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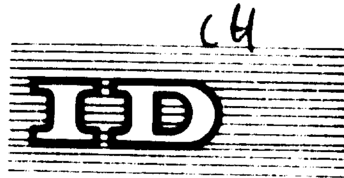

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COMMERCIAL BANKS AS A SOURCE OF INDUSTRIAL FINANCE

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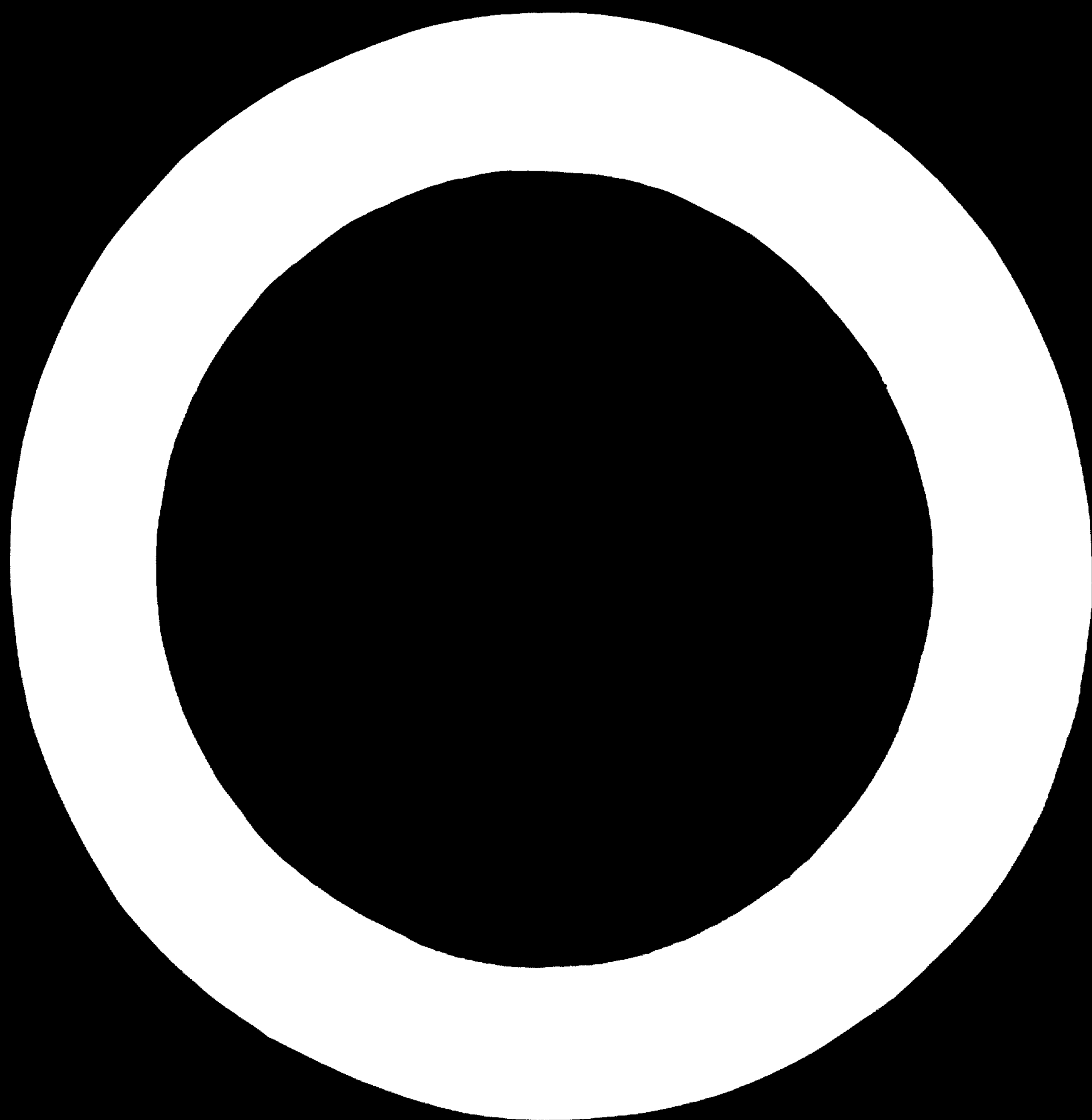

