Bauerle's Bank Notes

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All Lit Up

Denied financing by his bankers, 31 year-old Thomas Edison sold most of his patent portfolio in 1878 and spent the proceeds to electrify lower Manhattan four years later. A satisfactory means of lighting communities already existed: gaslight. Electric illumination was as novel as Jeff Bezos' recent suggestion that Amazon use drone aircraft for parcel delivery. Then as now, loan yields did not warrant banks taking venture capital risk. So bankers' decision to sit out Edison's experiment made sense.

Ever practical, Milan, Ohio's native son built his electric light bulb manufactory alongside the Pennsylvania Railroad's North Jersey approach to New York City. At nighttime, passengers could see the glowing light bulbs illuminate Edison's laboratory, fostering interest in his technology, visitors to his demonstration site and demand for his product. Edison astutely made electrifying J.P. Morgan's mansion a key part of the lower Manhattan project, in which Morgan and the Vanderbilt family co-invested with Edison. Edison knew if Morgan embraced the technology, other bankers would follow suit. Meanwhile, George Westinghouse wired his friend Henry Frick's Pittsburgh home, the sixth structure in that city to be electrified. Once understood to be useful, safe and reliable, the new technology spread rapidly. By the 1930's, the Rural Electrification Administration brought the technology to the most remote areas of the nation. Edison Electric became General Electric and every reader knows the rest of the story.

Today, as our nation again reinvents itself as the world's most vibrant, digital economy, bankers are at a distinct disadvantage. Alternative providers of business and consumer financing abound. Many are new and untested. The New Yorker recently reported the emergence of "a crowdfunding marketplace where people looking to start a business, say, or pursue more education can raise cash from investors. In exchange, they pay some of what they earn over the next five or ten years-what percentage you have to pay is determined by how much you want to raise and by the [funding company]'s algorithm's assessment of your earnings potential." To critics who see these arrangements as involuntary servitude, the article's author responds, "Young people are already indentured-to their student loans and to credit-card companies." Courtesy, it must be said, of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, enacted at the urging of issuers and securitization-funders of student and credit-card loans.

History does repeat itself. Until Congress made it illegal to do so, community bankers personally took equity positions in borrower companies that sought bank loans but really needed equity capital. J.P. Morgan (the man) and the Mellons built their fortunes that way. The latter controlled five Fortune 500 companies when Andrew Mellon died in 1937 and owned sizeable stakes in a dozen others. In a parallel vein, Nobel Prize-winning economist James Tobin structured a scholarship repayment plan for Yale students in the 1960's under which they paid a percentage of their earnings to amortize the loan portion of their financial aid package. Bill Clinton was a beneficiary.

Today's loan funding schemes differ from earlier ones because they bypass banks (or the Yale endowment in the Tobin Plan's case). Lenders and borrowers make their market on the Internet and the sponsors' algorithms source, price and distribute custom-tailored financing with no muss, no fuss and no human touch, or at least that is what they claim. How durable these alternative providers are remains to be seen. They may go the way of NextBank, N.A., the Internet bank that failed in 2002 after it lent indiscriminately to technology industry workers who took out credit card loans, then defaulted when the tech bubble burst in 2001. Or, like eBay's PayPal and Bill Me Later services, the new non-bank banks may triumph because superior technology, cost structure and execution enable them to outperform insured depository institutions in the market.

Either way, banks ignore the competition at their peril. They must reexamine their value proposition, acknowledge that the protection legal regulation once provided has been circumvented, and compete head to head with the nimble neophytes. Only recognition of these realities, coupled with adaptive reinvestment of hard-won earnings, will enable survival. Anything less will amount to selling oil for illumination in the face Edison and Westinghouse.