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Family Finance: Value Creation and the Democratization of Cross-Border Governance

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As Mira Wilkins has argued, there is a curious disconnect between business and financial history (Wilkins 2004). Whereas business history literature has rediscovered the importance of family business in many countries and in many sectors of contemporary commercial life, for example, little has been written about family banking as an alternative to joint-stock, management-run financial institutions. This lacuna is odd for many reasons. First, family banking is one of the best-known examples of family business in history. Second, family banks once played a much greater role in international investment banking than it does today. Third, some family financial institutions are still active (dominant) in certain market segments and countries. This paper will focus on how, when and why family banking lost its position in international (multinational) banking during the first few decades of the twentieth century. Although political upheaval and a widespread movement to reduce the power of private financial institutions undermined their businesses, family banks suffered, too, from America's maturing as a financial center. I will argue that this shift is connected with the increased importance of American markets and financial regulations, which, in the 1930s, deliberately steered financial transactions away from private dealings and toward transparent impersonal exchanges and capital markets with new forms of aggregated capital and individual investors, in which

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private banks were ill-suited to manage or at the least for which they had no special competitive edge. Using concepts drawn from an earlier paper on family businesses and relying mostly on secondary sources, this paper will further argue that in markets or market segments, such as Leveraged Buyouts, where uncertainty forms a greater part of the transactional environment, family banking still plays a significant role.

Avoid litigation and political controversy, and always keep out of the public eye.

—Cosimo Medici's father's deathbed advice to his son, quoted in Christopher Hibbert, *The House of Medici*

Family and financial capitalism proved to be transition stages in the evolution of the modern enterprise and of modern capitalism.

—Alfred Chandler, "*The United States: Seedbed of Managerial Capitalism*," in Managerial Hierarchies

Introduction

This paper aims at bridging a gap among three academic literatures, which unfortunately have remained too distinct: family business studies, banking histories, and financial theory. It will not attempt to establish new ground in any of these areas, just to highlight some connections, from which all three might deepen their understanding of their slices of social phenomena. As Mira Wilkins has pointed out, a curious disconnect has existed between business and financial history, which leads to a failure to grasp parallel, disparate or interdependent trends in their development.[1]

During much of the second half of twentieth century, for example, financial theory strove to emulate the techniques of natural science, only more recently integrating the social component and institutional configurations in economic decisions.[2] Financial and legal literatures concerning corporate governance have begun to recognize—and even attempted to quantify—the contribution of family ownership to firm profitability and the reduction of control costs (the agency problem).

1. Mira Wilkins, "Disjunctive Sets?
2. Barberis and Thaler, "A Survey of Behavioral Finance." Behavioral finance is a relatively young field, which only very recently has been accepted by financial theorists as a plausible explanation for many financial paradoxes about efficient markets and investor behavior. Its emphasis on the limits of arbitrage and investor rationality cry out for more historical treatment of markets and agents.

But they rarely have delved into the evolution of family participation in ancillary or controlling institutions, such as banks, and that participation's effect on firm costs and benefits.[3] Economic theory's treatment of institutions as information flow conduits and as recourse underwriters is spotty at best. Indeed, the institutional component in making capitalism possible often receives cursory treatment. Historically (and perhaps for transitional economies now) these institutions may have had particular importance as markets evolved from what is sometimes characterized as *insider to outsider systems*, i.e., systems in which investors remain close to (insider) or are far away (outsider) from the firm using their funds.[4]

I want to stress, too, that this paper is primarily about changes in transatlantic financing (primarily European and North American investment banking), not domestic or colonial, between the end of the nineteenth and the end of the twentieth centuries. My aim here is to present some initial thoughts about the political, economic, and attitudinal changes that form the context for the institutional transformation for handling with market imperfections, especially to highlight some changes in the role of private banking in dealing with uncertainty. By evoking family banking and private equity, I hope to suggest some plausible causes for the changes in the relative strengths of private versus publicly owned institutions in this sector. In addition to bringing together strands of business history and financial theory, I also hope that the paper will make a contribution to understand better how our own era's brand of globalization differs from or resembles that which preceded World War I.

Whereas the degree of cross-border financial flows before 1914—only surpassed by some measure in the last decades of the twentieth century—is well documented, less attention is paid to how private institutions furthered those flows in a financial environment which lacked integrated multinational financial institutions and much of the regulation investors view as commonplace today.[5] The financial integration of the nineteenth century gave rise to a set

3. See Anderson and Reeb, "Founding-family Ownership and Firm Performance: Evidence from the S&P 500," and Dyck and Zingales, "Private Benefits of Control: An International Comparison." Historians tend to be better at understanding the role of these institutions in value creation and social choices. See, for example, Carnevali, *Europe's Advantage*.

4. See La Porta, Lopez-de-Silanes, and Shleifer, "Corporate Ownership Around the World," and Mayer, "New Issues in Corporate Finance."

5. By some measures, foreign investment in 1914 was triple that in 1960. The 1914 levels were only surpassed in the 1970s. During the 1920s, foreign investment fell to 8% of world output. Today total foreign investment as a percentage of World GDP is five times the 1914 level. Obstfeld and Taylor, *Global Capital Markets*, 52–55.

of corporate governance issues and approaches from which we may still learn.[6] Although historians have become increasingly interested in comparative national analysis, recent discussions about the evolution of corporate governance hardly address issues of cross-cultural control and the role of particular institutions in creating the trust necessary to allow huge international capital flows when public regulations was in still its infancy.[7] During the pre-World War I period of globalization, an epoch which rivaled our own in the integration of markets, private institutions, often organized into formal and informal cross-border "clubs" dominated by family networks, filled the regulatory "trust vacuum" and managed substantial risks. Moreover, what is often neglected in the literature is the degree to which some older forms of corporate governance hang on in the midst of a new round of international convergence.[8]

Despite the importance of family banking to the development of modern capitalism and the great number of "biographies" of family bankers, the transformation of banking, especially international banking, from family to managerially dominated has played a relatively small role in discussions of the Chandlerian model and financial history. The overriding theme of most of the great histories of banking houses such as Morgan, Warburg, Rothschild, Baring, and their key personalities seems to be that the glory days of these institutions are, so to speak, "Gone with the Wind."[9] Many aspects of banking today could be portrayed as excellent examples of Chandler's flow-through industries, which achieved a dominant position in many sectors by mastering the efficient transformation of uninterrupted, large-scale streams of inputs, the output of which was matched with high demand fostered by further investment in distribution.[10]

6. Hannah, "Pioneering Modern Corporate Governance," 642. Unlike many writers, Hannah emphasizes the international scope and influence of corporate governance practices, especially those coming from Britain.

7. Herrigel, "A New Wave in the History of Corporate Governance." See also Morck, ed. *A History of Corporate Governance Around the World.*

8. Herrigel, 477. We still have an insufficient understanding of the degree to which ownership and control divided and when it did in many countries. See Hannah, "The 'Divorce' of ownership and Control from 1900 Onwards" for an excellent assessment of what we know and do not know about the patterns of ownership.

9. See Burk, *Morgan Grenfell 1838–1988*; Ziegler, *The Sixth Great Power*; Chernow *The House of Morgan* and idem, *The Warburgs*; and Ferguson, *The House of Rothschild.* Ferguson, for example, emphasizes the family's inability to produce enough talented male offspring as one of the major reasons for the bank's relative decline.

10. See Williamson, *The Mechanisms of Governance*, 78–79. Williamson, relying on earlier work by Pollak, sees that families may contribute incentives, loyalty, monitoring and altruism, but also tends to see international family banking as a

Although much has been written about the transformations in transportation and communication, which helped set the stage for the revolutions in manufacturing and distribution of goods and the switch from family- to management-run firms, similar narratives—perhaps equally incomplete accounts—for service sectors are less prevalent in the literature.[11] Even those who record the powerful persistence of family business in many countries and sectors seem to be at a loss as to how to explain the phenomenon.[12] In the recent literature that has reinterpreted Chandler's somewhat one-sided, American-dominated account of the evolution of big business, family banking is hardly evoked.[13] While Chandler's well-known explanation of the decline of firms and even whole national economies as the failure to shift from family to multidivisional managerial firms with dispersed shareholding has come in for a great of criticism—as with much of his own original work—most of his critics draw their examples from nonfinancial sectors.[14]

Much of this article will focus on the role of family banks in the United States, but the great weight of these banks was not confined to American markets. To be sure, by the middle of the nineteenth century, joint-stock banks in many countries provided a great deal of competition to private banks by harnessing larger deposit bases and providing new services, forcing the private banks into many cooperative efforts. Nonetheless, well into the twentieth century, joint-stock

weigh station on the way to internalizing cross-border transactions. Their economic value rested on substituting for managerial hierarchies which could efficiently replace third-party contractual hazards. This view goes a long way in describing why so many international banking activities have been internalized. As will be discussed, much of what I will argue tends to support his view that families are particularly useful where trust is otherwise missing. But I will argue, in contrast, to Chandler and Williamson that there are a lot of areas of financial value creation for which the attributes of family business are still needed.

11. Cassis in *Capitals of Capital*, 42–43, writes quite rightly about a revolution in banking with the creation of joint-stock and universal banks, but says little about how and why family banks lost their competitive advantage in international investment banking.

12. See Jones, *Multinationals and Global Capitalism,* 183–86.

13. Colli and Rose, "Family Firms." This excellent study cites the neglect of family business in the economic literature. Colli's valuable compendium of research on the history of family business only examines the effect of financial markets on the formation and persistence of family firms (*The History of Family Business, 1850–2000,* 34–35). Miller and Le Breton-Miller use only two examples of family banks from hundreds of firms to illustrate the competitive advantages of family businesses. One of those has not been family run for decades. See Miller and Breton-Miller*, Managing for the Long Run.*

14. See, for example, Cassis, et al., eds., *Management and Business in Britain and France,* an important series of studies, which has helped move research away from Chandler's "one-size-fits-all" America-centered focus, contains little or nothing about family banking.

banks had difficulty in replicating the cross-border reach of family banks in the United States and other major economies.[15] Many of the early "multinational" joint-stock English banks had their headquarters only in the UK, with their operations in colonial or developing markets. Today many of those banks maintain integrated, transnational operations all over the world internalizing the relationships that were once integrated by families or networks of smaller institutions,[16] but by some accounts, at least, current attempts of mixing the attributes of public and private banking in one institution are fraught with difficulties.[17]

American regulations especially, and the surge of economic activity there, provided private banks with special challenges and opportunities.[18] Even when the United States began to export more capital around the turn of the century and after World War I, private, not joint-stock banks led the way in deal making and to a lesser extent in distribution of new securities.[19] Well into the twentieth century, regulation and communication hampered most of the continental European joint-stock banks—such as Deutsche Bank and Crédit Lyonnais, the two largest by some measures—in running comprehensive banking operations in New York and other financial capitals, often pushing them into alliances with private as well as other banks.[20] For example, neither had an office in the other's country. Apart from London, their direct involvement with cross-border investment banking and other financial activities in major markets relied to a large

15. Cameron, "Introduction," in Cameron and Bovykin, *International Banking 1870–1914.* Cameron emphasizes how banks, especially private banks, were probably the first multinationals. For their relative strength in cross-border finance, see the contributions by Carosso, Sylla, Bonin, Tilly, and Wilkins.

16. Jones, *Multinationals and Global Capitalism,* 113.

17. "For Richer, for even Richer," *The Economist*, 16 Feb. 2008, 74.

18. See De Long, "Did J.P. Morgan's Men Add Value?" Although private bankers may not have produced some of the market innovations for which De Long gives them credit, at the very least they provided the "hands on" management that calmed distant investors sufficiently to put huge amounts of money into the turbulent but dynamic US market. See Hannah, "What did Morgan's Men really do?"

