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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

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I am pleased to testify on S. 2718, a bill that would facilitate the establishment and operation of export trading companies.

At the outset, I should like to reaffirm the view of the Board that the United States needs a strong export sector. The development of export trading companies will probably assist in achieving this goal, although in my view fundamental economic factors, such as U.S. price performance and exchange rates, will continue to be the most important factors. Banks have an important role to play in financing U.S. exports, and banks can assist export trading companies in this country by providing financing and by offering a wide range of export-related services. But bank ownership of trading companies raises broad issues of public policy, some of which were set forth in an earlier statement submitted to this Committee.

My statement today on behalf of the Board of Governors is limited to the issues raised by provisions for bank ownership of trading companies, and possible ways of dealing with these issues.

The separation of banking and commerce has a long tradition in American banking and is emodied in several banking laws, most notably the Bank Holding Company Act and the Glass Steagall Act. The Federal Reserve believes that this separation has been a major element of strength for the American banking system and the American economy.

While I covered many of the problems involved in permitting significant bank ownership of trading companies in my earlier statement submitted to the Committee, I would like to briefly summarize the main problems.

-- banks that are engaged in commercial trading may be exposed to high risks, particularly when leveraging is involved, as is typically the case with trading companies. This risk could well be much larger than the original investment. I might note that a few years ago a Japanese bank reported losses of one-half billion dollars from the failure of a major trading company with which it was closely associated.

-- bank supervisors would be involved to a substantial degree in decisions regarding the operations of trading companies; and the regulations necessary to protect banks from a range of possible future problems could well hamper the operations of these trading companies.

-- bank owned trading companies and their clients may have access to credit on more favorable terms than other companies; alternatively, large banks could use bargaining power obtained through trading company affiliates to obtain an increasing share of the banking business of client firms. Although regulations can help avoid the most blatant types of abuse (and the bill includes provisions regarding terms of credits), it would be a difficult task to supervise credit judgments through regulations with the specificity needed to ensure protection from unfair competition.

In light of these problems, the Federal Reserve has tried to design safeguards that would make it possible to permit a degree of bank participation in export trading companies without breaching the separation of banking and commerce. In this connection it needs to be recognized that trading companies may be engaged in importing, and thus involved in some commercial activities in the United States as well as in commercial activities abroad. Most of the Board's recommendations have been incorporated in S. 2718, and they have helped strengthen the provisions of the bill by reducing risks to banks. But two important provisions were omitted, and because the Board's recommendations represented an integrated proposal, the omissions substantially reduce the protections which the Federal Reserve believes are needed.

In particular, the Board urges that S. 2718 be further amended to provide that:

(1) a banking organization be permitted to invest in an export trading company only up to 20 percent of the shares of the trading company;

(2) a group of banking organizations could not own more than 50 percent of the voting stock of any single export trading company.

I should like to provide some background.

Although there may be debate on the exact percentage of equity interest at which an investor ceases to be essentially a portfolio investor and becomes actively associated with management the best guideline appears to be the point at which an investor can make use of equity accounting -- generally 20 percent. Where an ownership interest is 20 percent or more, accepted standards of accounting normally call for a bank (or any company) to include on its balance sheet and income statements its proportionate share of the net assets and earnings of a company. Experience in international banking has generally shown that where bank ownership in a foreign company permits the use of equity accounting, the bank frequently tends to become involved in management aspects of the business and to be identified with the company in the eyes of the financial community. Where such identification exists, a bank may find it necessary to stand behind all of the liabilities of a company in case of financial difficulties, in order to preserve the bank's standing in international financial markets. In the case of companies that are highly leveraged, a bank's potential loss could well be much larger than the original investment.

By contrast, at levels of ownership interest at which equity accounting does not apply, the immediate rewards to an investing bank would be the dividends it might receive on shares and income from loans or services provided to the trading company. Under those circumstances a bank would tend to treat a trading company on an "arms-length" basis, and the bank's reputation would not become clearly associated with that of the company in which it had invested.

To strengthen its recommendation on limiting ownership interests, the Federal Reserve earlier proposed that an export trading company could not bear

the name of an investing bank nor represent that it was affiliated with a bank. Provisions to accomplish this have been included in S. 2718. As we saw in the case of REITS in the mid-1970s, public identification of a bank with another enterprise can involve the bank in substantial potential commitments and, in the case of difficulties, in substantial losses, even where there is no bank ownership interest. However, where a significant ownership interest exists, even if there is no public identification through the name of the trading company, there is also a likely commitment on the part of the bank. Thus, in devising rules for export trading companies where bank investments are contemplated, it is necessary to couple the restriction on public identification of banks and trading companies with a limitation on bank ownership interests.

