Family Finance

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Family Finance:
Value Creation and the democratization of cross-border governance

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Abstract: As Mira Wilkins has argued, there is a curious disconnect between business and financial history. (Wilkins, 2003) 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 20th 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 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.

I. Introduction.

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*, p. 41.

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*, p. 28.

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 history and financial history, for example, which leads to a failure to highlight parallel and separate trends in their development.[1] During most of the second half of 20th century, for example, financial theory strove to emulate the techniques of natural science, failing to integrate the social component and institutional configurations in economic decisions.[2] I want to stress that this is primarily about changes in transatlantic financing (primarily investment banking), not domestic or colonial, between the end of the 19th and the end of the 20th 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 dealing 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 a better understanding of 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 decade of the 20th 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.[3] The financial integration of the 19th century gave rise to a set of corporate governance issues and approaches from which we may still learn.[4] 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.[5] 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 despite a new round of international convergence.[6]

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." [7] 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.[8]

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.[9] 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.[10] In the recent literature that has re-interpreted Chandler's somewhat one-sided, American-dominated account of the evolution of big business, family banking is hardly evoked.[11]

While Chandler's well-known explanation of the decline of firms and even whole national economies as a 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 non-financial sectors.[12]

Much of this piece will focus on the role of family banks in the United States, but the great weight of these banks in international finance was not confined to American markets. To be sure, by the middle of the 19th 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 20th century, joint-stock banks had difficulty in replicating the cross-border reach of family banks in the United States and other major economies.[13] Many of the early "multinational" joint-stock English banks had only their headquarters in the U.K., 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,[14] but by some accounts, at least, current attempts of mixing the attributes of public and private banking in one institution are fraught with difficulties.[15]

American regulations especially, and the surge of economic activity there, provided the private banks with special challenges and opportunities.[16] Even when the United States began to export more capital around the turn of the century and after World War I, it was the private, not joint-stock banks, which led the way in deal-making and to a lesser extent in distribution of new securities.[17] Well into the 20th 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 at the turn of the century – in running comprehensive banking operations not only in New York but many other financial capitals, often pushing them into alliances with private as well as other banks.[18] For example, neither had an office in the other's country. Apart from London, in major markets, their direct involvement with cross-border investment banking and other financial activities relied to a large extent on agents and correspondent

relationships. These banks had enormous distribution capacity in their own markets but were short of reliable talent on the ground in many key markets to find and manage investment opportunities.[19] 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. [20]

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 the geographic separation. In contrast, during much of the 20th 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 100 years, private and family financial institutions, however, have remained strong players in several important activities. In these activities, 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.[21]

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 takes these explanations more broadly and over a longer period than is done typically in the literature.[22] 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 the much of the 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 up through out own period, well-informed and sophisticated private bankers profitably exploited market inefficiencies.[23] Indeed, they seem at their best when markets are spooked and investors hesitant 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. Some of the financial intermediaries described in this paper perform only some traditional banking functions.

The 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 merely changed the needs for intermediation. Second, an increase in public oversight designed to a large extent to contribute transparency to markets has decreased the value for holding private information. Lastly, a theoretical approach to finance that has emphasized quantitative analysis has developed to explain and manage risk in this new environment. From the capital asset pricing to option pricing models, modern finance has attempted to price risk based on statistical estimations of volatility and rewards of assets. Approaches to decision making designed for passive investors, leaving active management to those inside companies who control real assets (the management of volatility and reward), these techniques are ways of looking at the world of finance geared to inform investors as to how much reward he or she can expect with a given level of volatility or how much volatility he or she will have to expect for a given level of

reward. It is not designed for active management of assets or for clients who want more than the "expected" return. 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, it is often forgotten that investors must not only have easy access to it, they must also trust it when they get it. Establishing trust is not always easy, especially where regulation is weak or where there is little in the way of 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, any fluctuation 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 like instances falls into the realm of risk; all other forms of risk are part of uncertainty.[24] This approach to the risk of investing risk implies that the risk of individual securities not explained by market movements can be diversified away too easily for the market to reward taking them. But 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.[25]

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 19th century and their diminished role at the end of the 20th. It will argue that the evolution of capital markets have evolved in such a way over the past 100 years so as to undermine family banks' chief competitive advantage – their ability to manage various forms of uncertainty or unique risk. That is not to say that capital markets at the

beginning of the 20th century were not large and robust, even by early 21st century standards.[26] Merely that in the absence of certain institutions and regulations, family firms played a huge role compared to today in their international integration because of the degree of unique risk for which there was little alternative but active management as a means of ensuring adequate rents to entice investors to place their funds in often distant, innovative ventures. Where the management of unique risk remains the best way of doing business, family banks have maintained a strong competitive position.

My paper is divided into three further sections. The first deals with the activities of family banks at the end of the 19th century and the regulator and technological environment, which gave them their competitive advantage. The second part will highlight the changes in markets that undermined family banking. The third will discuss some sectors in which family financial intermediaries have held their own at the end of the 20th century and will suggest some theoretical reasons for this persistence.

II. Competitive Advantages of Family Banking Circa 1900.[27]

> 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*, p. 28.

Few financial historians doubt that international finance was dominated through much of the 19th century by private banks.[28] What is at issue is the nature of their strengths during the period, and the timing and causes of their decline. Although I have deliberately sought to avoid a precise date, I will argue that until the early 20th century family organization of private banks aided them in establishing reputations for picking and monitoring investments, and for establishing a cross-border presence that enhanced communication between potential users and suppliers of capital, a capacity that joint-stock financial intermediaries could only achieve in much of the world 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 more general 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, most of the important ones were. Moreover, their family ownership helps explain the competitive advantages of even the non-family 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. Family banks were just one of the main vehicles for achieving this competitive advantage in what we call banking at the end of the 19th century. In the 21st century, 'financial intermediary' is probably a better term.[29]

Family banks had an enormous advantage in the arena of cross-border lending. From ancient times well into the 20th 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 multi-poled businesses held together by family ties. Second, while engendering trust across borders through legal or other means was in its infancy, they instilled confidence in their judgment because family loyalty implied long-term commitment and discretion. In addition to correspondent relationships, the family was able to 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."

Some of the oldest institutions whose name recognition has survived to the present day were family banks, which not only played important roles in the economic but also the political history of their day. According to at least one leading scholar in the field, a strong argument could be made that they "constituted the first multinational business firms."[30] 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 the first movers in the field, they were at the core of cross-cultural economic interaction and managerial innovation from the 14th through the 16th centuries and remained market leaders in many financial services well into the 20th century.[31] But

as Giovanni Medici, father of the Great Cosimo, recognized, the family's position was fragile.[32]

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.[33] It is plain that for a great number of transactions and sorts of information, those who need to invest or access savings have a great many ways to by-pass private banks today which were unavailable 100 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. [34] Only three of the largest 250 family companies in the world are banks.[35] Private banking in England peaked in the 1820s, but its decline was gradual and concentrated in domestic banking activities.[36]

Nonetheless, some family banks thrive and may still have social usefulness.[37] 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.[38] Until very recently, a few private banks 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's view that "financial dynasties" have receded "to the status of historic dinosaurs" is a bit exaggerated, in the area of cross-border issuances of securities there is no doubt.[39] As with the loss of any specie, the passing away of these "dinosaurs" may have unforeseen economic ecological consequences, if I might continue with this paleontological metaphor. In the eyes of many, family firms in general still provide a source of economic and social value. It should not be forgotten that the earliest discussions of corporate governance issues took as their starting point the loss of 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.[40]

Through most of recorded time, in contrast to our own, business has been conducted by or with the aid of religious institutions or families, or some combination of the two. These two institutions seemed to provide 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."[41] 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.[42]

