

For release on delivery
9:30 a.m. E.D.T.
June 17, 1986

Statement by
Manuel H. Johnson, Jr.
Member, Board of Governors of the Federal Reserve System
before the
Subcommittee on International Finance and Monetary Policy
of the
Committee on Banking, Housing, and Urban Affairs
United States Senate

June 17, 1986

Thank you for the opportunity to present the views of the Federal Reserve Board on S. 1934, the bill to amend the Export Trading Company Act of 1982. We at the Board support efforts to lower this country's trade deficit, and wish to work with Congress in attempting to arrive at solutions to the problem. It is not the view of the Board, however, that amending the Bank Export Services Act ("BESA") is necessary at this time. Given the unfavorable economic conditions that have existed since enactment of the BESA, we feel the existing statute has not been given a fair test, and that its effectiveness should be evaluated in the future. As to the specific provisions of S.1934, the Board opposes three of the revisions to the BESA proposed in the bill on grounds of safety and soundness, but has fewer reservations concerning two other proposed revisions.

In my testimony, I will review briefly the Board's implementation to date of the BESA (Title II of the Export Trading Company Act of 1982), discuss some of the experiences of bank-affiliated export trading companies ("ETCs") and other trading companies, and analyze and give in greater detail the Board's views on the provisions of S. 1934.

The BESA and the Board's Regulations

The Export Trading Company Act of 1982 ("ETC Act") was designed to help promote exports by facilitating the formation and operation of ETCs. The BESA provides a limited exception to the nonbanking prohibitions of the Bank Holding Company Act by permitting bank holding companies and certain other types of banking organizations to make equity investments in ETCs. The purposes of the BESA were: (1) to provide for the establishment of U. S. ETCs that could be competitive with foreign-owned ETCs; (2) to provide U. S. commerce, industry and agriculture, especially small and medium-sized firms with a means of exporting their goods and services; (3) to foster the participation by regional and smaller banks in the development of ETCs; and (4) to facilitate the formation of joint venture ETCs between bank holding companies and nonbank firms.

Thus, the BESA represents a dramatic departure from traditional banking legislation in that it permits participation by banking organizations in commercial ventures. In recognition of this expanded latitude, however, Congress included a number of prudential safeguards to limit potential adverse financial effects on banks affiliated with ETCs. The statute provides that a bank holding company may not invest more than 5 percent of its consolidated capital and surplus in an ETC nor lend more than 10 percent of its consolidated capital and surplus to an ETC. It also provides that a bank holding company may invest in an ETC only after allowing for

review by the Federal Reserve. The Federal Reserve is required to review the notice in order to determine whether the proposal may result in unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest, or whether the investment would have a materially adverse effect on the safety and soundness of a subsidiary bank of the bank holding company.

The Board issued final regulations implementing the BESA in June, 1983. These regulations were later modified to simplify the notification process and provide for delegated authority to the individual Federal Reserve Banks to review certain ETC notifications. Virtually all of the notifications of intent to establish ETCs have been acted upon within the 60-day time period set forth in the statute, and no notification by a bank to invest in an ETC has been disapproved. Fifteen of the 24 ETC notifications filed after the adoption of the delegation procedures were processed by the Reserve Banks with no Board review.

Response to the Act

As you are well aware, the economic climate since the ETC Act was passed has not been favorable to exports. The Act was signed during the fourth quarter of 1982 when the U.S. economy was in the depths of a recession and the volume of exports had fallen more than 20 percent from its peak in 1980. Since that time, U.S. output and employment have expanded

rapidly. By contrast, U.S. exports have rebounded only moderately and still remain below their 1980 peak. The U.S. trade deficit increased from \$25 billion in 1980 to approximately \$125 billion in 1985.

The weakness of U.S. exports can be attributed to a number of macroeconomic developments that took place in the early to mid-1980's and that have continued until fairly recently. These factors include the rise of the dollar against foreign currencies; the relatively sluggish growth of foreign economies; and the drop in imports by countries experiencing problems meeting their external debt obligations.

