STATEMENT ON

S. 144, "EXPORT TRADING COMPANY ACT OF 1981"

PRESENTED TO

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

BY

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FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 A.M.
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I appreciate the opportunity to present this statement to your Subcommittee on S. 144, the Export Trading Company Act of 1981.

Senator Heinz, in your letter of invitation as Chairman of the Subcommittee on International Finance and Monetary Affairs, you asked the FDIC to comment on four questions:

- -- the necessity for bank participation in trading companies;
- -- the circumstances under which banks should be permitted control of the trading companies, and what safeguards, if any, are necessary over that control;
- -- whether an antitrust immunity is necessary to encourage the formation of export trading companies;
- -- how the various sections of S. 144 resolve the above issues and whether, if the legislation were enacted, the financial provisions of the bill are adequate to successfully implement it.

The stated purpose of S. 144 is "to increase United States exports of products and services ... by encouraging more efficient provision of export trade services to American producers and suppliers." The bill describes export trading companies as companies principally engaged in exporting and facilitating the exportation of goods and services produced in the United States.

S. 144 was introduced with 44 co-sponsors from both sides of the aisle. A companion bill, H. R. 1648, was introduced in the House by Congressman LaFalce. Other versions

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of the legislation, including variations that would omit bank participation entirely or that would limit controlling investments to bank holding companies, have also been introduced and are coming under discussion.

Within this context of momentum, I am grateful for this opportunity to express our views as insurer of the people's deposits in our banking system.

Last July, I testified for the FDIC before the Banking, Housing and Urban Affairs Committee on predecessor legislation, S. 2718. The main thrust of our testimony at that time was that the historical separation between banking and commerce has served our country well and should not be altered lightly. Our views today are much the same.

We remain sympathetic with the main purposes of the bill. We recognize the importance of S. 144's objective of strengthening the export of United States products and services by encouraging the improvement of export trade services to American producers and suppliers. We do not oppose export trading companies -- we support them. From our perspective, however, we have questions about the degree and type of bank involvement.

We have a general concern about banking organizations taking any equity position in export trading companies. We recognize, of course, that there are times when compelling

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national interest requires a change in traditional practices and that we should not be forever bound to the past. This may be such a case. You must take a broader view of this legislation and its context than we do.

It is important in your deliberations for you to recognize that, notwithstanding the priorities which direct us toward altering the environment of banking, such changes are not made without consequence. You are hearing other points of view expressing the benefits expected to be realized by the legislation. It is our responsibility as insurer of the public's bank deposits to express to you our perception of the potential for increased risk to the United States banking system. We want to highlight the fact that this would represent an historically significant incursion of banking into the province of commerce.

We recognize the fact that S. 144 retains certain safeguards incorporated into the legislation last year in an effort to meet the supervisory concerns expressed by the Federal Reserve, the Comptroller of the Currency and the FDIC. These measures would limit the risk to our banking system, but they would not eliminate it, nor would they overcome the basic conflict inherent in the mingling of banking and commerce.

A passage in Chairman Volcker's letter of August 20, 1980, to your full committee concerning last year's bill is still relevant:

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My concern about the provisions of S. 2718 that are designed to give supervisors powers to step in and prevent unsafe practices is that it would involve the supervisors to a substantial degree in decisions regarding operations of export trading companies. Bank supervisors are not able to anticipate all future eventualities in acting on applications and are unlikely to be able to supervise the operations of export trading companies sufficiently closely to ensure that risks to banks could be avoided, when those risks are magnified by bank control and involvement in management.

At this point, a review of the provisions of S. 144 may be useful. Then, I will turn to the four questions put by your letter, Senator Heinz.

PROVISIONS OF S. 144

Section 105 of S. 144 would allow any bank, Edge Act or Agreement Corporation, or bank holding company -- collectively referred to as "banking organizations" -- to invest up to five percent of its consolidated capital and surplus (but not exceeding $10 million) in one or more export trading companies without prior regulatory approval if the investment does not amount to control. In the case of an Edge Act or Agreement Corporation not engaged in banking, the percentage limit would be 25 percent of its consolidated capital and surplus. Proposed investments exceeding the dollar limit or amounting to control would require prior approval of the appropriate Federal regulatory agency. The agency would be required to act on an application within 120 days.