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COMMERCIAL BANKS AS A SOURCE OF INDUSTRIAL FINANCING

I INTRODUCTION

The Federal Reserve Act of 1913 codified the traditional view of the lending function of commercial banks. A well-managed bank, it was believed, extended credit only on "short-term self-liquidating agricultural, industrial, or commercial paper which was originally created for the purpose of providing funds for producing, purchasing, carrying, or marketing of goods." Banks should not, according to traditional theory, extend money to "finance fixed investments of any kind; or any investments of a purely speculative character; or for carrying or trading in stocks and bonds...; or to finance relending by cooperative marketing associations and factors."[1] This is the so-called "real bills" doctrine which maintains that banks should lend only to finance a transaction to acquire goods which will then be either processed or shipped and then sold, the proceeds of the sale being used to repay the loan. The bank is thus "protected" by the goods themselves which back the transaction, and which will, in the course of the normal operating cash conversion cycle of the company, be transformed back into cash. These funds would be advanced on the basis of customers' promissory notes, or drafts drawn on customers

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[1] The Federal Reserve Act of 1913, 38 Stat. 826.

by their suppliers.[2]

This has all changed, particularly since World War II, and banks now extend funds under a wide variety of arrangements for many different purposes, including even, in certain cases, equity capital in exchange for shares of common stock.[3] But although the absolute dollar total of loans to businesses has increased dramatically, the total percentage of all bank credit which goes to commerce and industry has declined (due to the huge increase in consumer and mortgage loans, which had been insignificant in the 1920's). There are three major reasons for the relative decline of banks as a source of industrial financing: (1) funds for both working capital and company expansion have been increasingly generated within the largest individual companies from earnings and capital consumption allowances; (2) there has been a steady growth in the number and variety of non-bank financial institutions which compete with or complement banks as a source for industrial financing;[4] and (3) the American public has generated huge amounts of money which have been tapped through the open market for stocks and bonds.

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[2]The theory behind this kind of lending still survives in the Federal Reserve provision that only notes arising from this type of transaction can be discounted with (i. e. sold to) the Federal Reserve Bank. This form of Reserve Bank loan is, however, resorted to much less frequently than are advances, for which other types of a member bank's assets may be used as collateral.

[3]Cf. below the discussion of Edge Act Company financing, pp.19-21.

[4]Sources of various kinds of credit which may be incorporated into the financial structure of the company include: suppliers who sell on open account, or buyers who prepay; finance companies and factors; life insurance companies; organizations such as the Ford Foundation; venture capital companies; private placements of a company's promissory notes with another corporation; pension funds; cooperative unions; investment banks; development banks; national governmental institutions (such as the United States' Small Business Administration); international organizations and specialized agencies of the United Nations; the World Bank and its sister institutions, the International Finance Corporation and the International Development Association; United States Government institutions such as the Agency for International Development (AID) and the Export-Import Bank; and the Edge Act Company subsidiaries of commercial banks in the United States.

Although the kind of financing required by a company will generally dictate what kind of e lender should be approached, the following general advantages and disadvantages in dealing with banks may be kept in mind:

<u>Advantages</u>: 1. The creation of a working relationship with a bank which provides a wide variety of services.

2. The establishment of a credit standing with the bank, which not only eases the application for credit in the future, but provides the smaller company with an excellent credit reference in the trade.

3. Access to the bank's financial contracts to other possible sources of capital.

4. General advice and counsel by experts in the field of finance.

5. A source of credit information at the bank on one's corporate customers.

6. In many cases, lower borrowing costs.

<u>Disadvantages</u>: 1. The bank may require that confidential information be divulged.

2. The bank may require its permission before certain management decisions are made.

3. The creation of a liability which, if it is not paid exactly as agreed, detracts from the company's reputation in financial and trade circles.

4. The possible necessity to maintain compensating balances.

5. The necessity to keep the bank informed periodically

6. Possible delay in securing funds.

As the needs of industry have changed, bank lending practices have adapted themselves to the new kinds of financing required. Many of the newer forms of financing require complicated and detailed legal and financial arrangements to be worked out, and it has become more difficult to make generalizations. The largest loans tend to be tailor-made to the situation. Costs vary, depending on prevailing money market conditions, the length of the loan, the administrative costs to the bank, the amount of time which must be spent in investigating and preparing the proposed financing, and the bank's judgement of the risk involved. The length of the customer's relationship with the bank, and the bank's judgement about his company's future may also affect the cost of borrowing.

II BANKS AS A SOURCE OF WORKING CAPITAL

Working capital is defined by the credit analyst as the excess of current assets over current liabilities. The management of the ordinary operations of an industrial company results in a flow of funds through the business, and it is the transformation of these funds from one form to another that is meant by the managing the working capital position of a company. Thus, sales result in the transformation of inventory into accounts receivable and cash. Permanent or minimum working capital is the amount of these current assets minus current liabilities that a company needs to operate even in its least active periods. Variable or seasonal working capital is funds needed for limited periods of time because of seasonal purchases or heavy activity.