Moreover, as was discussed during early hearings on the BESA, U.S. manufacturers have not traditionally made widespread use of trading companies as a medium for exporting their goods. By one estimate, in 1982, there were about 2,000 American-owned trading companies active in the United States. However, these companies were involved in only about ten percent of all U.S. exports. Larger U.S. multi-national companies with substantial sales abroad had their own in-house marketing capability or a few had trading company subsidiaries. Thus, at the time the Act was passed, the trading company generally was not a prominent vehicle for selling U.S. exports, and it was unlikely that the patterns of U.S. businesses with exporting capabilities could be changed in only a few years.

Notwithstanding this business environment, 40 bank holding companies have notified the Federal Reserve System of their intent to invest in ETCs. (Tables attached as an Appendix to this testimony show the status of each ETC notification acted upon by the System). Several of these ETCs appear to be operating profitably and expanding their overseas operations.

In contrast, the performance of many of these bank-affiliated ETCs has been disappointing. In fact, eleven are no longer operational. In addition to poor economic conditions in their first years of existence resulting in diminished profit potential, these ETCs 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, one ETC experienced substantial difficulties because a major customer broke the terms of its trade agreement; another lost its capital because of its inability to deliver on a major contract; and a third was closed after suffering significant losses resulting from the lack of adequate controls over its trading activities. At least four bank holding companies have discontinued the operations of their ETCs either temporarily or permanently because the operating losses were found to be unacceptable.

There is no evidence, however, that ETCs affiliated with banks have been any less successful than trading companies that have no connection with banking organizations. While there is no means of tracking all these trading companies, the General Accounting Office has conducted a survey of 23 trading organizations that have obtained certificates of review from the Department of Commerce. Many of these firms reported that business has been disappointing, citing economic factors, particularly the high value of the dollar as the reason. It is also interesting to note that the membership of the National Association of Export Companies, an organization composed primarily of nonbank export trading companies, dropped by half in the last four years, and is only beginning to increase again. This drop in membership is reportedly a result of the fact that many of the member companies have gone out of business.

S. 1934

There is an understandable concern about the mediocre performance of ETCs since the passage of the Act resulting in attempts to deal with the situation by amending sections of the BESA. The amendments would modify certain of the Board's regulations. Broad trends, however, such as unfavorable economic conditions -- not the Board's regulations -- have impeded the results of the legislation. Moreover, three of the bill's provisions present serious issues related to the safety

and soundness of banking organizations investing in ETCs. From a supervisory standpoint, we are less concerned about the other two provisions. However, I would note that the provision dealing with the calculation of export revenues does raise policy questions about Congressional intent in establishing ETCs to foster U.S. exports.

1. Transactions with Affiliates

The BESA provides that extensions of credit from a bank to its affiliated ETC are covered by section 23A of the Federal Reserve Act. Section 23A is a cornerstone of the regulatory structure for protecting banks from credit judgments made for noncommercial reasons. It generally limits the amount of credit that banks may extend to a nonbank affiliate and subjects such credit extensions to certain collateral requirements.

S. 1934 would exempt from section 23A of the Federal Reserve Act a bank's transactions with its affiliated ETC. The purpose of this exemption, according to the statement introducing the bill, is to remove a competitive "disadvantage" from ETCs, permitting them to borrow from their affiliated bank without meeting the collateral requirements of section 23A.

Experience over the years has demonstrated that limitations on self-dealing between a bank and its affiliates are essential to help curb abuses, to maintain bank safety and

soundness and to prevent excessive risk to the federal safety net. Congress also has recognized the importance of the protections found in 23A -- every deregulatory proposal in the last four years has used section 23A as the central mechanism for preserving the safety and soundness of banking organizations with expanded powers to enter nonbanking areas.

