Resources and reputations: historical precedents for recent banking crises

Marc Flandreau and Juan Flores look at the banking crisis of 1825–1826 and draw lessons for investment bankers today

Tolstoy famously joked that while happy families are all alike, every unhappy family is unhappy in its own way. The quip applies surprisingly well to the financial system. Normal times always look alike – split risk, distribute, diversify – but crises are *sui generis*.

Or are they? According to Bundesbank president Axel Weber, speaking in September 2007 before the distinguished audience of the US Federal Reserve's annual symposium in Jackson Hole, Wyoming, the recent turmoil in the market for funds is reminiscent of the bad old days. In the nineteenth century, he recalled, banks were subject to runs. The result was contagion: withdrawals on the liability side forced liquidations on the asset side (the only alternative being outright suspension of operations, never a good signal to the market), leading to asset price declines.

Likewise, September 2007 witnessed a run on funds. Those very investors who were lining up to get aboard hedge funds and other financial vehicles a few months earlier were now rushing for the exit. Faced with this situation, fund managers had to liquidate assets (closing the funds is a temptation but it entails costs: BNP-Paribas gave one illustration of this). Massive asset liquidations reduce the worth of the collaterals on which credit rests, triggering margin calls and further liquidations.

The catch with this parallel, according to Weber, is that it outlines a key difficulty with the current situation. The tools that modern central banks have at their disposal can only directly address 'old-style' runs inside the traditional banking sector. These instruments emerged through a historical process, making them wholly inadequate to deal with problems that develop outside this sector.

The interpretation may be disputed. For one thing, one could argue that it is deposit insurance, not the availability of a discount window at the central bank that brought an end to bank runs. Deposit insurance comes as a counterpart to regulation and supervision and it is not clear that those (often the banks themselves) who developed the 'vehicles' out of which panicked investors are now scrambling would find attraction in tighter controls. And it could also be said that the language used by Mervyn King, Governor of the Bank of England, to motivate the rescue of Northern Rock was precisely that of Walter Bagehot, nineteenth century pioneer of the doctrine of the lender of last resort.

In any case, it is in the essence of the modern financial system that central banks cannot do much about the situation, beyond helping sound institutions with ample liquidity. The problem was brewed in the financial system and the financial system will have to find its way out. But how? One particularly useful parallel could be with the 1825–1826 collapse of Latin American and Southern European sovereign debt in the London market.

It began with securitisation. Early bankers had lent to sovereigns from their own balance-sheet and suffered terrible losses when default struck. But in the late eighteenth and early nineteenth centuries financial 'innovations' in Amsterdam and then London popularised the use of government endorsed bearer investment certificates – in plain English, government bonds. There goes that formula again: split risk, distribute, diversify. The result was, in the early 1820s, a surge of sovereign debt issues in the London capital market. Investment banks did the origi-


Neapolitan Five Per Cent Certificates

No 576

With Interest from the 1st July 1822.

Received Fifty Four Pounds Seven Shillings ten pence being Ten per Cent on Ducats 200 Neapolitan Rente, on payment of the balance on or before the 1st February 1823 with Four per Cent Interest thereon from the 15th October 1822 the Bearer will be entitled to Certificates for that Amount of Stock with Interest Coupons from the 1st July 1822.

Ducats 200 Rente at 80 pr Cent
Exchange pr 4.40 pr Ducat
and pr 25.65 pr £ Stg — £ 548.18.7
10 pr Cent Deposit — 54.17.10

Balance to pay the 1st Feby 1823 with 4 pr Cent Interest from 15 Octr 1822. — £ 494.0.9

London 14 October 1822

Entd

Neapolitan Loan by N. M. Rothschild

Contracted by C. M. de Rothschild

Scrip receipt issued for a deposit paid on a bond from the 1822 5 per cent 20,000,000 ducat Neapolitan loan contracted by Carl de Rothschild in Naples and issued by Nathan Rothschild in London.

nation, then sold the stuff to the public. In the pile of securities sold that way, you could find good stuff (such as the bonds of Prussia or Austria) but also junk bonds (the securities of Argentina and Colombia). You could even find the securities of a country that did not exist, notably the imaginary Kingdom of Poyais. Importantly, there was little way to tell those bonds apart: at that time there were no credit rating agencies. If you are now told that lots of Germans were buying, then the whole thing will look familiar enough.