19. Cameron, "Introduction,"14–15.

20. In 1913, Deutsche Bank operated only three branches outside of German and two partially owned subsidiaries for international banking. Only one branch was in a major market (London) and only approximately 10% of its staff worked outside of Germany. Kulla e-mail to author. Crédit Lyonnais, in contrast, operated many more branches, but London was the only one in a major developed market. The agencies in Vienna and New York had to be closed soon after they were opened. See Nougaret, "La banque internationale,"in *Le Crédit Lyonnais,*ed. Desjardins, 486–87. See also Tilly, "International Aspects of the Development of German Banking," and Bonin, "The Case of the French Banks" in *International Investment Banking,* eds. Cameron and Bovykin. Both emphasize the importance of international transactions to and constraints on joint-stock banks from setting up full banking operations in many major markets except London.

extent on agents and correspondent relationships. These banks had enormous distribution capacity in their own markets but were short of reliable talent to find and manage investment opportunities in key markets.[21] By way of contrast, in 1900, from London and other financial capitals, without branches or subsidiaries, relying on family connections and correspondent bank relationships, family banks handled not only trade financing, but also led the way in multinational lending.[22]

A series of political decisions on both sides of the Atlantic to make finance more "public" and more "democratic" shrank the opportunities of private bankers to manage capital, especially for cross-border projects, transferring much of their *raison d'être* to governments and large public institutions. Before World War I, most countries shared a reliance on active stakeholder involvement in companies. Especially, when the suppliers and users of funds were separated by great distances, family banks offered a means of overcoming geographic separation. In contrast, during much of the twentieth century, in most of the developed world, regulatory oversight, transparency, diversification, and liquid markets displaced active investor management as the bulwark of corporate governance, a tendency that some regulators now regret. Despite a reduction in economic power, over the past hundred years, private and family financial institutions, however, have remained strong players in several important activities. For example, markets, regulators, and investors, especially for those investors seeking "above average returns," have not yet found convincing substitutes for the advantages of family-like intermediaries in analysis and monitoring of companies. Indeed, an argument could be made that only through their brand of close management can real economic profit be earned at all.[23]

Many explanations have been offered for the evolution of differences and similarities among countries in their methods of corporate control, as well as for the apparent worldwide ascent of what is often called the market-based mechanism of corporate governance. The evidence presented here tends to support the more political and cross-border investor explanations, but positions these

21. Kobrak, *Banking on Globalization*: *Deutsche Bank and the United States,* 1–166.

22. Jones, *British Multinational Banking*, 5.

23. Every financial textbook points out that companies add shareholder value when the risk and time adjusted value of their cash flows exceed the real cost of equity capital, usually measured by historical data designed to exclude uncertainty. As the benchmark (hurdle rate) is defined by market risks excluding unique risk, if the net value of the discounted flows is zero, the investor is indifferent. Adding value would seem to require taking on and managing effectively uncertainty. This relationship was first highlighted in Knight's, *Risk, Uncertainty and Profit.*

accounts more broadly and over a longer period than is done typically in the literature.[24] Whereas most explanations view political and cross-border investor factors as explanations for the development of America's once-unusual system and that system's ability over the last few decades to produce a new convergence, I will argue that politics was a worldwide phenomenon, that cross-border influences on corporate governance predated the Bretton Woods Era, and that the transformation was accompanied in many aspects of finance by an institutional revolution. Nevertheless, in contrast to some of the literature on the history of corporate governance, which tends to emphasize discontinuities rather than the continuities in corporate governance practices, this paper tackles the question of how and why some institutions first flourished and then survived, indeed thrived in some activities, in the face of major structural changes in corporate governance regimes.

For hundreds of years, well-informed and sophisticated private bankers profitably exploited market inefficiencies.[25] Indeed, they seem at their best when markets are spooked and investors hesitate to risk funds, that is, where uncertainty is high. To be sure, families are not the only institutions that can marshal funds by instilling trust and convincing investors that they can deal with uncertainty. Conversely, some family banks perform only traditional banking functions.

This paper suggests that three intertwined developments in capital markets have tended to undermine the competitive advantage of private banks in some financial areas. First, greater access to financial markets, which has democratized financing by increasing the number of transactions, and the size and standardization of financial markets has also reduced or changed needs for intermediation. Second, an increase in public oversight, designed to contribute transparency to markets, has decreased the relative economic value of holding private information. Last, a theoretical approach to finance emphasizing quantitative analysis has developed to explain and manage risk in this new environment. From capital asset pricing to option pricing models, modern finance has attempted to price risk based on statistical estimations of asset volatility and rewards. Approaches to decision making designed for passive investors, leaving active management to those inside companies who control real assets, are geared to inform investors as to how much reward they can expect at a given level of

24. These include the economic, legal, political and cross-border investor explanations. See Herrigel, "A New Wave in the History of Corporate Governance," and Fohlin, "Does Civil Law Tradition and Universal Banking Crowd out Securities Markets?" for excellent arguments against the view that the explanation of capital market differences is best explained by civil versus common law systems.

25. See Peter Temin and Hans-Joachim Voth, "Riding the South Sea Bubble."

volatility or how much volatility to expect for a given level of reward. I say that the three aspects are intertwined because it is hard to imagine modern capital markets without all three attributes together.

Although most modern finance is predicated on a belief in a high degree of capital market efficiency with a random succession of price movements around a predictable trend—that is, all relevant information about the value of a security is embedded in the price of that security—history teaches us that the degree of market efficiency varies over time. For markets to be efficient in this sense, investors must not only have easy access to them, they must also trust them—matters often forgotten. Establishing trust is not always easy, especially where regulation is weak or where there is little personal credibility. The improvements of market regulation and increases in the quantity and type of instruments contribute to modern finance's focus on market or systematic risk (the volatility of any security's movement that can be explained by the whole market) versus unique risk (fluctuations that cannot be explained by market movements). The quantification of security fluctuation against the market and the building of efficient portfolios using historically accumulated data of numerous similar instances fall into the realm of risk; all other forms of risk are considered uncertainty.[26] Underlying all of this is the belief that virtually all relevant information is embedded in a security's existing price and that the owner of the security has no appreciable impact on its value by virtue of his ownership and efforts. To effectively diversify, institutions must be sufficiently large and conduct many transactions to reduce the unit cost of each transaction and spread risk in many different baskets.[27]

By exploring both the economic contribution of family business and the evolution of capital markets and society, this paper addresses the strengths of family banking at the end of the nineteenth century and its diminished role at the end of the twentieth. It will argue that capital markets have evolved in such a way as to undermine family banks' chief competitive advantage—their ability to manage various

26. This distinction owes a lot to the American economist Frank Knight, who argued, in contrast to Alfred Marshall, that profits could exist in a static state. For Knight, it was not change that produced profit but deviation from expected conditions. Uncertainty about the future causes the special reward of profit. Knight distinguished between insurable risk and uninsurable uncertainty. Profit was the reward for taking on production in the face of uncertainty. This though is consistent with financial valuation tools like Net Present Value.

27. Brealey and Myers, *Principles of Corporate Finance,* 136–37. Unique risk can be diversified away by making investments in other assets. It is sometimes called unsystematic, diversifiable, or specific risk, for which, according to financial theory, investors will not be rewarded, because it can be readily (cheaply) diversified away.

forms of uncertainty or unique risk. Of course, capital markets at the beginning of the twentieth century were large and robust, even by early twenty-first-century standards.[28] Yet in the absence of certain institutions and regulations, family firms then played a huge role in international market integration because of the degree of unique risk demanding active management that ensured returns sufficient to entice investors' funds to often distant, innovative ventures. Wherever the management of unique risk remains the best way of doing business, family banks have tended to maintain a strong competitive position.

This discussion is divided into three further sections. The first deals with the activities of family banks at the end of the nineteenth century and the regulatory and technological environments, which gave them their competitive advantage. The second part highlights market changes that undermined family banking. The third analyzes some sectors in which family financial intermediaries have held their own at the end of the twentieth century and will suggest some theoretical reasons for this persistence.

Competitive Advantages of Family Banking Circa 1900[29]

Capital markets weren't so advanced, and investors weren't so numerous, sophisticated, or well informed as today. A banker's seal of approval ensured that firms would enjoy unimpeded access to capital at highly attractive rates.

Ron Chernow, *The Death of the Banker*, 28.

28. See O'Sullivan's account (in "The Expansion of the U.S. Stock Market") of how the US equity markets developed in number of offerings and trading between 1885 and 1930. Although there is good evidence that many capital markets were very well developed before World War I, transaction costs were much higher, the number of participants much lower—especially if you including pension and mutual funds as representing mostly small investors—and the variety of instruments much lower than today. See also, Rajan and Zingales, "The Great Reversals."

29. As is often the case with work carried out on family business, the problem of definition is difficult. What constitutes a family business? There also are many related questions. Is a sole proprietorship a family business? If a firm is publicly owned with many nonfamily managers but functions with significant family input, can it be a family business? I will use the following broad definitions of a family business or more specifically a family bank: A family business is one in which either ownership, control or strategic advantage rests to a large extent on family ties. Though 'to a large extent.' is one of those uncomfortably vague expressions, which we rely on perhaps too often, I can see little good in trying to come up with some quantifiable division. Even by this vague definition, however, it should be clear that the House of Rothschild in the mid-nineteenth century was a family business and that Citibank in the year 2000 is not. About other cases we can argue.

Few financial historians doubt that private banks dominated international finance through much of the nineteenth century.[30] What is at issue is the nature of their strengths and the timing and causes of their decline. While deliberately avoiding precise dating, I will argue that until the early twentieth-century family organization of private banks aided them in establishing reputations for picking and monitoring investments, and for establishing cross-border presences that enhanced communication between potential users and suppliers of capital, a capacity that most joint-stock financial intermediaries could only achieve much later.

The title of this section is a little misleading. I have chosen to link 'family' and 'banking' for several reasons. First, even though many of their activities are better described by the term "financial intermediary," these institutions were called banks in 1900. Not all the private banks whose role in international finance I want to emphasize were family institutions, but most of the important ones were. Moreover, family ownership helps explain the competitive advantages of even the nonfamily owned banks, that is, the strong bonds of kinship or friendship that allowed these institutions to coordinate activities and engender trust over significant amounts of time, which otherwise would have been extremely difficult. In the twenty-first century, "financial intermediary" is probably a better term.[31]

30. Cassis, *Capitals of Capital*.

31. Cassis, *City Bankers*. Although Cassis does not make this generalization about the family structure of private and merchant banks, his discussion indicates that this was the case. Some other readers may be disturbed by my use of the term 'family bank' when most of the banks I will discuss are often described in banking history literature as private banks and conform to the activities of merchant banks, for which there is ample discussion and a sense of their role in financial history. I take this liberty because I want to focus on the governing and ownership structures of private banks and merchant banks, which were often partnerships in the hands of families or very influenced by family relationships. To be sure, 'private bank' is an ambiguous term itself. It refers to banking partnerships in England with capital in the hands of partners, who have unlimited liability. On the continent, it is associated with *haute banques*. Merchant banks, a type of private bank, which grew out of trade financing and which, like the *haute banque*, did much of their business around 1900 in what we would now call international investment banking. Not all these private banks, *haute banques* or merchant banks were family businesses, but many were.

