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Statement by

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before the

**Subcommittee on Financial Institutions
Supervision, Regulation and Insurance**

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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I am pleased to testify on H.R. 6016, a bill that would facilitate the establishment and operation of export trading companies.

At the outset, I should like to restate the view of the Board that the United States needs a strong export sector. Export trading companies have been proposed as a means of contributing to the achievement of this goal by providing producers of goods and services, having additional business opportunities, with a way of reducing the risks associated with foreign business endeavors and offering them a wide variety of services. Export trading companies may be able to provide assistance to small and medium size U.S. businesses producing goods that can be marketed abroad.

It has been suggested that bank participation, particularly bank ownership participation, is essential to the effective operation of export trading companies. In the Board's view, the question whether export trading companies can be of significant help to U.S. exporters does not depend upon such a role for banks, as I have testified in the past. But in any event there are, I believe, more important problems of principle posed by bank equity ownership of entities directly engaged in commerce. Bank control of trading companies runs counter to our long-standing national policy, firmly embedded in legislation, of the separation of banking and commerce.

This policy has its basis in two principal concerns: (1) the safety and soundness of particular banks, and of the banking system in general, might be impaired if banks were closely affiliated with the ownership, management and operation of a potentially high risk nonbank business, and (2) a bank might allocate available credit on bases other than the creditworthiness of the borrower by preferring customers of the banks' affiliates or by denying credit to competitors of the banks' affiliates--possibilities that illustrate the basic issues of avoiding conflicts of interest and excessive concentration of resources.

The separation of banking and commerce has served this nation well in promoting a strong banking system and economic competition. The Board is concerned that a breach of that traditional separation in the case of trading companies could adversely affect the safety and soundness of our banks as well as their role as impartial arbiters of credit, and could be an adverse precedent for breaches of this wall in other areas.

The Board is also concerned with the risks arising from bank involvement as managers and controlling investors in new enterprises at a time when bank capital generally is at an uncomfortably low level. The Board and the Comptroller of the Currency recently issued a joint policy statement setting forth their concerns over the secular declines in the capital ratios of the nation's largest banking organizations, and indicating their intention to encourage through supervisory policies appropriate steps to improve the capital positions of the lower ranking members of this group. This situation suggests the need for caution in any opening of the doors to new enterprises with largely unknown risks.

While reiterating the view that banking organizations should not generally have controlling interests in export trading companies, I shall direct my remarks to the specific provisions of H.R. 6016 as they relate to the concerns of the Board

The Board has previously supported the view that if there is to be bank affiliation with export trading companies the investments should be held only through bank holding companies. I am pleased that H.R. 6016 goes far toward meeting this objective by providing that interests in export trading companies could be held only through bank holding companies or Edge Corporations.

There has been much discussion recently of the proper location and amount of supervision of nonbanking activities of bank holding companies. The Treasury, for example, has suggested that all nonbanking activities should be required to be conducted through separate subsidiaries of a bank holding company. This, in its view, would adequately insulate affiliated banks from such activities and so would make possible virtually automatic approval of the activity and allow regulatory oversight to remain minimal.

In the past, the Board has seen no strong need to require banking activities to be conducted in separate subsidiaries. Indeed, there are, in fact, advantages in the form of economic efficiency and easier regulatory oversight to allowing banking organizations the latitude to develop organizational structures designed to suit their unique needs. This approach has proven advantageous to banks and holding companies of all sizes and locations in providing a range of banking activities in structures that promote competition. We continue to support this approach as a general principle for banking activities, and particularly for expanded securities activities that are closely related to banking.

On the other hand, the Board believes the appropriate location for trading company activities would be in a subsidiary of a holding company, rather than in a direct subsidiary of the bank or its Edge Corporation. In the case of export trading companies the Board believes this to be a desirable arrangement since export trading companies would represent the first instance of bank holding companies being permitted to own companies engaged in commerce as distinguished from banking. This arrangement would have the advantage of assuring uniform regulatory oversight over a new and potentially risky activity.

The Board would be further concerned if the traditional barrier between banking and commerce were breached not only by allowing banking organizations to engage in nonbank activities but also by allowing banking organizations to be partners in ventures with nonbank companies. We have generally opposed joint ventures involving bank holding companies and nonbank organizations, especially where the nonbank company was engaged in manufacturing or commercial enterprise. Accordingly, the Board believes that any export trading company legislation should restrict the ability of banking and nonbanking organizations to own jointly an export trading company.

