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Report to the Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, Committee on Government Operations
House of Representatives

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EXPORT PROMOTION

Implementation of the Export Trading Company Act of 1982

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The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

At your request, we reviewed the implementation of the Export Trading Company Act of 1982. The Act was passed on October 8, 1982, after several years of debate and was intended to reduce or eliminate some perceived barriers to U.S. exports, including concern over violation of U.S. antitrust laws and the level of expertise and financing available to support small and medium-sized exporters. Congress concluded that export trading companies (ETCs), similar to those in foreign countries, were the mechanisms to overcome these export barriers and set out to encourage their formation with this legislation.

Constraints to Growth and Impact of ETCs

Thus far, the exports facilitated through ETCs have not been significant. According to the banks and ETCs we visited, the economic conditions of the past few years, particularly the high value of the dollar against the currencies of foreign countries, has hampered the exporting of those ETCs which have been established. Yet, in our opinion, bankers and exporters have an increased awareness of export trading and are in a position to take greater advantage of it when the economic conditions become more favorable. The increased awareness toward exporting could result in the formation of many more ETCs and, eventually, in increased export trade.

With respect to the Export Trade Certificates of Review title of the Act, as of October 1, 1985, 57 trading companies (including 29 newly organized ones) had received certificates from the Department of Commerce extending antitrust protection to their export trade activities and the 230 firms and individuals participating in the certificates. Our discussions with 23 ETCs indicated that many had not done as well as they had hoped. Many companies did say that their exports had increased measurably, and they believed that having a certificate of review (which grants the antitrust protection) helps to attract business and provides them with legitimacy. But, economic factors, particularly the high value

of the dollar, have hurt the performance of the ETCs and forced shifts in their planned activities.

With respect to the Bank Export Services title of the Act, as of October 1, 1985, 40 ETCs had been formed by 40 bank holding companies (bank ETCs), with a total authorized investment of about $84 million, ranging from a high of $18 million to a low of $10,000. Most of the ETCs are still in the formative stages—organizing, looking for personnel, and identifying markets and potential customers. Most expect to incur losses during their start-up phase; only a few have engaged in trade transactions, which have generally been small. The 8 bank ETCs we contacted report only limited exports. From our discussions with them and our attendance at a conference on ETC operational experiences, we noted a wide variance in the approaches being followed.

In our opinion, it would be unrealistic to expect that removal of export barriers in and of themselves would yield a major increase in exports, since U.S. export performance is determined by many variables, including the level and growth of gross national product in foreign countries; the value of the dollar; the availability of international lending and the current developing country debt problems; U.S. technological leadership; foreign tastes, preferences, and barriers to U.S. products; U.S. business attitudes; and impediments to U.S. exports created by U.S. laws and regulations. The most important determinants are fundamental economic factors, such as foreign economic growth and relative exchange rates.

According to Commerce and Federal Reserve Board representatives, it is too early to evaluate the success of the legislation or to judge U.S. firms' efforts to penetrate new markets. Commerce representatives advised us that the Act is not a panacea. They stated that it is one of many programs to help U.S. firms increase exports and that its effect on exports is difficult to quantify because its effect cannot be separated from the effects of other programs or measures designed to assist exporting. Further, the economy in general and economic events, such as third world debt, the value of the U.S. dollar, and the worldwide recession, can significantly affect achievement of the Act's objectives.

Concerns That Regulations Will Affect ETC Performance

A major concern is the degree to which bank ETCs are regulated. Bank ETCs believe that certain provisions of the Act and certain Federal Reserve Board regulations and policies have affected or will affect their export performance, potential to compete with foreign-owned trading companies, and ability to survive. Of particular concern are the provisions that bank ETCs (1) must engage exclusively in international trade, (2) must meet the requirement that 50 percent of their total revenues from all sources be derived from exporting, (3) cannot invest in firms that export services, (4) must observe the same collateral requirements as non-bank affiliates when borrowing from parent banks, and (5) must have a leveraging, or asset-to-capital, ratio not greater than 10 to 1, thereby limiting the amount that can be borrowed. The Board's collateral requirements and the leveraging ratio are intended to protect the solvency and soundness of banks.

The Export Trading Company Act itself requires that bank ETCs engage exclusively in activities related to international trade. The Federal Reserve Board views its definition of exports and the 50-percent requirement imposed by its regulations as necessary to carry out the intent of the legislation, which is to promote exports. Regarding the export of services, the Board reasons that its restriction that bank ETCs serve only as export facilitators is sufficiently supported by the Act's purpose and the legislative history. The Department of Commerce disagrees with the Board regarding the restriction on the export of services. Commerce contends that both the statute and the legislative history clearly indicate that Congress intended that a bank could invest in an ETC which exports goods or services or which facilitates the export of goods or services of others by providing export trade services.

Two of these issues seem particularly important to us, and since receiving agency comments we have given additional consideration to them. With regard to the required extent of export revenues, we believe the Board clearly is authorized to establish the requirement that more than 50 percent of revenue be from exports. The term "principally" in the context of the statutory provision contemplates that the preponderance of an ETC's activity will not be imports, and the legislative history on the House side anticipates the Board's measuring an ETC's activities in terms of revenue shares. The Board acted within its authority by defining "principally" only in terms of export revenues and in setting the requirement that exports be more than 50 percent of all revenues.