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In reviewing bank proposals for investment exceeding $10 million or amounting to control, the Federal regulatory agency must consider the financial and managerial resources, the competitive situation, and the future prospects of the banking organization and the export trading company concerned. Additionally, however, the agency must take into account the benefits of the proposal to U.S. business, industrial and agricultural concerns, and the improvement the proposal would bring to the U.S. competitive position in world markets.

Applications for approval of investments exceeding $10 million or amounting to control could not be approved if the agency finds the probable benefits outweighed by any adverse financial, managerial, competitive or other banking factors. The language indicates that banking risk is to be weighed, not on its own characteristics, but in relation to the benefit to be realized by the economy. The agency could impose conditions it feels would limit a banking organization's financial exposure to an export trading company, or which would prevent conflicts of interest or unsafe or unsound banking practices.

The bill also would prohibit the total of a banking organization's historical cost of the direct and indirect equity investment in and loans to any one export trading company from exceeding 10 percent of the organization's capital and surplus.

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Agencies would be authorized to set standards for the taking of title to goods by any export trading company subsidiary of a banking organization to ensure against any unsafe or unsound practices that could adversely affect a controlling banking organization investor. In particular, the appropriate Federal banking agencies may establish inventory-to-capital ratios, based on the capital of the export trading company subsidiary for those circumstances in which the subsidiary may bear a market risk on inventory held.

S. 144 would impose the following additional restrictions:

1. The trading company's name may not be similar in any way to that of the investing banking organization.

2. A banking organization may not make loans to any export trading company in which it holds an equity interest, or to any customers of the company, on terms more favorable than those afforded similar borrowers in similar circumstances, or involving more than normal risks of repayment or displaying other unfavorable features.

3. Banking organizations could not own any stock interest in an export trading company which takes positions in commodities or commodities contracts, securities or foreign exchange other than as may be necessary in the course of its business operations.

S. 144 would empower the regulatory agency to order termination of a banking organization's investment in an export trading company "whenever it has reasonable cause to believe that the ownership or control of any investment in an export trading

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company constitutes a serious risk to the financial safety, soundness, or stability of the banking organization and is inconsistent with sound banking principles or with the purposes of this Act or with the Financial Institutions Supervisory Act of 1966. . . ."

In any such case, the banking organization has a right to notice and hearing and ultimate appeal to the courts.

Section 105(a)(13) of S. 144 contains a revised definition of an "export trading company" which, among other things, makes clear that it may be a profit or nonprofit organization and that it is prohibited from engaging in underwriting, selling or distributing securities except to the extent of its banking organization investor and that it is prohibited from engaging in manufacturing or agricultural production activities. Section 105(a)(5) incorporates a new definition of "banker's bank," for purposes of such a bank's participation in export trading companies to make clear that it is an institution insured by the Federal Deposit Insurance Corporation.

CHANGES FROM S. 2718

We recognize and applaud the fact that S. 144 contains many of the changes that we had recommended in our discussion of S. 2718 last year.

Specifically, S. 144 contains a recognition of State authority as we had proposed. Section 105(g) of S. 144 would affirm a State's right to prohibit State-chartered banks from investing in export trading companies or to apply conditions,

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limitations or restrictions on such investments in addition to any provided under Federal law.

S. 144 incorporates into Section 105(c)(3) a provision we requested prohibiting export trading companies from speculating in securities or foreign exchange. The same provision also would preclude speculation in commodities and commodity contracts.

S. 144 accommodates our previous concern about language in Section 105(d)(2) which would have given the agencies a 270-day deadline in which to establish standards for taking title to goods and holding inventory. The purpose of standards would be to prevent unsafe and unsound practices. We had said that the issue was too new and complex to lend itself to the formulation of regulations within 270 days. The new bill eliminates the deadline.