It has been suggested that banks below a certain size, which might be unlikely to have a bank holding company parent, should be permitted to invest directly in export trading companies. But the reasons for restricting export trading company ownership to bank holding companies apply equally to banks that do not have a parent holding company. While the Board has in the past indicated that passive minority investments in export trading companies of a purely financial nature might be permitted for banks as well as bank holding companies, all significant investments in trading companies, and certainly all controlling investments, should be permitted only through a bank holding company.

In addition to prohibiting direct bank ownership of export trading companies, there are other safeguards in H.R. 6016 that I believe are important to limiting the risks to which a banking organization would be exposed as a result of a controlling interest in an export trading company. The bill recognizes that the area in which the bank's

expertise is likely to be of greatest value to the trading company is through financing, and places restrictions on the investments in and extensions of credit to the trading company by the bank holding company.

However, the proposal in H.R. 6016 to apply section 23A of the Federal Reserve Act to the bank holding company with respect to its extensions of credit to its affiliate trading company would be an unusual application of section 23A. That provision has previously been applied only to banks, and not to bank holding companies, with the purpose of safeguarding the resources of banks against misuse of those resources for the benefit of organizations under common control with the bank. I feel bound to point out that this provision in H.R. 6016 would virtually eliminate extensions of credit from the holding company to its controlled export trading company, because of the stringent collateral requirements of section 23A. On the other hand, the effect of this approach would be to permit without any limits extensions of credit by other nonbank affiliates, such as a holding company's finance company subsidiary, to the trading company.

A more effective approach would be to limit extensions of credit by a banking organization and its affiliates to any single export trading company to an amount that, together with its investment in that company, would not exceed 10 per cent of the banking organization's capital, while total equity investment by a banking organization in one or more trading companies could not exceed in the aggregate 5 per cent of the banking organization's capital. These loans could be made by the bank, its Edge Corporations, or other holding company affiliates. The bank's

lending would, of course, also be limited by the amount and collateral requirements of section 23A. We believe that this method of limiting the exposure of the banking organization to this new activity would be both workable and prudent.

In addition, I believe there are other reasonable steps that can be taken to limit the banking organization's financial exposure. H.R. 6016 could further be strengthened by a provision similar to that in S.734 prohibiting a bank holding company and its affiliates from making extensions of credit to the customers of its affiliated export trading company on terms more favorable than those afforded similar borrowers in similar circumstances, and requiring that such extensions of credit should involve no more than the normal risk of repayment nor present other unfavorable features.

The Board also believes that a bank holding company-controlled export trading company should be prohibited from taking title to goods or commodities except in very limited circumstances. The export trading company should be allowed to take title to goods or commodities only on the basis of firm orders from customers or where necessary to effectuate a sale. Moreover, the bill should clearly authorize the Board to determine that if a bank holding company-controlled export trading company holds manufactured goods or commodities in inventory in order to speculate in price movements in these goods such activity would constitute an unsafe or unsound practice.

There are two additional safeguards in H.R. 6016--concerning the use of the name of the bank or bank holding company as the name of the export trading company and the participation of these companies in manufacturing--that are of particular importance to the Board in considering this legislation. We have in the past supported the safeguard in H.R. 6016 that prohibits an export trading company from having a name similar in any respect to that of the bank or bank holding company with which it is affiliated through stock ownership. As in the case of REITs in the mid-1970's, public identification of a bank with another enterprise could involve the bank in significant losses, even where there is no bank ownership interest.

We believe that the use of the name of the bank or bank holding company to promote the activities of an export trading company, which are not in our view closely related to the business of banking, is inappropriate for a number of reasons. First, it incorrectly implies that the full faith and credit of the affiliated bank stands behind the export trading company. Second, it could have an adverse effect on the reputation and public confidence in the bank if the export trading company were to suffer a financial setback. Third, there would be a greater likelihood that the assets of the banking organization would be depleted in order to bail out a troubled export trading company with a similar name.

We have made the same recommendation for bank participation in securities functions such as stock and bond mutual funds. This recommendation has even greater force with respect to bank holding company activity that breaches the line between commerce and banking. Accordingly, the Board supports the proposal that an export trading company not bear a name similar to that of its affiliated bank or bank holding company, even where the bank holding company has a controlling ownership interest in the export trading company.