The statute, however, does not itself address how such revenues should be calculated or whether revenue should be the sole basis for determining if an ETC is organized and operated principally for the purpose of exports. In fact, it does not even include the term "revenue." Therefore, for calculations to meet the 50-percent requirement we believe the Board could redefine its own term "revenues" to include only proceeds from imports to and exports from the United States. This change would exclude, for purposes of establishing whether an ETC meets the 50-percent requirement, the proceeds from foreign products sold in overseas markets that do not enter U.S. commerce. The Board could also devise indices additional to "revenue" to determine whether a company is "organized and operated" principally for exporting or facilitating exports and it could extend beyond 2 years the period during which qualifying revenues are computed. We believe such modifications could have the effect of reducing the extent to which companies view the current regulation as a potential impediment to operations and still assure that importing does not constitute the preponderance of ETC activity.

With regard to the agencies' interpretations of the Export Trading Company Act as it relates to export of services, we believe that Commerce's position is the better interpretation of the statute and its legislative history. In our view, the definition of export trading company in Title II of the Act permits bank holding company investment in an ETC which exports services.

Legislation currently before the Senate, S. 1934, the "Export Trading Company Amendments Act of 1985," would make changes to address these and other matters. The bill addresses computation of the Board's 50-percent requirement by proposing to amend the Act to provide that a company qualifies as an ETC when its export revenues exceed its import revenues. The intended effect is to exclude from the calculation of revenues those third-party transactions involving neither exports to nor imports from the United States. Also, the bill would clarify that a bank holding company may invest in an ETC which exports services and that revenue from the export of services produced by an ETC itself or an affiliate counts as export income.

Agency Comments and Our Evaluation

Board of Governors of the Federal Reserve System

We agree with the Federal Reserve Board comments that fundamental economic factors have created the unfavorable export markets in which many ETCs have had to operate. However, irrespective of the conditions of the variables that make up the primary trade determinants, if the Export Trading Company Act in fact reduced barriers to exports, we would expect to find exports higher than they would have been without the Act. We recognize, however, that such a direct cause and effect relationship may, in fact, be impossible to quantify or demonstrate statistically.

The Board also commented that our report gives undue emphasis to the questions that some bank holding companies have raised about new Board regulations on bank participations in ETCs. The Board emphasized that it promulgated its regulations to reflect a congressional concern for the balance between bank participation in ETCs and fundamental concerns about assuring the safety and soundness of banks that engage in commercial activities. The regulations that we found of concern to the bank ETCs are more fully discussed on pages 24 to 28 of appendix I. Our purposes in covering concerns of bank ETCs was to report on actual or perceived effects of the Act on export performance. Since our presentation includes the Federal Reserve Board's position, we believe the report to be fair and balanced.

Department of Commerce

The Department of Commerce commented that it appreciated the thorough review we conducted and agreed with our overall conclusions. Commerce had a few minor clarifications and additions and we made revisions to the report in response to these suggestions.

Appendix I discusses more fully the results of our work on the implementation of the Act.

As arranged with your office, unless you publicly announce its contents earlier, no further distribution of this report will be made until 30 days from its issue date. At that time, we will send copies of the report to interested parties and make copies available to others upon request.

Sincerely yours,

Frank C. Conahan
Director

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Abbreviations

ETC	export trading company. A bank ETC is an export trading company owned in whole or in part by a bank holding company
GAO	General Accounting Office
OETCA	Office of Export Trading Company Affairs

Implementation of the Export Trading Company Act of 1982

The Export Trading Company Act of 1982 was passed on October 8, 1982, to reduce or eliminate some of the perceived impediments to U.S. exports, including concern over violation of U.S. antitrust laws and over the level of expertise and financing available to support small and medium-sized exporters. Congress concluded that export trading companies (ETCs) similar to those in other countries were the mechanism to overcome these export barriers.

In Japan and Europe, ETCs handle a large share of the export market and play an important role in foreign trade. In the United States, multinational and other large corporations generally handle their own exports; small and medium-sized firms use export management companies, which act as the export departments for one or more manufacturers and provide export services similar to those of the ETCs.

Objective, Scope, and Methodology

The Chairman of the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, asked us to determine the progress made in implementing the Export Trading Company Act of 1982. We were specifically asked to analyze

1. the expectations held out for ETCs by Congress and the executive branch,

2. the number of ETCs formed and their activities,

3. the number of antitrust exemptions granted by the Department of Commerce and how effectively these exemptions have been used,

4. whether the ETCs have helped to lessen the trade deficit, and

5. reasons advanced for establishing such companies.

We interviewed representatives from the Federal Reserve Board and Department of Commerce, 8 ETCs owned by bank holding companies,[1] 3 banks which have not formed ETCs, and 23 ETCs which had obtained antitrust protection from Commerce. The size of our sample and the

[1]A company that owns at least 25 percent of any bank subsidiary and is registered by The Federal Reserve Board. The Act also allows bankers' banks (banks whose only clients are other banks) and Edge Act Corporations owned by bank holding companies (which are chartered by the Federal Reserve and engaged in international and foreign banking) to invest in ETCs, but so far only bank holding companies have done so.

selection of companies was based on resource limitations and professional judgement. We also talked with officials of the U.S. Export Import Bank about their loan activity under the Act.

We examined the notifications submitted by banks concerning their intentions to invest in ETCs and certificates of review issued by Commerce to ETCs to provide antitrust protection. We also reviewed the correspondence and files of both agencies. We made our review in accordance with generally accepted government audit standards.