Permanent working capital should not be raised from temporary sources. If it is borrowed on a short term basis, the bank may require repayment, and this might result in the embarrassment of the company. Some companies with poor credit ratings and little working capital attempt to obtain long term funds by taking out a succession of loans at different banks, the proceeds of one loan being used to pay off another. Banks are often unwilling to lend on this basis because of the embarrassment this might cause if one of a series of loans were rejected by any of the company's lenders. If the funds cannot be raised through the sale of stocks or bonds, a term loan from a bank might be considered.[5]

Longer-term loans for permanent or minimum working capital, are, by the usual definitions, classified as term loans since they will not be repaid within a year. Functionally, however, they belong with ordinary commercial loans since they are, in principle, repayable out of working capital. Term, non-working capital loans, however, are paid out of net cash <u>income</u> over a period

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[5] Term loans will be discussed in Part III.

of years. But longer-term working capital loans are "related to a constant flow of transactions each of which, by itself, is of relatively short duration but which succeed each other so rapidly that no sooner has one beenliquidated than another takes its place."[6]

Theoretically, then, a permanent working capital loan is, in its effect, a series of shorter term loans which, for convenience, are written as one term loan. But the bank, in this case, becomes concerned not only with the working capital position of the borrower, but also with his long term prospects for income and growth as in an ordinary term loan for the aquisition of fixed assets.

To summarize, loans may be classified as commercial or term by the following criteria: maturity of less or more than one-year: source of repayment from working capital or earnings; and purpose, to acquire working capital (current) assets, or fixed assets. Obviously it is possible for a loan to overlap in the commercial and term categories.

Working capital needed for limited periods of time may be borrowed from temporary sources, and banks are the most widely used source of temporary working capital. The wisdom of any given borrowing policy (and, from the bank's point of view, the soundness of any credit granted) depends on the accuracy with which the company can project its short term requirements and cash flows. Bank loans may be on a time basis, with typical maturities running from 30 days to several months and renewals not uncommon; or they may be on a demand basis with no set maturity. The bank always likes to feel, however, that the company could pay off its loans or obtain credit elsewhere if necessary. It is not uncommon for banks to request that a company go "off the books" for a short period of time, or replace the funds with a loan from

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[6] Howard D. Crosse, Management Policies for Commercial Banks, Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1962; Ch. XI, "Lending Practices." Cf. also B. H. Backhart, ed., Business Loans of American Commercial Banks, New York: The Ronald Press Company, 1959.

another bank. This assures the bank that the company has sufficient liquidity and that it has good credit rating elsewhere.

If the amount of the credit is high, or if the bank's appraisal of the credit indicates the necessity, the bank may require that working capital loans be secured. There is wide variety of collateral agreements which can be tailored to the type of loan, its purpose, and general bank policy.

The most riskless type of secured loan is that secured by readily marketable government or corporate bonds or stocks listed on a major stock exchange or for which there is an assured market. These loans are particularly flexible in that they may be used for any valid business purpose. Banks will require that the current market value of the securities exceed the loan by a margin which is determined by the type of security, general bank policy, and business conditions. These margins may range from 5 to 10% on short term government securities, to 50% on unlisted or speculative securities.

Accounts receivable are occasionally accepted as security for short-term commercial loans, but usually only when no other collateral is available. Banks would prefer to loan on the general credit of the borrower, in which his accounts receivable are given due consideration. Accounts receivable financing is usually done either by a sales finance company or a factor. Factors purchase accounts receivable outright, usually without recourse. The customer is informed that his account has been sold by the company to a factor, and the company is told when an account has been collected. Companies wishing to avoid having their customers know that their accounts have been sold may borrow money against a pledge of accounts as security. In this case, the customer is not informed that his account has been pledged. Loans made in this fashion usually range between 70% and 90% of the face value of the accounts, depending on their quality and age. Accounts receivable are not usually used

as a source of financing by large industrial firms with good credit standings. Because of the administrative costs incurred by the lender or purchaser of the accounts, the cost of this kind of borrowing is relatively high. Most industrial firms sell to wholesalers who pay in a very short period of time.

Inventories and goods in transit may be pledged as security in several ways. This kind of financing is especially important in international trade. Documentary letters of credit take many forms, depending on the type of security offered. Order bills of lading (as opposed to straight bills of lading, which are non-negotiable) are used as collateral, since this document is required at the point of destination to take possession of the goods. The bank releases the bill of lading to the recipient when all the conditions of the letter of credit and/or sales contract have been met. Trust receipts, by which the bank is given title to goods which are then given to the borrower on the condition he keep them in saleable form until conditions of payment have been met, have been found to be legally weak as collateral; and banks now prefer warehouse receipts issued by bonded warehouses which acknowledge receipt of goods and set forth the conditions under which they will be released.

In addition to financing goods in transit or in storage, banks will lend money against certain kinds of merchandise and commodities held in the company's inventory. To be useful as collateral, the goods must have standardization of grading and quality control, durability, marketability, and stability of demand. The bank may also want to protect itself against adverse price fluctuations by requiring the borrower to hedge his holdings by dealing in futures on a commodity exchange (buying and selling goods for delivery at a future date). Grains and certain metals have proved to be excellent security on a loan because they can be effectively hedged, and because they meet the above tests.

