For release on delivery
9:30 a.m. E.S.T.
March 25, 1987

Statement by

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before the

Subcommittee on International Finance and Monetary Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

March 25, 1987

I am pleased to appear before you today to discuss the topic of bank-affiliated export trading companies.

In its consideration of the export trading company legislation in 1982, the Congress determined that U. S. export performance was inhibited by the inability of U. S. businesses, especially small- and medium-sized companies, to develop foreign markets for their products due to their lack of expertise in the mechanics of exporting. The Congress therefore sought to promote the establishment of companies that could supply the necessary expertise in order to assist U.S. companies in increasing exports of their goods and services. In enacting the Bank Export Services Act ("BESA"), the Congress decided that one method by which export trading companies could be developed was by permitting affiliations with banks through a bank holding company structure.

Now that we have had some experience with the operation of bank-affiliated export trading companies under the legislation, we thought it would be useful to share information on that experience with you in connection with the Committee's consideration of further refinements to the export trading company concept. While a beginning has been made in the development of export trading companies as promoters of U.S. exports, unfavorable economic conditions have not provided an atmosphere in which export trading companies can flourish.

Since the passage of the legislation in October 1982, the Federal Reserve has acted upon 43 notifications by bank holding companies to establish export trading companies. Sixteen of these have been acted upon by the Reserve Banks under authority delegated to them by the Board in 1983. This number represents more than 50 percent of the notifications processed since the delegation rules were adopted.

The Board recently conducted a survey of nine bank-affiliated export trading companies, selected to provide diversity of size and geographic location of the bank holding company parent. For those export trading companies responsive to the survey, the assets size ranged from $210,000 to $21 million, with the average being $8.2 million, and gross revenues ranged from $110 thousand to $18 million, with the average also being $8.2 million.

The activities of these export trading companies were also quite diverse. Several were engaged almost exclusively in transactions involving the purchase and sale of goods, while the others received their income largely from fee-based services. The services included transportation; marketing and consulting; acting as an agent for a Foreign Sales Corporation; and trade financing services. The survey suggests that bank-affiliated export trading companies are able to offer a broad range of services under the current statute and regulations and a number appear to be operating profitably.

While results suggest some bank-affiliated export trading companies are operating successfully, others have experienced some difficulties. Of the 43 bank-affiliated export trading companies of which the Board received notice, 14 are no longer operational. In a few instances, the cessation of export trading company activity was related to changes in the ownership of the export trading company, such as through acquisitions and mergers. However, this performance has been largely related to the difficulties that bank holding companies have experienced in operating an export trading company. In addition to poor economic conditions in their first years of existence, described below, which resulted in diminished profit potential, these export trading companies have also encountered start-up difficulties resulting from unfamiliarity with the trading business. Other problems encountered are peculiar to the activities of trading companies, regardless of how long they have been operating: for example, a customer breaking the terms of its own trade agreement, or the inability of an export trading company to deliver on a major contract, or inadequate controls over the trading activities.

To the extent that the performance of bank-affiliated export trading companies has been disappointing, it should be noted that there is no evidence that trading companies without bank affiliation have been any more successful. While there is no comprehensive means of tracking the performance of all these trading companies, the General Accounting Office, in the course of preparing its February 1986 Report to Congress on the Implementation of the Export Trading Company Act of 1982, conducted a survey of 23 trading organizations that had obtained certificates of review from the Department of Commerce. Many of those firms reported that business was disappointing, citing economic factors, particularly the high value of the dollar, as the reason.

Although the experience of bank-affiliated export trading companies to date has fallen short of expectations, this is due primarily to the highly unfavorable economic climate for U.S. exports that resulted from the overvalued exchange rate for the U.S. dollar, the lack of adequate economic growth in foreign industrial countries, and the need for adjustment in many developing countries. Therefore, the period since 1982 has clearly not been a fair test of the viability of bank-affiliated export trading companies on which far-reaching changes in the law should be based. In addition to the macro-economic conditions faced by export trading companies, there are other factors contributing to their slow development. It is still a fledgling industry; the oldest of the bank-affiliated export trading companies is not yet four years old. Moreover, a review of several articles concerning bank-affiliated export trading companies in recent years indicates that the affiliation of two such different corporate cultures as banking and trading inevitably creates difficulties in forging a viable and profitable enterprise. I might add that the publications generally do not attribute the lack of success of export trading companies to the Board's regulations, but rather to the various economic and business factors that I have mentioned.