Background

During deliberations on how to increase exports, Congress concluded that potential exports were not being realized due to a number of factors, including a lack of business expertise in exporting, limited financing, and government regulations. Congress believed that, to reach a significant number of potential exporters, well-developed ETCs were needed to provide a full range of trade services and to achieve economies of scale in order to lower unit costs. Congress expected that ETCs could be more successful if they were allowed to draw upon the financial resources and expertise of the banking system. Congress also believed that reducing the antitrust issue as an impediment to export trade would be helpful.

Title I of the Act sets forth the purpose, which is to increase exports of products and services by (1) forming an office of Export Trade in the Department of Commerce to promote and encourage the formation of ETCs, (2) allowing bank holding companies to invest in ETCs, (3) reducing restrictions on trade financing, and (4) modifying the application of antitrust laws to export trade. Title I of the Act defines an ETC as including a person, partnership, or association which operates principally to export goods and services produced in the United States or facilitates the export of such goods or services by an unaffiliated person by providing export trade services. An ETC may buy and sell goods and services or act as a broker on a commission basis without taking title to the goods. ETCs may offer a wide range of exporting services, such as market research; finding foreign distributors; preparing documents for export sales; taking title to goods; and arranging for transportation, insurance, financing, and other ancillary services.

Title II permits bank holding companies, under the review and supervision of the Federal Reserve Board, to invest in ETCs that are exclusively engaged in activities related to international trade and principally

engaged in exporting (bank ETCs). Title II also establishes a loan guarantee program in the U.S. Export Import Bank for exporters. Title III authorizes Commerce, with Department of Justice concurrence, to issue certificates of review to exporters that provide antitrust protection for their export activities. Title IV further clarifies the application of the antitrust laws to export trade.

The Act does not set specifics either in terms of increased exports that were expected to result or in the number and size of ETCs that were expected to be formed. Expectations regarding the number of small and medium-sized firms that would use the services of an ETC and the number of businesses that would seek antitrust protection were not quantified. The Senate committee which reported out the bill indicated that both the banks and the bank regulatory agencies could be expected to proceed cautiously. The Senate report stated that, at most, $1 billion in total bank investments and loans to ETCs might be anticipated within 5 years after enactment (Oct. 1987).

According to Commerce and The Federal Reserve Board, it is too early to evaluate the success of the legislation or to judge U.S. firms' efforts to penetrate new markets. Commerce representatives advised us that the Act is not a panacea, as it is one of many programs to help U.S. businesses increase exports; they said it is difficult to quantify the Act's effect on exports because its effect cannot be separated from the effects of other programs or measures designed to assist exporting. Further, the rate of economic growth in foreign countries, the debt problems of developing countries, and the value of the U.S. dollar relative to other currencies can significantly affect achievement of the Act's objectives. Commerce representatives will have one measure of the Act's performance in the annual reports submitted by companies that obtained antitrust protection under Title III. However, even exports listed in such reports cannot necessarily be attributed to the Act. Such a direct cause and effect relationship may in fact be impossible to quantify or demonstrate statistically.

Export Promotion

Pursuant to the Act, Commerce established the Office of Export Trading Company Affairs (OETCA) to promote and encourage the formation of ETCs and to facilitate contact between producers of exportable goods and services and firms offering export services. For fiscal year 1986, OETCA has a budget of $746,000 and 17 staff members. To inform the public about the Act, OETCA initially participated in 49 ETC conferences

nationwide. It then held a second round of conferences to provide guidance to those seriously interested in forming or using ETCs. These conferences covered legal issues, business planning, financing, and government assistance. Commerce also held ETC conferences for the banking industry.

OETCA distributed information kits containing copies of the Act, Commerce and Federal Reserve Board regulations and guidelines, and materials explaining other related government programs. In March 1984, OETCA published The Export Trading Company Guidebook, which explains the provisions of the Act, the advantages of establishing or using an ETC, the organizational variables in designing an ETC, financial considerations, and other information. To increase exporting awareness, OETCA conducted individual counseling sessions, mostly with small and medium-sized firms interested in forming ETCs. It also published a Contact Facilitation Service Directory in June 1984, which lists by state both export service providers and U.S. producers of goods and services that wish to be registered. This will be updated periodically and is intended to serve as a clearinghouse for producers to contact ETCs and for ETCs to identify possible clients for their services.

In commenting on our draft report, Commerce noted that OETCA has also offered counseling to about 450 firms on Title III antitrust matters, other government assistance and financing programs, and exporting in general. OETCA produced and distributed the Handbook for Professionals to assist the Federal Bar Association in counseling on the Export Trading Company Act. OETCA has organized industry-specific outreach activities not only to the banking industry but also to the U.S. agricultural export community and to small and medium-sized manufacturing firms.

Commerce has no data available on its success in bringing producers and ETCs together or on the number of ETCs formed as a result of the promotion efforts.

Antitrust Protection Under Titles III and IV

The Act provided two means of clarifying the antitrust laws and their application to export trade. The first, Title III, establishes a pre-clearance process that enables any person or company to determine in advance whether its export conduct is exempt from federal and state antitrust laws.

The Department of Commerce, in concurrence with the Department of Justice, determines whether or not the applicant's proposed conduct would

1. substantially lessen competition or restrain trade in the United States or substantially restrain the trade of any competitor of the applicant,

2. unreasonably affect prices of particular goods or services within the United States,

3. constitute unfair methods of competition, or

4. include any act that may reasonably be expected to result in the sale or resale in the United States of the goods or services exported by the applicant.