To understand the competitive economic and social advantages of family banks, it is necessary to go back to a time "far, far away," in which there was no World Bank, no Federal Reserve in the U.S., no Securities Exchange Commission (SEC) requirements – indeed there was no SEC – phone and telegraph services were neither cheap, completely reliable, instantaneous, nor completely secure.[43] Though large and even larger in some countries as a percentage of Gross Domestic Product in 1914 than they are today, capital markets were not nearly as deep and efficient as they are now, and the means for assessing and dividing risk were not nearly as well developed. Transactional costs were higher and derivative instruments nearly non-existent. Banking regulation and attitudes in the United States and other countries, at least, made cross-border financing in some respects harder and in others easier. For much of the 50 years that preceded World War I, national tensions were held in check, making truly multinational networks of independent organizations advantageous and feasible.[44] The Bank of England served as the lender of last resort for club of Gold Standard countries, whose governments by and large upheld certain rules of the game regarding stability and convertibility, but much of

the regulatory and technological infrastructure that makes the nearly-instantaneous linking of national markets feasible was not in place. Without the shared values and ties of family businesses, the internalization of international business transactions was just beginning for public firms. 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.[45] Arguably banking was one of the last sectors to build transnational Behemoths.[46]

Yet long before the Industrial Revolution, private banking helped to integrate financial and trade transactions in Europe. Continental Europe was the birthplace of private (U.S. name) or merchant banking (European). Many of these financial intermediaries' varied businesses grew out of trade transactions, trade financing, and foreign exchange dealings. Though some could trace their histories back to the Middle Ages, their number and activities blossomed in the 19th century. By the early 19th century, in addition to the most famous family, the Rothschilds from Frankfurt (relative late-comers), the Warburgs in Hamburg, Oppenheims in Cologne, the Mendelssohns and Bleichröders in Berlin, and several Huguenot families in the Rhineland had already established family banking businesses, some with international reach. Many of these had survived the vagaries of economic fluctuations, revolutions, political persecution and limits on family progeny during the past two centuries. Some of them were also intimately connected with the great political transformations in Germany.[47]

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, there were few restrictions on 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.[48] As a result, in Germany, during the 19th century, banking associations were very strong. Not only did they form

syndicates for the issuance of many securities, they also created joint ventures and long-term strategic alliances for many activities, especially foreign ones.[49]

Even in London, where a wide variety of financial institutions and services flourished, family banks played a substantial role in the economic life of the city. 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 own colonies. Family banks were the principal financial links between this trade center and the rest of the world. They served as guarantors of foreign and domestic businesses, who wanted to access the London market with their bills 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.[50] 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 English capital 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 do well. While inland bills of exchange disappeared, international ones grew rapidly, making "the merchant banks a permanent and indispensable cog in the works of English banking."[51]

Of the first Accepting House Committee, a group organized to insure liquidity for the system as World War I began, 12 of the 21 banks had reference to the family structure of the firm in the name (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.[52] Virtually all the largest, including Lazard, Barings, Rothschild, Hambro, and Morgan were family businesses linked to much of the rest of the world by "separate" family firms in other countries. The Germans, mostly Jews, provided much of the core of foreign banking community. Like Stern and Co., they not only operated in continental

Europe with their related family but also with joint stock banks in the United States and other countries.[53]

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 12 of all the 95 merchant banks in London were limited-liability companies. As Youssef Cassis put it, "The corollary of this private type of structure was that the business generally remained a family one." [54] This was true of almost all merchant banks, except for some rare cases in which the family did not elect to send a family member to London.[55] Even those were still family-run affairs, with their initial strength coming from the dispersion of family members in major centers of activity.

With few mergers, marriage remained the main method of combining interests and expanding the management pool. It was true, too, of bankers in joint-stock banks. Cohesion of international private networks even among them 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 co-religionists. Marriages brought in new blood and created "dynastic" alliances among these banks.[56] In spite of this limit to growth, the international reach of these banks was enormous. In addition to unsecured securities and syndicate loans, which are not broken down by region, in 1910 nearly half of Hambro & Sons investments, for example, were in North America.[57]

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 & Company, Speyer & Company, J.S. Bache & Company and Kuhn, Loeb & Co., played an important role in bringing to market both U.S. public and private securities. Many rich Jewish families, such as the Lewisohns and Guggenheims, who had made their wealth in other fields, set up banks downtown near Wall Street.[58] 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 western Europe. Foreign investors perceived more risk in the United States and required

a premium and direct oversight to invest there; family banks soothed the fears of foreign investors by managing their U.S. interests and also helped by mitigating the financial consequences of the periodic panics.

For much of the latter half of the 19th 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 federal and state law – mostly New York because of its importance – inhibited some of the international investment activity of American joint-stock banks. In the United States, national banks operated with relatively severe reserve and branching constraints. Before 1914, these restrictions even included an inability to deal in bank acceptances. By 1900 some American banks were approaching the size of their European rivals, but U.S. national banks had to work with private ones and form separate companies to deal with statutory limits on their activities. State banks were confined to the states in which they were licensed. 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, requiring virtually only to 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.[59] Before 1914, moreover, national banks could not open foreign branches and were restricted from engaging in some trade finance transactions. Foreign banks, for their part, were prohibited in some key states from maintaining offices that took deposits.[60] As private banks were not technically foreign owned, this restriction did not apply.

In short, even though European public banks were well established in their home markets and many had large portfolio investments in the United States, virtually all the banks in the United States with strong European financial clout in 1900 were family banks, not joint-stock institutions.[61] Even multinational British banks, which worked with foreign offices mostly in colonial regions, suffered from severe governance (control) problems.[62]

In general, business and banking were in some sense more personal in the 19th century than today. Relying more on character and integrity, bankers in some parts of the world preferred from their customers – and customers from their bankers – 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 association.[63] Many banks 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 19th century; it was, in short, far less of a commodity than it is today. Financial institutions were reflections of, and at the disposal of, their directors. They behaved more as "investment clubs" for channeling funds into projects, as Naomi Lamoreaux writes. In her study of New England banking in the 19th century, she argues that this region was very similar to other parts of the world.[64] Even the great money centers of the world functioned this way. Scores of banks operated around the turn of the century in this fashion: the Rothschild cousins, the Speyers, Seligman Brothers, to name just a few who served as lead deal makers and deal enforcers.

To illustrate the importance of and the competitive strengths in international banking of family firms in this context, I will draw on some aspects of the histories of the House of Morgan and the House of Warburg, one banking group of English origin, the other of German-Jewish. For lack of a better term, I will use the often-employed expression *house* to describe the complex and informal network that brought together the firms in different countries that made up the group of separate institutions. Given the subject of this paper, the term '*house*' has a special significance. I will use some salient examples about each to show why family banking played such an important role in international banking.

The histories of two of the most important private banks show that they made substantial profits by linking investors, who had little regulatory assurance of protection of their interests, with sometimes risky and often distant projects. Before international rating agencies and electronic transfers, even simple payments were difficult. These family banks had a rather unique international span of trust, for which in 1900 there was no obvious substitute. Moreover, the number of investments and investors was not yet

large enough and the techniques lacking to systematically diversify risks. The limited and sometimes distant liability of joint-stock banks stood in great contrast to the unlimited, personal, and close-to-home liability of internationally-connected family banks in key markets. Even though many debt instruments were backed by real assets, 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 more limited and many regulatory and technical obstacles thwarting internalization of cross-border tasks, family enterprises provided much of the same internalization which multinationals could only achieve later. These stories illustrate the role private banks played in investment bank, although they increasingly linked up with public banks for their mutual benefit. The stories also set the stage for their eventual decline, 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, the bank reached its zenith under the leadership of the son of Peabody's partner and successor, J. P. Morgan, Sr. (1837-1913) and his 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, J.P. senior came to dominate American banking and capital flows from England to the United States in a way that no other individual or institution of the time or since has. Profiting from America's thirst for capital in the last decades of the 19th century and Europe's fears of American mismanagement and sloppy regulation, Morgan and his associates in the U.S. and Europe brokered numerous government financings, corporate restructurings, and new equity offerings that were marketed in most of the developed world. With Britain providing the largest share of foreign investment to the world's fastest growing economy in the second half of the 19th century, maintaining offices in both London and New York was particularly important. Until the death of his father in 1893, the connection between the offices in New York (for many years, Drexel, Morgan & Co.) and London (J.S. Morgan & Co., later Morgan Grenfell) was the family bond of father

and son. In the absence of a Federal Reserve, the elder Morgan even stepped in to stabilize markets during times of panic, notably during the mid-1890s and in 1907.[65]