S. 144 also accommodates another concern we had raised last year. Section 105(b)(2) and (3) would require the appropriate banking agency to act within 90 days on written notice by banking organizations of their intentions to make additional investments or to undertake certain activities by export trading companies, and to act within 120 days of notice by a banking organization of its intent to make a $10 million investment or any controlling investment in an export trading company. If the agency fails to act within the time limits, the application would be deemed approved. In the predecessor legislation, S. 2718, the time limits were 60 and 90 days, respectively.

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We had recommended that -- in both instances -- the statutory limit be extended to 120 days.

Finally, we believe you have taken the proper course in adopting the stricter definition of "capital and surplus" in Section 105(a)(10), limiting that term to "paid in and unimpaired capital and surplus," including undivided profits. Last year we had expressed our concern that the broader definition in S. 2718 could be interpreted to include subordinated notes and debentures.

RISKS ASSOCIATED WITH CONTROL

Advocates of bank investment in export trading companies point to the expertise in foreign trade the banks could bring to such companies. We are not convinced that banks -- other than a few money center and regional banks -- have any particular expertise in foreign markets.

A bank controlling a foundering trading company may incur legal liability if, for example, the bank provides management or engages in significant intercompany transactions.

Perhaps of greater importance than the legal considerations, a bank might be under considerable pressure to come to the aid of a troubled export trading company it has sponsored. History offers many examples of banks and other companies that have come to the aid of troubled subsidiaries in order to protect the parent company's reputation in the business community.

Experiences in connection with bank-sponsored Real Estate Investment Trusts (REITs) are illustrative of the legal

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and practical business obligations banks feel toward undertakings they sponsor. Some banks provided assistance due to legal considerations stemming from interlocking officers and directors and the provision of advisory services. Others came to the aid of the sponsored REITs because they believed failure to do so would severely damage their bank's reputation in its community and in business and financial circles generally.

Whatever the motivation for the assistance, the exposure may be substantially greater than the bank's equity investment due to leveraging and the potential for off-balance sheet losses.

In addition, S. 144 as written, would fail to guard against sale of worthless assets to the bank by the export trading company. Section 105(c)(2) would place a 10-percent of capital and surplus limit on a bank's direct and indirect investments combined with extensions of credit in export trading companies. However, there is no limit on outright sales of assets by an export trading company to a bank. Nor is there a requirement for such transactions to be consumated on an arms-length basis. Transactions with affiliated organizations may well have a legitimate business purpose, as when a bank buys foreign exchange from its export trading company. However, these practices can also result in the transfer of worthless or subinvestment quality assets from the export trading company to the bank or the bolstering of the trading company's reported earnings by the payment of premium prices for the assets. We can point to the example of the Hamilton Bancshares

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holding company in 1974 as concrete proof that dealings with related entities can lead to the failure of a financial institution. In our judgment, the bill should be amended to provide a safeguard against such abusive practices.

SPECIFIC QUESTIONS

I would like to respond now to the specific questions in the letter of invitation. The first question was "the necessity for bank participation in trading companies."

We would point out that banks already have an alternative means of participating in the export trading services field. Measures have been taken recently by the Federal Reserve to strengthen U.S. exports by increasing the capabilities of Edge corporations to provide international banking services. Governor Wallich outlined these actions in his April 3, 1980, statement. He said that one change permitted Edge corporations to finance the production of goods for export and another change permitted Edge corporations to establish domestic branches, thereby increasing the possibilities for international banking services to expand into new areas. Governor Wallich noted that U.S. banks can now provide, either directly or through their Edge corporations and affiliates, a wide variety of services relating to exports. He said that in addition to a full range of financing services, these include foreign exchange facilities, information on foreign markets and economies, introductions, business references, and advice on arranging shipments.

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We are in the position today of testifying on banks' proposed participation in export trading companies before the potential of existing Edge corporation capabilities has been fully demonstrated.

The second question concerned "the circumstances under which banks should be permitted control of the trading companies, and what safeguards, if any, are necessary over that control."