When a favorable determination is made, a certificate of review is issued granting antitrust protection for the proposed export activities. A certificate holder is still subject to private party lawsuits for, among other things, injunctive relief and actual damages if any of the four standards are violated and the lawsuit is brought within 2 years. The certificate, however, does create a presumption of validity for the export conduct specified and the certificate holder can be awarded the costs of defending the action, including attorney fees, if it prevails in any action brought against it.

The second means, Title IV, amends the Sherman Act and section 5(a) of the Federal Trade Commission Act. Title IV clarifies that these antitrust statutes do not apply to export trade unless it has an adverse, anti-competitive effect on commerce in the United States or on the export commerce of a U.S. resident. Under Title IV, the antitrust laws would apply to export activity only if the activity has a "direct, substantial, and reasonably foreseeable effect" on the U.S. economy or U.S. competitors.

Commerce believes that affirmative exporting decisions may have substantially increased as a result of the jurisdictional limitation provided by Title IV. However, since Title IV requires no administrative action, it is not possible to estimate the impact with precision.

Process for Obtaining Certificates of Review

A company seeking a certificate files with OETCA an application which describes the company, its goods and services, and the export conduct for which the certificate is being sought. The company also provides

organizational and financial information. The application is forwarded to the Justice Department with published data on the industry to facilitate independent analysis of the application. OETCA prepares (1) a fact report describing the industry, the applicant, and the company's share of the market, (2) an economic analysis of how the proposed export conduct falls within the four standards of certification, and (3) a legal opinion on the proposed conduct. After Justice reviews and concurs with the issuance of the proposed certificate, the Secretary of Commerce issues a certificate based on the recommendation of the Director of OETCA.

Certificates of Review Issued

The first certificates were issued on October 25, 1983, about one year after the Act was passed, and as of October 1, 1985, certificates had been issued to 57 companies. As of September 1985, no applications had been denied, although modifications had been made and many had been withdrawn or returned to the applicants because they were incomplete. Of the 57 certificate holders, 28 provide export services to facilitate the sale of goods and services of non-affiliated firms in export markets and 29 holders or their members produce at least some of the goods or services that are exported.

The type of export conduct certified can be classified as horizontal or vertical. Horizontal arrangements are those in which domestic competitors have joined together to fix prices and allocate markets, customers, or quotas. According to Commerce, 24 certificates have been granted for which the antitrust issues were principally horizontal. Included in the horizontal classification are members of four Webb-Pomerene Associations (organizations engaged in exporting that combine similar products of different producers for overseas sales) which export cherries, wood chips, soda ash, and textile machinery, respectively. Also included are three other associations which were in existence before the Act was passed—one exports catfish, one exports rice, and one has members which operate duty free alcohol and tobacco shops along the Mexican border.

One horizontal arrangement, for example, is Chlor/Alkali Producers International, a joint venture of four companies that are competitors in the caustic soda and chlorine business. Under the certificate, each member may independently decide the quantity of caustic soda and chlorine it will make available for worldwide export and may enter into an exclusive agreement with Chlor/Alkali to act as export sales representative. Chlor/Alkali, on behalf of itself or its members, may establish

prices and the quantities it will sell in the export market and allocate the markets or customers among the members. Chlor/Alkali and its members may also discuss information about export sales and marketing efforts, quality and quantities, terms of contracts, expenses of exporting, and other export-related matters.[2]

Vertical arrangements are restrictive agreements with U.S. suppliers of export products or distributors in export markets. They can be nonexclusive or exclusive agreements where the ETC can refuse to deal with other U.S. suppliers or other distributors in export markets. According to Commerce, 31 certificates have been granted for which the antitrust concerns were principally vertical. For example, a certificate was awarded to Gate Group U.S.A., Inc., an ETC which represents manufacturers of graphic art equipment and supplies and provides export trade services (consulting, advertising, market research, insurance, product research, freight forwarding, foreign exchange, taking title to goods, and other services). Under the certificate, Gate Group may enter into agreements with a supplier to sell its products in designated markets and the supplier may agree not to sell directly or through any intermediary other than Gate Group. Gate may also enter into agreements with foreign sales representatives and establish prices and quotas for the products to be sold by its foreign representatives.

Appendix II is an analysis of the 57 ETCs that had received certificates as of October 1, 1985.

Some Reasons Why More Businesses Have Not Sought Certificates of Review

According to Commerce, more businesses may not have sought certificates of review because Title III is a new process. A company must provide proprietary business data to the Commerce and Justice Departments and may want to know that the benefits are worth doing so. We were advised that once a few major companies have sought certificates and it appears worthwhile to do so, many others will likely follow. A second reason why more businesses have not sought certificates may involve the lack of antitrust issues; most of the applications for certificates returned by Commerce because they were incomplete were withdrawn because the firms did not have antitrust issues—they did not handle competing products, had no need to fix export markets or prices, or did not want to combine with others for this purpose.

[2]According to OETCA officials, a suit has been brought against the Departments of Commerce and Justice by a private party for the improper issuance of a certificate to Chlor/Alkali; the case was pending before the Federal court as of Oct. 1, 1985.

The executive director of the National Federation of Export Associations, which represents 800 to 850 small and independent companies, told us that more companies have not applied for certificates of review because most companies are specialized and have such small shares of the market that they are not concerned about antitrust.