Banking then was in some ways broader and narrower than in our time. 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. They consisted primarily of governments, wealthy individuals, various sorts of commercial firms, and other financial institutions. The bank concentrated on large security offerings and trading foreign-exchange-related instruments, a much lower volume business then than now. Morgan used to boast that 96 of America's 100 largest companies were his clients, many of whom would make pilgrimages to see the bank, not vice versa.[66] But before many kinds of transactions became routine, regulations bred more specialized institutions and capital markets developed to allow potential clients direct access, banking services were more like those practiced by universal banks in their heyday. They not only provided various forms of capital, but also consulting, accounting and other services.[67]

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. That is why they were with Morgan. He and his colleagues practiced a discreet style. Clients felt as if they were accepted into an aristocratic club. In the uncertain world of pre-1914 finance, in which few reliable and quick sources of information were available, 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, Morgan was truly "the lord of creation,"[68] a position which the bank 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. Not only did the bank have the advantage of father and son in London in New York, it cultivated a

reputation for integrity and trust. 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, encouraged by the House of Morgan, English investors poured vast new sums not only into transportation companies but also into completely new ventures, such as electricity. As the house grew, especially the London branch, it took on more experienced bankers, but the first lot were all connected by a family bond.[69]

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 manage companies.[70] Investors from all over the world bought securities with promises of high profits based on the House of Morgan's continued involvement with the companies. As entrepreneurs exited firms, distant shareholders understandably asked the question: Who would watch the managers and protect their interests, a question that continues to trouble the holders of dispersed equity? 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.[71]

During the last quarter of the 19th 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 and inability to list on either the New York or Berlin stock exchanges. In this and other transactions, distant investors seemed incapable of controlling this visionary but roguish native 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 the Edison company. By 1892, the German investors seemed glad to be done with the Edison venture. Morgan took the lead in negotiating the terms of a merger between the companies. The Germans opted out of the Morgan-managed transaction, which seemed to favor the Thomson investors. The House of Morgan stayed close to the merged 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 representatives of the House of Morgan – who played an active role in bailing out the company during the Panic of 1893.

His own very active financial involvement did not preclude Morgan from relying on experienced managers to run the businesses. With good managers on board, he did not generally dictate policy for the successful firms for which he had organized capital.[72] But especially for capital intensive businesses, he and his colleagues stood ready to take a more active role and organize new capital, 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.[73] 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 reorganization plan that brought the Northern Pacific out of its third bout of financial distress in 1896, and served as the president of the newly constituted board. Like many lines, the Northern Pacific was beset by overcapacity, competition, and regulatory ambiguities. Like many of these lines, too, Morgan and other private banks mobilized international capital and took over many control tasks to ensure that the 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. With the great distance, Deutsche Bank managers, for example, 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. Morgan and his associates were particularly active in the management of the line and the balancing of the interests of various stakeholders. 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 and ups and downs with the restructuring, an investor had to have an 'in' with the insiders to know when to get out.[74]

By the end of the 19th century, however, there were already some signs that Morgan's influence was diminishing. As America's dependence on foreign capital and Britain's relative position as a provider of capital waned, so too did the value of his special position between 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. There were more depositors for national and state banks, more trust accounts, and more insurance policies, 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 a reliable go-between by actively monitoring investments. Between new regulations and competition, by the time of his death and succession by his son, J.P. had lost much of his relative financial clout. This was a process that accelerated after World War I, as will be discussed in the next section.

The House of Warburg.

At the end of the 19th century, 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, towards the end of the 19th century, the Rothschilds' inability to find a family member to go to New York and the house's reliance on the Belmont family contributed to the family's relative decline in the United States and the rest of the world. In addition, unlike some families such as the Rothschilds which bound their empire with bloodlines, the Warburgs used blood and marriage to create a kind of confederation of banking houses in most of the centers of world finance. It was the looser grouping than the Rothschilds' that allowed the family to move into areas in which direct decedents and the Rothschilds dared not tread. The Warburgs had at least in relative terms 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 16th century, the Warburg family became "Court Jews" as lenders at interest and dealers in foreign exchange in the area between Frankfurt and Hamburg. From Hamburg in the 17th 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 trade financing. Whenever the bank needed money, the 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.[75]

The Warburgs had the distinction of operating two of the leading banks in Germany and the United States. In the 19th century, Rosa, Malchen, and Moritz Warburg married heirs to some of the most important banking houses in Europe and the United States. Trained at the family and other private banks, the oldest son of Moritz and Charlotte (nèe Oppenheim), Max Warburg, by the beginning of the 20th century, was expanding the activities of the German office and his own reputation as one of Europe's leading financiers. Both his brothers, Felix M. and Paul, married into the Kuhn Loeb firm, considered the most up-and-coming bank in New York around the turn of the century, 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 the management of many companies on both sides of the Atlantic and helped organize many cross-border launches of securities, its story illustrates two important qualifications to the power of family banking at the end of the 19th and early part of the 20th . In their heyday, the Warburgs were more dependent than Morgan on joint-stock banks. They could make deals and monitor companies, but they needed more distribution. But by the first decade of the 20th century, 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, there was less need for active management for many of the companies in which the House of Warburg had the greatest interest. 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 control 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 and for a while partner, which had led to the active bank management of the latter line.[76]

Max Warburg had a very similar relationship to 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 in the United States but was generally less intense than some of Morgan's turnaround situations.[77]

Warburg family members were leaders of the banking community, who also 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 liberalism imploded. Despite its reputation as philanthropists in Germany and the United States, as 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 U.S. 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 even before the United States declared war on Germany. 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 relative of the founders of the firm, witnessed the question of his citizenry and loyalty.[78] Like other private bankers, such as Jack Morgan, Kahn 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 the necessity for most of the family to flee Germany in the late

1930s. The international Warburg family even ran afoul of their co-religionists for their criticism of the state of Israel, which they considered a throwback to primitive nationalism.[79]

But politics was not the only development that impaired the competitive strengths of private banks. Even before international consensus and flows broke down in the summer of 1914, the laying of international cables and later the introduction of the phone and wireless services reduced the costs of acquiring information and the competitive advantage of having reliable, autonomous representatives on the ground for other private, family banks such as the Rothschilds and Speyers - shifting power from them to larger, join-stock institutions.[80] Of the bank houses discussed here, Speyer was the oldest. As a banking business, it dated back to the Middle Ages, to a town 100 kilometers from Frankfurt whose name it also bore. In 1800, the family was reported to be 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 that ensued after 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 to be represented 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 U.S. 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.[81] 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 banks like Deutsche Bank could not, while utilizing the larger banks' greater fundraising capacities in their own markets. For 50 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.[82]

In 1934, the American Speyer bank closed its doors.[83] 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 decline. Many closed their doors 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.[84] Somehow the 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 diminished their economic benefits and turned them, in the eyes of many, into pariahs and causes of social disintegration.[85]

III. 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*, p. 7.

This section is designed to highlight 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 of the causes predated 1914 and some continued well into the second half of the 20th century. Moreover, the pace and kinds of changes differed to some extent from country to country and had ups and downs within the interwar period. But by World War II, family banks had lost much of their role in international finance. The story of how and why is remarkably the same in several large capital markets. In part, the relative decline can be attributed to the decrease in trade and an increase in capital market frictions, but this is only part of the story. Some of the frictions actually added to the importance of family banks. Although uncertainty helped private banks in the mid-20s establish themselves as the chief conduits of capital between Europe and America, the combination of chaos and increased government controls, which particularly characterized the early

and late interwar period, did not. Nationalist conflicts even affected relations among the Rothschilds and Warburgs, two banking families, who for many years seemed above patriotic passions, a stance that had greatly contributed to their earlier successes. The reaction to the war and the disorder that followed also involved an ideological turn against international banking, which hit family banking hard in some countries. Especially after 1929, when economic conditions and political tensions worsened, private banks' strength as international conduits actually became a political 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 control of banking activities by governmental authorities to insure that public and private good coalesced.

