements in Sections 1689 through 1691.

Loan Payments

The Bank did not account for and report on loans financed by the United States-funded Economic Development Loan Fund in a separate revolving fund,” as required by Federal law. Instead, the Bank included at least 54 of these loans with other loans financed by Republic funds. According to the Bank’s Financial Manager, when the 54 loans were transferred to the Bank in 1989, the Bank’s management did not realize that these loans had special accounting requirements. Therefore, the Bank did not establish a separate revolving fund for the loans. The oldest listing of these loans available from the Bank, dated

¹⁰A “revolving fund” is an “account that is repeatedly expended, replenished, and then expended again.” (Barron’s Dictionary of Accounting Terms)

December 31, 1989, identified 54 loans with total outstanding balances of almost \$1.3 million and 6 loans with zero balances. Of the 54 loans, we reviewed 20 loans with balances totaling \$687,476 as of December 31, 1989, and determined that through November 30, 1998, the Bank had collected a total of \$214,938 on these loans but had accounted for these collections as Republic revenues and not as Economic Development Loan Fund revenues. As a result, the Bank could not ensure that the \$214,938 was or would be used for loans in compliance with the requirements of the Economic Development Loan Fund program, as required by the Agreement and United States law.

Transferred Accounts

In two instances, the Bank transferred borrowers' Economic Development Loan Fund account balances to the same borrowers' accounts under other funds, which was contrary to the requirements set forth in the "Agreement." According to the Bank's Financial Manager, the loan balances were transferred to assist in collection efforts, and the Bank's management did not realize that these loans should have been accounted for separately. Details of the transferred loans were as follows:

- On September 13, 1994, the Bank closed out an Economic Development Loan Fund account totaling \$46,038 by writing off \$23,019 and transferring the remaining \$23,019 to the borrower's loan from Republic funds. According to the Bank's records, the borrower paid \$3,779 on the portion of the loan that was transferred to the Republic's loan fund.

- On May 30, 1996, the Bank transferred another borrower's entire Economic Development Loan Fund account balance of \$121,912 (\$97,994 in principal and \$23,918 in accrued interest) to the borrower's loan account in the Compact Section 111 Investment Development Fund. Subsequent to the transfer, the borrower paid an estimated \$18,597 on this loan.

As a result, of these two transfers, the Economic Development Loan Fund lost \$167,950 (\$46,038 and \$121,912) that the Bank could not lend for Economic Development Loan Fund purposes.

Recommendations

We recommend that the Chairman of the Board of Directors, Marshall Islands Development Bank, ensure that the Bank's Managing Director:

1. Establishes a separate revolving fund to account for loans made with Economic Development Loan Funds; computes all payments collected from borrowers since 1988; and deposits these funds, as well as all future Loan Fund payments, to this fund.

2. Returns the two loan balances related to the two transfers to the revolving loan fund established in accordance with Recommendation 1; computes all payments collected from borrowers since 1988; and deposits these funds, as well as all future Loan Fund payments, to the revolving fund.

Marshall Islands Development Bank Response and Office of Inspector General Reply

In the August 27, 1999, response (Appendix 3) to the draft report from the Bank's Chairman of the Board, the Bank said that its independent auditors "at no time" had "brought up" the combining of the former Trust Territories Economic Development Loan program with loans funded by the Republic "as an issue of concern to be corrected" and that "further reviews" of the Economic Loan Fund were needed before the two recommendations could be implemented. Based on the response, we consider Recommendations 1 and 2 unresolved (see Appendix 4).

Based on our review of actions taken by the Bank's Board of Directors and other information relating to outstanding loans assumed by the Bank at the time of its establishment, we determined that certain loans labeled by the Bank as "old loans" were Federally funded Economic Development loans. Our discussions with Bank officials and the Bank's independent auditors and our subsequent review of working papers from a prior single audit of the Bank confirmed that the Bank had erroneously reported the Economic Development loans as Republic-funded loans. The Bank subsequently located and provided us with a list of Economic Development loans as of December 31, 1989, which we then provided to the Bank's independent auditors. The independent auditors' resident representative in Majuro, who had performed the most recent Bank audits, said that when his firm began auditing the Bank, there was no indication in the Bank's records that the subject loans were anything but Republic loans. The auditors' representative stated that this issue would be addressed in the calendar year 1998 audit, which was in process at the time of our discussion.