In efforts to make refinements to the legislation governing the operations of bank-affiliated export trading companies, which we all see as a desirable effort, it should be remembered that banking organizations were perceived as providing two essential elements for a successful export trading company -- a source of capital and financing and a network of foreign offices able to evaluate foreign markets and provide necessary foreign contacts. The legislation therefore created a very limited exception to the statutory separation of banking and commerce in order to achieve the goal of improving the export sector of the economy. The BESA was not, as we read it, intended to let bank holding companies perform every type of international activity nor to relax to any great extent the provisions protecting bank safety and soundness. Bank-affiliated export trading companies were intended to assist other companies in the export of their goods and services and not to compete with these companies by becoming themselves producers of services for export. Moreover, the Act recognizes that there are activities from which export trading companies should be explicitly excluded, such as securities activities, agriculture, dealing in commodities, and manufacturing. The Act contains these and other important safeguards that are intended to maintain the separation of banking and commerce and to avoid compromising significant supervisory goals. These measures were adopted in recognition that one goal of national importance -- export promotion -- should not be achieved at the expense of another -- a safe and sound banking system.

The Board's regulations implementing the BESA are designed to carry out the statute's intent. Because the statute did not focus on promoting trade, but on promoting U.S. exports through <u>export</u> trading companies, our regulations are designed to ensure that such companies engage in trade services that promote U.S. exports. As a result, the Board's regulation requires that 50 percent of a bank-affiliated export trading company's business must derive from exporting or facilitating the export of goods and services produced in the United States by persons other than the export trading company and its subsidiaries. Under this test, a bank-affiliated export trading company may provide services to any party, foreign or domestic, that is connected to an international trade transaction, as long as the majority of the company's business is export-related.

Let me at this point clear up some confusion over one aspect of the 50 percent revenues test in the Board's regulations. A bank-affiliated export trading company may provide services not only to unaffiliated persons, it can also help to promote the goods and services of <u>any</u> of its affiliates; that activity is considered as facilitating a U.S. export under the regulation. For example, an export trading company could market abroad computer software developed by its bank holding company parent; revenues derived from that activity are considered export revenues. Thus, contrary to the perception of some, a bank-affiliated export trading company is authorized to assist its affiliates in exporting services.

As I have mentioned, one of the fundamental premises of the legislation is that bank-affiliated export trading companies will facilitate the export of goods and services of other U.S. companies and will not engage directly in such activities themselves. Accordingly, the Board's regulations, consistent with the purposes of the BESA, prevent a bank holding company, under the guise of an export trading company, from acting only as a service company for foreigners, that is, from engaging in a service activity, which might not be even a trade service, that is provided only to foreign parties. An example would be an insurance company that underwrites and sells property and casualty insurance policies to foreign customers.

This situation, in which a bank holding company becomes the producer of the service to be exported, would be inconsistent with an export trading company's role as a facilitator of exports. The regulations, however, permit formation of a joint venture with an insurance company to facilitate the sale of the insurance company's policies abroad. Therefore, there is a broad scope in the statute and the regulation for a bank-affiliated export trading company to provide services in support of exports.

Some of the legislative proposals have implicitly taken issue with the Board's regulation requiring that 50 percent of an export trading company's business derive from exports or facilitating exports produced by others. This is also the area of current regulation where the most flexibility is sought by the surveyed bank-affiliated export trading companies, i.e., in the application of the 50 percent of revenues test.