Along with the diminution of cross-border trade transactions in the interwar period, certain kinds of domestic business, especially government business, became more important to banks, an area of finance for which private banks seemed to have fewer advantages and one that tied them to national as opposed to international markets. Moreover, cross-border financing became more political. Even in the heyday of international financing in the 20s, a boon to private bankers who played an active role on both sides of the Atlantic, "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 U.S. government encouraged U.S. banks to assist with both the Dawes and Young Plans, which some bankers claimed impeded their business judgment and led to major defaults.[86]

After World War I, American financial institutions, both joint-stock and private found that they were able to circumvent to a large extent private banks with close European ties by developing contacts directly with foreign clients and opening up offices in Europe. While family banking still served as an effective linkage among national markets, the upsurge in European investment by joint-stock banks (and even by some new private banks) during the period turned out to be just the beginning of a huge onslaught of financial service FDI. Already before World War I, American trust companies had exploited loopholes in U.S. regulation to create foreign entities. But American national banks, unlike trust companies, for example, were not allowed to operate foreign branches

until shortly before World War I. By the late-20s, in addition to their large correspondent banking relationships, National City and other U.S. banks were operating many branches all over the world directly or through subsidiaries.[87]

Attacks on private banking were not born in the Depression. Perceptions of high finance in the United States during the Gilded Age unleashed a public outcry against private finance. From William Jennings Bryant's anti-Semitic diatribes against the common man's being "crucified on a cross of gold" to Louis Brandeis's warnings of powerful economic interests improperly using "other people's money," many segments of American society, even before the 1920s, were eager to diminish the unregulated power of private finance. Well before the 1929 Crash, politicians and regulators called for dismantling the power of banks and most of their attention was turned to the private, family variety. The Banking Crisis of 1931 only reinforced older fears and brought matters to a head. (If one were inclined to believe in historical repetition, conceivably Brandeis was playing Savanorola to Morgan's Medici.) Although Morgan was the most visible object of attack, anti-Semitism and, ironically, the Jewish banks' defense of German interests in World War I, worked against the German (largely Jewish) family banks in the United States. Forced to stress their Americanness, many of the banks floundered after World War I. With their public competitors attracting many new depositors during the Roaring Twenties and many of their stable businesses hurt by competition, blocked funds, and trade reductions, several of the large houses, at least in relative terms, suffered greatly. The dispersion of wealth produced a corporate and individual demand for deposits, and other passive investments available at large retail banks played an important role. 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.[88] The challenges were not just economic.

One of the many demands made by American Progressives was reform of the U.S. banking system. Many Progressives believed that the panics, depressions, and bankruptcies that so often beset the U.S. economy were caused, or at least exacerbated by greedy bankers who took the occasions to augment the premiums on assets, especially gold, which they owned, to sell them off at even higher profits. As early as the 1880s,

controlling private bankers, the "kings of Wall Street," who manipulated the currency for their own advantage, was a high priority for reformers. 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, who were unfairly charged with favoring war and their own interest over the public good.[89] Calls for reform were rooted in a fear of financial power wielded behind closed doors by a few individuals sitting on interlocking directorships. For many, this concentration violated the spirit of democracy and fair play, and worked against the general economic good. Although it was just these fears that delayed the re-establishment of a central bank in the United States, the creation of the Federal Reserve in 1913 owed much to the view that if the credit system must be controlled then at least the centralization of power must be in public hands.[90]

American lawyers and regulators focused much of their attention on breaking the power of banks, both private and public. The issue was centered on their ability to take deposits and use the funds to invest in risky securities, as underwriters or for their own account, creating a risk mismatch of sources and uses of funds.[91] Only later, did the unscrupulous practice of margin selling by the banks for client purchases of securities become a centerpiece of regulatory efforts to control the banks and securities trading in order to reduce both stock market and money supply gyrations.[92]

These discussions were by no means unique to the United States. During the interwar period, banks, especially international banks, came under a great deal of pressure because of the generally shaky economic conditions of many countries and also because of a new discomfort caused by international capital dependencies. While not universal and, to be sure, not completely new, harsh discussions and politically charged debate about the role of banks played a major role in the politics of many countries during the interwar period, threatening, if not curtailing the economic functions of even large banks, but also of smaller, family banks, in Germany, Great Britain, Austria, Belgium, and Italy.[93] Just as economic conditions put them under more profit pressure, banks were under greater pressure to prove their social *raison d'être*.[94]

In America especially, blame for the 1929 Crash was placed squarely on the banking system and led to many regulatory measures, some of which had little to do

directly with banking but whose impact anyway undermined the principal strategic advantages of private banks. Those who had for political or business reasons resented the power of money-centered banks and the centralization of economic decision-making in small groups had a great deal of political ammunition. The Glass-Steagall Act (1933), which forbade combining commercial and investing banking under one roof, is the best known of the regulatory changes, but there were several others. The regulatory pressure tended to push financial services into more 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 ripped apart the 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 and it enlarged the capacity of other institutions to sweep up dispersed savings.[95] House of Morgan, already weakened by the death of J.P., the creation of the Federal Reserve, a steady stream of public and congressional attacks, and the worldwide financial crisis was forced to divest itself of many of its operations. It never regained its former importance. Several of its former divisions are now part of other banks.

A series of securities laws – for example, the Securities Exchange Act of 1934 – led to the establishment of 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 set up the legal basis for mutual and pension funds, which would eventually not only provide an enormous vehicle for funneling funds into capital markets but would also redefine 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 company, thus limiting the economic incentive to participate in management actively, once the strength of private banks.[96] The legislation emphasized diversification of mutual and pension funds as investors' primary protection against bad selection of companies rather than active oversight and at times management, as had been practiced by private and other banks up to that time.

The interwar period witnessed not only a reduction in trade and private cross-border flows, it changed much of the form of both, in ways that were unfavorable to private banking and their links to companies. Through the whole period, Germany and

Britain never got back to their 1913 levels of trade in services. In the case of Germany, trade was disrupted by transfers of goods as payment of reparations, not private sales. 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. All of this coupled with the fever pitch of investment in Germany and the United States during the mid-20s weakened their oversight capacity.[97] U.S. private banks, such as Morgan and Dillon Read, underwrote most of the U.S. 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.[98] 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 were for several years receiving huge amounts of financing from the United States for dubious projects.[99]

Oddly, many of the changes for German private banking during the interwar period paralleled those in the U.S., but with a very different *modus operandi* and somewhat different timing. During the 1920s, international banking was blamed for 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, though constituting only a small portion of overall German banking assets 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* companies, two elements of society most hurt by the economic chaos following World War I. 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.[100] But the private banks that provided the funds, which were at first very

welcome, soon disappointed citizens on both side of the Atlantic with the degree of control they exercised on companies and, worse still, unwelcome foreign dependencies. Their greatest economic asset had become a political liability.

But by the mid-1930s, international transactions, the bread and butter of private banks, were severely curtailed and banks became highly 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 and took a huge toll on the whole banking sector, particularly private banks in Germany. In 1930, foreign investment as a percentage of world output was less than half its level in 1914.[101] From 1913 to 1938, nearly 60% of Germany's private banks had disappeared, most of the loss coming after 1929, while the number of banks in total remained nearly the same. Their percentage of total commercial banking assets fell from 19% to 11% from 1930 to 1938.[102] Even before the Nazis came to power, however, banks existed more and more to funnel private savings into state debt. Not only did the private banks have little to recommend them for this task, by then 1933, too, 35% of the banking assets in the country were already in State hands. Banks came under more and more pressure to relinquish their traditional, broad fiduciary role with companies in favor of their responsibility to the "nation."[103] On both sides of the Atlantic, greedy international bankers were blamed for the crisis.