Our strong preference is that banks should not be permitted at the outset to acquire a controlling interest in export trading companies.

We recommend that Section 105 be amended to include a provision that at this time no banking organization, alone or in concert with its affiliates, be permitted to acquire more than 20 percent of the voting stock of an export trading company or to control the company in any other way, and that not more than 50 percent of an export trading company's voting stock be owned by any group of banking organizations.

The rationale for these recommendations is to give the banking industry and the bank regulators an opportunity to gain experience and develop a measurable track record before a final determination is made as to whether banking organizations should be permitted to control export trading companies.

If, however, legislation permitting bank participation and control of export trading companies is reported, we would recommend that the bill include certain amendments to ensure oversight by the appropriate Federal regulatory agency.

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Specifically, we recommend that the bill also be amended to require that any investment by a banking organization in an export trading company, regardless of amount, be subject to prior approval by the appropriate Federal banking agency. This would assure that the appropriate Federal supervisory agency would not be precluded from ruling on a matter affecting the safety and soundness of the bank simply because the institution may be a part of a larger banking organization.

Secondly, to deal with the purchase of assets problems we have described, we recommend that the following be added at the end of § 105(c)(2) on page 14, line 2, of S. 144:

> For the purposes of this paragraph (c)(2), "extensions of credit" shall be deemed to include (A) the acquisition of any asset from, or the assumption of any liability of, an export trading company which is a subsidiary of the banking organization, other than at fair market value in the normal course of course of business, (B) any such acquisition or assumption while the trading company is in default on any of its obligations or liabilities in an aggregate amount exceeding such trading company's own capital and surplus, (C) any such acquisition or assumption subsequent to issuance of notice by the appropriate Federal banking agency that no such acquisition or

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assumption be effected; but such term shall not include the purchase at prevailing market rates of foreign exchange and investment securities of the types eligible for purchase by national banks.

Thirdly, we recommend a technical amendment in order to clarify regulatory jurisdiction. Section 105(a)(12) adopts the definitions of "control" and "subsidiary" found in Section 2 of the Bank Holding Company Act of 1956. In addition to a 25 percent stock ownership test and an election of a majority of directors or trustees test, Section 2(a)(2) of the Bank Holding Company Act of 1956 provides for a finding of control by the Board of Governors if, after notice and opportunity for hearing, the Board determines that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. This determination, for purposes of the Export Trading Company Act, should be made by the appropriate Federal banking agency, so that the determination of control and approval of an investment by a bank which would constitute control would be made by the same regulatory agency.

We recommend, therefore, that Section 105(a)(12) of S. 144 be amended by insertion of the following after "1956;" at line 16:

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provided, however, that for purposes of the Export Trading Company Act of 1981 the determination of control as provided in Section 2(a)(2) of the Bank Holding Company Act of 1956 shall be made by the appropriate federal banking agency;

The third question in the letter is "whether antitrust immunity is necessary to encourage the formation of export trading companies."

We understand that the Department of Justice has engaged with the committee in lengthy consultation on this question, and, in this instance, we would defer to that department.

The fourth question is "how the various sections of S. 144 resolve the above issues and whether, if the legislation were enacted, the financial provisions of the bill are adequate to successfully implement it."

Our major concern is the issue of control, and we have already given you our recommendations in this area. With regard to the financial provisions, we would not favor any increase in the limits on aggregate investment and investment and loans by banks in export trading companies. We are concerned that beyond these statutory limits, there always exists the possibility that investing banks could be sued for additional unlimited amounts as the result of the failure of an export trading company or an act of the export trading company. This would be unusual, but it could occur if the stakes are high

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enough, and this would be the circumstance that would arouse our concern about the safety and soundness of the bank. We see no way to circumscribe this liability.

CONCLUSION

We appreciate the opportunity to comment on this bill. Should you be inclined to accept any of our suggestions we would be glad to provide drafting assistance by our staff.

NOTE: In accordance with 12 U.S.C. §250. The views expressed herein are those of this agency and do not necessarily reflect the views of the President.

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