It is sometimes argued that banks can better limit their risks by maintaining control over their affiliates. This proposition may well be valid in the case of commercial banking affiliates; it does not, however, represent a basis for preferring to allow a bank to acquire control over a commercial firm rather than to limit bank involvement in management of that firm through restrictions on bank ownership.

The philosophy of the Federal Reserve proposals -- that bank ownership and management of trading companies should be limited -- was designed not only to reduce risks to banks, but also to hold to a minimum the need for regulation of the operation of export trading companies, while permitting banks to provide some financial support. Underlying this approach is the view of the Board that bank supervisors need to develop ways of reducing the burden of supervision, both on the supervisory agencies and on the banking community. In the area of international banking, the Board has taken some steps to implement this view in revising its Regulation K last year, and the Board staff is reviewing proposals that would further reduce the regulatory restrictions on Edge Corporations.

The export trading companies provided for in S. 2718 would be organized and operated principally for the purpose of exporting goods or services produced in the U.S. as well as providing services to facilitate such exports. If U.S. banks were to have important ownership and management interests in trading companies, they would be engaged indirectly in a host of activities not currently permissible under U.S. law. For example, under the Act trading companies could purchase for export commodities and manufactured goods, and could provide services in such fields as accounting, tourism, engineering, architecture and transportation. U.S. banking organizations do not have extensive experience in these nonbanking activities, nor do the bank supervisory agencies.

The bill directs the bank regulatory agencies to establish standards to ensure against unsafe or unsound export trading company practices that could affect any banking organization that controlled a trading company. Development of the requisite expertise to cope with the almost limitless range of activities that would be permitted to export trading companies under S. 2718 would be time consuming and costly to the bank regulatory agencies. If banks owned trading companies, they would, of course, also need to develop expertise in those lines of activity in which the trading company specialized. In sum, in view of the risks of bank ownership of trading companies, and the large costs that would be associated with efforts to control those risks through regulation, we believe there is a basic presumption that bank ownership should only be allowed on a scale that does not involve an important management interest.

The second Board recommendation was that S. 2718 contain a limit on the total investment in a single export trading company by all banking organizations combined. If banks as a group controlled a trading company, the banks would

likely be identified with the company, even though none had an interest of 20 percent or more. This identification could expose the investing banks to the risk of large losses in the event of the failure of the trading company.

These recommended restrictions on bank investment do not represent severe restraints on the operations of export trading companies. For example, under the Federal Reserve proposal, 3 banks together could supply up to 50 percent of the capital of a trading company. And that trading company would be able to operate on the basis of its own business judgment without being subject to the special operating rules established by bank supervisory agencies that are contemplated under S. 2718.

Moreover, banks can provide support to trading companies in a number of ways apart from equity investments. First among these is financing -- the area in which the bank's expertise is likely to be of greatest value to the trading company. The Federal Reserve proposals contemplated that a banking organization could lend to any single export trading company an amount which together with its investment in that company would not exceed 10 percent of the bank's capital, while total equity investment by a bank in one or more trading companies could not exceed in the aggregate 5 percent of the bank's capital. Such loans could be made by the bank, its Edge Corporations, or other holding company affiliates.

These different members of a banking organization could also provide other services, such as foreign exchange, information on foreign markets, letters of credit, advice on arranging shipments, and insurance brokerage. I recognize that under the Board's Regulation K, it would not be possible for Edge Corporations to supply to export trading companies the full range of services that a bank could supply, and I believe that it would be appropriate to allow Edge Corporations additional authority to enable them to assist export trading companies. The Board might under appropriate restrictions create for export trading companies

a special status under Regulation K similar to that proposed last year for domestic qualified business entities -- a proposal on which the Board has not yet acted.

Moreover, I should note that Regulation K provides that Edge Corporations will apply to the Board to engage in providing services that would be incidental to international or foreign business, and the Board may expand that list of permissible financial services on the basis of the facts submitted in the applications.

In conclusion I should re-emphasize that the U.S. economy would best be served by having banking organizations assist trading companies as bankers and limited investors rather than as owner-operators of these firms. This will permit banks to provide the financially related services in which they have expertise, while permitting trading companies to innovate unfettered by regulation of their activities. At the same time it will preserve the separation of banking and commerce and the role of banks as the impartial arbiters of credit.