The capacities of private Jewish bankers for managing international flows, however, seemed to be grudgingly acknowledged even by the Nazis. During the early years of the Third Reich, even Jewish private banks played an important role in economic life of the country. Useful in maintaining the international trade credits, which even the autarkic Nazi regime required, some Jewish banks even had a voice in political decisions. Though it is not clear what combination of perceived use to the National Socialist autarchy, racist program and the stature of Hjalmar Schacht, President of the Reichsbank, who to some extent worked to shield them from the ideologues in the regime, private Jewish banks were protected from the early rounds of anti-Semitism. Banking was one of the last sectors touched by Aryanization.[104] But by the end of the 1930s, the National Socialist Aryanization policies had led to the redistribution of all Jewish private banks into the hands of "German" banking houses and a huge reduction in cross-border financial transaction. 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. In many ways, events and regulation relevant to businesses of family banks during the first half of the 20th century set the stage for developments in the second.

The period following World War II, though clearly less dramatic and devastating for family banking than the interwar, continued with some old challenges and brought to the fore new ones that tended to undermine family banks' role as go-between between private borrows and lenders in different countries. In the aftermath of the war, most international flows were State-driven, coordinated by quasi-public institutions. Private lending was virtually non-existent. While trade recovered, a good deal was supported by national and supranational institutions, which took over much of the role of 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**.** The spreading of branch and subsidiary networks helped joint-stock banks utilize a relatively new device for servicing their clients' deposit and borrowing needs, EuroDeposits, which increasingly supplanted traditional cross-border lending and thereby private banks' role as intermediaries. With huge joint-stock banks internalizing international finance by investing in computing power and in operating foreign branch networks with deposits effectively out of the control of national banking authorities, 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 importantly, a new kind of investment banking, spearheaded by American institutions that were forced to focus on underwriting or lending, came to dominate the sector. These financial institutions sold market analysis and their distribution capacity for a fee, deliberately shunning their older oversight role and the importance of relationships. With fees determined by competitive bidding – not relationship – and more and more investors relying on rating agencies and government regulators, the oversight functions of banks became increasing redundant for investors and risky for the banks, who had previously held on to substantial amounts of their clients' securities. With this new financial

architecture, it is not hard to understand why many banks found intolerable bearing the risks without the necessary control or compensation.

In terms of sheer volume, it is clear that family banks now play a much smaller role in world finance, especially international finance, than they did in 1900. As internal acceptances passed out of existence in England at the end of the 19th century, so too have they disappeared among developed nations at the end of the 20th. Credit analysis is done by international services. The actual transactions have been replaced by electronic transfers. Nearly half of world trade is made up of intrafirm transactions, 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 have turned foreign exchange markets into huge and highly-integrated markets, where risks are managed by computer models and statistics. The amounts 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.[105] 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 is decisive. In international investment banking, comparisons between the role between family and joint-stock banks in 1900 and now are virtually impossible to make. In 1900, no joint-stock bank firm had a multinational, investment banking operation between continental Europe and the United States. Now nearly all do. But in at least one financial area, family structures remain very competitive. Only in unregulated spaces of financial intermediation provided private (family) banks with an appropriate playing field to match their skills with the potential for high rewards.

IV. 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: Game Theory, Transaction Costs, and Economic Policy*, p. 3.

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

It was founded in 1976 by three friends, two of whom were cousins, who were too restless for the public firm Bear, Stearns, Inc. 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 taking of buying small firms with debt.[106] Most ventures like theirs disappeared in short order. Their venture, in contrast, became a durable financial powerhouse, whose survival and profitability depended primarily, according to one account, "on the stability and capabilities of their founders … ."[107]

Their idea was not unique. They would buy well-established, privately controlled companies with regular cash flows, financed nearly entirely by debt (Leveraged Buyouts, 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 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. The very "burdening" of the company with large amounts of debt, which committed free cash flows, and making substantial shareholders out of managers contributed to reconciling their interests. Nevertheless, both groups seemed to profit from a trusted intermediary, who was perceived as understanding the interests of not only equity investors and managers but debt holders, too. Like their predecessors during earlier merger waves in the United States (1897-1904, for example), these bankers remained "corporate insiders," meeting regularly with both management and investors. How KKR functions is a throw back to the finance capitalism of a bygone era, which had been, in the United States at least, curtailed 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."[108] By the late 1970s, many observers believed that the lack of control of American corporations had led to a crisis in American management. Many companies were underutilizing their assets, over-investing, or just squandering their shareholders funds.

What made the rise of KKR so extraordinary was its ability to gather vast sums of cash from investors willing to take on great risk. Although its total of the absolute number of M&A deals and even LBOs remained small, when measured by total value the results were quite extraordinary for a firm with less than 24 employees. By the mid-1980s, the average KKR deal was 30 times higher than the average M&A deal. KKR was able to tap new sources of funding, including larger and larger pools of equity capital, and expanded the sectors into which leveraged buyouts had been employed, culminating some would say with the $31 billion RJR Nabisco buyout in 1988, which was only one of six major buyouts KKR did that year. Its ability to expand rested on KKR's credibility, which seemed to dwarf newly established departments of larger and often public banking houses. For KKR and its investors, despite the high levels of debt, this phenomenon had to be more than a high stakes poker game.[109]

KKR had to convince its many conservative investors, such as pension funds, insurance companies and educational endowments, that this new sort of acquisition could manage the risks from beginning to end. The inherent risk of high leverage bore with it a responsibility to carefully select companies and managers, perform a 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 the companies they acquired more rigorously than most investors and boards of directors. Above all, if the companies ran into trouble, they 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 oversaw $59 billion in assets representing 35 companies – four Fortune 500 firms were larger in terms of assets – with just six general partners and 11 professional associates.

Like their colleagues in early periods, KKR partners' efforts were not universally appreciated. Even though in Europe active insider corporate governance was more the norm, many observers watched in horror of the breaking down of barriers to acquiring and restructuring business, which often meant firing employees. Turning corporate control into a market seemed to be merely a recipe for unemployment and instability. Even in the U.S., KKR's form of active, closed-door financial power exercised by a small group excited heated debate.[110] Nevertheless, KKR's techniques and financing have an international reach. Its 1987 funding involved seven foreign investors.[111] As in many other sectors during the last decades of the 20th century, family-styled businesses were part of a revolution in business practices, here namely the trend toward re-instituting owner-managed companies.[112]

As painful as it may be to denizens of family business, private equity firms may have much in common with family banks in 1900. Both traded on their reputation for evaluation and management of companies, and above all discretion in the execution of transactions. Like the family financiers of the past, **their** competitive advantage rests on instilling trust about the long-term credibility of their advice and willingness to stand

behind their judgments. As the Robber Barons of the past have shown, not all successful businesses, even family ones, are run by likeable people.

V. 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*, p. 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. Forester*.

The stories of "family" banks point to several generalizations about their strengths and the evolution of capital markets. The growth in the number of sources of financing and investment opportunities have increased the ability of financial firms to standardize and diversify their offerings, thereby creating great economies of scale and an ability to apply mathematical modeling and modern notions of risk diversification to optimize risk and reward relationships. For example, large commercial or universal multinational banks are able to spread the risks of depositors across vast geographic and industrial areas. In niches of markets where diversification is impractical or financially uninteresting, where individual investors can only make money by managing unique risk 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 beneficiary of funds require an element of trust that go beyond regulatory or contractual assurances. As was the case in the 19th century, it would seem that they have particular advantages for acquiring and managing business opportunities in emerging markets.[113] In short, their *raison d'être* appears to be managing uncertainty rather than risk.

Secondly, as has always been the case, private banks thrive in sectors of the market where regulation is intentionally or by default weak. They have always "filled regulatory and technological gaps" – the spaces where economic actors were

uncomfortable with existing regulatory protections or investment opportunities.[114] While a good argument can be made that those spaces are smaller than say in 1900, especially in places like the United States, some of the suppliers and the users of capital seek out banks that exploit or protect participants from the "loopholes." By some estimates, international private banking manages $7 trillion in funds. Although much of this money belongs to high-net-worth individuals seeking to avoid taxes or other government controls by investing in places like Luxemburg, Switzerland, and the Channel Islands, avoidance of governmental oversight is not the only incentive for investors to use private banks.[115] 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. For this kind of service and confidence-building control, family banking offers extraordinary advantages.