The experience to date reinforces the desirability of maintaining the protections afforded by section 23A. In one case, a bank lent to its affiliated ETC amounts in violation of section 23A without required collateral. The ETC was unable to repay the advances and thus the condition of the bank was affected. Had section 23A been complied with, the bank would not have exposed itself to these losses. Therefore, an exemption from section 23A for transactions with an ETC does not appear to be in the best interests of preserving safety and soundness as it creates the opportunity for a bank's resources to be misused in support of the affiliate's trading activities. In the area of extensions of credit, it is most important to strike the proper balance between encouraging the growth of ETCs and preventing imprudent banking practices. Moreover, the application of section 23A does not impose a competitive disadvantage on ETCs affiliated with banks. They, like other trading companies, are free to borrow from unaffiliated lenders on terms determined by the market.

The Board as a matter of policy has generally not granted exemptions from section 23A. With respect to ETCs, however, the Board has included in its regulations a waiver from the strict collateralization standards of section 23A for those transactions in which the ETC takes title to goods against a firm order and the lending bank maintains a security interest in those goods. The Board has determined that in these circumstances a waiver would permit ETCs to obtain financing for transactions in goods without creating undue risk to the affiliated bank. In addition, the Board has stated that it would consider granting ETCs additional waivers from these collateral requirements based on specific requests.

The bill also would relieve extensions of credit by a bank to its affiliated ETC from the quantitative limits of section 23A. These limitations provide that a bank may lend no more than ten percent of its capital and surplus to an affiliate. The BESA itself limits extensions of credit by a bank holding company or its subsidiaries to an affiliated ETC to ten percent of the holding company's capital and surplus. Thus, the bill's proposed exemption could have the effect of significantly increasing the exposure of a bank to its affiliates. The Board strongly recommends that the quantitative limits on these extensions of credit be retained.

2. Capital Adequacy

In reviewing notices by banking organizations to invest in ETCs, the Board considers the assets to equity ratio

of each proposed ETC on a case-by-case basis, taking into account, among other factors, the riskiness of the ETC's proposed activities. S. 1934 would prohibit the Board from disapproving a bank's investment in an ETC solely on the basis of the proposed asset to equity ratio unless that ratio were greater than 25 to 1.

The Board, by reason of its responsibilities as a bank regulator, has historically recognized the need for the maintenance of adequate capital in individual state member banks and bank holding companies and in the banking system in general. Capital provides a buffer for banking organizations in times of poor performance, helps to maintain public confidence in particular banking organizations and in the banking system, and supports the reasonable growth of banking organizations. An evaluation of capital adequacy is one of the major purposes of a bank or bank holding company examination.

Congress has recognized the necessity for banking organizations to maintain adequate capital. In the International Lending Supervision Act of 1983, Congress required the bank regulatory agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions." For this purpose, capital requirements are assessed on a consolidated basis, although the capital adequacy of subsidiary organizations is also taken into account. The

latter is necessary because the condition of affiliated organizations can have an important effect on their related banks.

In the case of ETCs the Board strongly recommends against the proposed legislative standard for the leveraging of ETCs. In carrying out its duty to preserve the safe and sound operation of bank holding companies, the Board must be able to examine carefully the capital structure and proposed leveraging ratios of bank-affiliated ETCs. Capital adequacy is a critical determinant of the financial strength of the ETC and of its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent holding company or the safety and soundness of affiliated banks. There is no justification for a statutory rule allowing a minimum capital level for bank-affiliated ETCs substantially less than that required for banks, when the ETCs' activities are likely to be outside the normal range of banking operations and therefore present greater, not fewer, risks. Thus, we do not adhere to the presumption of S. 1934 that a leveraging ratio of 25:1 would be consistent with the sound financial operation of an ETC. Many factors must be taken into account, such as the nature of the ETC's business, the size of its inventory, and the size of the bank holding company's investment in the ETC. Only a case-by-case analysis permits all these factors to be taken adequately into account.

In this regard, the Board recently acted on a request from a bank holding company to adopt a leveraging ratio for its ETC that was higher than the 10:1 ratio it had proposed in an earlier notification to a Federal Reserve Bank. After determining that the nature and riskiness of the activities proposed for the ETC were similar to those of secured lending transactions, the Board approved a leveraging ratio of 17:1. This action is illustrative of the flexible approach followed by the Board with respect to the capitalization of ETCs.

