Accounting History

Book review

Baring Brothers and the Birth of Modern Finance

Peter E. Austin
London: Pickerng & Chatto, 2007, xiv + 265 pp.
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This excellent, provocative volume by Peter Austin is a useful addition to the Pickering and Chatto financial history series that is ably edited by Robert E. Wright. Peter Austin examines the origins of modern finance by focusing primarily on the early experience of the Baring Brothers firm in the USA through the Panic of 1837. Although much of this ground has been worked over in the earlier studies of Ralph Hidy, Phillip Ziegler and John Orbell, Austin differentiates his work by emphasizing a more cognitive-behavioral approach than earlier contributors to understanding financial organization dynamics. Austin concentrates on delineating the mind set of key partners responsible for guiding the firm's business as a means of better understanding their decision processes as they successfully directed the activity of their business during a major financial crisis. Besides firm archival records, Austin's cogent analysis is also informed by his effective use of the diaries of two key Americans admitted to the partnership, Joshua Bates and Thomas Wren Ward. These individuals played critical roles in facilitating the achievement of Baring's great market triumphs in the New World during the 1830s. (Austin also provides an epilogue that contrasts the factors contributing to financial management success in the 1830s against those that led to the near fatal Argentine bond funding of the 1890s and the pernicious derivative trading in Singapore during the 1990s.)

By the 1830s Barings Brothers had evolved a strategy that gave priority to capital preservation over profit maximization. By the end of the Napoleonic Wars, it had risen to the leading ranks of Europe's banking community, playing a central role in financing the post-conflict international settlements. Senior partners were well connected in London, then the world's financial center, through service in key policy-making institutions including Parliament and the Bank of England.

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Sensitive to the inherent fragility of contemporary global finance, its partners worked diligently to reduce investor perceptions about the risk of the firm by implementing ultraconservative policies. The bank built a reputation for reliability in financial emergencies by maintaining high levels of liquidity and avoiding reliance on borrowing. An important part of the strategy, called "changing too soon", seemed predicated on a belief in the cyclical nature of economic affairs. This operation involved the early withdrawal from highly active markets as they reached their apogees and before the onset of decline into recession. During the anticipatory winding downs in business, Barings addressed the problem of weak credits when markets were relatively stable and the impacts of any portfolio dislocations could be more readily accommodated. The objective was to assure that the bank had sufficient funding to sustain its activities through the inevitable troughs in business activity. The firm wanted to reach a state where its paper, even during the midst of great financial turbulence, would be accepted without question in the world's far-flung business centers because of an unblemished reputation for solvency. Moreover, this further strengthened the firm by allowing it to be more selective in accepting clients. In making these choices, the firm traded off quantity for quality and market share for safety. The bank reduced portfolio risk by limiting the size of its customer base to include only the most credit-worthy entities. Baring Brothers' clients paid for this safety by incurring higher fees for premium service.

Austin's study also emphasizes the importance of institutional rules and the personal qualities of its agents as sources of superior firm performance. The two Americans recruited as senior agents were both highly seasoned businessmen with deep knowledge of the complexities of contemporary banking practice. They identified strongly with the partnership and its goals. Their actions were restricted by formal house rules such as prohibitions against borrowing, entry into particular markets and demanding exclusivity from clients in providing banking services. They maintained a constant stream of correspondence with the London headquarters reporting on local conditions. Generally, the direction of major policy decisions was from the center to the periphery with London defining the broad parameters of policy and the US agents developing implementation plans.

The study makes a very interesting discovery about the role of local agent perceptions in guiding the destiny of the partnership during the crisis of 1837. Despite long experience and deep knowledge, the assessment of developments rendered by their key representative in the two years leading up to the crisis proved faulty. Barings might have experienced substantial losses had they placed more reliance on their agent's prognostications, for example, of the trends in cotton prices and the continued solvency of state debt issues. Instead, the senior partners in London demanded a strict adherence to the seemingly more intuitive approach of "changing too soon". In fact, Austin discovered that Barings changed

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too soon by two years, reducing their exposure to US markets beginning in 1835. Nevertheless, the strategy proved highly successful with the bank coming through the storm unscathed and in strong financial condition.

The firm presaged the institutional practices of modern corporations in two ways. First, like the central office structure of modern corporations, the power to make strategic decisions remained a prerogative of top management. The senior executive cadre, doubtless, wanted to exercise this authority directly to protect their reputations and invested capital. The senior cadre benefited from a global view of the business through regular correspondence from regional agents. They also were kept well informed about the direction of affairs through their close ties with elite bankers and politicians in London and other financial capitals. The scope of authority of the second managerial echelon, the agents that represented the firm in specific overseas markets, seems to have been restricted to reporting about local business conditions and fulfilling the strategic mandates emanating from the center.

Second, the firm seemed modern through its use of a primitive form of business cycle analysis, a dimension of professional economics that began to flourish during the early decades of the twentieth century. The success of the "changing too soon" strategy essentially hinged on the ability to time market entry to low points in the business cycle and to withdraw after the subsequent restoration of prosperity. The strategy of "changing too soon" that derived from this perception about the nature of economic dynamics proved highly effective in protecting the interests of wealthy clients interested in preserving capital and avoiding risk. It is not clear from Austin's narrative how this idea about the recurring patterns of business change developed. The exploitation of this dynamic certainly would have seemed vindicated by the 1830s, based on the analysis of the firm's past experience. However, there may have been other cultural factors that inclined the firm's management to conceptualize economics in cyclical terms. Did traditional notions inherited from the Renaissance, such as "Fortune's Wheel", reinforce intuitions that the time spectrum in economics was punctuated by successive periods of expansion and decay? Did the periodicity of natural phenomena in the form of tidal, weather and seasonal flux serve as persuasive analogues for describing the normal sequence of change in business affairs? Such a convergence in thought might have been possible given the covenants that generally controlled the timing, duration and liquidation in contracts for financing agricultural and navigational enterprise during this era.

Peter Austin's original study should benefit scholars in several fields. His book illuminates an important transitional period in US financial history by focusing on the actions of a leading banking organization. It also helps to extend the theory of the firm by evaluating critical factors that shaped the evolution of decision processes in early banking organizations. In addition it helps to amplify

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our understanding of finance by providing insight into the ways that agency relationships and portfolio selection practices were successfully handled during a period when financial capitalism was seriously constrained by limited information resources and communication capabilities.

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