

## Edge Act and Agreement Corporations in International Banking and Finance\*

With the steady rise in international trade and investment, United States banks have been expanding their foreign activities. As a consequence, there has been considerable growth in the international departments of United States banks, and the banks have also made increased use of additional possibilities for doing business abroad. Among these possibilities are the so-called Edge Act and Agreement corporations. By now, twenty-three banks and bank holding companies operate a total of thirty-six such subsidiaries.

Edge Act and Agreement corporations are United States corporations carrying out international banking and financing operations, some of which—notably equity investment abroad—the parent banks themselves are not permitted to undertake under existing laws and regulations. The corporations' actual functions range from acting as holding companies to rendering a wide variety of international banking services; and they include also the financing—through term loans and equity participations—of industrial and financial projects in both developed and underdeveloped countries. Furthermore, under strictly prescribed conditions and incidental to their main purpose, the corporations do a limited business in the United States.

### BACKGROUND<sup>1</sup>

The origins of Edge Act and Agreement corporations go back almost half a century—to a time when a broader scope for private American financial activity abroad appeared de-

sirable. In 1916, section 25 of the Federal Reserve Act was amended so that any national bank with a capital and surplus of \$1 million or more was authorized to invest, singly or jointly, up to 10 per cent of its capital and surplus in a corporation chartered under Federal or state law to conduct "international or foreign banking" activities. Each corporation was required to "enter into an agreement" with the Board of Governors of the Federal Reserve System as to the type of activities it would undertake and the manner in which it would conduct its operations. The wording of this provision gave rise to the name Agreement corporation.<sup>2</sup>

As an additional inducement to the expansion of the foreign business of the United States, Congress passed a law in December 1919 (sponsored by Senator Walter E. Edge of New Jersey). This act added section 25(a) to the Federal Reserve Act, a section that authorized the Board of Governors to charter corporations "for the purpose of engaging in international or foreign banking or other international or foreign financial operations . . . either directly or through the agency, ownership, or control of local institutions in foreign countries". The stock of these corporations, which have come to be called Edge Act corporations, is also eligible for bank ownership. The corporations must be capitalized at a minimum of \$2 million.

The activities of Edge Act corporations are thus governed by the Federal Reserve Act, and by the related Regulation K of the Board of Governors which was first issued in 1920 and has since been periodically revised. The primary purpose of the latest revision, effective September 1, 1963, was to enable Edge Act corporations to operate more effectively in financing international trade and commerce.<sup>3</sup>

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<sup>1</sup> For a fuller description, see F. M. Tamagna and P. B. Willis, "United States Banking Organization Abroad", *Federal Reserve Bulletin*, December 1956, pp. 1284-99; Richard A. Wiley, "Edge Act Corporations—Catalysts for International Trade and Investment", *The Business Lawyer*, XVI, July 1961, pp. 1014-29; and T. M. Farley, *The "Edge Act" and United States International Banking and Finance* (mimeographed) New York: Brown Brothers Harriman & Co., May 1962.

<sup>2</sup> Since the Banking Act of 1933, these provisions have been applicable to state member banks of the System as well; and both national and state member banks have, or have had, such corporations. All Agreement corporations have been state chartered.

<sup>3</sup> An authoritative description of the major changes may be found in a Board of Governors press release dated August 23, 1963.

NUMBER OF EDGE ACT AND AGREEMENT CORPORATIONS\*  
1956-64

End of year	Edge Act corporations	Agreement corporations	Total
1956	3	4	7
1957	4	3	7
1958	5	3	8
1959	6	3	9
1960	10	5	15
1961	11	5	16
1962	22	4	26
1963	30	5	35
1964 (March)	31	5	36

\*Numbers exclude corporations organized but not yet open for business on dates given. There were two such corporations at the end of 1963 and one at the end of March 1964.

After a short period of moderate operations during roughly the first decade following World War I, Edge Act and Agreement corporations were relatively inactive until the midfifties, although there were a few significant exceptions. Since the late fifties, on the other hand, their number has grown markedly. As shown in the accompanying table, most of this recent growth has been in Edge Act rather than in Agreement corporations.

#### PRESENT USES AND FUNCTIONS

The uses and functions of Edge Act and Agreement corporations are influenced by two main factors—the scope granted by laws and regulations and the needs of their parent banks. Between January 1957 and September 1963, an Edge Act corporation was required by Regulation K to operate either as a “banking corporation” or as a “financing corporation”. While the activities of the two types of corporations could overlap to a modest extent, banking corporations had a much wider range of banking powers than did financing corporations. In particular, they could accept deposits, which financing corporations could not do. On the other hand, the equity investments of banking corporations were limited to the stock of corporations engaged in banking or closely related activities. Financing corporations—which operated solely on the basis of parent bank funds plus retained earnings—were empowered to invest in foreign concerns not engaged in banking (and only in these).