Private banks cater to a special clientele that wants more than average service and returns. Those who turn to private banks expect a better risk-adjusted return for their investments than they can expect through investment vehicles open to the public. They seek something special, a return not available to the "average investor." With most markets considered efficient – that is, with fairly priced assets – institutions, such as 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 make the abnormal returns they and their investors demand. As most finance books 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, and thereby reasserting the ability of shareholders to earn abnormal returns.

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 the impersonal nature of that order 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 makes applying mathematical analytic tools for quantifying the relationship between volatility and reward, dividing risk into its

component parts, and discovering exotic hedge and arbitrage opportunities feasible.[116] Greater transparency and theoretical explanation of market movements have reassured investors and attracted new forms of investment. Risk management for many sectors of capital markets has become a mathematical exercise; not the daily bread of most investors, but a phenomenon that allows financial intermediaries to offer attractive, new offerings to their corporate and individual clients. The claim has even been made that all aspects of life can be divided and further sub-divided so as to allow businesses and people to pick and choose which they want to accept or not.[117] Technological improvements, government commitments to complete convertibility, and easy access to lightly regulated funds contribute to viewing risk in terms of measurable volatility while simultaneously undermining the need for the kind of mediation performed by family banks 100 years ago. Financial markets function with many new bridges between lender and borrower, and perhaps the delusion that uncertainty has been vanquished or made irrelevant for investment analysis. Nevertheless, even traders of options know that the patterns of movement and volatility of the underlying assets of options may change radically, often quickly, sometimes without evident explanation. In short, we have a great many capital market mechanisms for hedging against some forms of risk, such as inflation, but those, such as political risk, are not on the radar screens of financial actors.

Curiously, even though this "Sea Change" in attitudes about risk, the techniques of managing it, and the markets that go along with it are not entirely but very much American inventions – universal banking, one of many ways of spreading risk has only had a short history in the U.S. – little about world capital market evolution and its American roots have found their way into the growing literature about the Americanization of business. An argument could be made that these capital market changes have had at least as much of an effect as Fordism on the rest of the world and in some ways are not American at all. Some financial history literature has started to address the effect of American institutions and regulation on European markets and firms.[118] The impact of these changes – such as the tendency of investment banks even in continental Europe to take less responsibility for their issues and clients – on management and corporate governance responses to crisis has scarcely been emphasized.[119] But here, too, we find a separation of literature about business

developments from that about their ancillary institutions and thought processes.[120] Although many aspects of the new finance are not really very American, the tendency to prefer liquidity over commitment, and a great concern for the cost of free riders have been hallmarks of American attitudes toward corporate governance and the regulation of new intermediaries such as pension and mutual funds.[121]

In contrast, this paper is meant to suggest merely 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 (see note) 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 to market fluctuations, and that portion of risk attributable to unexpected changes in overall market relations and a specific company's reaction to them. Indeed, the family bank was born to manage political uncertainty. It thrived when this type of risk was of paramount importance for investors and while investors and the banks themselves hoped that active oversight might ensure adequate risk-adjusted returns. Those intermediaries may still provide a vital service in dealing with both unique risk and with the uncertainty associated with the fallibility of relying on historical patterns to predict future relationships. In the 21st century, it is a truism to say that, as banks lose their regional and product monopolies, they are likely to face enormous pressure to find new products and new market segments, a task that often adds risk and costs. We have already seen how some efforts of banks to expand their activities and provide innovative service have produced new uncertainty. Moreover, political risk, which for a time, held diminished importance for investors, seems to have made an unfortunate comeback. Perhaps these new uncertainties will produce new opportunities for private, family banks.

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Notes

[1] Mira Wilkins, "Disjunctive Sets? Business and Banking History," unpublished paper, European Banking History Conference, May 28-29, Athens, Greece.

[2] "A Survey of Behavioral Finance," Nicholas C. Barberis and Richard H. Thaler, in *Handbook of the Economics of Finance*, eds. George M. Constantinides et al, (Amsterdam: Elsevier, 2003), pp. 1053 –1122. 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.

[3] By some measures, foreign investment in 1194 was triple that in 1960, only to be surpassed in the 1970s. During the 1920s, foreign investment fell to 8% of world output. Today it is five times that level. Maurice Obstfeld and Alan M. Taylor, *Global Capital Markets: Integration, Crisis, and Growth* (Cambridge: Cambridge University Press, 2004) pp. 52-55.

[4] Les Hannah, "Pioneering Modern Corporate Governance: A View from London in 1900," *Enterprise and Society*, Vol. 8, No. 3, (2007), p. 642. Unlike many writers, Hannah emphasizes the international scope and influence of corporate governance practices, especially those coming from Britain.

[5] Gary Herrigel, "A New Wave in the History of Corporate Governance," *Enterprise and Society*, Vol. 8, No. 3, pp. 475-489. See also Randall K. Morck, ed. *A History of Corporate Governance Around the World: Family Business Groups to Professional Managers* (Chicago: National Bureau of Economic Research, 2005).

[6] Herrigel, p. 477.

[7] See K. Burk, *Morgan Grenfell 1838-1988. The Biography of a Merchant Bank* (Oxford: Oxford University Press, 1989), P. Ziegler, *The Sixth Great Power. Barings 1762-1929* (London, 1988), Ron Chernow's *The House of Morgan* and *The Warburgs*, and Niall Ferguson's *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.

[8] See Oliver E. Williamson, *The Mechanisms of Governance* (Oxford: Oxford University Press, 1996), pp. 78-79, who relying on earlier work by R. Pollak sees that families may contribute incentives, loyalty, monitoring and altruism, but also tends to see international family banking as a 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 to 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 not sufficient. 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.

[9] Yousseff Cassis in his *Capitals of Capital*, writes quite rightly about a revolution in banking with the creation of joint-stock and universal banks, but he has little to say about how and why the family banks lost their competitive advantage in international investment banking. Cambridge: Cambridge University Press, 2006. pp. 42-43.

[10] See Geoffrey Jones, *Multinationals and Global Capitalism: from the nineteenth to the twenty-first century*, pp. 183-186.

[11] Andrea Colli and Mary B. Rose, "Family Firms in Comparative Perspective," in Franco Amatori and Geoffrey Jones, *Business History Around the World* (Cambridge: Cambridge University Press, 2003). In their excellent study, cite the neglect of family business in the economic literature. Andrea Colli's excellent compendium of research on the history of family business only examines the effect of financial markets on the formation and persistence of family firms. Andrea Colli, *The History of Family Business 1850-2000* (Cambridge: Cambridge University Press, 2003) pp. 34-35. Only four of five works in his extensive bibliography deal with family banking. Danny Miller and Isabelle 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. Danny Miller and Isabelle Le Breton-Miller*, Managing for the Long Run: Lessons in Competitive Advantage from Great Family Businesses* (Cambridge, MA: Harvard University Press, 2005.

[12] See, for example, Youssef Cassis, et al, eds., *Management and Business in Britain and France: The Age of the Corporate Economy* (Oxford: Oxford University Press, 1995) an important series of studies, which has helped get research away from Chandler's "one-size-fits-all" America-centred, contains little or nothing about family banking.

[13] Rondo Cameron, "Introduction," in Rondo Cameron and V.I. Bovykin, et al, eds. *International Banking 1870-1914* (Oxford: Oxford University Press, 1991). pp. 3-15, 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.

[14] See Geoffrey Jones, *Multinationals and Global Capitalism: from the nineteenth to the twenty-first century* (Oxford: Oxford University Press, 2005), p. 113.

[15] "For Richer, for even Richer, *The Economist*, February 16, 2008, p. 74.

[16] See, for example, J. Bradford De Long, "Did J.P. Morgan's Men Add Value?: An Economist's Perspective on Financial Capitalism," in *Inside the Business Enterprise: Historical Perspectives on the Use of Information,* Peter Temin, ed. (Chicago: University of Chicago Press, 1991). Although the private bankers may not have produced some of the market innovations, for which De Long gives them credit, at the very least they provided a kind of "hands on" management that calmed distant investors sufficiently to put huge amounts of money into the turbulent but dynamic U.S. market. See Les Hannah, "What did Morgan's Men really do?" University of Tokyo, Discussion Paper ,CIRJE F465, January 2007.