Banks occasionally make short-term commercial loans secured by real estate or other fixed assets, but, as with accounts receivable, usually only as a last resort. The costs involved in tax and title searches, execution of instruments, recording, appraisal, and insurance make this an expensive and difficult way to borrow. Real estate is more commonly used as collateral on medium and long term financing where the expense and time involved is justified.[7]

Most working capital loans are unsecured, but this usually requires an intimate and long-standing relationship with the bank, or an unquestioned capacity to repay. Since it does not involve the technical and legal arrangements and administrative problems of secured loans, unsecured borrowing is usually the least expensive source of short term capital.

In the United States, most manufacturers sell on open account, and when they borrow it is directly from the bank on their own promissory note. In other countries, however, drafts are more common, whereby the manufacturer sends along with his shipment a draft ordering the buyer to pay him under stipulated conditions. The buyer "accepts" or endorses the obligation and returns it to the manufacturer. When the manufacturer borrows from the bank, it is by selling his draft to the bank at a discount which is equal to the bank's interest charges and any fees charged. These drafts are known as trade acceptances.

Banker's acceptances are an excellent form of borrowing for customers with excellent credit standing. Banker's acceptances are drafts drawn on banks by manufacturers or merchants, ordering the bank to pay a specified sum on a future date. If the bank is sure the funds will be forthcoming from the company on that date, it endorses the draft by stamping it "accepted." It then becomes an unconditional obligation of the bank. Since the bank's credit standing is irreproachable, these acceptances can be sold on the open market at a very good rate. If the bank sells the acceptance immediately, it has

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7 See Part III, pp. 17-18.

not extended any of its own funds, but has substituted its credit standing for that of the company. For this service the bank charges a fee of about 1½% per year.[8] (or, 3/8 of 1% on a 90 day draft, etc.) Acceptances may be secured by having bills of lading or warehouse receipts attached, giving title to marketable goods.

Banker's acceptances are particularly useful in foreign trade, due to a manufacturer's lack of intimate knowledge of or easy recourse to its overseas customers.

When, in a bank's judgement, an application for credit does not otherwise fully meet its requirements, it may be possible to extend the credit if the borrowing can be guaranteed either by the principals personally, or by a third party of unquestioned ability to pay. Guarantees of other banks and of governmental agencies set up for this purpose are particularly desired by banks.

Established customers of a bank may request or be offered a line of credit if the company expects to borrow seasonally or over a period of time.[9] This eases the bank's job of analyzing loans, since the bank can do an annual analysis of the company without needing a full-blown analysis every time part of the line is taken down. They also help the company in its own financial planning. Lines of credit are, however, only declarations of intent and do not obligate the bank. They may be cancelled or modified at any time. In fact, the bank usually reviews its line at least once a year, based on periodic financial reporting from the company.

Lines of credit are frequently opened for large corporate customers who frequently borrow above the limits of the bank officer's credit authority. The bank's Board of Directors authorizes the line, and then the bank officer can

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[8] A 90-day draft with a face value of $10,000 might be computed as follows: $10,000 less 3/8% fee, less the going rate, 4½% per year, for bankers' acceptances equals $9,887.12½, net proceeds to the beneficiary of the draft.

[9] Ordinary borrowing, not done under an established line of credit is said to be on an "offering basis."

authorize individual loans under the line without further reference to the Board of Directors.

Lines of credit are quite specific about the amounts of specific kinds of credit the bank will advance. Thus, a bank might establish a line of $1 million for documentary letters of credit up to 90 days, $250,000 for unsecured credit, and $500,000 for loans secured by marketable securities. In addition to interest on loans (and fees or commissions on letters of credit), a bank may require, especially when money is tight, compensating balances of, typically, 20% of the amount of the line, or of the amount outstanding.

As with all kinds of short-term commercial lending, banks try to have their credit-line customers "off the books" for at least a short time every year.

It should be emphasized that banks want to be repaid out of ordinary funds generated from operations. They do not require security with the expectation that they may have to take possession of the collateral. The administrative costs involved in collecting on collateral, or in suing for an unsecured loan would make such a loan unprofitable. Companies have a higher value as "going concerns" that they do in liquidation. But, more importantly, banks feel they have an important obligation to both the company and the community to see that their loaning function is a service to the company, not a potential cause of embarrassment. What in the long run is good for the company is also good for the bank. And banks perform a service by providing the company with an independent analysis of it's projected generation of funds.