In light of the critical importance of the capital adequacy of each subsidiary company in a bank holding company organization, the Board needs to retain its discretion in this area.

3. Exporting Services

The BESA, read together with the Board's regulations, defines an ETC in which a banking organization is permitted to invest as a company that is exclusively engaged in international trade, and that principally exports, or provides services to facilitate the export of, goods and services produced by others. S. 1934 would modify the definition of an ETC to include companies that principally export goods or services produced by themselves or any of their affiliates. This revision would permit a bank to invest in any company that provides its own services to foreign customers regardless of whether the services relate to trade.

The common thread throughout consideration of the original legislation was that the experience and expertise of banks in financing foreign investment was thought to be needed by export trading companies -- companies that serve as intermediaries for producers and suppliers of goods and services in the foreign marketing and sale of their products by providing a range of export trade services. It was not intended that banking organizations would serve as a source of capital investment in various service industries generally and assume the risks associated with those industries.

The Board's regulations do not limit the ability of bank-affiliated ETCs to offer a broad range of trade-related services both in the United States and abroad. For example, the BESA and the regulations permit ETCs to provide consulting, market research, marketing, insurance product research and design, legal assistance, transportation including freight forwarding, warehousing, foreign exchange, financing and taking title to goods, when provided in order to facilitate the trade in goods and services produced by others. According to the notifications to the Federal Reserve, a number of ETCs are providing many of the trade services included in this list. Moreover, the Board has recognized that this list of services is not exhaustive. For example, upon demonstrating that the activities were related to international trade, one ETC has acquired a company in England that engages in customs bonding

services and in certain types of inventory control services related to cross-border trade. In addition, the Board has responded favorably to several export trading company notifications that specifically contemplated the establishment of overseas offices and divisions.

The practical effect of S. 1934 would be to change the Congressionally intended emphasis in the BESA from promoting U.S. exports and employment to providing a vehicle by which commercial banking organizations, through the medium of an ETC, could acquire organizations serving overseas customers without any benefit to the United States trade or balance of payments position. The proposal would thus have the effect of changing the incentive in the ETC Act to promote U.S. exports, while potentially undermining the public policy objectives embodied in the separation of banking and commerce. Such important public policy issues should be addressed directly and not indirectly through technical changes in the BESA.

While the last two provisions of S. 1934, which I will now discuss, appear to raise few supervisory concerns on our part, the calculation of the export revenues provision, as I have mentioned, does raise questions of policy.

1. Calculation of Export Revenues

The BESA defines an ETC as a company "organized and operated principally for purposes of exporting [or facilitating

the export of] goods and services produced in the United States" This definition reflects Congress' goal of improving U.S. export performance. In accordance with this purpose, the Board's current regulations require that more than half of an export trading company's revenues over a two-year period be derived from U.S. exports.

Under S. 1934 a company would qualify as an export trading company if its revenues from exports exceed its revenues from imports. Revenues derived from third party trade or associated with countertrade would be excluded from the calculations. This would mean that an "export trading company" could be a company substantially engaged in third party trade or countertrade involving two foreign countries, with minimal involvement in exporting goods or services from the United States. In fact, the proposal could hurt U.S. exports, since the goods being traded outside the United States can be substituted for goods exported from the United States. Such a result would amount to a substantial alteration of Congressional intent as to the purposes of ETCs to promote the export of U.S. goods and services and would be contrary to the original premise for allowing bank holding companies to engage in this activity: that the increased risks undertaken by a bank holding company through an ETC would be counter-balanced by an increase in U.S. exports. Ultimately, however, it is up to Congress to determine whether ETCs should continue to have as their primary purpose the export of U.S. goods and services.