An additional confusion stems from a somewhat different sense of private banking today. Private banking has now come to mean servicing the banking needs of wealthy clients, an activity in which private banks (my sense) excel but in which even large public banks engage, 'private' referring to the nature of the transactions and services rather than the ownership structure of the bank. Although I will slip from time to time between the terms, my discussion is intended to focus on the investment and international banking activities of private banks and how those activities were influenced by family associations. In what follows, however, I will

Family banks had an enormous advantage in the arena of cross-border lending. From ancient times well into the twentieth century, family banks possessed essentially two characteristics that helped make them first movers in the field of international banking. First, while establishing and controlling multinational (multicultural) structures was very tricky, they could establish multipoled businesses held together by family ties. In addition to correspondent relationships, families could establish a quasi-multinational structure. At a time when creating actual subsidiaries would have posed an obstacle to the very sort of transaction the family banks wanted to conduct, the family became a kind of "holding institution." Second, when sustaining trust across borders was in its infancy, they instilled confidence in their judgment because family loyalty implied long-term commitment and discretion.

Some of the oldest institutions still recognized today were family banks, which played important roles in economic and political history. According to at least one leading scholar, a strong argument could be made that they "constituted the first multinational business firms."[32] The Medici and Fuggers are only the best known of hundreds of early modern banking and trading firms, which held deposits, made loans, dealt in bills of exchange (an Italian innovation), and changed money through a large "multinational" branch network. As first movers, they defined the core of cross-cultural economic interaction and managerial innovation from the fourteenth through the sixteenth centuries and remained market leaders in many financial services well into the twentieth century.[33] But as Giovanni Medici, father of the Great Cosimo, recognized, a family's position was fragile.[34]

Family banking by some measures has not fared well over time. Like private banks in general, family banks in particular, no longer are central to investment banking. Consider a few facts. Although we have no league tables for 1900, all accounts of investment banking activities in New York stress the names of many private banks; few joint-stock companies are mentioned, whereas today all the major investment banks are public companies.[35] For many transactions

use the terms 'family' and 'private banking' interchangeably unless the distinction is important for the discussion.

32. Cameron, "Introduction," 3.

33. By the end of the fifteenth century Jacob Fugger administered a network of branch houses and trusted colleagues that permitted "international" money transfers and lending, which helped overcome distances and dangers through most of early modern Europe. Achterberg and Müller-Jabusch, *Lebensbilder Deutscher Bankiers,* 21–27.

34. Hibbert, *The House of Medici,* 158–203.

35. Wilkins, "Foreign Banks and Foreign Investment in the United States," in *International Investment Banking,* eds. Cameron and Bovykin.

and varieties of information today, those who need to invest or access savings have multiple ways to bypass private banks, which were unavailable hundred years ago. What is true for multinational investment banking is also true for many other banking services. While many family businesses have outlasted governments, nations, cities, and once-mighty corporations, there are only two family banks on the list of the world's 100 oldest continuous family-owned firms. [36] Only 3 of the largest 250 family companies in the world are banks.[37] Private banking in England peaked in the 1820s, but its decline was gradual and concentrated in domestic banking activities.[38]

Nonetheless, some family banks thrive and may still have social usefulness.[39] As late as the 1970s, several private banks shared an important role as managers and co-managers of securities issues in the flourishing but nascent Eurobond market.[40] Until very recently, several were still big players in investment banking, and many commercial banks have felt a need to acquire the aura of once having been family-run to enter this lucrative field. Even if Ron Chernow exaggerates a bit, claiming "financial dynasties" have receded "to the status of historic dinosaurs," in the area of cross-border issuances of securities he is correct.[41] As with the loss of any species, the passing away of these "dinosaurs" may have unforeseen economic ecological consequences. It should not be forgotten that the earliest discussions of corporate governance issues took as their starting point the loss of

36. William T. O'Hara, et al. "The World's oldest family companies." All the listed companies are at least 225 years old. Four stayed in the same family for over 1000 years. The oldest was founded in 578 A.D. Berenberg Bank, one of the few remaining private banks in Germany, was founded in 1590 A.D.; Hoare & Co., founded in 1672 in London, is run by members of the eleventh generation of the family and enjoys a reputation for meticulous service for famous clients.

37. O, Hara, et al. "The World's oldest family companies." Oddly, the USA accounts for 130 of the 250. The companies, spread over 28 countries, had a minimum size of at least $1.2 billion in revenues. Countries, which are much more associated with family business, such as France (17) and Germany (16), account for far fewer, even taking into consideration the economies relative size. The family banks were in order of size: Banco Santander Central Hispano S.A. (number 14 on the list), a Spanish bank with nearly 12,000 employees and managed by the same family since 1857; Lazard LLC (101 on the list), French bank with only 2750 employees but revenues of $5 billion, managed by family and nonfamily members, specializing in M&A, and, finally, Espirito Santo Financial Group S.A. (126 on the list), the Luxembourg holding company for a Portuguese insurance and banking group.

38. Collins, *Banks and industrial finance in Britian, 1800–1939*, 19–21.

39. Sal. Oppenheim, a family-owned bank (seven generations), is one of the largest private banks in Europe and sufficiently financially vibrant to have recently bought a public bank. It manages Euro100 million in assets with 1500 employees in 20 offices all over EuropeSal. Oppenheim Website. www.Oppenheim.de

40. Battilossi, "Introduction," in *European Banks and the American Challenge*, eds. Battilossi and Cassis, 19.

41. Chernow, *The Death of the Banker*. xii.

property relationships inherent in family business, which Berle and Means saw, and other writers have since developed, as not only an economic cost but also as a political threat.[42]

In earlier centuries, in contrast to our own, business was conducted by or with the aid of religious institutions or families, or some combination of the two. Each provided a necessary framework and solace for the commercial activities of early entrepreneurs, whose "animal spirits" must have been severely tested by a myriad of risks and obstacles nearly unimaginable to today's "Masters of the Universe."[43] For some, however, financial markets and managerial hierarchies serve to alleviate the need for trust, once provided by these older human institutions. Indeed, many scholars and practitioners of our age find the role of family in major business enterprises hard to imagine. As Harold James put it in a recent contribution:

> The simple fact of the literal familiarity of capitalism perplexes many commentators, and many indeed wish to deny it. Conceiving of capitalism as a vast, inhuman process, based alternatively on swindle and exploitation, that dwarfs and destroys individuals, they cannot see that it has anything to do with the affection and emotional warmth of family life or any sense of personal responsibility.[44]

To understand the competitive economic and social advantages of family banks, it is necessary to go back to a time when there was no World Bank, no Federal Reserve in the United States, no Securities Exchange Commission (SEC) requirements—indeed no SEC—and when phone and telegraph services were neither cheap, completely reliable, instantaneous, nor secure.[45] Though large compared to Gross Domestic Product in many countries, capital markets in 1914 were not nearly as well developed. Transactional costs were higher and derivative instruments nearly nonexistent. Yet for the five decades preceding World War I, national tensions were usually held in check, making truly multinational networks of independent organizations advantageous and feasible.[46] The Bank of England served as the lender of last

42. Berle and Means, *The Modern Corporation & Private Property.* For a more recent expression of concern, see Dunning, *Making Globalization Good*.

43. See Moore & Lewis, *Birth of the Multinational.* Moore and Lewis emphasize religious institutions over family, but the family comes to the fore in the Roman period.

44. James, *Family Capitalism*, 2.

45. Fear and Kobrak, "Banks on Board."

46. See James, *The End of Globalization*, also Carr, *Nationalism and After*, a classic study of the evolution of nationalism and internationalism in the nineteenth and twentieth centuries.

resort for Gold Standard countries, whose governments by and large upheld certain rules of the game regarding stability and convertibility. That said, much of our current regulatory and technological infrastructure was absent. Only recently could companies begin to structure themselves into multipoled, interlocking confederations—sometimes referred to as transnational firms—instead of the more rigid home office and foreign subsidiary configuration which was commonly adopted by multinational business firms from 1918 to 1990.[47] Arguably banking was one of the last sectors to build transnational Behemoths.[48]

Long before the Industrial Revolution, private banking helped to integrate financial and trade transactions in Europe. Continental Europe was the birthplace of private (US term) or merchant banking (European). These financial intermediaries' varied businesses largely grew out of trade transactions, trade financing, and foreign exchange dealings. Though some commenced in the Middle Ages, their number and activities blossomed in the nineteenth century. Before that time, in addition to the Rothschilds from Frankfurt, the most famous family, the Warburgs in Hamburg, Oppenheims in Cologne, the Mendelssohns and Bleichröders in Berlin, and several Huguenot families in the Rhineland had established family enterprises, some with international reach. Many had survived the vagaries of economic fluctuations, revolutions, political persecution, and limits on family progeny across two centuries. Some of them were also intimately connected with the great political transformations in Germany.[49]

German regulations provided many opportunities for private banks. Nevertheless, for certain activities they were forced to band together to protect their interests or seek new markets, which sometimes allowed smaller banks "to fight above their weight." In most German-speaking states, banking activities were licensed, and even after the Reich was established, few restrictions limited banks working together. Well before bank shares could be publicly traded on exchanges in these regions, private banks (family banks) applied for the privilege to engage in specified banking activities, such as lending and dealing in foreign exchange. These were granted for restricted periods and with limited liabilities for the owners up to the par value of stock.[50] As a result, in Germany, during the nineteenth century, banking associations were very strong. Not only did they form syndicates

47. Kobrak, *Banking on Global Markets,* 271–367.
48. Kobrak, "Deutsche Bank and the United States."
49. Stern, *Gold and Iron,* 81–96.
50. See, for example, Matis, *Die Schwarzenberg-Bank,* 36–47 and 89–102.

for issuing securities, they also created joint ventures and long-term strategic alliances for many activities, especially international ones.[51]

Even in London, where a wide variety of financial institutions and services flourished, family banks played a substantial role. Although the City of London was unquestionably the financial center of the world for the half century before World War I, it depended on family banks to do cross-border business beyond Great Britain's colonies. Family banks served as guarantors of foreign and domestic businesses, who wanted to access the London market with their bills of exchange or who wanted to raise capital among English and other investors. Bills accepted this way became known as bank acceptances, and their issuers, acceptance houses.[52] Specialized among banks "proper" that took deposits, they provided domestic short-term loans and cleared domestic transactions. Most foreign transactions–accepting bills of exchange and issuing foreign loans—outside of the orbit of English colonies were handled by merchant banks, which were predominantly family enterprises. Despite England's relative industrial decline between 1870 and 1914 and the predominance of such family institutions, its banking activity, especially international banking, thrived. The city funneled billions of pounds to the rest of the world. Whereas domestic private banks disappeared almost completely before World War I, eclipsed by their joint stock competitors, international merchant banks continued to prosper. Inland bills of exchange disappeared, but international ones grew rapidly, making "the merchant banks a permanent and indispensable cog in the works of English banking."[53]

Consider the first Accepting House Committee, a group organized to ensure liquidity for the system as World War I began. Twelve of its 21 banks had reference to family structure in their names (Sons or Brothers). Several of the others had started out as family businesses and still had strong family ties with other institutions—for example, Morgan, Grenfell & Co.[54] Virtually all the largest, including Lazard, Barings, Rothschild, Hambro, and Morgan were family enterprises linked to much of the rest of the world by "separate" family firms in other countries. The Germans, mostly Jews, anchored the foreign banking community. Like Stern and Co., they operated in continental

51. Gall, "The Deutsche Bank," in Gall, et al., *The Deutsche Bank, 1870–1995*, 1–17.
52. Kohn, *Financial Institutions and Markets*, 527.
53. Cassis, *City Banker: 1890–1914*, 28.
54. Ibid., 30–31.