In view of the fact that only 57 businesses have received certificates of review which grant antitrust protection in advance, the concern over antitrust may not have been as much of a barrier to exporting as perceived. Businesses, however, may be relying on the protection under Title IV of the Act which is intended to clarify the antitrust laws in regard to export trade. In commenting on our draft report, Commerce emphasized the role that Title IV may have in reducing antitrust uncertainty. It noted that since Title IV is self-effecting and available to all U.S. exporters, the extent of its impact on increased exports cannot be determined.

Have the Certificates Been Useful?

We contacted 23 of the 57 certificate holders to learn how useful the certificates have been to them. The 23 companies were small; some produced or assembled products, others provided export trade services, some acted as commissioned agents, while others took title to goods.

The reasons given by companies for obtaining certificates were to obtain the antitrust protection and to enhance their stature with clients and the public; 19 companies said they had antitrust concerns. Over half of the companies responding said they had received other benefits from being certified, including the publicity, credibility, and image as approved ETCs. As one company official put it, the intangible benefits associated with the certificate include a little publicity and a Commerce "seal of approval" that provides legitimacy to the ETC. Several company officials also said that the certificate made it easier to deal with suppliers and others.

Many of the 23 companies that we contacted clearly had not done as well as they had hoped. Many companies did say they had a measurable increase in exports and believed that having certificates helped to attract business, but only 2 of 13 responding conclusively about their trade volume indicated they had done as well as anticipated. The other 10 companies said it was too early to tell because they had just recently received their certificates or they had no opinion.

Economic factors, particularly the current high value of the dollar, have hurt the performance of the ETCs considerably and forced shifts in their planned activities. Three companies attributed their lack of export business to the value of the dollar and five said it severely affected their businesses. To offset negative economic factors, many companies have turned to or are considering increased importing and countertrade.[3] Only one company said that economic factors have not affected its performance—the value of the dollar was already high when the company started and the company sells a unique product. Yet, 19 companies, some of which are new to exporting, said they could eventually compete with foreign firms, particularly if the value of the dollar declines.

Bank Holding Company Investment in ETCs

The intent of Title II is to develop ETCs in which bank holding companies will participate effectively in financing and development. Congress expected that banks would create ETCs which

- have powers sufficiently broad to compete with similar foreign-owned institutions;
- afford U.S. commerce, industry, and agriculture, especially small and medium-sized firms, a means of exporting at all times;
- have regional and smaller bank participation; and
- facilitate joint ventures between bank holding companies and non-bank firms that can handle all the needs of an exporting company.

Because bank holding company ownership of ETCs is a departure from the policy of separating banking from other types of business, the Act imposed certain restrictions. Bank holding companies were allowed to invest up to 5 percent of their consolidated capital and surplus in the ownership of ETCs and to loan the ETCs up to 10 percent of their consolidated capital and surplus. The Board of Governors of the Federal Reserve System may disapprove an investment (1) to prevent unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interests or (2) if it materially adversely affects the safety or soundness of a subsidiary bank of a bank holding company.

Proponents of bank involvement maintain that U.S. banks can provide important trade services, such as research, foreign market knowledge and experience, expertise in documentation, and, most importantly,

[3]Countertrade involves transactions where the U.S. seller is required to accept payment in goods or other instruments of trade from third countries.

financing. The banking provision was controversial because it breaks the traditional separation between banking and commerce. According to representatives of the Board, the separation was based on (1) the safety and soundness of banks and of the banking system in general, which might be impaired if banks were closely affiliated with ownership and management of a potentially high risk, non-bank business, and (2) the premise that the lending decisions of banks be impartial and based on sound economic and financial grounds.

Federal Reserve Board

The Board published its proposed rule implementing Title II in the Federal Register in January 1983 and the final rule became effective in July 1983.

Bank holding companies that wish to invest in an ETC notify the Board in writing about the nature of the investment and the activities of the proposed ETC. The notification is reviewed for financial and legal issues and a staff recommendation is made to the Board. The procedures allow bank holding companies to invest if they are so advised by the Board or if the Board does not disapprove the investment within 60 days. In December 1983, the Board delegated authority to review notifications of investment to the Federal Reserve Banks when certain criteria set forth in the regulations are met. Failure to meet the criteria means only that the Board must review the proposed investment. As of October 1985, no investments had been disapproved by the Board and the Federal Reserve Banks and the bank ETCs we visited had no problems with the Board procedures. They did, however, disagree with some of the rules and regulations imposed by the Board.

Bank Holding Company Investment

As of October 1, 1985, 40 ETCs had been formed by 40 bank holding companies; 30 of them are wholly-owned subsidiaries of the bank holding companies and 2 of these 30 were outright purchases of an ongoing ETC. Two of the 40 are subsidiaries of bank holding companies but will allow other investors to purchase an equity interest, and 8 are joint ventures—one between three bank holding companies and private investors, one between the same three bank holding companies and an ongoing ETC, one between a bank holding company and a manufacturer, and 5 between bank holding companies and ongoing ETCs. In several joint ventures, bank holding companies did not retain controlling interest.

The 40 ETCs are geographically disbursed—13 in the U.S. northeast, 11 in the U.S. west, 6 in the U.S. midwest, 9 in the U.S. south, and 1 overseas. The size of the bank holding companies which invested in the ETCs varies considerably; the total authorized investment in the 40 companies is about $84 million, ranging from a high of $18 million to a low of $10,000.

Table I.1 compares the size of the bank holding companies with the amount of authorized investments and shows that 9 multinational money center banks, accounting for 10 ETCs, have made the bulk of the investments.