III BANKS AS A SOURCE OF FIXED ASSET AND LONG TERM LOANS[10]

Fixed or capital assets are those which are acquired for use rather than resale. A typical example is that of a truck, which is part of the inventory, and therefore a current asset, of a manufacturer of trucks; but which is part of fixed equipment for a trucking firm which transports goods, and therefore a capital asset. Also classified as fixed assets are patents and copyrights, natural resources (but not the timber, ore, or oil which has been harvested from them), and permanent investments in affiliated or subsidiary companies (including the stocks and bonds held and funds invested in these companies).

An important financial distinction between current and fixed assets is that the former are valued at their resale or conversion value. The banker is concerned with the cash that will be generated by their sale. Fixed assets, however, are valued at their historical cost less depreciation, since they will not, in the ordinary course of events, be sold. They are important to the financial manager or banker, not because of their resale value, but because of their capacity to generate profits from their use. Fixed assets generate earnings either by increasing profitable sales or by decreasing the costs of existing sales (in the first case, an addition to plant; in the second case, an improvement in plant). The degree to which they may be depended on to increase earnings determines whether or not they are a sound investment for management or for a lender who is advancing money for their acquisition.

Since the fixed assets will usually be held for longer periods of time, and since the benefits accruing from their use will be distributed over time,

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[10] Short term loans almost always refer to loans of a year or less. There is no standard terminology to distinguish intermediate from long term loans; sometimes the former are taken to be loans of from one year to ten years, and the latter loans of over ten years. For our purposes, long term or term loans will be taken to include all loans over one year in maturity.

these assets are financed differently than current assets. The primary source for the acquisition of fixed assets is, of course, the funds that the owners put into the business. Large companies traditionally have secured long- term funds through the issue of stocks or bonds, or through private placements. In recent years, however, due to the taxable status of dividends and the high costs of these methods of securing funds, companies have turned to banks. Banks are often a better source when the amount needed is not large enough to justify the costs of other methods of financing, or because the company expects to be able to pay off the obligation too soon to justify obtaining the funds from truly long term sources such as bonds or insurance company lending.

Term loans can be evenly amortized, or can be arranged with a "balloon payment" at the end. An example of this latter arrangement is as follows: A company borrows $200,000 on a five year loan. It makes payments of $25,000 each year for four years. At the end of the fifth year, the balance of $100,000 comes due. This can then be refinanced at the bank or elsewhere with a new loan.

Term loans can be used, for almost any valid purpose: (1) to purchase fixed assets; (2) to refinance existing debt (e.g. to retire a bond issue to reduce interest charges; to rearrange the maturities of existing debt; to eliminate restrictive provisions on existing debt if warranted; or to retire preferred stock); (3) to revamp the company's capital structure, or (4) to replenish or increase "permanent" working capital. Most term loans are unsecured.

Years ago banks did not make term loans. Now, if we are to include certain revolving credits written for more than a year, term loans constitute at least half of all commercial loans by New York City banks.[11] Country banks make

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[11] Federal Reserve Bank of New York, "Term Lending by New York City Banks," in *Monthly Review*, XLIII (February, 1961), 27-31; and, William F. Treiber, "Recent Trends in Commercial Bank Lending and Borrowing," in *ibid.*, IIL (February, 1966) 29.

fewer term loans, but they frequently are heavily into 90 day renewable notes which, in effect, are term loans.

In making a term loan, banks like to protect themselves as much as possible against avoidable changes in a company's position and situation which might adversely affect the soundness of the credit extended. Closely-held, smaller companies often show minimum profits for tax purposes, while paying out large sums to the principal stockholders in salaries. Many of these companies have only a nominal net worth ("capital and surplus"), real equity capital coming in the form of loans to the company from the principals on wh ch interest is paid (interest is deductible for the company's tax return, whereas dividends are not). In this case the bank will require that debt to stockholders be formally subordinated to the bank's debt, and the personal guarantees of the principals (and their wives) may be required as additional protection. When the bank is relying especially on the quality of management or key personnel, it may require life insurance on the principals.

The bank may set minimum working capital or current asset positions below which the company may not fall without having the loan become immediately due and payable. The company may be required to increase its insurance on plant and equipment. It may be required to promise not to merge, consolidate, sell out, or invest in other corporations without first obtaining the bank s permission. Its ability to contract for additional short or long term debt may be contractually restricted, unless the bank's permission is obtained. The bank may set maximum salary and dividend levels. It may require that dividends or working capital above a certain level be applied to the loan to accelerate payment (usually reducing the last maturities first).

All of these restrictions, however, may be revised if there is a demonstrable and reasonable reason for doing so. Banks are aware that conditions change, and, generally, what is good for the company's long term prospects is also good for the bank. It is not, therefore, at all uncommon for banks to waive

or modify provisions of loan agreements during the course of the loan, as long as its own interests are being protected.