The latest revision of Regulation K eliminates the formal distinction between the two types of corporations and considerably modifies the substantive distinctions. A United

States bank thus has now more freedom to have *one* Edge Act subsidiary engage in both banking and financing operations. Nevertheless, there are still certain restrictions. For example, a distinction is drawn in the present regulation on the basis of whether or not a corporation is “engaged in banking” (i.e., has aggregate demand deposits and acceptance liabilities exceeding its capital and surplus). If it is, the corporation’s commitments to any one person are not permitted to exceed 10 per cent of its capital and surplus, whereas the limitation is 50 per cent if the corporation is not “engaged in banking”. For reasons such as this, and because of the recent date of the latest change in the regulation, the corporations’ activities still tend to reflect the prior distinctions. Thus, of the total of thirty-one Edge Act corporations active as of March 31, 1964 (as shown in the table), fourteen would previously have been considered banking corporations and seventeen financing corporations. This background, together with the availability of the Agreement corporation device, accounts for the fact that a number of banks have several subsidiaries. (Agreement corporations are limited to the powers exercised by Edge Act corporations engaged in banking.)

In terms of a rough distinction between the former banking and the former financing corporations, those active in banking either do a variety of business typical of that of the international department of a commercial bank or function as holding companies for equity investments in foreign banks. In some cases, they fulfill both functions. The former financing corporations have tended to operate in a different area, with investments in the stock of nonbank financial concerns, development corporations, or commercial and industrial firms.

Edge Act corporations have, for example, enabled banks with head offices outside New York City to operate in that key location for foreign banking operations (since an Edge Act corporation does not have to be established in the same city as the owning institution). Such a corporation may, for instance, hold demand and time (but not savings) deposits of foreign parties; issue or confirm letters of credit; finance foreign trade by extending loans and advances, by creating bankers’ acceptances, or by making other credit facilities available; receive items for collection and offer other services to customers, such as remitting funds abroad, purchasing and selling securities, or holding securities for safekeeping; issue certain guarantees; act as paying agent for securities issued by foreign governments and certain foreign corporations; and engage in both spot and forward foreign exchange transactions.

In their capacity as holding companies, Edge Act corporations can own the stocks of foreign banking subsidiaries and affiliates (which member banks cannot own

directly). This fact accounts for the existence of a number of Edge Act corporations (and of several Agreement corporations, which can serve the same purpose). A foreign banking subsidiary may be more advantageous than a branch, or it may actually be a necessity for doing business in a given country. Certain countries—e.g., the Union of South Africa—prohibit nondomestic banks from opening branches in their territory. A United States bank wishing to operate in such a country can do so by establishing a subsidiary, the stock of which would, however, have to be held through an Edge Act or Agreement corporation. In other instances—Brazil, Italy, and Liberia—such corporations have been the channel through which United States banks have acquired an interest in well-known foreign banks.<sup>4</sup>

Edge Act corporations have also been the instrument through which, as previously noted, United States banks have acquired equity interests in foreign nonbanking concerns.<sup>5</sup> Such investments, to be sure, are subject to prior specific consent of the Board of Governors under certain circumstances—as is the acquisition of stock in foreign banks.<sup>6</sup> Furthermore, such equity investments are only a fraction of the total assets of all Edge Act corporations, albeit a significant one of those formerly considered financing corporations. At any rate, equity investments in nonbanking concerns, and the combination of loans and equity acquisitions in “packages”, give the activities of a number of Edge Act corporations a distinct characteristic, well worth exploring in some detail. The remainder of this article is therefore devoted primarily to the portfolio management of Edge Act corporations in those cases in which they go beyond short-term commercial banking and holding com-

pany functions. (This covers mainly the former financing corporations but also includes a number of the former banking corporations. Agreement corporations are at present mainly used as holding companies for foreign subsidiaries and affiliates.)

#### FINANCING THROUGH EDGE ACT CORPORATIONS

**RECIPIENTS OF FINANCING.** Two broad classes of non-bank borrowers from Edge Act corporations may be distinguished—specialized foreign financial institutions, and commercial and industrial firms. As regards foreign financial intermediaries, Edge Act corporations have in numerous instances helped in the financing of foreign official or semiofficial development corporations through purchases of shares. These institutions, as the Edge Act corporations often do themselves, help finance slowly maturing enterprises in their early stages. By channeling funds to development institutions, an Edge Act corporation can avoid the detailed studies and investigations that might render small investments unprofitable. Edge Act corporations have also participated in foreign finance companies. Such companies may, for instance, be engaged in the financing of private purchases of consumer durable goods, including some manufactured in the United States. In a few cases, the portfolios of Edge Act corporations also include investments in the stock of foreign securities underwriters.