2. Inventory

The Board's regulations provide that a notice to invest in an ETC may be delegated to the appropriate Federal Reserve Bank, rather than reviewed by the Board, if the proposed export trading company will take title to goods only against firm orders, or if its inventory is worth less than \$2 million. Taking title to goods involves sufficient risk that the Board felt it should have the opportunity on a case-by-case basis to review carefully proposals involving this activity. The Board wanted to reserve the right to disapprove those proposals that could involve unsafe and unsound practices, as, for example, where a bank-affiliated ETC has an inadequate system of management controls, or where the ETC has insufficient safeguards to protect against a violation of the statutory prohibition against speculation in commodities. The Board has in fact reviewed and did not object to several notices where projected inventory is substantially greater than \$2 million.

S. 1934 prohibits the Board from imposing a dollar limit on an ETC's inventory unless the Board finds that the limit is necessary to prevent material adverse effects on a bank affiliate of the ETC. This provision would merely codify the Board's current practice and would provide the Board with sufficient authority to exercise its supervisory powers in this area when necessary.

Conclusion

In conclusion, I would like to emphasize again the Board's support for a strengthened and expanding export sector of the U.S. economy. In this context, we would urge Congress to allow for a fair testing of the existing law and to refrain at this time from adopting the proposed amendments.

NOTIFICATIONS TO ESTABLISH EXPORT TRADING COMPANIES

<u>Bank Holding Company</u>	<u>Export Trading Company</u>	<u>Date of System Action</u>	<u>Current Status</u>
Security Pacific Corporation, San Francisco, CA	Security Pacific Export Trading Company Los Angeles, CA	5/09/83	Operating
Citicorp, New York, NY	Citicorp International Trading Company, New York, NY	5/31/83	Operating
Walter E. Heller International Corporation, Chicago, IL	Heller Trading Company Chicago, IL	6/13/83	Closed
First Interstate Bancorp, Los Angeles, CA	First Interstate Trading Company, Los Angeles, CA	6/15/83	Operating
First Kentucky National Corporation, Louisville, KY	First Kentucky National Trading Company, Louisville, KY	7/25/83	Inactive
Union Bancorp, Inc., Los Angeles, CA	StanChart Export Services Company, Inc., Los Angeles, CA	7/25/83	Operating
Crocker National Corporation, San Francisco, CA	Crocker Pacific Trade Corporation, San Francisco, CA	8/30/83	Closed
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Bancorps' International Trading Corporation, Somerset, NJ	9/14/83	Operating
State Street Boston Corporation, Boston, MA	State Street Trade Development Corporation, Inc., Boston, MA	9/19/83	Sold
International Bancshares Corporation, Laredo, TX	IBC Trading Company, Laredo, TX	10/03/83	Not Activated
United Midwest Bancshares, Inc., Cincinnati, OH	United Midwest International Corporation, Cincinnati, OH		Closed

<u>Bank Holding Company</u>	<u>Export Trading Company</u>	<u>Date of System Action</u>	<u>Current Status</u>
U.S. Bancorp, Portland, OR	U.S. World Trade Corporation, Portland, OR	11/17/83	Inactive
First Chicago Corporation, Chicago, IL	First Chicago Trading Company, Chicago, IL	11/21/83	Operating
Rainier Bancorporation, Seattle, WA	Rainier International Trading Company, Seattle, WA	12/07/83	Operating
Shawmut Corp., Boston, MA	Shawmut Export Corporation, Boston, MA	12/12/83	Operating
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Company Limited, Hartford, CT	12/27/83	Operating
BankAmerica Corporation, San Francisco, CA	BankAmerica World Trade Corporation, San Francisco, CA	02/02/84	Inactive
Bankers Trust New York Corporation, New York, NY	Bankers Trust International Trading Corporation New York, NY	02/02/84	Operating
First National State Bancorporation, Newark, NJ	First International Trading Co., Newark, NJ	02/13/84*	Operating
Chase Manhattan Corp., New York, NY	Chase Trade, Inc., New York, NY	02/21/84*	Operating
Society Corporation, Cleveland, OH	Export Partnership for International Trade, Inc., Cleveland, OH	03/04/84	Operating
Fleet Financial Group, Inc. Providence, RI	Fleeting Trading Company, Providence, RI	03/19/84*	Inactive
First National Bancshares, Inc. Houma, LA	First Export Corporation, Houma, LA	04/06/84*	Operating
Manufacturers Hanover Corporation, New York, NY	C.I.T. International Sales Corporation, New York, NY	04/24/84	Operating
First Union Corporation, Charlotte, NC	First Union Export Trading Company, Charlotte, NC	05/07/84*	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