Since term loans involve a bank much more intimately with the future of the business and its management, term loan agreements are usually quite complex, and are agreed upon only after extensive study of economic, financial, legal, accounting, and operational details.[12] The company should be aware that there are minimum levels below which it is not profitable for a bank to incur the investigative expenses associated with term loans. Banks will vary, of course, but a lower limit of $100,000 for term loans is typical. It is possible, however, to borrow as little as $10,000 for a small-business term loan which is paid on a monthly installment basis. (This usually raises the effective cost of borrowing, however.) For regular term loans of over $100,000, the principal is paid back quarterly, annually, or in a lump sum at the end of the term. It is a cliche in banks to say that "the smaller the loan, the harder it is to make." This is due partly to the smaller return on the time spent investigating the loan, but more importantly, it is the smaller, less well-known companies that borrow small amounts. Thus, it is often easier and quicker to lend several millions of dollars to an industrial giant with tremendous resources than it is to lend a thousand dollars to the corner grocer. The disadvantages of small size can, however, often be mitigated by obtaining a suitable guarantee from the principals or a third party.[13]

On large projects running into the tens or hundreds of millions of dollars, it is common to work out a financing package (called a participation) with more than one bank or with banks and other institutional lenders, typically a bank or group of banks and an insurance company. Banks prefer shorter maturities

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[12] Author, "The Submission of Manufacturing Data to Commercial Banks"

[13] Cf. page 10 above.

with the possibility of accelerated payments from profits or working capital above a certain agreed upon level. Insurance companies, on the other hand, prefer longer maturities and dislike being prepaid. Prepayments on insurance company loans usually involve penalty charges. For large, long term financing needs, therefore, it is common to find these two complementary kinds of institutions working together, the banks taking the early maturities (e. g. up to seven years) and the insurance companies taking the later ones. Needless to say, the complexities of these arrangements require excellent legal, accounting, and financial management.[14]

The cost of term loans varies with several factors, including the bank's judgement of its risk. As with lines of credit, the bank may require compensating balances. If this truly immobilizes funds that would otherwise not be in banks, it should be calculated as one of the costs. It is not uncommon, especially on loans of longer terms, to tie the interest rate to the prime rate, sometimes also with a floor and a ceiling. Thus the rate in the loan agreements might read ½ of 1% above the prime rate (or 1.005 times the prime rate) not to exceed or fall below the present prime rate by more than 1%.

We earlier pointed out that banks look to earnings over a period of years as a source of repayment on term loans for the acquisition of capital assets. This needs to be modified somewhat. One reads that expansion is commonly financed from earnings plus depreciation and other capital consumption allowances. The only point to be made here is that increasing a company's depreciation allowances on its financial statements does not magically produce more funds with which to expand or pay off term loans. Increasing depreciation allowances will reduce reported earnings by exactly the same amount, and so the net effect

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[14] A typical term loan agreement can be found in K. K. White, Financing Company Expansion, New York: American Management Association, (A. M. A. Research Study # 64), 1964; Appendix A, "A Sample Term Loan Agreement," pp.113-120.

on funds of a change in depreciation allowances for any given year is zero.[15] The point is that the crucial factor is the flow of funds or changes in net working capital (especially cash). Depreciation is the major non-cash deduction from revenue in arriving at earnings. Therefore, to arrive at the net funds available for loan repayment, one adds back into the income of the firm amounts deducted for depreciation.

Real estate financing effected through mortgage loans is the primary business of savings and thrift institutions.[16] But about 25% of commercial banks' loans have been real estate loans. Of this 25%, one-third is for commercial and industrial real estate loans, the balance being for residential house mortgates. Construction loans amount to less than 5% of banks' loans. Nationally chartered commercial banks and state chartered banks in some states may make mortgage loans secured by first loans on improved real estate up to 75% of the appraised value for loans that do not exceed 20 years and when the principal is fully amortized during the term of the loan. A loan that does not provide for principal reduction during the course of the loan (i.e. the full amount of the principal comes due at the end of the term) may not be for more than 50% of the appraised value, nor run for more than 5 years.[17]

These Banks may also lend to finance construction of commercial or industrial properties. Such loans may not exceed 18 months, and arrangements must be made to refinance the construction loan with a regular mortgage upon the completion of the construction. All such loans rest primarily on the appraised value and marketability of the real estate being financed, and, as always, on the reputation of the company concerned.

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[15] A distinction must be made between public or internal financial reporting and tax reporting. If a company changes its depreciation allowance on its tax reports, this may change its taxible income, and therefore its taxes. Laws vary from country to country. In any case, changing depreciation charges has no effect on income before taxes.

[16] For a discussion of real estate financing, see S.A. Kahn, F.E. Case, and A. Schimmel, Real Estate Appraisal and Investment, New York: The Ronald Press Company, 1963.