These legislative proposals would alter the original intent of the statute in a fundamental way. The original bill was intended to promote exports and build an export-oriented infrastructure of trading companies. Some of the proposed legislation would not seem to further those goals.

First, these proposals would permit an export trading company to count as export revenues any revenues derived from third country trade. The rationale is that the export trading company itself is providing a service and that the third country trade activity does not hurt U.S. trade balances because it does not involve an import. Our view is that such proposals sanction the development of bank-affiliated trading companies that need not facilitate the export of any product produced in the United States at all. They would permit a trading company to set up foreign companies to provide a broad range of services to foreign parties without any benefit either to U.S. jobs or toward developing an export trading industry that can serve companies that actually produce goods and services in the United States. This approach would create a movement in the opposite direction from providing export trade services to those U.S. companies that need assistance in exporting.

Moreover, it is not readily apparent that, as many claim, third country trade would not harm U.S. trade. If a foreign country is buying computers from Germany, it is not buying them from the United States. Third country trade therefore can hurt U.S. exports, as many third country transactions are substitutions for U.S. exports.

In addition, by permitting bank holding companies to invest in any company, regardless of its business, as long as it offers its services exclusively to foreign customers, the proposed legislation would put bank holding companies into direct competition with other U.S. companies that are intended to be the primary beneficiaries of the original act, i.e., companies that produce goods and services in the United States which with the help of an export trading company could be exported. Such a result seems perverse in two ways. First, it reduces any incentive on the part of bank-affiliated export trading companies to market their trade services to U.S. companies. Under the proposals, if a bank holding company were to identify potential projects or markets abroad, it could establish a trading company to take on the project or service, rather than approach U.S. companies either to form a joint venture to take advantage of the opportunity or to otherwise assist the U.S. company in exporting its service.

Second, the proposals would expand the kinds of activities in which a bank holding company may engage indirectly through an export trading company. There is already a statutory and regulatory framework for the expansion of the operations of bank holding companies and Edge corporations outside the United States that provides considerable flexibility in both activities and investments. For example, in some instances, U.S. banking organizations have been permitted to establish foreign companies that underwrite and sell life insurance. This has been done, however, under statutes that allow the Federal Reserve to consider fully the effect on banks and the banking system, taking into account factors not applicable to the BESA. A radical change in the authority to conduct activities overseas, such as the proposals would provide, should be dealt with straightforwardly as a question of new products and services for banking organizations. The Board strongly supports authorization of some new products and services for bank holding companies but believes that they should be granted in a direct fashion, and not through trade legislation, especially where there would be no benefit to U.S. exports generally.

Although these proposals would shift the emphasis of the original statute from export promotion to promotion of international trade _per se_ by permitting bank holding companies to engage in general trading activities without regard to promoting U.S. exports, this is of course a matter for Congress to decide. The Board's regulations requiring a predominance of exports are, however, fully consistent with the intent of Congress at the time of passage of the BESA.

With respect to the ability of a bank to finance its affiliated export trading company, the BESA subjects a bank's extension of credit to an affiliated export trading company to the provisions of section 23A. As you know, section 23A requires collateralization for any extension of credit by a bank to an affiliate, usually in an amount that exceeds the face amount of the extension of credit. This is entirely appropriate in order to protect the bank. However, in recognition of the need for a bank-affiliated export trading company to secure funding for its trading in goods, the Board has provided a reasonable exception by waiving the excess collateral requirement for loans by a bank to its affiliated export trading company. The regulations require instead that the bank take a security interest in goods or the proceeds from the sale of goods that are subject to a contract of sale. This measure enables an export trading company to obtain financing for the activity for which financing is most needed but the exception does not subject the bank to undue risk.

This liberalization of section 23A's collateral requirements is the type of carefully crafted exception to the provisions of section 23A that we believe is most appropriate in this context. It is tailored to the needs of an export trading company but ensures that the assets of the bank will not be jeopardized.

The Board also expects a bank-affiliated export trading company to be capitalized adequately to support its operations. There is no regulatory requirement, however, for a certain capital level. Each case is evaluated based on its own facts.