Europe with their relatives, and in the United States and elsewhere with joint stock banks.[55]

In contrast to deposit banks, these institutions changed little during the decades before the Great War and jealously guarded their private and family structures. Few merged. Only two of the firms making up the Accepting House Committee were registered as limited companies, Baring Brothers and Wallace Brothers. In 1910, only a dozen of the 95 London merchant banks had adopted limited liability. As Youssef Cassis put it, "The corollary of this private type of structure was that the business generally remained a family one."[56] With few mergers, marriage remained the main method of combining interests and expanding the management pool in both family and joint-stock banks. Cohesion of international private networks rested on family relationships. Intermarriage was not systematic among all banking families, but it was within well-defined groups. Jewish and Quaker bankers and their female offspring tended to marry into the banking families of their coreligionists. Marriages brought in new blood and created "dynastic" alliances among these banks.[57] Despite this limit to growth, their international reach was enormous. In addition to unsecured securities and syndicate loans, which were not broken down by region, in 1910, nearly half of Hambro & Sons investments, for example, were in North America.[58]

The American financial scene was even more encouraging for family-styled banks. There were dozens. Many Jewish family banks on Wall Street, including Lehman Brothers, Hallgarten & Co., Speyer & Co., J.S. Bache & Co., and Kuhn, Loeb & Co., played an important role in bringing to market US public and private securities. Wealthy Jewish families, such as the Lewisohns and Guggenheims, who had made their wealth in other fields, set up banks downtown near Wall Street.[59] Lacking a central bank and a strong commitment to the Gold Standard, America was prone to financial panics and periods of sharp booms and busts to a greater degree than was Western Europe. Perceiving more risk in the United States, foreign investors required a premium and direct oversight to invest there; family banks soothed their fears by managing their US interests and by mitigating the financial consequences of panics.

After the mid-nineteenth century, many private banks not only had the advantage of their family network, they also were relieved of some confining regulations and nasty competition. A complex mixture of

55. Ibid., 36–37.
56. Ibid., 39.
57. Ibid., 214–15.
58. Ibid., 149.
59. Birmingham, *"Our Crowd",* 9.

federal and state law—mostly in New York—inhibited joint-stock banks' international investment activity. US national banks operated with relatively severe reserve and branching constraints, which, before 1914, even included an inability to deal in bank acceptances. By 1900, some American banks were approaching the size of their European rivals, but national banks had to work with private ones and form separate companies to overcome statutory limits on their activities. State banks operated only in the states which licensed them. Their size and regional connections limited public banks' interest in and ability to conduct foreign business. In contrast, following Anglo-Saxon custom, private banks were unlicensed; they could simply hang out a shingle to at least start doing business. Success, however, relied on their reputation for integrity. Not until the very end of the century did national, joint-stock banks and trusts begin to acquire retail and corporate clientele, which gave them the financial muscle to compete with the "internationally funded" private banks for international lending and other cross-border transactions. Even then, many of these national banks had large family sponsors, such as the Rockefellers.[60] Before 1914, moreover, national banks could not open foreign branches and were restricted in relation to trade finance transactions. Conversely, foreign banks were prohibited in some key states from maintaining offices that took deposits.[61] As private banks were not technically foreign owned, this restriction did not apply. In short, virtually all the banks in the United States with strong European financial clout in 1900 were family banks, not joint-stock institutions.[62] Even multinational British banks, which worked with foreign offices mostly in colonial regions, suffered from severe governance (control) problems.[63]

In general, business and banking were more personal in the nineteenth century than today. Relying on character and integrity, bankers and customers in some parts of the world preferred from one another

60. van Cleveland and Heurtas, *Citibank 1812–1970*, 1–31. See also Sylla, et al., *The Evolution of the American Economy,* 173 and Kohn, *Financial Institutions and Markets,* 207–13.

61. Carosso and Sylla, "U.S. banks in international finance," in Cameron and Bovykin, *International Banking*, and Wilkins, *History of Foreign Investment… before 1914.*

62. Wilkins, *History of Foreign Investment before 1914*. Although large joint-stock banks, such as Deutsche Bank and Crédit Lyonnais, invested in the United States, they labored there with considerable weaknesses. They worked primarily through agents and relied on private banks for a lot of the deal making and monitoring of investments. Focusing mainly on the distribution of securities in their home markets, the joint-stock banks left to family banks many of the value-enhancing steps needed to conduit billions in debt and equity funds from the capital-rich Europeans to the capital-hungry Americans.

63. Jones, *British Multinational Banking*, 46–53.

personal rather than institutional assurance. Although private bankers were no saints and at times destabilized rather than stabilized markets, they lived by strict codes, enforced by their informal associations.[64] Many relied on their own equity rather than on deposits and borrowings. Capital, especially domestically generated, was scarce (hard to come by and expensive) in the developing economies of the nineteenth century, far less plentiful than in emerging economies today. Financial institutions reflected their directors and were at their disposal. They behaved much like "investment clubs" for channeling funds into projects, as Naomi Lamoreaux noted. In her study of New England banking in the nineteenth century, she argues that this region was very similar to other parts of the world.[65] Even the great money centers functioned this way, including their leading banks: the Rothschild cousins, the Speyers, Seligman Brothers, to name just a few who served as lead deal makers and deal enforcers.

To illustrate family firms' importance and competitive strengths in international banking, I will draw on the histories of the House of Morgan and the House of Warburg, one having English origins, the other German–Jewish. The oft-employed term *house* (for commercial enterprise) helps describe the complex and informal networks that brought together individual firms in different countries to constitute the group of separate institutions. Given the subject here, the term '*house,*'—which denotes a place where individuals (often family members) live together sharing one roof and which connotes some shared purpose and even some interdependencies—has a special significance.

These two leading private banks made substantial profits by linking investors, who had little regulatory assurance of asset protection, with sometimes risky and often distant projects. Before international rating agencies and electronic transfers, even simple payments were difficult. In 1900, these family banks had a rather unique international span of trust, for which there was no obvious substitute. Moreover, diversifying risks was difficult, given the small number of investments and the lack of adequate techniques. In key markets, the limited and sometimes remote liability of joint-stock banks stood in stark contrast to the unlimited, personal, and close-to-home liability of internationally connected family banks. Even though real assets backed many debt instruments, there was little or no alternative to direct oversight of business that required close contact between managers and shareholders. With economies of scale in financial services limited, while regulatory and technical obstacles thwarted internalizing

64. Chernow, *The Death of the Banker*, 26.
65. Lamoreaux, *Insider Lending: Banks,* Introduction. 1–10.

cross-border tasks, family enterprises provided much of the reliability, which multinationals could only achieve later. These stories do set the stage for eventual decline; however, as governments increasingly took a dim view of the profits generated by private sources of information.

The house of Morgan

Founded in 1838 by George Peabody, this bank reached its zenith under the leadership of J. P. Morgan, Sr. (1837–1913), the son of Peabody's partner and successor, and J. P.'s son, J. P. Morgan, Jr. (1867–1943). Sent to New York by Peabody and his father after several years of training and education in both Britain and the United States, Morgan Senior came to dominate American banking and capital flows from England to the United States more than any other individual or institution of the time or since. Profiting from America's late nineteenth-century thirst for capital and Europe's fears of American mismanagement and sloppy regulation, Morgan and his associates brokered numerous government financings, corporate restructurings, and new equity offerings, marketed across the developed world. With Britain providing the largest share of foreign investment to the world's fastest growing economy, maintaining offices in London and New York was particularly important. Until his father's 1893 death, the connection between New York (for many years, Drexel, Morgan & Co.) and London (J. S. Morgan & Co., later Morgan Grenfell) was the father-son family bond. Before a Federal Reserve existed, the elder J. P. Morgan even stepped in to stabilize markets during times of panic, notably during the mid-1890s and in 1907.[66]

Banking then was both broader and narrower than today. Our modern conception of retail banking with numerous branches and tellers' windows hardly existed. Both the users and the providers of capital were far less numerous, consisting primarily of governments, wealthy individuals, plus various sorts of commercial firms and financial institutions. Morgan's bank concentrated on large security offerings and trading foreign-exchange-related instruments, then a much lower volume business than now. Morgan used to boast that 96 of America's 100 largest companies were his clients, many of whom would make pilgrimages to the bank, not vice versa.[67] However, before many transactions became routine, before regulations bred more specialized institutions, and before capital markets developed to allow potential

66. Chernow, *The House of Morgan*, Prologue. xv-xvii.
67. Ibid.

clients direct access, banking services widely resembled those practiced by universal banks in their heyday. They not only provided various forms of capital, but also consulting, accounting, and other services.[68]

Morgan was selling a service, his assurance that what he said about a security would come true. Clients expected him to take a direct interest in the affairs of the companies whose securities he had encouraged them to buy. He and his colleagues practiced a discreet style and clients felt as if they had been accepted into an aristocratic club. In the uncertain world of pre-1914 finance, with few reliable and quick sources of information, distant investors wanted their man on the spot, someone whose name and reputation not only was solid but whose work and commitment were assured by the closest of all bonds. If bankers in the pre-1914 period were masters of the economy, the House of Morgan was truly "the lord of creation,"[69] a position it held even after World War I, amalgamation, and the increased size of commercial banks had driven many other family banks into mergers or out of business.

The bank became a powerhouse all over the world, but British and American financial ties were its special territory. By 1910, the house had equals for business in other parts of the world, but for American–British business, it had no rival. Investors and borrowers rarely saw each other. Financial statements provided little reliable information. They had to rely on the implicit guarantee of their go-between, whose judgment and good character had to be of the highest order. Despite being burned by the failures of several American railroads, once again encouraged by Morgan's ability to restructure troubled companies, English investors poured vast new sums not only into transportation companies but also into new ventures such as electricity. As the house grew, especially the London branch, it hired more experienced bankers, but the first lot were all connected by a family bond.[70]

A few transactions illustrate how Morgan did business and why his style of banking was so important. Morgan earned enormous profits by leading several securities issues designed to stabilize the American currency, but perhaps his greatest influence was in the transformation of the ownership structures of American corporations. Unwilling to take full responsibility without full authority, Morgan was the point person for many of the most important private transactions of the day, an activity that required being prepared to step in and actively

68. Fear and Kobrak, "Banks on Board."
69. Ibid.
70. Burk, *Morgan Grenfell,* 29–45.

manage companies.[71] Investors bought securities with promises of high profits based on the House of Morgan's continued involvement with the companies. When entrepreneurs exited firms, distant shareholders understandably asked a question that continues to trouble the holders of dispersed equity: Who would watch the managers and protect investors' interests? As two experts noted about the syndication of the sale of $32.5 million in shares the railroad magnate William H. Vanderbilt wanted to sell: "Once again, the imprimatur of the investment banking intermediary implied a credit-screening process and a presumption of quality that carried the day. And both the celebrity and franchise value of the House of Morgan were further embellished."[72]

During the last quarter of the nineteenth century, Morgan played a key role in the development of new industries and the reorganization of established ones. His early support of Edison's plans for electrification in the United States is well known. By the late 1880s, however, Morgan pulled back somewhat from financing and managing the Edison businesses, giving way to a mostly German syndicate of banks and electrical companies put together by Deutsche Bank and led by its representative in the United States, Henry Villard. The Edison companies were consolidated and pushed forward with an aggressive development plan, which required a seemingly endless series of new funds. Morgan came to the view that the major firms in the field should be merged but under the leadership of Edison's rival, Thomson-Houston and its president, Charles A. Coffin. During the approximately two years, Villard served as Edison General Electric's president, investors grew uneasy about the new company's capital requirements, about its inability to list on either the New York or Berlin stock exchanges, and about this visionary but roguish German. Although Villard had long argued that consolidation in the sector was the only way of increasing profitability, Thomson-Houston, under the guidance of several private banks in the United States, hired sound management and became far more profitable than Edison. By 1892, the German investors seemed glad to be done with the EGE venture. Morgan took the lead in negotiating the terms of a merger, and the House of Morgan stayed close to the new company, General Electric (GE), which grew into one of the most valuable firms in the world. Morgan was less active than some other bankers, but much of the board of the new GE was made up of private bankers—including two Morgan representatives—who played an active role in bailing out the company during the Panic of 1893.[73]

71. This point comes through in all the main accounts of the House of Morgan: Chernow, Strouse, and Carosso.

72. Hayes and Hubbard, *Investment Banking,* 18.

73. Kobrak, *Banking on Global Markets*, 45–61.

His own very active financial involvement did not preclude Morgan's relying on experienced managers. With good managers on board, he did not generally dictate policy for successful firms he had helped finance.[74] Yet especially in capital-intensive businesses, Morgan and his colleagues readily took a more active role and organized new funding, a commitment that helped attract investors for new sectors like electrification and for old ones like transportation. In times of trouble, which all too often beset the poorly regulated American economy, Morgan and his colleagues plunged in to save companies in financial distress.