[17] Cameron, pp. 14-15.

[18] 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. E-mail, Bernd Kulla, Deutsche Bank Archive, March 20, 2008. 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. "La banque internationale," Roger Nougaret in *Le Crédit Lyonnais : 1863-1986*, Bernard Desjardins, et al, (Geneva: Droz, 2003), pp.486-487. See also Tilly, Richard, "International Aspects of the Development of German Banking," and Hubert Bonin, "The Case of the French Banks" in Rondo Cameron and V.I. Bovykin, eds. *International Investment Banking: 1870-1914,* Oxford: Oxford University Press, 1991. pp. 74-112 both of which 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.

[19] Christopher Kobrak, *Banking on Globalization*: *Deutsche Bank and the United States, 1870 to the Present* (Cambridge: Cambridge University Press, 2007), pp. 1-166.

[20] Geoffrey Jones, *British Multinational Banking: 1830-1990* (Oxford: Oxford University Press, 1993), p. 5.

[21] 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 individual or unique risk, any flows that equal are a matter of indifference to the investor. Adding value would seem to require taking on and managing effectively uncertainty. This relationship was first highlighted in Frank Knight's, *Risk, Uncertainty and Profit* (Chicago: University of Chicago Press, 1921), which will be discussed in the conclusion.

[22] These include the economic, legal, political and cross-border investor explanations. See Gary Herrigel, "A New Wave in the History of Corporate Governance, *Enterprise*

and Society, September 2007, Vol. 8., no. 3., pp. 475-486. See also in that issue Caroline Fohlin, "Does Civil Law Tradition and Universal Banking Crowd out Securities Markets? Pre-World War I Germany as Counter-Example, pp. 602-641, as one of many excellent arguments against the view that the explanation of capital market differences is best explained by civil versus common law systems.

[23] See Peter Temin and Hans-Joachim Voth, "Riding the South Sea Bubble," Massachusetts Institute of Technology Department of Economics Working Paper Series, December 21, 2003.

[24] This distinction owes a lot to the American economist Frank Knight, who argued , in contrast to several other economists such as 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. He 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. *Risk, Uncertainty and Profit* (Chicago: University of Chicago Press, 1921).

[25] Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* (New York: McGraw Hill, 1991) pp. 136-137. 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.

[26] See Mary O'Sullivan's account of how the U.S. equity markets developed in number of offerings and trading between 1885 and 1930. *Enterprise and Society*, pp. 490-538.

Although there is good evidence that many capital markets were very well developed before World War I, some with a market capitalization relative gross domestic product greater than today, transaction costs were much higher, number of participants much lower – especially if you including pension and mutual funds as representing mostly small investors – and variety of instruments much lower than today. See also, Rajan, Raghuram G. and Luigi Zingales, "The Great Reversals: The politics of financial development in the twentieth century, *Journal of Financial Economics*, (2003).

[27] 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 non-family 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-19th century was a family business and that Citibank in the year 2000 is not. About other cases we can argue.

[28] Cassis, *Capitals of Capital*.

[29] Youssef Cassis, *City Bankers: 1890-1914* (Cambridge: Cambridge University Press, 1994) Although Cassis does not make this generalization about the family structure of private and merchant banks, his discussion indicates that it 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, however, 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 use the terms family and private banking interchangeably unless the distinction is important for the discussion.

[30] Rondo Cameron, "Introduction" in *International Banking 1870-1914*, ed. Rondo Cameron, et al. (Oxford: Oxford University Press, 1991), p. 3.

[31] By the end of the 15th 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. Erich Achterberg and Maximilian Müller-Jabusch, *Lebensbilder Deutscher Bankiers aus fünf Jahrhunderten* (Frankfurt-am-Main: Knapp, 1963), pp. 21-27.

[32] Christopher Hibbert, *The House of Medici: Its Rise and Fall* (New York: Perennial, 2003) pp 158-203.

[33] Mira Wilkins, "Foreign Banks and Foreign Investment in the United States, in Rondo Cameron and V.I. Bovykin, eds. *International Investment Banking: 1870-1914,* Oxford: Oxford University Press, 1991. pp. 232-253.

[34] William T. O'Hara, et al. Http://www.familybusinessmagazine.com/oldworld.html. 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 11th generation of the family and enjoys a reputation for meticulous service for famous clients.

[35] *Family Business* Magazine, 2004. Oddly, the U.S. 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 120,000 employees and managed by the same family since 1857; Lazard LLC (101 on the list), French bank with only 2,750 employees but revenues of $5 billion, managed by family and non-family 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.

[36] Michael Collins, *Banks and industrial finance in Britian, 1800-1939* (Cambridge: Cambridge University Press, 1991) pp. 19-21.

[37] 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

[38] Stafano Battilossi, "Introduction: International Banking and the American Challenge in Historical Perspective," in Stefano Battilossi and Youssef Cassis, eds., *European Banks and the American Challenge: Competition and Cooperation in International Banking under Bretton Woods* (Oxford: Oxford University Press, 2001) p.19.

[39] Chernow, *The Death of the Banker*. p. xii.

[40] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation & Private Property* (London: Transaction Publisher, 2002, originally 1932). For a more recent expression of concern, see John Dunning, *Making Globalization Good*, Oxford: Oxford University Press, 2003.

[41] See Karl Moore & David Lewis, *Birth of the Multinational: 2000 Years of Ancient Business History* (Copenhagen: Copenhagen Business School, 1999). Moore and Lewis

emphasize religious institutions over family, but the family comes to the fore in the Roman period.

[42] Harold James, *Family Capitalism: Wendels, Haniels, Falcks, and the Continental European Model* (Cambridge, MA: Harvard University Press, 2006.), p. 2.

[43] Jeff Fear and Christopher Kobrak, Banks on Board: Banks in American and German Corporate Governance, 1870-1914, BHC, April 2008.

[44] See Harold James, *The End of Globalization* (Cambridge, MA.: Harvard University Press, 2001) for an excellent discussion of globalization. See Edward Hallett Carr, *Nationalism and After*, London: MacMillan, 1968 for a classic study of the evolution of nationalism and internationalism in the 19th and 20th centuries.

[45] Kobrak, *Banking on Global Markets.*

[46] Christopher Kobrak, "Deutsche Bank and the United States: From International to Transnational Finance," Columbia University, Working Paper, 2008.

[47] See Fritz Stern, *Gold and Iron: Bismarck, Bleichröder, and the Building of the German Empire* (New York: Knopf, 1977)

[48] See, for example, Herbert Matis, *Die Schwarzenberg-Bank. Kapitalbildung und Industriefinanzierung in den habsburgischen Erblanden 1787-1830* (Vienna: Verlag der Österreichischen Akademie der Wissenschaften, 2005), pp 36-47 and 89-102.

[49] Lothar Gall, "The Deutsche Bank from its Founding to the Great War 1870-1914," in Lothar Gall, et al, *The Deutsche Bank, 1870-1995* (London: Weidenfeld & Nicolson, 1995), pp. 1-17

[50] Meir Kohn, *Financial Institutions and Markets* (New York: McGraw-Hill, Inc., 1994), p. 527.

[51] Cassis, *City Banker: 1890-1914,* p. 28.

[52] Cassis, *City Bankers: 1890-1914*, pp. 30-31.

[53] Cassis, *City Bankers: 1890-1914*, pp. 36-37.

[54] Cassis, *City Bankers: 1890-1914*, p. 39.

[55] Ibid.

[56] Cassis, *City Bankers: 1890-1914*, pp. 214-215.

[57] Cassis, *City Bankers: 1890-1914*, p. 149.

[58] Stephen Birmingham, *"Our Crowd": The Great Jewish Families of New York* (New York: Tess Press, 1967) p. 9.

[59] Harold B. van Cleveland and Thomas F. Heurtas, *Citibank 1812-1970* (Cambridge, MA: Harvard University Press, 1985), pp. 1-31. See also Richad Sylla, et al., *The Evolution of the American Economy: Growth, Welfare, and Decision Making* (New York: MacMillan, 1995), p. 173. Meir Kohn, *Financial Institutions and Markets* (New York: McGraw-Hill, Inc., 1994), pp.207-213.