H.R. 6016 also provides that a bank holding company-owned export trading company may not engage in manufacturing. The Board's concern over bank holding company control of export trading companies is based on its continuing belief that the traditional separation of banking and commerce is a wise policy; accordingly, we favor legislation that limits the extent to which commercial activities may be engaged in through the export trading company, without significantly jeopardizing the viability of that company. I do not believe that a prohibition on manufacturing would in any way compromise the ability of export trading companies to play a constructive role in facilitating exports. For example, if modifications to products are required it would seem both preferable and feasible to have them performed by the manufacturer, or by an independent manufacturer, rather than by the export trading company. This provision would further the basic principle of the separation of the business of banking from the conduct of commerce.

Finally, H.R. 6016 provides that the Board approve each investment by a bank holding company in an export trading company. In the Board's view it is appropriate to allow some level of non-controlling investments (in excess of 5 per cent but less than 20 per cent) that may be made in export trading companies without applying the standards with respect to controlling interests in export trading companies that we recommend below, provided such investments meet the criteria in section 4 of the Bank Holding Company Act. It would be anticipated that applications of this type could be abbreviated and processed under expedited procedures.

With regard to the standards on controlling interests, H.R. 6016 as currently drafted, does not, in our view, provide sufficient guidance as to when the Board should disapprove an application to make a controlling investment in an export trading company. The bill states that the Board may not grant approval of any application to acquire an interest in an export trading company unless the Board has taken into consideration the financial and managerial resources, competitive situation, and future prospects of the bank holding company and the export trading company involved. The legislation also gives the Board the authority to impose restrictions, by regulation or otherwise, as the Board deems necessary to prevent conflicts of interest, unsafe or unsound banking practices, undue concentration of resources, and decreased or unfair competition.

In considering applications involving control, it might be appropriate to require that the Board find a reasonable likelihood that the bank investment would bring about an increase in the level of exports or in the penetration of foreign markets that would not otherwise occur. The Board should be authorized to deny an application unless the activities of the export trading company would be limited to international trade in specific goods and services and unless the bank investment could contribute substantially both to the establishment of the trading company and to exporting or facilitating the exportation of goods and services.

Also, the bill should state that if the Board finds there are any adverse financial, managerial, competitive, or other banking factors associated with the particular investment it has the discretion to approve the application only if it determines that the export benefits

clearly outweigh any such adverse effects. Such standards would place a heavier burden on bank holding company applicants to demonstrate the benefits of their proposed investment. The balancing test would be similar to the test that the Board administers in acting upon applications pursuant to section 4(c)(8) of the Bank Holding Company Act. The Board and its staff would, of course, be willing to work with the Subcommittee in drafting appropriate language to this effect.

In addition to its provisions regarding export trading companies, H.R. 6016 would amend the Federal Reserve Act to increase the aggregate limitation on the amount of eligible bankers' acceptances that may be issued by a member bank from 50 per cent of capital and surplus (100 per cent with the Board's permission) to 150 per cent of capital and surplus (200 per cent with the Board's permission). The limitations would be applied also to nonmember commercial banks and to U.S. branches and agencies of foreign banks.

The Board believes that it is both appropriate to expand the current aggregate limitation on the issuance of eligible bankers' acceptances and to apply those limits to the other entities with which member banks compete in the acceptance market. In applying the limitation on eligible bankers' acceptances to U.S. branches and agencies of foreign banks, the Board believes that the appropriate measure of capital is the worldwide capital of the parent foreign bank. Use of such a measure in this country would be consistent with the efforts being made to promote the use of worldwide capital, rather than local-based capital, for purposes of prudential limitations imposed in other countries.

The Board believes, however, that the provision as presently drafted presents potential problems with regard to participations. Under the existing language, a bank could expand the amount of its bankers' acceptances outstanding virtually without limit by issuing participations to other banks. Such a practice would undermine the effectiveness of the limits established by the bill and could adversely affect monetary policy to the extent that bankers' acceptance are substituted for liabilities that would otherwise be subject to reserve requirements. We believe that this problem could be corrected through a specific provision that authorizes the Board to establish terms and conditions under which participations in bankers' acceptances may be issued. In this connection, the Board previously submitted a draft bill that would not give rise to these problems, and recommends that this language be adopted in place of the present provision.

In conclusion, I should restate the Board's position 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. However, in the event that the legislation is enacted that would enable banking organizations to have a controlling ownership investment in export trading companies, the Board believes that the restriction of the ownership interests in export trading companies to bank holding companies, together with the other limitations on the holding company's relationship to its controlled trading company and on the activities of the trading company itself that I have discussed above, are important and necessary safeguards.