In most instances, however, Edge Act corporations finance foreign commercial and industrial borrowers directly through loans and equity participations. While such financings do not normally involve the acquisition of control, the Edge Act corporation is seldom a passive partner. The primary purpose typically is to supply capital to promising foreign enterprises at an early or other important stage. Thus, the Edge Act corporation may be dealing with a newly launched business or with a firm planning, or engaged in, a major expansion, modernization, or reorganization. Negotiating and carrying through such ventures call for ingenuity and enterprise.

**INDUSTRIAL AND GEOGRAPHICAL DISTRIBUTION.** The loans and equity investments of Edge Act corporations cover a broad spectrum—manufacturing, mining, and service industries; and, while the financing of public utilities is rare, there is one instance of a gas pipeline interest of an Edge Act corporation. Manufacturing industries are perhaps the most frequent borrowers, but a certain specialization within that broad category can be detected. Thus, Edge Act corporation financing, at least in the less developed countries, is often directed toward manufacturing enterprises that process a country's resources of pri-

<sup>4</sup> Edge Act corporations themselves may also establish branches or agencies abroad, although prior approval of the Board of Governors is required for the establishment of the first branch or agency in a particular foreign country.

<sup>5</sup> Since September 1963, of course, all Edge Act corporations have been permitted to hold both banking and nonbanking equity investments.

<sup>6</sup> Specific consent is *not* required when the stock acquisition (a) is incidental to an extension of credit to the foreign corporation (in making loans to foreign enterprises, Edge Act corporations frequently acquire an equity participation); (b) consists of shares in a foreign bank, but does not bring the Edge Act corporation's holdings of the voting stock of the foreign bank to or above 25 per cent; or (c) is “likely to further the development of United States foreign commerce”, provided the purchase of the stock of any one foreign corporation does not exceed \$200,000.

It should also be noted that Edge Act corporations, like all United States investors, would of course be subject to the proposed interest equalization tax on purchases of securities issued by foreign borrowers in developed countries. (This tax, proposed by the Administration in July 1963, has been passed in the House of Representatives but is still to be considered by the Senate.)

mary materials—concrete products from cement, chemicals based on oil, paper mills, cotton textile mills, and even steel mills where there is coal and iron ore.

Edge Act corporations appear to have no particular preference with regard to the geographical distribution of their portfolios. They will, of course, be deterred from financing in countries considered politically unstable, or those in which attitudes and policies are inimical to foreign investment. Apart from such obvious considerations, however, the location of loans and investments appears to be chosen only on the basis of business criteria. In terms of the value of equity investments alone, the portfolios of Edge Act and Agreement corporations at present appear to be distributed roughly as follows: Europe, about 40 per cent; Latin America, approximately 20 per cent; Canada, almost 20 per cent; Africa, about 10 per cent. The Far East accounts for almost one half of the remainder.

**INITIATING AN OPERATION.** Financing decisions of Edge Act corporations call for special skills in appraising not only technical matters but also the "human element" in the foreign business and political environment. Since in many cases it would be difficult—for lack of a market—to pull out should the project not be giving satisfactory results, the initial investigation and evaluation must be thorough.

The project is almost invariably initiated abroad, with the foreign concern in need of capital making contact with the Edge Act corporation or—more frequently—its parent bank. The initial proposal usually contains a fairly detailed description of the project, supported by documentation. Further data may be requested from the foreign party as the Edge Act corporation begins to look more closely into the proposal, and the officers of the Edge Act corporation or the parent bank may go abroad for personal study and negotiation. On the strictly technical side, the degree of reliance on the studies of the foreign applicant may be heavy in the case of well-established foreign firms.

The investor, as already suggested, will wish to find out a good deal about the foreign company's financial structure, management and organization, indebtedness, past history, the market outlook for its products, and its competitive position. This may well lead into studies of the host country's economy, growth, and policies, which in turn may necessitate some study of international trade and finance as they affect that country. All of these efforts are designed, of course, to add up to an informed appraisal of risks and earning prospects, which in turn becomes the basis for a firm decision.

*Size of financing.* Once the soundness and potential profitability of the project have been established, a deci-

sion is required on the size and type of a commitment and on possible partnership arrangements. The decision will vary not only from one project to the next, but also according to the role of the Edge Act corporation within the banking organization to which it belongs. On the whole, the minimum size of an individual financing that might interest an Edge Act corporation is smaller if the parent bank has a large network of foreign branches and representatives. For a bank without local representation, the costs of study and evaluation can be high and therefore worthwhile only for a relatively large potential financing. As regards the maximum size of an individual operation, one limitation—previously noted—is that an Edge Act corporation's commitments to any one party cannot exceed 50 per cent of its capital and surplus (10 per cent if engaged in banking). The size of such capital and surplus in turn reflects parent bank policy.