Some of the proposed amendments to the BESA that relate to section 23A and to capital requirements raise substantial supervisory concerns. The proposals would expand the ability of a bank-affiliated export trading company to take on the equity risk of foreign subsidiaries, clearly increasing the risk to which the export trading company is subject. At the same time, the proposals would reduce the safeguards for the affiliated bank, by exempting all transactions from the collateral requirements of section 23A and by permitting an export trading company to be less than adequately capitalized.

These changes would seem to be especially inappropriate at this time when there is a consensus that bank affiliates should be subject to market discipline. An affiliate should not be able to use a bank's resources -- and the federal guarantee for those resources -- except to the extent permitted by the provisions of section 23A. As the Board has consistently stated, if a bank-affiliated export trading company is creditworthy, it can obtain credit in the market even from a non-affiliate. If an export trading company is not creditworthy, an affiliated bank should not be placed at risk by being able to lend without collateral. Moreover, a total elimination of section 23A collateral requirements is directly contrary to the approach taken in other recent legislative proposals, which would actually strengthen the protection available to the bank.

As I have previously stated, the Board has been willing to be flexible in its approach to section 23A as it applies to loans to bank-affiliated export trading companies but only where the bank will not be adversely affected. We cannot support any proposal that would permit a nonbank affiliate to drain the resources of the bank in pursuit of its business.

With respect to capitalization, some of the legislative proposals would permit an export trading company to operate with a capital to assets ratio of 4 percent. That ratio would be low for most trading companies; such ratios are typically at least 25 percent for trading companies not affiliated with banks. The proposed ratio is even lower than the capital required of a bank. We see no justification for reducing the Board's ability to require that a bank holding company subsidiary be adequately capitalized in relation to its business. Having said this, it should be noted that where the proposed activities of a bank-affiliated export trading company have risk characteristics similar to those of a bank, the Board has determined that the export trading company may maintain a capital ratio equivalent to that required of a bank.

Such a proposal permitting a low capital to assets ratio would also be contrary to prudent supervisory policies as reflected in recent efforts, including those of the Congress in passing the International Lending Supervision Act of 1983, to increase capital of banking organizations involved in international activities. Moreover, it would remove bank-affiliated export trading companies from the market restrictions imposed on other companies not affiliated with banks, thereby encouraging increased risk-taking with its concomitant risk to the banking organization. It should be kept in mind that a bank can be harmed not only by direct interaction with an affiliate but also by a weakening of the bank holding company's ability to serve as a source of strength to its subsidiary banks.

In addition to the supervisory questions raised by these proposals on section 23A and capital adequacy, the proposals raise a serious issue of competitive equity. These proposals place bank-affiliated export trading companies in a favored position over all other competitors by removing them from the effects of market discipline. A bank-affiliated export trading company would have a ready source of financing, even if the company is not creditworthy, and could undertake a higher volume of activities because of its low capitalization. This situation would be entirely inconsistent with the concept of a level playing field.

In light of these factors, the Board must oppose any proposals that would increase the risk to the bank from the operation of the affiliated export trading company. Such export trading companies should be permitted to operate with sufficient flexibility to allow them to succeed but within appropriate constraints on their ability to harm their affiliated banks. We believe that the current statutory and regulatory framework achieves these goals. The recent past did not provide circumstances for the best test of the current framework. Changing economic conditions should make it easier for these export trading companies to operate more successfully in the next few years.

While we believe that the foregoing is a realistic assessment of both the current law and the proposals that have been introduced into the Congress, the Federal Reserve is, as always, willing to work with the Congress in developing necessary legislative reforms. We urge you, however, to keep in mind that some of the proposals raise serious supervisory concerns. Others are aimed at changing the purposes of bank-affiliated export trading companies from an export orientation to encouraging trade outside the United States or even U.S. imports. In the final analysis, of course, the goals for any new legislation are established by the Congress, and the Board always endeavors to adopt implementing regulations that reflect those goals.

Thank you very much.