CLASSIFICATION OF MONETARY AMOUNTS*

<u>Finding Area</u>	<u>Unrealized Revenues</u>	<u>Potential Additional Revenues</u>	<u>Funds To Be Put To Better Use</u>
A. Issuance of Commercial Loans			
Political Considerations	\$6,621,645	\$6,442,610	
Financial Analyses	176,256	431,004	
B. Collection of Delinquent Accounts			
Collection Practices	629,631	3,266,944	
Loan Records	208,021		
Property Management		7,500	
C. Economic Development Loan Fund			
Loan Payments			\$214,938
Transferred Accounts	_____	_____	<u>167,950</u>
Total	<u>\$7,635,553</u>	<u>\$10,148,058</u>	<u>\$382,888</u>

*All amounts represent Federal finds.

**MARSHALL ISLANDS DEVELOPMENT BANK
OUTSTANDING LOANS BY U.S. FUNDING SOURCES
AS OF NOVEMBER 30, 1998**

<u>Funding Source and Bank Fund Title</u>	<u>Number Loans</u>	<u>Total Amount Loaned</u>	<u>Total Amount Owed*</u>
Compact of Free Association:			
Section 111, Investment Development Fund	30	\$11,770,484	\$13,781,100
Section 211, Bond Proceeds Fund:			
Commercial Loans	8	905,696	1,034,419
Housing Loans	130	2,531,156	1,292,315
Trust Territory of the Pacific Islands:			
Economic Development Loan Fund	54**	1,273,751**	417,343
U.S. Department of Agriculture:			
Housing Preservation Grant Fund	281	492,939	122,896
Rural Development Fund	<u>4</u>	<u>56,000</u>	<u>56,000***</u>
Sub-Total	<u>507</u>	<u>\$17,030,026</u>	<u>\$16,704,073</u>
Compact of Free Association Fund Loans Converted to Air Marshall Islands Stock:			
Section 111, Investment Development Fund	1	\$850,000	\$1,350,809****
Section 211, Bond Proceeds Fund	<u>1</u>	<u>2,000,000</u>	<u>2,901,688****</u>
Total	<u>509</u>	<u>\$19,880,026</u>	<u>\$20,956,570</u>

*The current amounts owed were not available from the Bank's accounting system and are based on our audit calculations.

**The number of loans and loan amounts are based on the recorded outstanding balances as of December 31, 1989.

***These loans had not been finalized as of November 30, 1998, and no payments had been made on them.

****These amounts include delinquent principal and interest that were converted into stock effective December 31, 1994, plus estimated interest from January 1, 1995, through November 30, 1998.



Marshall Islands Development Bank

Post Office Box 1048
Majuro, Republic of the Marshall Islands
MH 96960

Board of Directors:

Donald Capelle Chairman
Joel Philip Vice-Chairman
Clyde Heine Director
Kinja Andrike Director
Amon Tibon Managing Director

All correspondence
to be addressed to:

MANAGING DIRECTOR
Tel.: (692) 625-3230/5270 Fax: (692) 6253309

August 27, 1999

Mr. Robert J. Williams
Acting Inspector General
United States Department of the Interior
Office of the Inspector General
Washington D.C. 20240

Subject: General comments on draft audit report-Assignment
No. N-IN-MAR-003-99-R)

Dear Mr. Williams;

During the past few days, the Board of Directors of the Bank has met several times to review the draft audit report resulting from the review of the operation of the Marshall Islands Development Bank by your office, and I want to inform you that the Board agrees with almost all of the recommendations that have been proposed and actions will be taken accordingly;

In addition to our responses to the recommendations, I am also submitting, on behalf of the Board, the following comments.

1. Paragraph 2 on page 10 states that on October 22, 1992 (the correct date is May 26, 1992), the Bank had issued an additional loan of \$160,632.00 to a construction company, which had previously made a loan of \$398,755.00 in February of 1991 to perform on a \$400,000.00 contract. The draft audit is questioning whether the bank should have made the loans in excess of its projected revenue from the construction contract. This finding is inaccurate!

Actually, the company had two other contracts that were also being used to secure the repayment of the two loans. One of them was to perform plumbing work at the Capital Complex for \$126,658.00 and the other one was with National Telecommunication Authority, worth \$71,408.00. The total of the three contracts exceeded the total amount of the two loans.