Morgan and other private banks played an important governance role in the rail sector, which in 1885 still made up over 75% of all the stocks traded on the New York Stock Exchange.[75] Although public banks provided much of the financing by purchasing securities and more importantly by distributing them, private banks took the lead in managing ailing lines. Together with Deutsche Bank, Morgan spearheaded the reorganization and management of the Northern Pacific Railroad in 1893. Indeed, Edward Adams, who replaced Villard as Deutsche Bank's representative, actually drafted much of the 1896 reorganization plan that brought the Northern Pacific out of its third bout of financial distress, and served as the newly constituted board's president. Like many lines, the Northern Pacific was beset by overcapacity, competition, and regulatory ambiguities. Here, Morgan and other private banks mobilized international capital and assumed many control tasks to ensure that shareholders did not lose their pants with their shirts. Deutsche Bank was particularly important to this reorganization due to the high number of German investors, but most of the management tasks fell to the House of Morgan, which headed the Voting Trust established to oversee the company for five years after it came out of receivership. Within two years, Adams was forced to withdraw from the board. Four of the five members of the voting trust were from private banking houses. Given the great distance, Deutsche Bank managers could not attend many meetings in New York, at which personnel, investment, and accounting decisions were made, and in general had trouble, even through their representative, influencing events. By the time the Voting Trust was dissolved, the investors who knew enough to hang on for the volatile ride were amply rewarded for their patience. But with all the intrigues among the participants

74. See Carlson, *Innovation as a Social Process*; Strouse, *Morgan*; and Kobrak, *Banking on Global Markets*. Although these accounts differ on some details, they are in agreement about virtually everything presented in this account.

75. O'Sullivan, "Expansion of the U.S. Stock Market," 495.

and ups and downs of restructuring, an investor had to have an 'in' with the insiders to know when to get out.[76]

By the end of the nineteenth century, however, signs that Morgan's influence was diminishing began appearing. As America's dependence on foreign capital and Britain's position as a provider waned, so too did the value of his special position linking the two markets. Americans became wealthier, both in amount and distribution of funds, and various forms of joint-stock institutions increased their share of investment activity. Depositors in national and state banks, trust accounts, and insurance policies all increased. Wealthy families like the Rockefellers funneled much of their investment activity through joint-stock banks such as Chase. Moreover, even as cries for better public regulation of the American financial system became louder, other private banks began to rival Morgan's ability to entice new foreign capital and serve as reliable go-betweens by actively monitoring investments. Facing new regulations and competition, by the time of his death, J.P. Senior had lost much of his relative financial clout. This process accelerated after World War I.

The house of Warburg

By 1900, the House of Warburg was Morgan's main rival in New York, surpassing even some of their more famous competitors, whose partner structure constrained growth. According to some accounts, the Rothschilds' inability to find a family member to go to New York in the late nineteenth century, and their consequent reliance on the Belmont family, contributed to the family's relative decline. In addition, unlike families such as the Rothschilds which bound their empire with bloodlines, the Warburgs used blood and marriage to create a confederation of banking houses in most of the centers of world finance. It was this looser grouping that allowed the family to move into areas in which direct descendents and the Rothschilds dared not tread. The Warburgs had relatively longer success than the Rothschilds, but in the end, their position too was undermined by national hostilities and technology.

Forbidden to own land and carry on trades, like many Jews in the sixteenth century, the Warburg family became "Court Jews" as lenders at interest and dealers in foreign exchange in the area between Frankfurt and Hamburg. In the seventeenth century, the family interest moved to financial activities outside of what would become Germany. M.M. Warburg & Co. was a private bank deeply involved in

76. Kobrak, Banking on Global Markets, 62–92.

trade financing. Whenever the bank needed money, its men married into other wealthy Jewish families, which also served to create commercial ties with Russia, Hungary, and France. Like many other family businesses, the Warburgs suffered at times from a dearth of qualified, motivated sons; they, in contrast to many other family banks, sent out their daughters to bring back new capital and new partners.[77]

The Warburgs operated two of the leading banks in Germany and the United States. In the nineteenth century, Rosa, Malchen, and Moritz Warburg married heirs to important banking houses. Trained at the family and other private banks, the oldest son of Moritz and Charlotte (nèe Oppenheim), Max Warburg, by the turn of the century, was expanding the German office's activities and his own reputation as one of Europe's leading financiers. His brothers, Felix M. and Paul, married into the Kuhn Loeb firm, considered in 1900 New York's most up-and-coming bank, second only to Morgan in power. Felix's daughter married a Rothschild, his sister a Speyer. The house's marital relationships gave it a rare advantage. It could team up in various countries with strong partners while using its own international network to coordinate business opportunities. There was no partnership agreement or need to be exclusive.

Although the House of Warburg was involved in managing many companies on both sides of the Atlantic and helped organize many cross-border securities launches, its story illustrates two important qualifications to the power of family banking in this period. In their heyday, the Warburgs depended more on Morgan than on joint-stock banks. They could make deals and monitor companies, but they needed help with distribution. Soon after 1900, even Morgan found himself working more closely with joint-stock banks and trusts, such as Bankers Trust, which he helped found, to distribute securities and for other purposes. Unlike Morgan, however, the House of Warburg was more involved with companies whose original owners remained very active managers, in contrast to the Edison companies or the Northern Pacific. Kuhn Loeb's Jacob H. Schiff was an important personal and financial advisor to the Great Northern's owner–manager James J. Hill. Although Hill needed someone like Schiff to restrain some of his entrepreneurial "animal instincts" and calm other investors, Hill was one of the most knowledgeable, disciplined railroad men in the business. With his own management skills and Schiff's financial acumen, Hill's line never got into the same troubles as the Northern Pacific, its main competitor, which had led to active bank management of the latter line.[78] Max Warburg had a very similar

77. Chernow, *The Warburgs,* 3–68.
78. Martin, *James J. Hill & the Opening of the Northwest,* 394–522.

relationship with Albert Ballin, managing director of the Hamburg-American Line (HAPAG). Ballin convinced a reluctant Warburg to join his Supervisory Board against the policy of the bank. With the Ballin–HAPAG involvement, Kuhn Loeb invested in the German firm and Warburg joined the boards of several other German companies, a role that tended to be more active than usual for the family in the United States but was generally less intense than some of Morgan's turnaround situations.[79]

Warburg family members were both leaders of the banking community, and occupied important political and social roles on both sides of the Atlantic. In the pre-World War I environment, their visibility enhanced their national status as well as their membership in a kind of international network of like-minded financiers; after 1914, it hurt them as economic liberalism imploded. Despite its reputation as transatlantic philanthropists, once national passions heated up, the family suffered large losses. Although the "American branch" fared better, it too came under a great deal of political scrutiny. Paul was a brilliant monetary theorist, who helped with the creation of the US Federal Reserve in 1913. But as the New York Warburgs, along with other bankers of German origin (ironically mostly Jews), tried to gather support and funds for the German cause before America entered the war, they were heavily criticized. Simmering frictions between rival firms in New York exploded into vitriolic debates about patriotism. Otto Kahn, a naturalized German–American partner at Kuhn Loeb who had married a founder's relative, endured questioning of his citizenry and loyalty.[80] (Like other private bankers such as Jack Morgan, Kahn later became one of the main focal points of general attacks on the banking system and international finance in the 1930s.) In Europe, Max Warburg helped negotiate the Versailles Treaty, for which he and others were branded traitors by many Germans. Even Max Warburg's sense of German identity, his enthusiasm for German imperialism before World War I, and the Jewish–American banks' general support of financing Germany during the First World War did not prevent the Hamburg Warburgs' firm's *Aryanization* and most of the family's flight from Germany in the late 1930s. The internationalist Warburgs even ran afoul of their coreligionists for criticizing the state of Israel, which they considered a throwback to primitive nationalism.[81]

However, politics was not the only development that impaired private banks' competitive strengths. Even before international consensus and capital flows broke down in 1914, laying international

79. Chernow, *The Warburgs*, 103–106.
80. Collins, *Otto Kahn,* 94–97.
81. Chernow, *The Warburgs,* 545–715.

cables and introducing phone and wireless services lowered the cost of acquiring information and the private, family banks' competitive advantage of having reliable, autonomous representatives on the ground—shifting power from the Rothschilds and Speyers to larger, join-stock institutions.[82] Of the houses discussed here, Speyer was the oldest, dating back to the Middle Ages, to a town 100 kilometers from Frankfurt whose name it also bore. In 1800, the family was reportedly richer than the Rothschilds. With a great deal of foresight, in 1837, in the wake of the collapse of America's second central bank and the panic following the lapse of its charter, Philip Speyer opened an operation in New York to deal in foreign exchange and to trade European merchandise. The House of Speyer operated in London as Speyer Brothers, in New York as Speyer & Co., and in Frankfurt as Speyer-Ellisson. As one of the first European banks operating in New York, it played a leading role in financing the Civil War and turning New York into a leading financial center. Other family members joined Philip. Using the USA as a kind of staging area before World War I, the house became particularly well known for financing Latin America and the Philippines, bringing millions of dollars in funds from Europe.[83] As a private bank with close connections, it could work with joint-stock companies, performing services in New York such as discounting bills, taking deposits, and buying and holding securities, which rivals like Deutsche Bank could not, while utilizing the larger banks' greater fundraising capacities in their own markets. For fifty years, Deutsche Bank and Speyer, who were tied by a family relationship, cooperated in many ventures. Speyer's ability to handle day-to-day transactions, give advice, and find deals to be placed in Germany aided Deutsche Bank's business enormously.[84]

In 1934, the American Speyer bank closed its doors.[85] The world was in a state of financial meltdown and its services, if desired at all, could be performed by others. To be sure, Speyer's fate might have been extreme, but most of the great private banks had suffered enormous declines. Many ceased business or merged with other firms; some were absorbed into public firms. From 1914 to 1950, one of the great private banks of German and British origin, Schroders, saw its political loyalty questioned due to its "German name" and its underwriting and trade financing profits oscillate and decline. By 1960, the bank had transformed itself into a public company.[86] Somehow the

82. Ferguson, *The House of Rothschild*, 369–411.
83. "Rise of New York's Great Investment Houses," *New York Evening Post*, 15 Oct. 1926.
84. Kobrak, *Banking on Global Markets*, 144–60.
85. "Speyer Becomes Investment Unit," *The Wall Street Journal*, 14 June 1934.
86. Roberts, *Schroders*, 352–54.

strengths of family banking lost much of their luster or, worse still, became liabilities. The "hereditary calling" of banking which emphasized "character and connections," key components in the private banks' ability to "divide and diminish risks," had in times of crash and public outrage about insider information undercut their economic benefits and turned them, in the eyes of many, into pariahs and causes of social disintegration.[87]

Ideological, Regulatory and Market Turns: Revolutions in Savings, Investment, and Expectations

> The separation of ownership and control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear.
>
> Berle and Means, *The Modern Corporation & Private Property*, 7.