Inevitably, this had to collapse. There were various suspects for the market downturn and contemporary speculators did not forget to blame the Bank of England's decision to call off the party and raise interest rates (rating agencies were prudent enough to avoid existing yet, and

Lionel de Rothschild (1808–1879) is depicted as 'the modern Crœsus' in *The Period*, 1870, seated on a throne of money bags and surrounded by crowned heads from around the globe who pay homage to the man from whom they must borrow.

thus escaped criticism). When the collapse occurred in the autumn of 1825 (these things always happen during the autumn) people looked around for advice, and found none. Investors just ran.

Many bankers still had stacks of deals on their books. There were good deals that people would no longer buy, such as a major issue for the Kingdom of Naples underwritten by Nathan Rothschild. There were also terrible deals with governments who claimed that the bonds had been issued without their consent. And of course there were all kinds of other deals that suffered from 'contagion' as a result.

In the midst of the collapse, however, an intriguing phenomenon occurred: not all securities were going down the drain. To cut a long story short, there was a breakdown between Rothschild-sponsored securities and the rest.

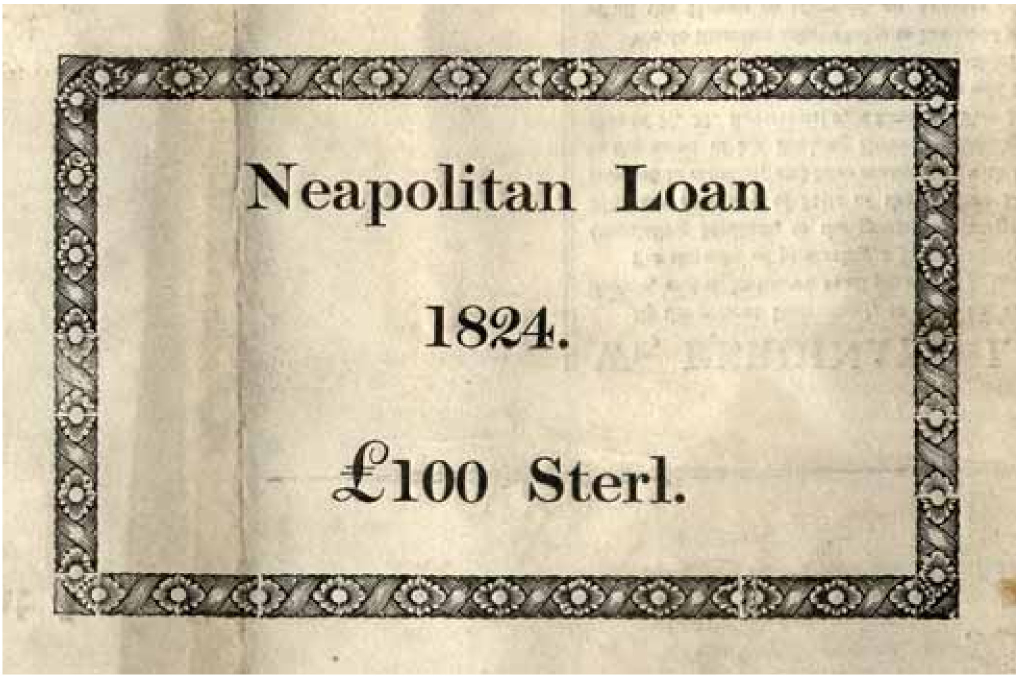
The reason was the following: Rothschilds trusted their own deals, and were prepared to pledge their own money in order to make ends meet. Among many other things, they took the entire Neapolitan bond issue onto their book, working with their own capital. One of the few available balance sheets of the Paris house of de Rothschild frères, dated June 1826, shows Neapolitan bonds at 15% of the total asset side. This amounted to one fifth of the 1824 London issue and was almost equivalent to the capital of the house of Barings. James de Rothschild wrote to his brother Carl in Vienna that if it 'had not been for their purchases' Neapolitan funds would be trading much lower and perhaps 'discredit would be complete'. We can conclude that concerns about brand promotion led the house of Rothschild to include extensive post-issue services in their underwriting, providing in effect market support. Support operations for the Neapolitan loan continued in October 1827 when the house of Rothschild announced that they would buy future coupons thus offering nothing short of an outright insurance against default. There was also diplomatic manoeuvering: Naples was having to finance its military occupation by Austria, and the Rothschilds in Vienna attempted to persuade Metternich to put an end to this situation in order to alleviate Naples' financial burden.[1] It would take too long to review here all the schemes that the Rothschilds implemented to support Naples.