[60] Carosso, V.P. and R. Sylla, "U.S. banks in international finance," R. Cameron and V.I. Bovykin, eds. *International Banking* (New York: Oxford University Press, 1991) and Mira Wilkins, *The History of Foreign Investment in the United States Before 1914* (Cambridge, MA.: Harvard University Press, 1989)

[61] Wilkins, *The History of Foreign Investment in the United States 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.

[62] Geoffrey Jones, *British Multinational Banking: 1830-1990* (Oxford: Oxford University Press, 1993).

[63] Chernow, *The Death of the Banker*. p. 26.

[64] Naomi Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (Cambridge: Cambridge University Press, 1994) Introduction.

[65] Ron Chernow, *The House of Morgan* (New York: Simon & Schuster, 1990), Prologue.

[66] Ibid.

[67] Fear and Kobrak, "Banks on Board."

[68] Ibid.

[69] Kathleen Burk, *Morgan Grenfell: The Biography of a Merchant Bank, 1838-1988* (Oxford: Oxford University Press, 1989) pp. 29-45.

[70] Ron Chernow, *The House of Morgan*, Jean Strouse, *Morgan: American Financier* (New York: Perennial, 2000) and Vincent P. Carosso, *The Morgans: Private International Bankers, 1854-1913* (Cambridge, MA.: Harvard University Press, 1987).

[71] Samuel L. Hayes III and Philip M. Hubbard, *Investment Banking: A Tale of Three Cities* (Boston: Harvard University Press, 1990,), p. 18.

[72] See W. Bernard Carlson, *Innovation as a Social Process: Elihu Thomson and the Rise of General Electric, 1870-1900* (Cambridge: Cambridge University Press, 2002), 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.

[73] O'Sullivan, p. 495.

[74] Kobrak, *Banking on Global Markets.*

[75] Ron Chernow, *The Warburgs: The 20th Century Odyssey of a Remarkable Jewish Family* (New York: Random House, 1993)

[76] Albro Martin, *James J. Hill & the Opening of the Northwest* (St. Paul: Minnesota Historical Society Press, 1984), pp. 394-522.

[77] Chernow, *The Warburgs*, pp. 103-106.

[78] Theresa M. Collins, *Otto Kahn: Art, Money, & Modern Time* (Chapel Hill: University of North Carolina Press, 2002), pp. 94-97.

[79] Chernow, *The Warburgs.*

[80] Niall Ferguson, *The House of Rothschild: The World's Banker, 1849-1999* (New York: Viking, 1999).

[81] "Rise of New York's Great Investment Houses," *New York Evening Post*, October 15, 1926.

[82] Kobrak, *Banking on Global Markets.*

[83] "Speyer Becomes Investment Unit," *The Wall Street Journal*, June 14, 1934.

[84] Richard Roberts, *Schroders: Merchants & Bankers* (London: MacMillan,1992).

[85] Landes, pp. 8-9.

[86] Stephen A. Schuker, "Money doctors between the wars: The competition between central banks, private financial advisers, and multinational agencies, 1919-39," in Marc

Flandreau, *Money Doctors: The Experience of International Financial Advising: 1850-2000* (London: Routledge, 2003) pp. 49-77.

[87] Cleveland and Heutas, Citibank, pp 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. Jane E. Hughes and Scott B. MacDonald, *International Banking* (New York: Addison Wesley, 2002), pp. 27, 90-101, 149. By the early 90s, 280 foreign banks from 65 countries with 1,000 offices operated in the United States.

[88] Cleveland and Heurtas, *Citibank,* p. 41.

[89] Richard Hofstadter, *The Age of Reform* (New York: Vintage Books, 1955), pp. 75-78. See the work of Mrs. S.E.V. Emery, *The Seven Conspiracies which enslaved the American People* and Gordon Clark *Shylock as Banker*, which are discussed and quoted by Hofstadter.

[90] Hofstadter, *The Age of Reform*, p. 254.

[91] Thomas K. McCraw, *Prophets of Regulation* (Cambridge, MA.: Harvard University Press, 1984) p. 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* (New York: Frederick A. Stokes, 1914).

[92] McCraw, p. 181.

[93] See Harold James, "Introduction," and Gerald Feldman, "Political disputes about the role of banks," in Harold James et al, eds. *The Role of Banks in the Interwar Economy* (Cambridge: Cambridge University Press, 1991).

[94] Charles H. Feinstein, et al, "International Economic Organization: Banking, Finance, and Trade in Europe between the Wars," In *Banking, Currency, and Finance in Europe Between the Wars*, ed. Charles H. Feinstein (Oxford: Clarendon Press, 1995), pp. 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.

[95] Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton: Princeton University Press, 1993)

[96] Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton: Princeton University Press, 1993)

[97] Feinstein, pp. 21 and 127.

[98] Feldman, "Political disputes."

[99] O'Sullivan and Gerd Hardach, "Banking in Germany, 1918-1919" In *Banking, Currency, and Finance in Europe Between the Wars*, ed. Charles H. Feinstein (Oxford: Clarendon Press, 1995), pp. 269-295.

[100] Keith Ulrich, *Aufstieg und Fall der Privatbankiers. Die wirtschaftliche Bedeutung von 1918 bis 1938* (Frankfurt: Knapp, 1998)

[101] Obstfeld, p. 55.

[102] Hardach, pp. 273 and 280.

[103] Harold James, *The Nazi Dictatorship and the Deutsche Bank* (Cambridge: Cambridge University Press, 2004).

[104] Ulrich, and Christoph Kopper*, Zwischen Markt wirtschaft und Dirigismus: Bankenpolitik im „Dritten Reich": 1933-1939* (Bonn: Bouvier 1995).

[105] Chernow, *The Warburgs.*

[106] George P. Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (Cambridge: Cambridge University Press, 1998)

[107] Baker and Smith, p. 3. See also Bryan Burrough and John Helgar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: Harper, 1991) 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.

[108] Baker and Smith, pp. 6-7.

[109] Baker and Smith, pp. 23-26.

[110] Baker and Smith, pp.26-27.

[111] Baker and Smith, p. 202.

[112] See Gordon Donaldson, "The Corporate Restructurings of the 1980s – and it importance for the 1990s," Stephen Kaplan, "The Staying Power of Leveraged Buyouts," and Mike Wright, et al, "Corporate Restructuring, Buyouts, and Managerial Equity: The European Dimension," all in Donald Chew, *Studies in International Corporate Finance and Corporate Governance Systems: A Comparison of the U.S., Japan and Europe*

(Oxford: Oxford University Press, 1997) for good discussions of the social and economic impact of LBOs in the United States and Europe.

[113] Svend Ehlern, *International Private Banking: A Study on international private banking with special focus on the portfolio management business* (Bern: Verlag Paul Haupt, 1997), p.77.

[114] Russel Taylor, *Private Banking Renaissance* (London: Lafferty Group, 1995) pp. 10-14 and p. 131.

[115] Taylor, pp. ix-x.

[116] Robert J. Shiller, *The New Financial Order: Risk in the 21st Century* (Princeton: Princeton University Press, 2003).

[117] Shiller, for example. Although Shiller makes use of the distinction between risk and uncertainty, he never mentions Knight.

[118] See, for example, Stefano Battilossi and Youssef Cassis, eds., *European Banks and the American Challenge: Competition and Cooperation in International Banking Under Bretton Woods* (Oxford: Oxford University Press, 2002)

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

[120] See, for example, Jonathan Zeitlin and Gary Herrigel, eds., *Americanization and its Limits: Reworking US Technological and Management in Post-war Europe and Japan* (Oxford: Oxford University Press, 2000)

[121] See Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970) and

Michael Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, in Donald Chew, *Studies in International Corporate Finance and Corporate Governance Systems: A Comparison of the U.S., Japan and Europe* (Oxford: Oxford University Press, 1997), who lay out the issue extraordinarily well. Ironically, the much -hated in Europe LBOs, described above, are a way in which exit and voice are reconciled by re-allocating assets.