The draft audit also claims that the first loan was already delinquent when the final drawdown on the \$160,632.00 loan was made. It states that although the borrower had paid \$29,216.00 on the principal of the Compact loan, the last such payment was made on September 1, 1993, and the loan was 62 months delinquent. If you count the number of months from February 1991 to September 1993 there are only 30 months during that period. How can the loan be delinquent for 62 months?

The borrower had paid over One Hundred Thousand Dollars before September 1, 1993, and not \$29,216.00, as claimed in the draft audit on page 10. Listed below are some of the payments that were made prior to September 1, 1993.

1. October 02, 1992	Receipt No: 4420	\$ 64,000.00
2. October 15, 1992	4464	1,890.58
3. November 5, 1992	4546	8,966.29
4. December 14, 1992	4698	12,066.41
5. February 18, 1993	4927	5,287.27
6. May 18, 1993	5261	4,969.91
7. July 5, 1993	5438	<u>3,215.71</u>
		\$100,393.17

Under the Loan Agreement, the borrower is only required to pay \$5,450.00 a month but during the period up to September 1, 1999, the borrower had paid more than One Hundred Thousand Dollars and couldn't have been delinquent for 62 months as claimed in the audit.

2. On the overall draft itself, the Board would like to comment that although most of what is said about non compliance with the provisions of the Compact of Free Association, Federal and Republic Laws could be true, the Board feels that most of the non compliance would have been avoided if the Bank had been given more autonomy and independent from the start.

Under the original Act that established the Bank, the business of the Bank was under the control of the Board of Directors but received directions from the Cabinet. By the time the Act was amended, giving the Board more autonomy and independent, most of the Bank's fund under the Compact was already been used for projects that the RMI Government felt were important for the development of the Marshall Islands economy.

Although the conclusion that the Bank did not comply with the provisions of the Compact of Free Association, Federal and Republic laws, Bank policies and guidelines may be true, the Board feels that these non compliance could have been minimized, or avoided, if the IDF Advisory Board, established under Article III, Section 2(a) of the "Agreement between the Government of the Republic of the Marshall Islands and the Government of the United States of America Regarding the Investment Development Fund of the Marshall Islands pursuant to Section 1 l(c) of the United States Public Law 99-239" had taken a more active role in its capacity as an Advisory Board to the fund.

Under the Agreement, the President of the Marshall Islands and the President of the United States of America were to appoint representatives from their respective countries, in addition to the U.S Ambassador to the Marshall Islands, to constitute the Board.

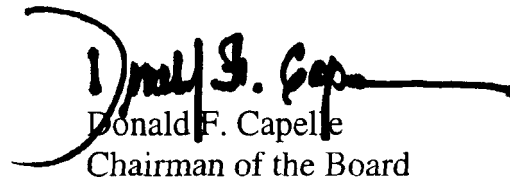
The only advise given by the IDF Advisor Board was for a loan to fund a joint venture fishing project between the Marshall Islands Development Authority and a U.S. citizen in the amount of \$1,000,000.00 with another \$1 ,000.000 placed in the Bank of New York as security for the loan. We all know that the project was a failure, benefiting only the U.S side, and at the end, the Bank had to accept a three hundred thousand dollars (\$300,000.00) settlement and forgive close to two million dollars in principal and interest to avoid losing everything.

When the term of the first IDF Advisory Board was expired, a letter from former President Kabua , dated April 26, 1993, was sent to the U.S Ambassador David Field notifying him of the new appointees representing the RMI Government. The President also asked the Ambassador to request the President of the United States to appoint the U.S Government representatives to join him (the Ambassador) to complete the IDF Advisory Board. Until now no one knows whether the

appointments were made or not, as there has not been a meeting of that Board.

If you have question concerning our responses or comments, please contact Amon Tibon, Managing Director, at telephone (692) 6254.527 or fax (692) 6253309.

Sincerely,


Donald F. Capelle
Chairman of the Board

copy: file



Marshall Islands Development Bank

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Clyde Heine Director
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1 September 1999

Mr. Peter J. Scharwark, Jr.,
Senior Auditor
Pacific Office
Guam

Dear Mr. Scharwark, Jr.

Please find our comments and responses to Mr. Robert J. Williams with respect to the draft audit report of the Marshall Islands Development Bank. Total number of pages including this one is seven (7).

Please let us know if we have to re-fax any missing pages.