In effect, as one Rothschild suggested to his brothers, 'next time' they should work with their own capital from the beginning! However, once the market understood what Rothschilds were prepared to do, the brothers came back and helped out.

Which brings me to my second point. The reason why Rothschilds could do this is that they were sitting on a mountain of capital. At a towering £4.4 million, the Rothschilds' capital stood way above their competitors' and was ten times that of Baring Brothers', their nearest rival whose own capital was retreating from its peak at the end of the Napoleonic Wars. This sheds a very interesting light on the Rothschilds' ability to weather the storm (see *Table 1*).

Table 1 Capital of Various Merchant Banks[2]

Bank	**Date in London (if applicable)**	**Capital (million £)** 1810s	**Capital (million £)** 1820s and beyond
Baring Brothers	1763	0.7-1.1 (1815–1816)	0.49
Rothschilds:	1805	1.8	4.37
Nathan (London)	1805	0.75 (1818)	1.14 (1828)
Amschel (Frankfurt)	n.a.	0.70 (1818)	0.8 (1828)
Salomon (Vienna)	n.a.	n.a.	0.8 (1828)
Carl (Naples)	n.a.	n.a.	0.8 (1828)
James (Paris)	n.a.	0.35 (1818)	0.8 (1828)
Frederick Huth & Co.	1808	n.a.	0.3 (1845)
Brown, Shipley & Co.	1810	0.12 (1815–1816)	0.35 (1825–1830)
Frühling and Goschen	1814	n.a.	0.04 (1830)
Glynn, Mills, and Co.	1753	n.a.	n.a.
B.A. Goldschmidt	n.a.	n.a.	0.22 (1826)
J. Henry Schröder & Co.	1818	n.a.	0.26 (1852)
J.H. Schröder & Co. (Liverpool)	n.a.	n.a.	0.05 (1839)



Detail from the bond issued by N.M. Rothschild for the 1824 5 per cent £2,500,000 Neapolitan government loan.

At the end of the day, the market had learnt the lesson: Rothschild-sponsored deals were safer and performed much better than others in periods of crisis. This was in part because Rothschilds were safe but also because they were full of cash.

Today's global investment banks (think of Goldman Sachs, think of Barclays) are poised to learn, or rather re-learn, this age old lesson. In a world of *laissez faire* you neither should nor can expect too much from the central bank.

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NOTES

1 Bertrand Gille, *Histoire de la maison Rothschild. Tome I: des origines à 1848* (Geneva: Librairie Droz, 1965), pp.162–8. The balance sheets can be found at the Archives nationales du monde du travail, 132 AQ 3.

2 Based on research carried out by the authors as part of a project aimed at understanding the functioning of the nineteenth century market for sovereign debt. Project findings are being disseminated through papers and seminars, the first of which is *Bonds and Brands: Lessons from the 1820s*, (Centre for Economic Policy Research Discussion Paper n° 6420, 2007). This paper, as well as several ones in preparation, makes extensive use of The Rothschild Archive. It is also a follow up of an earlier project aimed at understanding the determinants of reputation in nineteenth century bond markets. See Marc Flandreau, 'Caveat emptor: coping with sovereign risks under the international gold standard 1870–1914', in H. James, M. Flandreau and C.-L. Holtfrerich (editors) *International Financial History in the Twentieth Century: System and Anarchy* (Cambridge: Cambridge University Press, 2003) and also, Marc Flandreau and Frédéric Zumer, *The Making of Global Finance*, (OECD Research Monograph, 2004).