Most Edge Act corporations probably will not normally consider requests involving less than \$100,000, and some even place the preferred lower limit as high as \$1 million. But actual commitments have occasionally fallen well below these minimum levels, and they frequently range upward into several millions.

*Period of financing.* Edge Act corporations tend to extend loans over a broad range of short and intermediate maturities. As to equity investments, the corporations usually seek to disengage themselves within five to ten years. The size of an Edge Act corporation is a factor in the maturity structure of its portfolio. Most such corporations naturally consider their capital as a revolving fund—new investments being made with the proceeds of the liquidation of previous ones. The larger corporations tend to make somewhat longer loans than the smaller ones, because their more numerous and bigger commitments generate larger return flows from which frequent new financings can be undertaken. Smaller corporations prefer to restrict their time horizon to shorter periods in order to avoid situations in which they might be out of the new-project business—unless, of course, the parent bank injects new capital.

In liquidating equity holdings, Edge Act corporations frequently avail themselves of prenegotiated resale agreements (discussed below). In some instances, the foreign partners make efforts to develop a local market for such securities.

*Remuneration.* The negotiation of the amount and form of its remuneration tends to be an intricate operation for an Edge Act corporation, since the circumstances of individual financings tend to differ widely. Equity participations frequently are a method of compensating for risks exceeding those ordinarily taken on loans. (Sometimes an

Edge Act corporation makes an equity investment while the parent bank grants a loan.) When both a loan and an equity investment are involved, the potential returns from the financing will typically be appraised as a whole rather than separately. For example, relatively low interest on the loan portion can be offset to some extent by a higher equity interest for the Edge Act corporation. Besides the possible dividend income, the equity portion of the investment may, of course, result in a capital gain—often a very important consideration. Should no present or foreseeable market for the shares exist—as is true in many instances—the Edge Act corporation may enter into an agreement with the firm's local shareholders for the sale at predetermined future dates of its holdings to them. The sale price is determined according to any of a number of formulas, which usually contain a provision for ascending values of the shares.

The Edge Act corporation often receives some additional shares or cash as a bonus to compensate it for the efforts expended in bringing together various partners—including technical assistance and third-party capital—in an enterprise it helps to finance. The work done in initiating and negotiating such partnerships frequently entails the devising of an intricate financial structure.

*Associates in financing.* Most Edge Act corporations consider local partnership of the highest importance and often believe it advisable that the local partners hold majority control. Technical management, on the other hand, is frequently supplied from abroad.

With the exception of investments in subsidiaries, Edge Act corporations are unlikely to be the sole or principal capital-supplying partner in large projects. Other private United States or foreign investors, as well as United States or international government lending agencies, are frequent participants. Such mixed investments are often made in conjunction with the International Finance Corporation (IFC)—a 76-member subsidiary of the International Bank for Reconstruction and Development (World Bank). The IFC is authorized both to grant loans and to make equity investments in private enterprises located in developing areas, and thus undertakes operations frequently quite similar to those of Edge Act corporations. To date, most of the investments made jointly by Edge Act corporations and the IFC have been in the fast-growing field of development corporations. In a recent financing, for instance, the Private Development Corpora-

tion of the Philippines sold shares totaling \$6 million equivalent to the IFC, to ten Edge Act corporations and one Agreement corporation, to three other United States private investors, and to four banks in other countries; in addition, the Philippine institution received loans from the World Bank and the Agency for International Development (AID) of \$15 million and \$7 million, respectively.

The participation of a governmental agency, however, does not entail a guarantee of the Edge Act corporation's investment. If such a guarantee is desired, the Edge Act corporation may apply to the AID. The AID has an insurance program for new private United States investments in underdeveloped countries that covers three types of risks: inconvertibility, expropriation, and damages due to war or civil disturbances. Edge Act corporations are steady users of this facility.

#### OUTLOOK

Edge Act corporations, as has been shown, are a highly adaptable instrument of international finance and enhance the range of activity of United States commercial banks. An intensified use of such corporations therefore may be expected whenever the general conditions for expanded international trade and financial operations are favorable. This was the case in the early 1920's when Edge Act and Agreement corporations first blossomed. It has been the case again since the late fifties following the end of the postwar reconstruction period and the relaxation of exchange controls. In order to participate fully in the recent growth of international commerce and investment, United States banks "rediscovered" the Edge Act instrument.

A substantial further increase in Edge Act (and possibly also in Agreement) corporation activities may thus, in a broad sense, depend upon the future growth of international trade and investment. Currently, of course, economic transactions among the industrialized countries are continuing to rise. Furthermore, quite a few newly emerging nations are seeking to avail themselves of the managerial and financial capabilities of the industrialized countries through private as well as through public channels. There is a distinct possibility, therefore, of a continued rise in the activities of Edge Act corporations and hence in their role in United States foreign economic relations.