<u>Bank Holding Company</u>	<u>Export Trading Company</u>	<u>Date of System Action</u>	<u>Current Status</u>
Alaska Mutual Bancorporation, Anchorage, AK	Mutual International Corporation, Anchorage, AK	06/06/84*	Operating
Frontier Bancorp, Vista, CA	Interbank Trading Company, San Diego, CA	07/30/84*	Not Activated
Florida Park Banks, Inc. St. Petersburg, FL	Park Services International, Inc., St. Petersburg, FL	09/19/84	Closed
Capital Bancorp, Miami, FL	Capital Trade Services, Inc., Miami, FL	09/20/84*	Operating
CoreStates Financial Lancaster, PA	CoreStates Export Trading Company, Philadelphia, PA	10/13/84*	Operating
North Valley Bancorp, Redding, CA	Casia-Pacific Company, Redding, CA	10/18/84*	Operating
Maryland National Corporation, Baltimore, MD	MN Trade Corporation, Baltimore, MD	12/18/84*	Operating
Marine Corporation, Milwaukee, WI	Marine Financial Services, Inc., Milwaukee, WI	12/31/84*	Operating
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Florida Interbank Trading Company, Inc., Jacksonville, FL	01/07/85	Operating
First Wisconsin Corp., Milwaukee, WI	InterContinental Trading Co., Inc., Rolling Meadows, IL	02/11/85	Operating
Commerce Union Corporation, Nashville, TN	Commerce Trading Corporation, Nashville, TN	03/22/85	Operating
Valley National Corporation, Phoenix, AZ	Valley International Trading Company, Phoenix, AZ	04/16/85*	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

<u>Bank Holding Company</u>	<u>Export Trading Company</u>	<u>Date of System Action</u>	<u>Current Status</u>
Manufacturers Hanover Corporation, New York, NY	Manufacturers Hanover World Trade Corporation, New York, NY	04/21/85*	Operating
Marine Midland Banks, Inc., Buffalo, NY	Marine Midland Trade, Inc., New York, NY	04/21/85*	Operating
United Bancorp of Arizona, Phoenix, AZ	United Bank Export Trading Company, Phoenix, AZ	07/05/85	Operating
InterFirst Corporation, Dallas, Texas	InterFirst World Trade Corporation, Dallas, Texas	04/28/86	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

OTHER EXPORT TRADING COMPANY NOTIFICATIONS

<u>Bank Holding Company</u>	<u>Export Trading Company</u>	<u>Date of System Action</u> ¹	<u>Request</u>
Security Pacific Corporation, Los Angeles, CA	Security Pacific Trading Co.	01/18/84	Expand Activities ²
Society Corporation, Cleveland, OH	Export Partnership for Intercontinental Trade Inc.	03/20/85	Additional Investment
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Co.	04/05/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	04/09/85	Additional Investment
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	07/29/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	11/08/85	Invest in Bonded Collateral Management Vehicle
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	12/19/85	Additional Investment
Chase Manhattan Corp., New York, NY	Chase Trade, Inc.	02/26/86	Increase Leveraging ³ to 17:1
Ramapo Financial Corp., et al., Wayne, NJ	Bancorps' International Trading Co.	05/12/86	Additional Investment

¹In each instance, the Federal Reserve had no objection to the proposal.

²In its notification to the Board to establish its ETC, Security Pacific sought to engage in only limited ETC activities. The purpose of this notification was to enable it to engage in the full scope of the activities permitted under the BESA.

³Technically, this request was for relief from a commitment, not an ETC notification.