

FOR RELEASE ON DELIVERY
EXPECTED AT 2:30 PM EST

Statement by
Henry C. Wallich
Member, Board of Governors of the Federal Reserve System
submitted to the
Subcommittee on International Finance
of the
Committee on Banking, Housing and Urban Affairs
U.S. Senate
April 3, 1980

I am pleased to submit a statement on S. 2379, a bill that is designed to facilitate the formation and operation of export trading companies. My statement on behalf of the Board of Governors is limited to the section of the bill that provides for bank investment in trading companies.

The Board strongly supports the view that the United States needs a strong export sector, and I have been concerned that exports are sometimes hampered by government regulations. It is noteworthy that, under such handicaps, U.S. exports have nevertheless grown rapidly in the past several years. This growth however has reflected in good part the depreciation of the dollar, and the improved competitive position of the United States that has resulted, as well as the benefits from the expansion of economic activity abroad. Over the past two years exports have increased 50 percent in value and 20 percent in volume, with strong performances in both agricultural and manufactured goods. We should expect that growth in our exports will depend in part on growth in the main markets in which we sell. Thus, as economic activity slows abroad, we should expect growth in our export sales to slow also, although we still look for some increase in exports of manufactures this year. Further growth in exports and a narrowing of the U.S. trade deficit in the years ahead will depend on our ability to bring inflation under control and to establish an environment favorable to growth of productivity and the international flows of goods and services.

Among the measures already taken to strengthen U.S. exports are certain actions by the Federal Reserve to increase the capabilities of Edge Corporations to provide international banking services. I recently reviewed these measures before this Subcommittee. These changes in rules for Edge Corporations were in response to the Congressional mandate in the International Banking Act, and were designed to help the financing of exports. One change expanded the powers of

Edge Corporations by permitting them to finance the production of goods for export. A second change permitted Edge Corporations to establish domestic branches, thereby increasing the possibilities for international banking services to expand into new areas. In the nine months since this change in Board regulation, the Board has approved applications for branches of Edge Corporations in 11 cities, including five cities in which no Edges have previously operated. A number of other applications for Edge Corporations are anticipated over the next few months.

The concrete benefits of these actions in expanding international banking services, and in particular in facilitating the financing of U.S. exports will, of course, be observed only gradually. But we believe that they may be significant over the longer run.

The bill before this committee seeks to strengthen U.S. exports by facilitating the establishment of export trading companies that could supply and package a range of services necessary for exporting, and that could also engage directly in selling goods for export. It would enlist the support of U.S. banks for both types of activities by permitting banks and Edge Corporations to invest in export trading companies. In this connection it might be noted that although banks and Edge Corporations cannot now invest in such trading companies, bank holding companies are permitted to hold up to 5 percent of the stock of nonbanking companies as passive investments.

The Board shares the view that banks have expertise in some of the areas noted in the bill. U.S. banks can now provide, either directly or through their Edge Corporations and affiliates, a wide variety of services relating to exports. 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. A number

of U.S. banks with sizable networks of international banking and financial facilities have substantial expertise in these areas. Moreover, the provision of these advisory and ancillary services are a useful adjunct to international financing, which is the principal business of many banks and of Edge Corporations. Edge Corporations have wide latitude under the law to provide advisory services related to exporting. In addition, in the case of uncertainty about the permissibility of certain activities, Edge Corporations may apply under the Board's procedures for permission to broaden the scope of the export-related services that they offer. No requests of this sort have yet been received. The Board would of course review any such applications carefully in the light of all the surrounding circumstances.

Extension of the investment powers of banking institutions to include companies that buy and sell goods and services for their own account would go far beyond these existing financial facilities. Such an extension would raise basic questions regarding the traditional separation of banking and commerce. This tradition, which stands in sharp contrast to the practice in some countries abroad, helps ensure that banks will remain impartial arbiters of credit and contribute to a healthy competitive environment in the commercial sector.

The separation of banking and commerce has a long tradition in American banking. It is embodied in the Bank Holding Company Act, and endorsed by the Board. That tradition has served this nation well in promoting economic competition and a strong banking system. In addition, the Board has several more specific concerns about a breaching of the separation of banking and commerce, as is proposed in S. 2379.

(a) The possibility that bank-owned companies or manufacturing companies dealing with them will have more favorable access to bank credit than other companies. For example, the associated company might well receive more

liberal credit terms such as lower interest rates, longer maturities, and less stringent collateral requirements. Moreover, as between otherwise equal potential borrowers, the bank might well make credit available to an associated company but not to others. Thus, there is a potential for unfair competition among trading companies.

(b) The exposure of the bank that arises from risks encountered in commercial trading and the holding of inventories. This risk is enhanced when high leveraging is involved as is typically the case with trading companies. Margins for error are small in circumstances where the nature of the business necessarily contains the potential for sizable price movements and marked shifts in demands for products. In the case of Japanese banks associated with Japanese trading companies large losses were sustained in one instance where a trading company failed, and difficulties have been encountered by others.

(c) The possibility of conflicts of interest in the exercise of its credit judgment between the bank's fiduciary responsibility to depositors and its ownership interests. Examples of such classic conflicts are legion, the more obvious ones being where bank management runs undue risks in extending credit to such an associated company in the hopes that the company will be successful and provide a handsome return to shareholders and hence management; or where it continues to extend credit to an associated company in distress rather than cut its losses.

(d) The increased complexity of bank supervision. For bank supervisors, as for bank management, there are very substantial differences between supervising banking and financial activities and supervising commercial enterprises, which involve risks that must be evaluated and controlled on the basis of specialized knowledge and expertise.

The Board would be concerned about this legislation also because of the precedent that would be established. In today's environment, with rising prices for energy and the need for painful cuts in many areas of the economy, pressures might well arise for banks to make investments in areas where worthwhile economic and social objectives are being threatened by the need to economize. Taken alone, each of these objectives might be worthwhile, but in aggregate they could represent a substantial claim on bank capital.

We need to remember that bank capital is low already--about \$90 billion for all banks relative to total liabilities of \$1.5 trillion. Capital ratios have been declining over the years, in part as a result of inflation, and there is now little room in bank balance sheets for new generic risks. If we now encourage banks to divert capital from its traditional role as a support for lending activity and to invest it in nonbanking activities, we are necessarily curtailing the amount of lending that banks can do for other purposes. Bank capital can most productively be invested in supporting banking activity.

Edge Corporations, banks and bank holding companies may currently engage in some of the activities offered by trading companies. Moreover, the Board has established procedures under the recently revised Regulation K by which member banks, bank holding companies and Edge Corporations can apply to engage in new international activities, and the Board is committed to processing applications in an expeditious manner. Banks are, of course, not permitted to engage in "buying or selling goods, wares, merchandise or commodities in the United States," and the Board has supported this limitation on bank activity.

If the activities of Edge Corporations and banks were to be extended to permit the buying and selling of goods for export directly--or if a bank holding company were permitted to own more than 5 percent of the shares of an export trading company--the Board believes that special standards for participation in such activity would be needed. Such standards should include limitations on the share of ownership of export trading companies and on the types of activities in which they engage. Our staff would be available to work with Subcommittee staff in seeking standards that would meet the objectives of the bill while retaining appropriate safeguards.