Table I.1: Size of Bank Holding Companies and Their Investments in ETCs

Dollars in thousands

Size of bank holding company	Number of ETCs	Total approved investment	
		Amount	Percent
Money center banks[a]	10	$71,103	84
Assets over $5 billion	13	6,573	8
Assets between $1 billion and $5 billion	5	3,250	4
Assets below $1 billion	8	1,275	2
Joint venture of three banks	2	702	1
Dissolved ETCs	2	1,150	1
Total	**40**	**$84,053**	**100**

[a]The Federal Reserve Board has classified 17 U.S. bank holding companies as multinational or money center bank holding companies—large organizations located in major financial centers in the United States.

Operating Experience and Approach of bank ETCs

The ETCs have little operating experience. The first one was authorized in May 1983, so has had almost 3 years experience. Over one-third of the proposals, however, date from the beginning of 1984, so the operating experience of these companies is much shorter. The Federal Reserve Board stated that most were still in the formative stages—organizing, looking for personnel, identifying markets and potential customers, etc. Most expect to incur losses during their start-up phase and only a few have engaged in trade transactions, and these have generally been small. Our survey confirms this; the eight bank ETCs we contacted reported only limited exports.

From our discussions with the eight bank ETCs and our attendance at a conference on ETC operational experiences, export trends, and federal policy matters, we noted a wide variance in the approaches being followed and the scope of operations. Bank ETCs were formed for various

reasons; most of the ones we contacted were formed generally as a new source of profits, but banks also wanted to provide additional services to their clients. According to one bank ETC representative, the banking industry has become very competitive, so banks must scramble to find new ways to serve customers and make profits.

The differences in approaches followed in forming ETCs and the scope and focus of operations are shown in the examples below.

A—An ETC was established in May 1984 with a general manager and a bank attorney as the only employees. It provides trade development services in such areas as export licensing and market research and contracts out for much of these services. The bank holding company is taking a cautious approach in trying to purchase the right export management company or to form the right joint venture. The company finds it difficult to find an export management company to purchase, as there are few with the right management and characteristics.

B—The bank holding company purchased an ETC in 1984 which has been in business since 1971 and has about 75 employees. The company specializes in exporting computer graphics products, and little has changed since the acquisition. The affiliated bank has brought a few clients to the company, and the company president has assisted these potential clients by examining whether products can be sold abroad or whether a client's approach is viable.

C—The bank holding company acquired a consumer finance and leasing corporation in 1984 which had its own inactive trading company subsidiary. The subsidiary was reactivated with a staff of six experienced traders who had sales contacts in different parts of the world. The company operates similar to a trading house and prefers to take title to goods. Although the company was very active during 1984, there have been few exports and most of its business has involved third-country trades. The company handles mostly textiles and chemicals but will trade any products. It "works with" the bank's in-house trade group that provides bank clients with export-related services.

D—This trading corporation was established in 1983 and represents small to medium-sized U.S. companies in overseas markets, principally China. Its primary expertise is in the metal processing industries, such as can manufacturing equipment. China is viewed as a difficult market for most manufacturers, and the trading corporation believes it knows

how to sell in China. It also attempts to sell Chinese goods in the United States.

E—The ETC began operations in February 1984 and is a full service trading company with over 40 employees engaged in export, import, third-country trade, and countertrade. It focuses on specific product areas in advanced technology, forest and agricultural products, and machinery and other general products, including chemicals, construction materials, fertilizer, coal, and machinery. In addition to buying and selling products, it also provides trade related services, such as transportation, insurance, and financing.

The bank ETCs that we contacted said the value of the U.S. dollar makes it difficult to sell new products. On a recent European visit, representatives of one ETC found that U.S. goods of high quality were about 35 percent (and on occasion 70 percent) above the market price; foreigners will pay a premium of about 5 percent, but not the high prices required because of the value of the U.S. dollar. Another representative said that sales have been disappointing, the ETC lost five potential deals to foreign competitors in a 5-day period in December, and "the value of the U.S. dollar has been a killer".

Aside from the value of the dollar, one ETC representative said another concern is that many U.S. companies are not geared to export and do not look beyond the U.S. market. U.S. companies do not view the world as the marketplace even though they may not be operating at full capacity. Another said U.S. companies do not believe they need a "middle-man" or ETC. Even though they are not experienced in international trade, U.S. companies often believe they can handle such trade without the assistance of an ETC.

One representative of an ETC seemed very optimistic about its future. The ETC could not go into all areas of business, so it carved out some niches—medical products, food systems, technology, and telecommunications. It incurred a loss during 1984 but expected a profit in 1985. The ETC employs 40 to 45 people and has offices in Europe, East Asia, and Latin America. In the representative's opinion, opportunities do exist but success comes with hard work and being creative. He stated that to have a successful ETC, the bank holding company must be committed to the business, be "diversified-minded" and not let the ETC become an extension of bank services, realize the business is complicated and will take time to be profitable, and make a $5 million to $10 million investment and the ETC must (1) be flexible and have a business strategy, (2)

identify U.S. products that are competitive, (3) hire people experienced in international trade, and (4) "focus, focus, focus", meaning that it must sort out the right products and locations.

Some Reasons Why Bank Holding Companies Have Not Invested in ETCs

The Bank Administration Institute and the Conference Board jointly researched whether the banking community responded favorably to the Export Trading Company Act. In a questionnaire sent to 1,000 of the largest U.S. banks in August 1983, 126 of 160 responding banks reported they had no plans to create bank ETCs and 34 were considering it. Although the data are not current and the response rate was low, the following reasons given for lack of interest may be representative of the banking community in general.