We now turn our attention to some of the factors that led to family banking's relative decline in international banking. Although World War I played an enormous role, the shift cannot be attributed to one event or circumstance. Indeed, some causes predated 1914, others continued well past mid-twentieth century, while national variations in rates and sorts of changes occurred during the interwar period. Still, by World War II, family banks' international financial prominence had diminished. In part, this relative decline can be attributed post-1914 trade obstacles and an increase in capital market frictions. Even so, some frictions actually added to the importance of family banks. Although uncertainty helped private banks in the mid-1920s establish themselves as the chief conduits for transatlantic capital, the combination of chaos and increased government controls, which particularly characterized the early and late interwar period, proved negative. Nationalist conflicts even affected relations among the Rothschilds and Warburgs; internally families abjured patriotic passions, a stance that had greatly contributed to their successes. The reaction to the war and the disorder that followed also generated an ideological turn against international banking, which hit family banking hard in some countries. Especially during the global depression, private banks' strength as international conduits actually became a political

87. Landes, *Dynasties*, 8–9.

and economic liability. Tainted by their foreign associations, their privileged sources of information came under greater public supervision. This control included more extensive rules about the dissemination of financial information and more active state control of banking activities to ensure that public and private good coalesced.

With public banking competitors attracting many new depositors and many of their stable businesses hurt by competition, blocked funds, and trade reductions during the "Roaring Twenties," several large private houses also suffered greatly, at least in relative terms, from trends that had begun even earlier. As early as 1910, in Germany the wealth of the largest private bankers barely equaled the share capital of Germany's largest public bank, a fact that made joint-stock companies especially strong in the distribution of new securities in their own country.[88] America's dispersion of wealth produced a corporate and individual demand for deposits and other passive investments available at large retail banks. From 1895 to 1905, National City (now Citibank), for example, increased corporate deposits eightfold. Overall assets grew by 22% per year, adding a phenomenal amount of cash to the banking system.[89] Yet the challenges to private banks were not limited to domestic competition for funding.

Right from the start of hostilities in 1914, finance took on a much more political character, but in ways that had a mixed impact on private banks' fortunes. Through much of the 1914–1945 period, trade and other forms of international exchange diminished or became more government supervised. As cross-border transactions shrank, certain kinds of domestic business, especially government business in Germany, also became more important to banks, enlarging a nation-based area of finance where private banks seemed to have fewer advantages. With the American prosperity during the first few decades of the twentieth century, came a radical reduction in that country's dependence on foreign capital and a huge increase in U.S. investment for political purposes. In general, cross-border financing became more political. Even in its heyday of the 1920s, "private" transactions had a large government component. In 1921, the Harding administration tried to impose public supervision of foreign loans. The Reichsbank oversaw funds coming into Germany and the US government encouraged American banks to assist both the Dawes and Young Plans, which some bankers claimed impeded their business judgment and led to major defaults.[90]

88. Treue, "Das Privatbankwesen im 19. Jahrhundert," 566.
89. Cleveland and Heurtas, *Citibank,* 41.
90. Stephen A. Schuker, "Money doctors between the wars: The competition between central banks, private financial advisers, and multinational agencies, 1919–39,"

Competition for the more limited international business heated up. After World War I, American financial institutions found that they were largely able to circumvent private banks with close European ties by developing contacts directly with foreign clients and opening up offices in Europe. Already before World War I, American trust companies had exploited loopholes in US regulation to create foreign entities. Until 1913, American national banks, unlike trust companies, for example, were not allowed to operate foreign branches. By the late 1920s, in addition to their large correspondent banking relationships, National City and other US banks sponsored branches all over the world, directly or through subsidiaries.[91] With the liberalization of New York banking law, too, which began shortly before World War I, some foreign joint-stock banks found operating in America's most important money market easier while American banks found that they had more negotiating leverage to enter foreign markets.[92] The international bank investments during the first half of the twentieth century were only the first wave in a veritable tsunami of financial-service foreign direct investment that followed World War II, as both European and American public banks increased their financial muscle and above all tested or just avoided national regulatory limits.

On both sides of the Atlantic, long before the 1929 Crash, however, neither government officials nor the public at large was enthusiastic about financial institutions' international clout, especially their ability to engage in uncontrolled international capital flows. Although national willingness to tolerate supranational institutions and free flows of capital tended to ebb and flow with economic conditions, attacks on private and public banking were not confined to periods of economic decline. The excesses of the Gilded Age, for example, unleashed a public outcry. From William Jennings Bryan's anti-Semitic diatribes against the common man's being "crucified on a cross of gold" to Louis Brandeis's warnings that powerful economic interests improperly used "other people's money," many segments of American society were eager to reduce the power of private finance. One of

91. Cleveland and Heutas, *Citibank*, 78–79. By 2000, commercial banks had created a huge network of branches and subsidiaries all over the world. Most developed countries had accepted that foreign banks could do outside of their own country whatever they did inside. In the United States alone, foreign banks operate 300 branches—that is, entities that are not legally or financially distinct from their parents—and nearly 100 subsidiaries, mostly for making wholesale rather than retail loans. From 1975 to 2000, total assets by foreign banks grew in the United States from approximately $50 billion in 1975 to $1.2 trillion in 2000, which accounted for approximately 20% of all banking assets in the United States. (Hughes and MacDonald, *International Banking*, 27, 90–101, 149.) By the early 1990s, 280 foreign banks from 65 countries with 1000 offices operated in the United States.

92. Lees, *Foreign Banking and Investment in the United States,* 3–45.

American Progressives' many demands was reform of the US banking system. Many believed that the panics, depressions, and bankruptcies that so often beset the US economy were caused, or at least exacerbated, by greedy bankers who, on such occasions, augmented premiums on their assets, especially gold, to sell them for even higher profits. As early as the 1880s, controlling private bankers, the "kings of Wall Street" who gained through currency manipulations, was a high priority. Although private bankers like Morgan and Drexel were not exempt, the calls for greater protection of poor farmers and workers were often linked to anti-Semitism and the very visible Rothschilds, unfairly charged with favoring war and their own interests over the public good.[93] Critics argued that financial power wielded behind closed doors by individuals sitting on interlocking directorships violated the spirit of democracy and fair play and worked against the general economic good. Although these fears indeed delayed the reestablishment of a central bank in the United States, the 1913 creation of the Federal Reserve owed much to the view that if the credit system must be controlled, then at least such centralized power must be in public hands.[94]

Most of critics' attention, before and after World War I, turned to private, family enterprises. The 1929 Crash merely brought to the fore all over the developed world deep-seated perceptions and fears of financial dependencies, with which names of leading family banks were easily identified.[95] American lawyers and regulators focused on breaking the power of banks, both private and public, whose insider information could easily be turned into extraordinary private gain. Their attack centered on banks' ability to take deposits and use the funds to invest in risky securities (as underwriters or for their own accounts), creating a risk mismatch between sources and uses of funds.[96] Only later, did the unscrupulous practice of margin selling by the banks for client purchases of securities become a centerpiece of regulatory efforts in order to reduce both stock market

93. Hofstadter, *The Age of Reform*, 75–78.

94. Ibid., 254.

95. The Banking Crisis of 1931 especially brought matters to a head. (If one were inclined to believe in historical repetition, conceivably Brandeis, who led the attack on banks, especially Morgan, in the early twentieth century, was playing Savonarola, who led the attacks on the Medici in fifteenth-century Florence.) Although Morgan was the most visible object of attack, anti-Semitism and, ironically, the Jewish banks' defense of German interests in World War I, undercut the German (largely Jewish) family banks in the United States. Forced to stress their American-ness, many floundered after World War I.

96. McCraw, *Prophets of Regulation,* 165. The most famous work from the era dealing with this problem was Louis Brandeis's *Other People's Money and How the Bankers Use It*, 1914.

and money supply gyrations.[97] These discussions were by no means unique to the United States. During the interwar period, banks, especially international banks, came under pressure due to generally shaky economic conditions and their supranational interests. While not universal and, to be sure, not completely new, harsh discussions and politically charged debate about banks infused national politics during the interwar period, threatening, if not curtailing the economic functions of both large banks and smaller, family banks in Germany, Great Britain, Austria, Belgium, and Italy.[98] Just as economic conditions constrained profits, banks encountered greater pressure to prove their social *raison d'être*.[99]

In America especially, blame for the 1929 Crash was placed squarely on the banking system and led to many regulatory measures, which undermined private banks' principal strategic advantages. The Glass-Steagall Act (1933), which forbade combining commercial and investing banking under one roof, is the best known of these regulatory changes, but there were several others. Regulatory constraints tended to push financial services toward specialization, which might have been a boon to the smaller, private banks and did help some create very focused investment banking houses. But the legislation terminated private banks' capacity to serve as universal banks—taking deposits, underwriting securities, and even serving as brokerage houses—a combination of services that had served them well. This restriction helped enlarge the capacity of other institutions to sweep up dispersed savings.[100] The House of Morgan, already weakened by J. P.s death, the creation of the Federal Reserve, a steady stream of public and congressional attacks, and the worldwide financial crisis, had to spin off many of its operations. It never regained its former importance; several of its former divisions are now parts of other banks.

A series of securities laws—for example, the Securities Exchange Act of 1934—established public audits and required detailed accounting standards designed to put insiders and outsiders on nearly the same footing. Within two decades of the crash, American regulators had installed the legal basis for mutual and pension funds, which

97. McCraw, 181.

98. See James, "Introduction," and Feldman, "Political disputes about the role of banks," in *The Role of Banks in the Interwar Economy,* eds. James et al.

99. Feinstein, et al., "International Economic Organization," in Feinstein, *Banking, Currency, and Finance in Europe Between the Wars*, 21–22. According to the authors, not only were profits from relationship banking harder to win, the closer banks' relationship was with clients, the greater the likelihood the banks were to fail.

100. Roe, *Strong Managers, Weak Owners,* 53–145.

eventually provided an enormous vehicle for supplying capital markets and also redefined corporate governance. Their legal and tax foundation limited ownership interest in any one company and in the amount of the total assets that could be put in any one investment, thus reducing the economic incentive for active management, once a strength of private banks.[101] The legislation emphasized diversification of mutual and pension funds to provide investors' protection against bad selection, rather than active oversight and at times management, long practiced effectively by private and other banks.

Moreover, the interwar period it changed the forms of cross-border trade and private capital flows in ways that were unfavorable to private banking and their links to companies. Through the whole period, Germany and Britain never restored their 1913 levels of trade in services. In Germany, trade was disrupted by transfers of goods as well as by the pressure to pay reparations. During the inflation period, many banks and their clients were awash with cash, which intensified competition and allowed many clients to become independent of their banks. Interestingly, countries in which companies and their banks were particularly close were hardest hit by the financial upheavals of the interwar period. Banks in many European countries became more dependent on short-term deposits and took on more risks. Such shifts, coupled with feverish investment surges in Germany and the United States during the mid-1920s, weakened their oversight capacity.[102] US private banks, such as Morgan and Dillon Read, underwrote most of the US loans going into Germany, but neither the American nor the German banks, public and private, enjoyed the governance power they once had had. Tainted by the weakness of the whole financial system, foreign dependencies, and some spectacular scandals, international banks lost much of their credibility with key constituencies in Germany.[103] What Mary O'Sullivan wrote about American firms' weakening capacity to guarantee the quality of new issues could also be applied to their German counterparts who received huge amounts of financing from the United States for dubious projects.[104]

Oddly, many interwar changes in German private banking paralleled those in the USA, but had a different *modus operandi* and different timing. During the 1920s, international banking was blamed for

101. Ibid.
102. Feinstein, "International Economic Organization," 21, 127.
103. Feldman, "Political disputes," 13–18.
104. O'Sullivan and Hardach, "Banking in Germany, 1918–1919" in Feinstein, *Banking, Currency, and Finance in Europe Between the Wars*, 269–95.

many of Germany's economic woes. The rhetoric of many popular parties, not just the Nazis, called for curtailing their activities. Although Germany tended to encourage family business and encourage banks to take responsibility for the governance of companies, even private banks, especially Jewish ones with their particularly close foreign loyalties, were more vulnerable. Private banks did little business with the masses and some, like the large public banks, were perceived as doing too little for *Mittelstand* (mid-sized) companies, two elements of society most hurt by the postwar economic chaos. But through much of the 1920s, they remained very vibrant, using their foreign contacts to bring in foreign capital and to help some Germans place investments outside the country.[105] Yet the private banks that provided the funds soon disappointed citizens on both sides of the Atlantic with the degree of control they exercised over companies and, worse still, with their unwelcome foreign dependencies. Their greatest economic asset had become a clear political liability.