Revolving credits are often employed to finance a large expansion of working capital, and less often to provide interim financing during plant construction. After the expansion is complete, the credit is paid off either by an increase in equity capital through the issue of stocks on bonds, or by converting the outstanding amount to a regular, fixed-amount term loan repayable over a number of years. Revolving credits are, in effect, lines of credit for a period beyond one year. The borrower may take down the funds as he needs them over a specified period of time, and may repay and reborrow during the life of the credit. In addition to interest charges on the outstanding balance, the bank charges a small commitment fee for the unused portion. The advantage of the revolving credit is that the borrower can adjust the credit in accordance with need (although the agreement places some limitations on the minimum amount of any one note).

The revolving credit usually takes the form of 90 day notes which the bank automatically renews unless there have been significant changes in the company's plans or prospects.

Construction loans, however, are usually of a special type in which funds are lent based on a complicated formula which expresses the appraised value of the properties at various stages of completion.

A new and interesting form of financing the acquisition of equipment, plant, or land is the sale and leaseback. Insurance companies are more involved in this type of financing than banks, but banks have been developing their sale and leaseback programs in the last few years. Under this arrangement, the bank (in the name of a nominal trustee) purchases the assets and leases them under contract to the company. This is not done only to acquire new assets, but has a particular advantage as a way of acquiring cash for a company which has fully

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[17] Federal Reserve Act, rev. 38 Stat. 826, 24 (U. S. C., Title 12).

depreciated (for tax purposes) older assets. The company sells the assets to the bank and can then deduct their rental for income tax purposes. But the wisdom of this policy requires careful expert analysis.

Sale and leaseback is not, it should be emphasized, a way to shift the risk of ownership onto a bank. Banks are not suppliers of venture capital on the same footing with stockholders. A bank will require that the contract for the leaseback fully protect it from losses due to obsolesence or changes in the company's operations. The lease becomes a fixed obligation of the company, regardless of how or whether it uses the assets.

There remains to be discussed the special para-bank services performed by Edge Act Corporations. These are subsidiaries of U.S. commercial banks authorized under Section 25 (a) of the Federal Reserve Act, as revised in 1957 in Regulation K. These companies invest in equity, grant loans abroad, and provide other international services which their parent banks either can not by law, or would not as a matter of bank policy, provide in their normal banking departments. In practice, it is not the law (which is very broad) on the subject, but bank policy which confines the activities of Edge Act Corporations, since banks tailor these activities to supplement their normal business, to bring in new business for the bank, and to satisfy the requests of established customers. A discussion of the potential range of Edge Act services does not, therefore, serve any useful purpose, since few of these services are actually being offered.

Since each of these subsidiaries are tailored to the needs and policies of the parent banks, generalization is difficult. Edge Act Corporations tend to specialize to a certain degree in certain types of investments, and each has excluded certain types of investments from the list of projects it will consider. In general, however, an Edge Act Corporation will perform one or more of the

following services:

"(1) finance contracts, projects, or activities performed abroad, the importation into or exportation from the US of goods, the delivery through domestic transport facilities of goods so imported or their assembly or packaging for resale without essential change therein, if the Corporation financed the importation, and the domestic shipment or temporary storage (but not production) of goods being exported or accummulated for export, if the Corporation is financing their exportation;

"(2) take over or acquire obligations, growing out of transactions it could have financed at inception;

"(3) guarantee customers' debts or otherwise agree for their benefit to make payments if the guarantee is related to a type of transaction described in (1) above;

"(4) buy and sell spot and future foreign exchange;

"(5) receive checks, bills, drafts, acceptances, notes, bonds, coupons, and other securities for collection abroad, and collect such instruments in the US for customers abroad;

"(6) hold securities in safekeeping for, or buy and sell securities upon the order of, customers abroad; and

"(7) acquire and hold <u>without prior approval</u> of the Federal Reserve Board shares of corporations organized under foreign law if such acquisition (a) is incidental to an extension of credit by the Corporation to the corporation whose shares are acquired, (b) consists of shares in a foreign bank, or (c) is otherwise likely to further the development of US foreign commerce; but no acquisition may cause a Corporation to hold 25% or more of the voting shares of a foreign bank and the aggregate amount invested in the shares of any other corporation may not exceed $200,000 or its equivalent. (Equity acquisition in excess of these limits requires prior approval.)"[18]

Most Edge Act Corporation transactions are term loans with a typical maturity of seven years and a fixed interest rate supplemented by equity or equity-type rewards such as convertible debentures, direct equity investment, stock bonuses, rights or options to purchase stock, and contingent interest.