1. The geographical area serviced by the banks had a relatively small number of firms engaged in exporting, and some banks did not even find it necessary to have an international department.

2. Many banks are conservative and believe that ETCs should be undertaken only by the large international banks.

3. There were no bank ETCs in the country which could serve as models to be emulated.

4. The profitability of an ETC is too uncertain or other areas of banking are more profitable.

The low response rate (16 percent) may also be indicative of the lack of knowledge or interest in establishing ETCs in 1983. In 1984, we contacted three money center banks that had not established ETCs, and they gave us the following reasons for not doing so.

Bank A, when the Export Trading Company Act was passed, considered several options and almost acquired a high-tech ETC. A bank representative said that the banking environment is changing—deregulation allows banks to operate interstate and more capital is needed for lending activities. Export trading is a new area where margins are small. The bank will consider an ETC while viewing other priorities for its capital, and an ETC will be formed only if it appears more attractive than other business areas. The bank did purchase a small company that assists in marketing U.S. products overseas and specializes in the market needs and trade opportunities of certain countries.

Bank B decided that an ETC is not part of its business strategy at this time, but it has not closed out the possibility for the future. The bank can encourage trade and meet the needs of its clients without establishing an ETC. Most bank clients are large multinational companies experienced in exporting and importing and do not need the services envisioned in the Act.

Bank C stated that its expertise on how to export is what is important to bank customers; a bank does not need to form an ETC to provide its clients with the knowledge to export. Bank representatives also pointed out that the environment for ETC formation has not been good; for several reasons, potential constraints on the bank's capital and the strength of the U.S. dollar made a poor climate for exporting. Since the ETC was a non-traditional use of bank management's time and there was no history of bank ETCs, they decided it was not the right business for the bank at this time.

bank ETC Comments on Federal Reserve Board Regulations and Policies

Bank ETCs believe that certain provisions of the Export Trading Company Act and of the Federal Reserve Board's regulations and policies have affected or will affect their export performance, potential to compete with foreign-owned trading companies, and ability to survive. According to these ETCs, the regulations and policies appear inconsistent with the congressional intent of facilitating financing for exports and drawing on the resources of the banking system to create successful bank ETCs. One representative said that if the Board maintains its regulations and policies, the bank holding company will sell its ETC because it's a vast problem to run a business within such narrow confines, particularly when the policies have no relation to world trade. In general, the banks believe that it is discriminatory to subject bank ETCs to regulations and policies that do not encompass non-bank ETCs. Five concerns cited are as follows.

1. The definition of exports - The Act requires the bank ETC to be operated principally for the purpose of exporting; the Board has defined this as making 50 percent of total revenue—including exports, imports, and the sale of foreign products in overseas markets—from exporting over a 2-year period. The proceeds of countertrade and trade that the ETCs arrange between two foreign countries are counted as non-export revenue. The bank ETCs argue that if half of the business must consist of exports, they may not be able to meet the Board's requirement. They assert that, as a minimum, the 50-percent requirement should encompass more than a period of 2 years and that a transaction necessary to

make an export sale should not be counted as non-export revenue. For example, the element of a countertrade transaction involving a third country or an import into the United States should not be counted as non-export revenue. One representative said that the purpose of Title II is to provide for meaningful and effective participation by bank holding companies and that it gives bank ETCs powers sufficiently broad to enable them to compete with similar foreign-owned institutions in the United States and abroad; thus, he believes that the 50-percent requirement conflicts with Title II.

The Federal Reserve Board views its 50-percent requirement and its definition of exports as necessary to carry out the intent of the legislation, which is to promote exports. Importing is less difficult, and the Board feels that without the 50-percent export requirement, bank ETCs would have less incentive to find markets for U.S. goods. The Board is reluctant to take what it feels would be a stance against the export intent of the legislation. Board representatives advised us that ETCs which have commented on the regulation stated that the problem is anticipatory; they have not had any difficulty meeting the test to date.

With regard to the required extent of export revenues, we believe the Board clearly is authorized to establish the requirement that more than 50 percent of revenues be from exports. The term "principally" in the context of the statutory provision contemplates that the preponderance of an ETC's activity will not be imports, and the legislative history on the House side anticipates the Board's measuring an ETC's activities in terms of revenue shares. The Board acted within its authority by defining "principally" only in terms of export revenues and in setting this requirement that exports be more than 50 percent of all revenues.

The statute, however, does not itself address how such revenues should be calculated or whether revenue should be the sole basis for determining if an ETC is organized and operated principally for the purpose of exports. In fact, it does not even include the term "revenue". Therefore, for calculations to meet the 50-percent requirement, we believe the Board could redefine its own term "revenues" to include only proceeds from imports to and exports from the United States. This change would exclude, for purposes of establishing whether an ETC meets the 50-percent requirement, the proceeds from foreign products sold in overseas markets that do not enter U.S. commerce. The Board could also devise indices additional to "revenue" to determine whether a company is "organized and operated" principally for exporting or facilitating exports and it could extend beyond 2 years the period during which

qualifying revenues are computed. We believe such modifications could have the effect of reducing the extent to which companies view the current regulation as a potential impediment to operations and still assure that importing does not constitute the preponderance of ETC activity.