But, by the mid-1930s, international transactions, the bread and butter of private banks, were severely curtailed and German banks became dependent on government loans and business. The Banking Crisis of 1931 and a series of governmental reactions to it had already shattered cross-border lending. In 1930, foreign investment as a percentage of world output was less than half its 1914 level.[106] From 1913 to 1938, nearly 60% of Germany's private banks disappeared, most closing after 1929, while the total number of banks remained nearly the same. Their percentage of commercial banking assets fell from 19% (1930) to 11% (1938).[107] Even before the Nazis came to power, however, bank operations more and more funneled private savings into state debt. Not only did the private banks have little to recommend them for this task, already by 1933 state agencies held 35% of the nation's banking assets. Banks came under more and more pressure to relinquish their traditional, broad fiduciary role with companies in favor of their responsibility to the "nation."[108] On both sides of the Atlantic, greedy international bankers were blamed for the crisis.

Private Jewish bankers' ability to manage international flows, however, seemed to be grudgingly acknowledged, even by the Nazis. During the Third Reich's first few years, Jewish private banks played an important role in economic life of the country. Useful in maintaining international trade credits, which even the autarkic Nazi regime

105. Ulrich, *Aufstieg und Fall der Privatbankiers.*
106. Obstfeld, *Global Capital Markets,* 55.
107. Hardach, "Banking in Germany, 1918–1919." 273, 280.
108. James, *The Nazi Dictatorship and the Deutsche Bank,* 22–37.

required, some Jewish banks even had a voice in political decisions. Some combination of perceived use to the National Socialist's autarchic, racist program and the maneuvers of Reichbank President Hjalmar Schacht, who to some extent worked to shield them from the ideological extremists, protected private Jewish banks from early rounds of anti-Semitism. Banking was one of the last sectors touched by *Aryanization*.[109] But by the end of the 1930s, these National Socialist policies triggered the redistribution of all Jewish private banks into the hands of "German" banking houses, and hence a huge reduction in cross-border financial capacity. In short, by the outbreak of World War II, not only had much of the international network been destroyed, State policies in two important markets had virtually eliminated their economic reason for being and ability to function. In many ways, events and regulation affecting family banks during the first half of the twentieth century set the stage for developments in the second half.

The period following World War II, though clearly less dramatic and devastating for family banking than the interwar, extended some old challenges and generated new ones that undermined family banks' role as intermediaries between private borrowers and lenders transnationally. In the war's aftermath, most international flows were state-driven, coordinated by quasipublic institutions. Private lending was virtually nonexistent. National and supranational institutions largely supported trade recovery, replacing banks. As private transactions picked up in the 1950s and 60s, joint-stock banks increased their ability to establish branches and subsidiaries in foreign countries. Spreading branch and subsidiary networks helped joint-stock banks utilize a relatively new device for servicing their clients' deposit and borrowing needs, EuroDeposits, which increasingly displaced traditional cross-border lending and thereby private banks' role as intermediaries. As huge joint-stock banks internalized international finance by investing in computing power and by operating foreign branch networks holding deposits national banking authorities could not control, low cost alternatives to family or other private institutions for linking national markets sprung up. Even countries that had used banks to vet the quality of new securities increasingly turned to public institutions like the SEC to judge the quality of debt and equity issues. Most important, a new kind of investment banking, spearheaded by American institutions forced to focus on underwriting or lending, came to dominate the sector. These financial institutions offered market analysis and their distribution capacities for a fee,

109. Ulrich, *Aufsteig und Fall der Privatbankiers* and Kopper, *Zwischen Markt wirtschaft und Dirigismus*, 221–91.

deliberately shunning their older oversight role and the importance of relationships. With rates determined by competitive bidding—not relationships—and investors increasingly relying on rating agencies and government regulators, banks' oversight functions became increasing redundant for investors and risky for the banks, who had previously held substantial portions of their clients' securities. Given this new financial architecture, many banks understandably found it intolerable to bear the risks without having the necessary control or compensation.

In terms of sheer volume, family banks now clearly play a much smaller role in world finance, especially in international finance, than they did in 1900. As internal acceptances passed out of existence in England at the end of the nineteenth century, so too have they disappeared among developed nations at the end of the twentieth. Credit analysis is done by international services. Physical transactions have been replaced by electronic transfers. Nearly half of the world trade is made up of intrafirm exchanges, which do not require the same level of credit analysis. The combination of huge flows, market fluctuations, and convertibility of most major currencies, coupled with technological and statistical advances, has turned foreign exchange markets into huge and highly integrated operations, where risks are managed by computer models and statistics. The volumes and types of bank investments have shifted greatly. Once sedate corporate clients access short-term and long-term credit instruments almost directly without the need of a bank intermediary.[110] Credit cards, checking accounts, and international access to cash machines have replaced the need for specialized banking instruments to make purchases for individuals in all corners of the world.

To be world class in these arenas requires huge investments in computer technology and marketing, for which family banks are ill-prepared. Here, the capacity of large, joint-stock companies to mobilize large numbers of small depositors, raise capital on public markets, and manage millions of accounts all over the world has proven decisive. In international investment banking, comparing the roles of family and joint-stock banks in 1900 and today is virtually impossible. In 1900, no joint-stock bank had an investment banking operation linking continental Europe and the United States. Now nearly all do. But in at least one financial area, family structures remain very competitive. Unregulated spaces of financial intermediation provide private (family) banks with an appropriate playing field to match their skills with the potential for high rewards.

110. Chernow, *The Warburgs*, 429–44.

Value Creation and Family Banking Circa 2000: Private Equity

> Overall economic performance depends on transaction costs and these mainly reflect the level of trust in the economy.
>
> Mark Casson, *The Economics of Business Culture*, 3.

Curiously, in the lucrative sector of Leveraged Buyouts (LBOs) family-style financial institutions have remained very strong. This remains one of the principal activities of private equity firms, generally privately controlled firms that specialize in buying public companies to take them private. Not only is the most famous, Kohlberg Kravis Roberts (KKR), a family business, so too are its chief rivals, Forstmann, Little, and Clayton, Dublilier & Rice. Many families that sold off their initial businesses have entered the private equity arena. Although some analysts have questioned the economic and social value of private equity, wealthy investors, both corporate and individual, evidently disagree with them. Some theorists view private equity as an efficient means of handling the agency problem, which arises from owners' separation from managing their property. The story of how KKR became the sector leader is instructive.

Three friends, two of them cousins, who were too restless for the public firm Bear, Stearns, Inc., founded KKR in 1976. Jerome Kohlberg, Henry Kravis, and George Roberts opened two offices—one in New York, the other in San Francisco—to solicit funds from banks and individuals who were familiar with their practice of buying small firms with debt.[111] Most ventures like theirs disappeared in short order. Their firm, by contrast, became a durable financial powerhouse, whose survival and profitability depended primarily, according to one account, "on the stability and capabilities of the founders . . . ."[112]

The partners' idea was not unique. They would buy well-established, privately controlled companies with regular cash flows, financed nearly entirely by debt (LBOs). By employing high, tax-deductible leverage from investors who also owned shares, they lowered the financial cost by maximizing the benefit of the tax shield with little bankruptcy cost effect. Success required assessing the cash

111. Baker and Smith, *The New Financial Capitalists,* 1–43.

112. Ibid., 3. See also Burrough and Helgar, *Barbarians at the Gate* for a lively and less sympathetic account of KKR's activities. The two sources agree though that the close relationship between Kravis and Roberts was an important success factor. Personal relationships were also important for the other bidding groups, but they appeared less able to manage certain other attributes such as secrecy.

potential of the firm, carefully planning for interest and principal payments, promoting long-term efficiency and appropriately motivating managers and other equity investors. KKR proved particularly adept at cultivating trust with debt and equity holders. KKR's efforts seemed to fill a yawning gap in corporate control, which features prominently in financial theory, the agency problem, or how to align the interests of shareholders with those of managers. "Burdening" the company with large amounts of debt, which committed free cash flows to investors, and making managers substantial shareholders contributed to reconciling these interests. Nevertheless, both groups seemed to profit from having a trusted intermediary, perceived as understanding the interests of equity investors, managers, and debt holders, too. Like their predecessors during earlier US merger waves (e.g., 1897–1904), these bankers remained "corporate insiders," meeting regularly with both management and investors. How KKR functioned was thus a throwback to the finance capitalism of a bygone era, curtailed, in the United States at least, by a combination of government restrictions and reduced financial incentives. "As fiduciaries, they guarded the interests of both shareholders and bondholders, while providing informed advice on corporate strategy, policy, and financial structure."[113] By the late 1970s, many observers believed that the lack of shareholder control in American corporations had led to a crisis in American management. Many companies were underutilizing their assets, overinvesting, or just squandering their shareholders' funds.

What made KKR's rise so extraordinary was its ability to gather vast sums of cash from investors willing to take great risks. Although its share of all merger and acquisition (M&A) deals and even LBOs remained small, when measured by total value, the results were extraordinary for a firm with fewer than 24 employees. By the mid-1980s, the average KKR deal's dollar value was 30 times the average M&A deal. KKR tapped new sources of funding, including larger and larger pools of equity capital, and expanded the sectors into which leveraged buyouts had spread, culminating with the $31 billion RJR Nabisco buyout in 1988, only one of six major KKR takeovers that year. KKR's credibility, which seemed to dwarf newly established departments of larger and often public banking houses, anchored its expansion. For the firm and its investors, despite the high levels of debt, M&A could not simply be a gamble, a high stakes poker game.[114]

KKR had to convince conservative investors, such as pension funds, insurance companies, and educational endowments, that this new sort of acquisition could manage its risks from beginning to end.

113. Ibid., 6–7.
114. Ibid., 23–26.

The inherent risks of high leverage, which adds to the variability of returns and the probability of financial distress, bore with them a responsibility to carefully select companies and managers, perform proper due diligence, price the acquisition properly, and prudently structure the balance sheet. For this, KKR had to commit itself to staying close to the companies in order to build long-term value. The partners monitored enterprises they acquired more rigorously than did most investors and boards of directors. Above all, if acquisitions ran into trouble, the partners committed themselves to sorting out the problem. KKR involved itself in the strategic tradeoffs between long-term investment in R&D and advertising versus short-term positive cash flows. Faith and reliability in their judgment and the efficacy of their efforts were everything to their ongoing business. These were hard to delegate outside of the "family." By 1989, KKR's six general partners and eleven professional associates oversaw $59 billion in assets representing 35 companies—just four Fortune 500 firms were larger in terms of assets.