Any project submitted to an Edge Act Corporation should be responsibly planned and backed and supported by complete marketing, financial, economic, legal, engineering, and accounting studies. One project financed in part by an Edge Act Corporation was a textile mill costing about $6 million. Of this, the Edge Act's portion was $2.5 million in loans and stock. The rest was financed by local entrepeneurs, a government sponsored development bank,

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[18] Business International, <u>Financing Foreign Operations</u>, New York: Author, 1964, p. 15.

and a European technical partner. Edge Act Corporations place a high value in having competant technical partners from developed nations.

Edge Act Corporations are limited in their experience in particular industries and particular countries. Because of their self-imposed limitations in certain areas, and because of the multitude of sources of financing, before a project is submitted for evaluation, a preliminary survey of several of these sources should be made to determine their activities and abilities in a particular country or industry. Not only do individual Edge Acts choose to stay out of certain countries because of their evaluation of the risks, but they also avoid having too heavy a percentage of their investments in any one country or industry. Thus, the ideal Corporation is one which has had significant activity in a particular area, but which has not reached its limit of what it considered to be over-commitment to this area.

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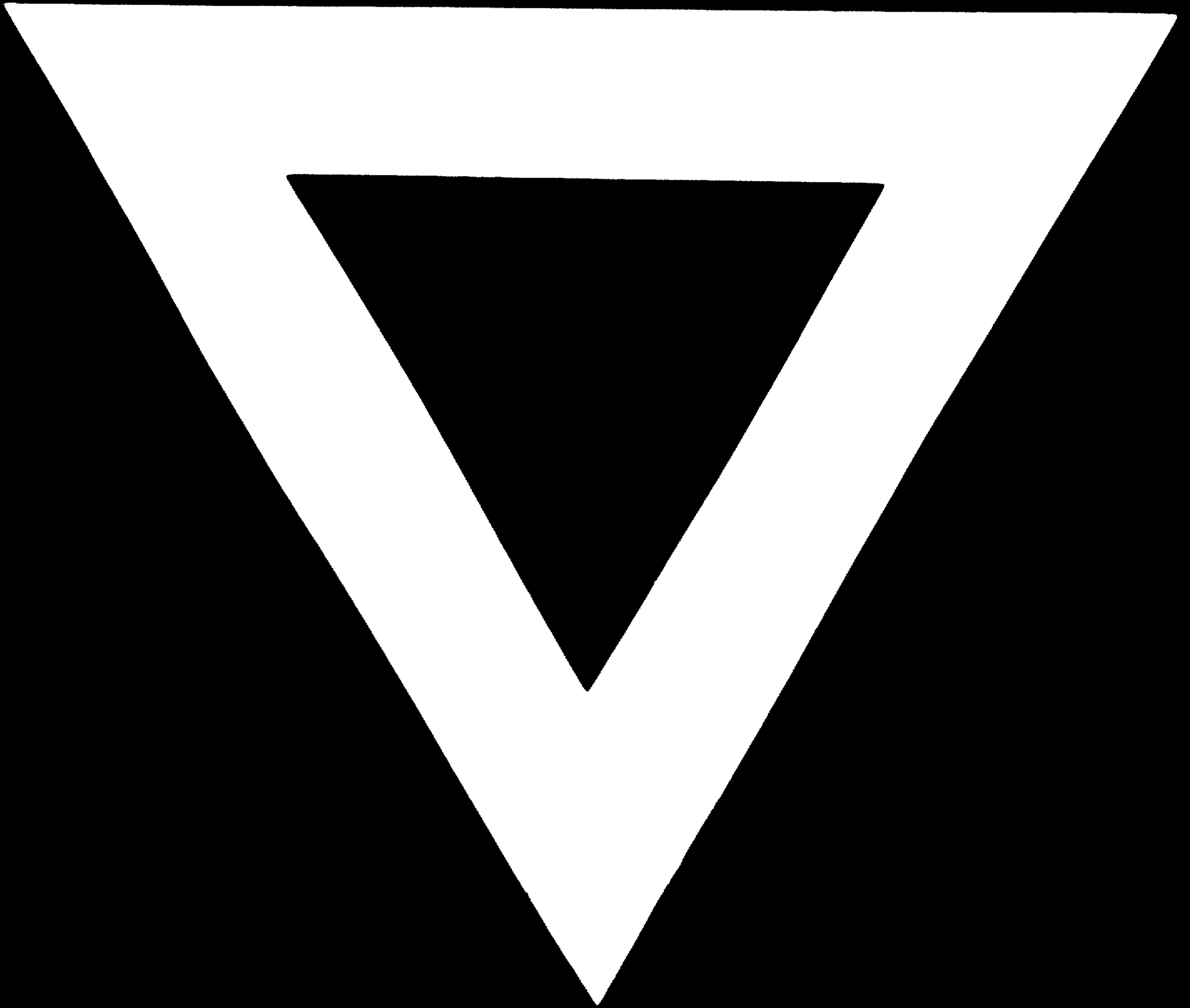

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