2. Section 23A collateral requirements - Section 23A of the Federal Reserve Act states that extensions of credit from a bank to its non-bank affiliates shall be secured by collateral with a market value of 100 to 130 percent of the credit, depending on the nature of the collateral. Although the Export Trading Company Act exempted transactions between a bank and its ETC from the collateral requirements of any federal law in effect on October 1, 1982, this exemption, according to the Board, was nullified a week later upon passage of the Garn-St Germain Depository Institutions Act of 1982. Board regulations have permitted a bank to advance funds to its ETC to purchase goods if its ETC has a contract to sell the goods and the bank has a security interest in the goods or in the proceeds from the sale of the goods equal in value to the funds advanced. The Board has also indicated that it will consider waivers in certain cases, and it has granted at least one waiver.

For affiliate lending, bank ETCs state that they are already subject to the 10-percent limit of capital and surplus for extensions of credit and to the provision that the bank may not extend credit to the ETC or customers on more favorable terms than it affords similar borrowers; they believe these provisions provide adequate protection for the solvency and soundness of banks and therefore section 23A is unnecessary. According to the Board, however, these restrictions are intended to protect the resources of the bank from abuse by related companies. We were advised that section 23A restrictions are the linchpin of current efforts to deregulate the banking industry, reflecting the view that banks are subject to unsafe or unsound practices if free to lend to affiliates on an unrestricted basis.

3. Exclusive international trade - The Act requires that a bank ETC be exclusively engaged in activities related to international trade. One of the largest bank ETCs views this as counterproductive and contends it is difficult to restrict one's services solely to international activities; in working with a customer, it sometimes is necessary to take a position in or to finance the sale of a commodity when only a portion of that commodity will be exported. Although this kind of transaction helps the export market and is typical of foreign banking firms in Europe, the bank ETC believes it is prohibited from doing this.

4. Exporting of services - The Act defines a bank ETC as "a company which does business under the laws of the United States or any State, which is exclusively engaged in activities related to international trade, and which is organized and operated principally for purposes of exporting goods or services produced in the United States or for purposes of facilitating the exportation of goods or services produced in the United States by unaffiliated persons by providing one or more export trade services."

Under the Board's definition, an ETC can only provide services to facilitate the export trade of others. Thus, under the Board's definition, a bank ETC may not invest in a company that only provides services to foreign customers (such as a construction company or an insurance firm). The Department of Commerce disagrees with the Board's position on this and there has been an exchange of correspondence about the matter between the Secretary of Commerce and the Chairman of the Board of Governors of the Federal Reserve System. The Board reasoned that its position that bank ETCs serve only as trade facilitators and not as investors in service industries is sufficiently supported by the Act's purpose and the legislative history. The Board believes that Congress would not regard banking investment in construction companies, general insurance underwriters, or mining companies, for example, as within the scope of activities authorized by the Act. The Board's interpretation of legislative intent was also explained in a letter to the Chairman of the House Committee on Banking, Finance and Urban Affairs and to other legislators at the time the final regulations were adopted.

Commerce contends that the regulatory definition of an ETC adopted by the Board is not supported either by the language of Title II or its legislative history. Instead Commerce contends that a straightforward reading of the statutory definition clearly indicates that Congress intended an ETC to export goods and services itself or to facilitate the exports of goods and services of others by providing export trade services. Commerce concludes that the Board, by finding in the statutory language an "ambiguity" on which to base its interpretation, has merely established a vehicle to permit the Board to substitute its own view of the proper role for bank ETCs for the role Congress expressed in the statute and the legislative history.

We reviewed the positions of both the Board and Commerce concerning the interpretation of the statutory definition of a bank ETC. Based on our review of the statute, its legislative history, and the respective positions of the two agencies, we believe that Commerce's position is the better

interpretation of the statute and its legislative history. In our view, the Export Trading Company Act's definition of "export trading company" permits bank holding company investment in an ETC which exports services.

5. Leveraging ratio - In considering proposed investments and in delegating authority to Federal Reserve Banks, the Board's policy is that the bank ETC asset-to-capital ratio will not exceed 10:1. This limits the amounts that can be borrowed. Bank ETCs believe that the ratio should not be imposed on them and that because of the barriers to and risks inherent in the export business, a low leveraging ratio does not give them an adequate chance for success. On the other hand, the Board intends to protect the banks against unsound practices and the 10:1 ratio protects the solvency and soundness of banks. The Board might consider granting a waiver for individual cases if it concludes that no potential harm exists to the bank.

U.S. Export Import Bank

Section 206 of the Act directed the U.S. Export Import Bank (Eximbank) to establish a loan guarantee program for exporters and ETCs. In response, Eximbank approved the Working Capital Guarantee Program in January 1983 to assist companies, especially small and new-to-export companies, to obtain working capital for export-related projects, such as purchasing inventory or developing export marketing programs. Eximbank is not supposed to compete with private sources of funding, so the program should cover loans that otherwise would not be made by commercial lenders.

Under the program, a lender must indicate that it will not approve the loan without the Eximbank loan guarantee. The loan guarantee covers both principal and interest. As much as 90 percent of the principal and interest (up to the U.S. Treasury borrowing rate for comparable maturities plus one percent) can be guaranteed. The lender is at risk for the balance of the unguaranteed principal and interest. For the guarantee, Eximbank receives a fee of one percent of the loan amount for loans maturing in 180 days or less; for longer maturity periods, the fee increases.

This is the only Eximbank program that guarantees loans for U.S. exporters rather than foreign purchasers of U.S. exports. To publicize the program, Eximbank sent brochures to about 14,000 commercial banks and 16,000 small businesses and participated in about 40 seminars on export financing with the Department of Commerce and the