Bauerle's Bank Notes

East of Cairo

May 18, 2015

One of the ironies of economic life in the Obama years is that elected officials of both parties are opening the U.S. economy to greater foreign competition while limiting American banks' ability to finance growth of domestic enterprises. The proposed Trans-Pacific Partnership inched closer to Congressional approval last week after the President lobbied Democrats to withdraw their objections. Whether the agreement will win approval remains uncertain. Meanwhile, since Dodd-Frank became law, American banks from J.P. Morgan to regional institutions have scaled back or eliminated their involvement in equity and mezzanine debt financing of American businesses because of Dodd-Frank's strictures on activities other than loans and deposits.

Cairo, Illinois, the Southern-most city in that state, sits at the junction of the Ohio and Mississippi rivers. Its fortunes declined as rails eclipsed rivers as the nation's primary trade routes. To the North, Galesburg, Illinois, gained as Cairo lost, because it positioned itself as the intersection of the Chicago, Burlington & Quincy and Atcheson, Topeka & Santa Fe railroads. Now both are part of the BNSF network. Today, the railroad is Galesburg's largest employer because the North American Free Trade Agreement led Maytag to close its Galesburg appliance manufacturing plant in 2004 and transfer production to Mexico. In his campaign for U.S. Senate that year, Barack Obama described the workers as "victims of globalization."

The New York Times' report on present day Galesburg quotes Gordon Hanson, an economist at the University of California: "I think what we've learned is that the U.S. labor markets aren't as flexible and self-correcting as I think we had presumed. The uneasiness I have about the way we've handled globalization is not so much globalization itself. It's that if you don't have the right safety net, you're going to impose an enormous amount of hardship." [i]

Hanson's reference is to the social safety net of transfer payments, from job training programs to national health insurance. In our view, an equally important safety net is private and public financial support of American businesses that compete effectively in a global economy. That is where banks come in.

In Cairo, Galesburg, and Peoria, Illinois (home of Caterpillar), capital formation sponsored by banks and government is the staff of economic life. The Illinois legislature in the early 1850s promoted railroads by prohibiting counties from taxing railroad property. When some counties levied taxes anyway, the Illinois Central Railroad hired Springfield lawyer Abraham Lincoln to defend the constitutionality of the statute, which he argued twice to the Supreme Court of Illinois, winning both times.[ii]

In Lincoln's time, and until the mid-20th Century, a local bank president could provide personally the equity capital that growing businesses needed in addition to having his bank lend money to the enterprises. The practice was commonplace, and legal, until the Great Depression. The practice continued on an informal basis in many community banks for several decades after Glass Steagall. Large banks revived the practice later, such as by Citibank's creation of Citicorp Venture Capital Corporation. Dodd-Frank swung the pendulum the other direction, leading many banks to divest their private equity investment businesses.

In the American landscape beyond New York City, commercial banks remain the fulcrum for business capital formation. The regulatory reality, however, is that banks cannot themselves provide the full suite of capital resources businesses require. For that reason, our Renaissance Partners continues to team banks with non-bank capital providers to help companies source the capital they need.

Renaissance Partners is not a fund; rather, it introduces companies seeking capital to those who provide it. Current offerings include:

- Growth equity, including through minority interest investments in privately owned companies, funding levels being keyed to achieving agreed-upon performance milestones.
- Credit enhancement, customized to make bankable deals out of situations that otherwise do not meet bank credit underwriting criteria. These may be either real estate or commercial and industrial projects. Private investors are the source of the credit enhancement.
- Working capital solutions for companies whose recent operating performance does not qualify them for bank financing.

One of the most promising applications of these tools is the emerging shale gas supply chain economy. The Financial Times Monday reported that U.S. imports from Saudi Arabia of crude oil dropped under 1 million barrels a day for the first time since the onset of the 2008 Recession.[iii] The Saudis, the newspaper said, have adopted an East of Cairo strategy, selling to China and other points east much of the production previously sent to the United States.

The vicissitudes of international trade will continue to shape the U.S. economy, with or without new trade agreements. What remains important for U.S. regional and local economic actors is protecting and preserving the competitive position of home grown enterprises. Banks must play a central role in that drama and government leaders must help them do so by enabling their competitive position rather than handicapping it. Non-bank providers of capital can and should play a complementary role by filling needs banks are precluded from serving and doing so in ways that build vibrant and enduring companies that employ our citizens. That is the best safety net.

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[i] "Perils in Trade Deals When Factories Lose and Towns Struggle," New York Times, May 18, 2015.

[ii] After his second victory, Lincoln submitted a bill for $5,000, twice his agreed-upon fee. The railroad's president allegedly protested, "For that kind of money, I could have had Daniel Wesbter." Said Lincoln, "That would not have produced a better result."

[iii] "Saudi Oil Sales to U.S. at Post-Crisis Lows," Financial Times, May 18, 2015.