As with their pre-1914 colleagues, KKR partners' efforts were not universally appreciated. Although European active insider corporate governance was more common, many observers watched in horror as barriers to acquiring and restructuring businesses collapsed, which often meant firing employees. Turning corporate control into a market seemed a recipe for unemployment and instability. Even in the United States, KKR's form of active, closed-door financial power, exercised by a small group, excited heated debate.[115] Nevertheless, its techniques and financing had an international reach (e.g., 1987 funding involved seven foreign investors).[116] As in many other sectors since the 1970s, family-style businesses contributed to a revolution in business practices, here the trend toward re-instituting owner-managed enterprises.[117]

As peculiar as it may initially seem, today's private equity firms may have much in common with family banks in 1900. Both traded on their reputations for evaluating and managing companies, and above all, for discretion in executing transactions. Like the family financiers of the past, competitive advantage in private equity rests on investors' trusting the long-term credibility of their advice and their willingness to stand behind their judgments. As the Robber Barons illustrated,

115. Ibid., 26–27.
116. Ibid., 202.
117. See Donaldson, "The Corporate Restructurings of the 1980s"; Kaplan, "The Staying Power of Leveraged Buyouts," and Wright, et al., "Corporate Restructuring," all in Chew, *Studies in International Corporate Finance* for good discussions of the social and economic impact of LBOs in the United States and Europe.

not all successful businesses, even family ones, are run by likeable people.

Conclusions

> To resort to voice, rather than exit, is for the customer or member to make an attempt at changing the practices, policies, and outputs of the firm from which one buys or of the organization to which one belongs.
>
> Albert O. Hirschman, *Exit, Voice, and Loyalty,* 30.

> But Humanity, in its desire for comfort, had overreached itself. It had exploited the riches of nature too far. Quietly and complacently, it was sinking into decadence, and progress had come to mean the progress of the Machine.
>
> "The Machine Stops," *The Collected Tales of E.M. Forster,* 186.

"Family" banks' histories point to several generalizations about their strengths and the evolution of capital markets. First, the growth in the number of sources of financing and investment opportunities increased the ability of financial firms to standardize and diversify their offerings, thereby creating economies of scale and applications for mathematical modeling and modern notions of diversification to optimize risk and reward relationships. For example, large commercial or universal multinational banks spread depositors' risks across vast geographic and industrial domains. However, in market niches where diversification is impractical, where individual investors can only make money by managing unique risks, and where sources of funding have to be tailored to individual needs, private banks still thrive. Even where modern portfolio management techniques are employed, family banking is especially effective where both the provider and the beneficiary of funds require elements of trust that go beyond regulatory or contractual assurances. As was the case a century ago, private banks have particular advantages where business opportunities in emerging markets are concerned.[118] In short, their *raison d'être* appears to be managing uncertainty rather than risk.

Second, as ever, private banks thrive in markets where regulation is weak, intentionally or by default. They have always "filled regulatory

118. Ehlern, *International Private Banking,* 77.

and technological gaps"—the spaces where economic actors mistrusted extant regulatory protections or investment opportunities.[119] Plausibly, whereas those spaces now are smaller than say in 1900, especially in the United States, some suppliers and users of capital seek out banks that exploit or protect participants from the "loopholes." By some estimates, today international private bankers manage \$7 trillion. Although much of this money belongs to high-net-worth individuals seeking to avoid taxes or government controls by investing in places like Luxemburg, Switzerland, and the Channel Islands, added incentives influence the choice to use private banks.[120] For these services, customers not only prefer personal attention but discretion, limited public control, and the personal liability of their bankers, since pursuing regulatory remedies to protect assets has several obvious drawbacks. Here, family banking offers extraordinary advantages.

Private banks cater to a special clientele that wants better than average service and returns. With most markets considered efficient—that is, offering fairly priced assets—institutions like family banks, which seek to provide "superior" returns, must find business segments where assets are not "fairly priced" or where their efforts can appreciably increase value, as they once did, to generate and sustain the abnormal returns they and their investors expect. As most finance texts attest, "abnormal results" accrue to those who manage real assets, for example, managers of companies. Private equity in some sense is an attempt to restore active shareholder management or at least reduce agency cost, thereby reasserting shareholders' potential to earn exceptional returns.[121]

Much has been written about the "new financial order," about technological change, new intermediaries, the globalization of finance, mass participation in financial markets coupled with government and public support and regulation. For this paper, what needs to be stressed is *that order's impersonal nature and its incomplete description of the financial world.* To be sure, the greater size and volume of transactions, as well as the standardization of instruments, make feasible applying mathematical tools to the relationship between volatility and reward, dividing risk into its component parts, and discovering exotic hedge and arbitrage opportunities.[122] Greater transparency

119. Taylor, *Private Banking Renaissance*, 10–14, 131.

120. Taylor, ix-x.

121. Interestingly, using the distinction that resembles market versus active governance, Kim and Hoskisson, "Market (United States) versus Managed (Japanese) Governance," and Buckley, "Cross-Border Governance in Multinational Enterprise," expand the notion of governance to include transactions control within a firm (Buckley across borders). The internalization of functions in large corporations may be seen as a means of increasing active management of assets.

122. Shiller, *The New Financial Order*.

and theoretical explanation of market movements have reassured investors and attracted new forms of investment, even though mathematical risk management and the details of financial regulation are not the daily bread of most investors. For many, faith in regulatory control and reliance on diversification seem to have supplanted the need for the kind of mediation performed by family banks a hundred years ago. In short, we have a great many capital market mechanisms for acquiring information about and hedging against some risks, such as inflation and credit, but the implications of uncertainty do not seem to be on the radar screens of many financial actors.[123]

Curiously, although this "Sea Change" in attitudes about risk, techniques for managing it, and their accompanying market innovations are largely, but not all, American inventions, little about world capital market evolution and its American roots has found their way into the growing 'Americanization of business' literature.[124] An argument could be made that these capital market changes have had at least as much of a transnational business effect as Fordism or management consulting. But business historians have as yet had little to say about how capital market innovations affect business in general, let alone discussed the degree to which they actually are attributable to American dominance or other causes.[125] The impact of these capital market changes on management and corporate governance responses to crisis has scarcely been tackled by those who can compare today's system with other paradigms of bygone eras.[126] Here, too, we find a separation of literatures analyzing business developments from scholarship concerning their ancillary institutions and thought

123. Financial markets function with many new impressive methods of hedging risk and building bridges between those in need of and those with excess funds. These innovations help sustain the delusion that uncertainty and even counterparty risk have been sufficiently vanquished that they can be relegated to trivial elements of investment analysis. Even though option traders should know that the patterns of movement and volatility of the underlying assets (as well as the creditworthiness of customers) may change radically, often very quickly, sometimes without evident explanation or signals from credit rating agencies, our control systems seem ill adapted to recognize and deal with these eventualities. For an excellent discussion of the dangers of market-based risk management see "Confessions of a Risk Manager," *The Economist,* and an excellent explanation of bank risk management systems Gene D. Guill, "Bankers Trust and the Birth of Modern Risk Management."

124. For a notable exception, see Schröter, *Americanization of the European Economy*, 55–58.

125. See Battilossi and Cassis, eds., *European Banks and the American Challenge.*

126. See Kobrak, *Banking on Global Markets*, especially interviews with Rolf Breuer and Hilmar Kopper, 23 Jan. 2006 about Deutsche Bank reducing its close relationship to companies.

processes.[127] Although some aspects of the new finance are not really very American in origin—indeed, some like offshore banking, for one, are responses to American regulation—and some very American ones, like private equity are throwbacks to earlier investment forms, the tendency to prefer liquidity over commitment, to encourage public (transparency) over private information, and to avoid free rider costs at the expense of close monitoring have been hallmarks of American attitudes toward corporate governance and the regulation of new intermediaries for nearly a hundred years. These intermediaries include pension and mutual funds, whose 2005 assets equaled total World Product and whose regulation limits the size of holdings, which in turn makes direct intervention in company management uneconomical.[128]

Their regulatory restrictions, economic incentives, and sheer size have had a huge impact on how we measure and manage the risk–reward relationship, as well as on the contours of corporate governance.[129] Two trends over the last twenty years illustrate the importance of exit and "financial insurance"—as opposed to the active investor intervention that is less feasible for these intermediaries—for managing risk-reward relationships. During the 1990s, the number of M&A deals nearly quadrupled; their dollar value increased tenfold.[130] Moreover, the fivefold increase of derivatives trading from 1998 to 2006—a staggering $500 trillion worth of transactions by recent counts (only 20% of which are done on public markets) as measured by the notional value of the underlying securities (total World Product is a mere tenth of that sum)—indicates the reliance powerful financial players place on market-based contracts as a substitute for active risk management, or perhaps conversely, as a means to profit from risk.[131] To be sure, some smaller, specialized firms (Hedge Funds)—trading on secrecy, sophisticated modeling, and regulatory loopholes, and sharing some of the qualities associated with family firms—have developed to exploit market anomalies and even at times to actively manage firms. They are very important for the volumes on derivative markets, but the total funds under hedge-fund management ($1500 billion, in 2006) is not much more than the assets of several

127. See Zeitlin and Herrigel, eds., *Americanization and its Limits.* McKenna, *The World's Newest Profession.*

128. Erturk, et al., *Financialization at Work*, 4.

129. See Hirschman, *Exit, Voice, and Loyalty* and Michael Jensen, "The Modern Industrial Revolution," in Chew, *Studies in International Corporate Finance,* who lay out the issue extraordinarily well. Ironically, the LBOs much hated in Europe and described above, are a way in which exit and voice are reconciled by reallocating assets.

130. Gaughan, *Mergers, Acquisitions and Corporate Restructurings*, 50.

131. Erturk, et al., *Financialization at Work*, 4–9.

individual joint-stock banks.[132] In short, a large part of risk management has shifted to market-based, market-priced mechanisms for which joint-stock banks' size, and ability to diversify regionally and across product lines, quickly tap into various national capital markets, and to invest in people and computing capacity all over the globe, ostensibly give them their competitive edge.[133] Yet in the twenty-first century, it is a truism to say that, as joint-stock banks lose regional and product monopolies, they are likely to face enormous pressure in finding new products and new market segments, a task that often increases risk and costs. We have already seen how bankers' efforts to expand their activities and provide innovative service have produced new uncertainties.

In contrast to the strengths of large money-market banks, this paper suggests that family banking is more adept, or better put, has a competitive advantage, in managing the unique or residual risk (that portion of risk that cannot be explained by historical market relationships), the real "profit" in business as Knight emphasized and the "above average" return which certain clients will demand. As he stressed, "real" profit only comes from managing uncertainty. That uncertainty may come in at least two distinct forms: that portion of investment risk in a firm's fortunes that cannot be correlated with market fluctuations, and that portion of risk attributable to unexpected changes in overall market relations and a specific company's reaction to them. The family bank was born to manage nonmarket, political uncertainty. It thrived when this type of risk held paramount importance for investors and while investors and the banks themselves hoped that active oversight might ensure adequate risk-adjusted returns. Although private equity firms are beginning paradoxically to go public and as late as 2006, the value of private equity transitions was less than $400 billion, their increasing international financial intermediation may point to as well as help fill a governance gap, perhaps even rendering enough service managing unique risk and uncertainty for society at large to justify their enormous fees. Sadly, too, political risk, which for a time held diminished importance for investors, seems to have made an unfortunate comeback. Perhaps these revisited uncertainties will generate new opportunities for private, family banks.

132. Erturk, et al., *Financialization at Work,* 12. Although I have referred to these instruments as market based, strictly speaking many, are handled as private transactions (Over-the-Counter, OTC), mostly among banks. They occupy a curious position between public and private transactions. Their prices, however, are based on market prices and many of the instruments themselves are also traded on public markets.

133. Kobrak, "From International to Transnational Finance."

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