Thank you.


Amon Tibon

RESPONSES TO RECOMMENDATIONS ON (A) ISSUANCE OF COMMERCIAL LOANS.

Recommendations:

1. The Board of Directors of the Bank will make sure that the Policies and Guidelines will be revised to require that development loans, funded under the Compact funding, are in conformance with the applicable goals and objectives contained in the Republic's 5-year economic plans as a condition of approval.
2. The Board of Directors of the Bank will submit a formal request to the Cabinet to amend the bank's enabling legislation so that the number of government officials is reduced and the number of private business representatives appointed to the Bank's Board of Directors is increased and to require formal acknowledgement and approval by the Bank's Board of Directors of any loan applications subject to possible political influence. Written statements would be required by voting members of the Board that they had no conflict of interest and that they were not aware of any financial risk related to politically influenced loans.

The request will be submitted before the January 2000 session. Management will be responsible for this.

3. As recommended, the Board of Directors of the Bank will submit a formal request to the Cabinet to have at least one member from the Bank's Board to represent the Bank on the Board of Directors of the Air Marshall Islands Inc.. This will be done before the end of the year, and management will also be responsible for it.
4. Management will comply with recommendation from now on.

RESPONSES TO THE RECOMMENDATIONS ON (B) COLLECTION OF DELINQUENT LOANS.

Recommendations:

1. The Board of Directors will ensure that the Managing Director enforces

the loan provisions for seizing loan collateral for loans that are significantly delinquent. In order to do this more effectively, the Bank's legal counsel will be asked to revise the loan documents so that the seizing of the loan collateral does not require a lot of court proceedings. This recommendation will be carried out as soon as possible and will be the responsibility of the Managing Director.

2. This recommendations has already been in place as it required by the Board of Directors of the Bank, and amendments to the Policies and Guidelines will be made to require regular supervisory reviews of files on loans that are delinquent.
3. As recommended, the bank will hire or assign someone to manage all properties seized or managed by the bank. This should be implemented sometimes in January, 2000.
4. Management agrees that Bank needs a new or improved computerized system. Management has discussed the subject matter with the Computer Specialist working with the Bank of Marshall Islands, and the actual work has already been started. The new system should be in place before the end of the year.
5. The Bank has already implemented this recommendation and will make sure all management agreements contain languages that would specify the amount of fee the Bank would charge a borrower for services provided.

RESPONSES TO RECOMMENDATION ON (C) ECONOMIC DEVELOPMENT LOAN FUND

Recommendations:

Comments: Before these two recommendations can be implemented, the Bank needs further reviews of the Economic Loan Fund that was managed by the former Trust Territory of the Pacific Islands. Since 1991 the Bank is being audited by an independent auditor, as required by the Marshall Islands Development Bank Act, and at no time this subject matter has ever being brought up as an issue of concern to be corrected.

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
A.1	Management concurs; additional information needed.	Provide the target date and the title of the official responsible for revising the Bank's Policies and Guidelines to require that Compact-funded development loans are in conformance with the Republic's 5-year economic plans.
A.2 and A.3	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. However, we request that copies of the Cabinet's responses to the Bank's requests be provided to our office.
A.4	Implemented.	No further action is required.
B.1	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. However, we request that a sample copy of the revised loan documents be provided to our office.

Finding/Recommendation Reference	Status	Action Required
B.2	Management concurs; additional information needed.	Provide the target date and the title of the official responsible for amending the Bank's Policies and Guidelines to require supervisory reviews of files on delinquent loans. However, we request that a copy of the revised Policies and Guidelines be provided to our office.
B.3	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. However, a copy of the documentation showing when a property manager has been assigned should be provided to our office.
B.4 and B.5	Implemented.	No further action is required.
C.1 and C.2	Unresolved.	Reconsider the recommendations, and provide responses indicating concurrence or nonconcurrence. If concurrence is indicated, provide action plans that include target dates and titles of the officials responsible for (1) establishing a separate revolving fund for former Trust Territories loans and (2) depositing into the fund all loan payments and the two loan transfers made since 1988 and all future loan payments.

**ILLEGAL OR WASTEFUL ACTIVITIES
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HOTLINE

U.S. Department of the Interior
Office of Inspector General
1849 C Street, NW
Mail Stop 534 1- MIB
Washington, D.C. 20240-000 1

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