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Korinna Schönhärl Editor

Decision Taking, Confidence and Risk Management in Banks from Early Modernity to the 20th Century

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This Palgrave Macmillan imprint is published by Springer Nature The registered company is Springer International Publishing AG The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland This volume provides a wealth of historical case studies of different techniques used over time by bankers to assess and mitigate their exposure to different sources of risk. By combining institutional, sociological and behavioral perspectives, it emphasizes the relevance of culture, social networks and institutional rules for bankers' perceptions of risk, lending decisions and investment strategies. An entertaining and instructive reading both for financial historians and banking practitioners

—Stefano Battilossi, Associate Professor, Universidad Carlos III Madrid, Spain, and Editor, Financial History Review

Acknowledgments

This book draws on papers presented during the workshop 'Decision Taking, Confidence and Risk Management in Banks: 19th and 20th Century' in February 2015. It took place at the KWI Essen (Kulturwissenschaftliches Institut, Institute for Advanced Study in the Humanities). The plan was to bring together an interdisciplinary and international group of researchers to discuss new methodological approaches to banking history, which sometimes seems to need fresh input. My interest in this topic emerged during my project 'Financers Desired Spaces. European Bankers and Greece in the 19th Century', which researches the motives of British, French, German and Swiss bankers to invest their money in that high-risk emerging market. All contributors to the workshop were invited to present one methodological approach or idea and to illustrate its use and function in an empirical case study taken from their current research. The workshop's discussions indeed offered plenty of helpful ideas and stimulation about how historians can deal with bankers' investment motives. Our chairs and commentators Dirk Baecker (Friedrichshafen), Johannes Bähr (Frankfurt a. M.), Boris Barth (Konstanz), Youssef Cassis (Florence), Christopher Kopper (Bielefeld) and Dieter Ziegler (Bochum) made major contributions to our results.

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This book is dedicated to my daughters Pauline and Ricarda, the source of my energy and happiness.

Korinna Schönhärl Essen, in May 2016

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Introduction

Korinna Schönhärl

1 Bankers' Investment Decisions and Risk Management

During the recent years of crisis, public opinion has drawn a very negative picture of bankers and their investment decisions, which are considered to be predominantly motivated by profit maximisation, lacking all kinds of social responsibility (N.N. 2013). Certainly, profit has always been a driving force for bankers, as it necessarily is for all entrepreneurs who want to succeed. But when researching the worldwide history of investment, one soon realises that rational choice theory does not provide sufficient methodological approaches to understanding all variants of bankers' investment behaviour (Green and Pohle Fraser 2008). Sometimes banks have invested despite rather poor expectations of profits and insufficient risk

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premiums. Sometimes they let apparently good investment opportunities go to their competitors, although the risk seemed to be low. How can banking historians understand and explain their decision-making? Primarily it should be acknowledged that bankers are humans of flesh and blood with emotions and experiences and ethical norms, who cannot be squeezed into a narrow model of homo economicus (Berghoff 1999, 174). Bankers' investment decisions and the motives behind them should be looked at more closely. Why did bankers take their decisions in the way they did? What mechanisms of decision-taking were established in banking from early modern times until the twentieth century, and how did they change over time? What kinds of risk management techniques were used and to what extent did they succeed? How did bankers perceive risks and how did they try to limit them? Which factors contributed to the constitution of confidence and which factors damaged it? These questions can certainly only be answered with the help of elaborate methodological concepts. Thus this volume presents methodological approaches for banking historians to analyse questions pertaining to bankers' decisionmaking. The methodological tools are not only introduced in theory, but their practical application to empirical research based on archive material is also demonstrated in selected case studies.

2 Risk, Confidence and Decision-making: Some Definitions

In order to research risk management, it is necessary to define the term 'risk': the possibility that an action causes losses for or damage to the actor (Baecker 2008, III). Decisive for choices related to risk management is the interpretation of the situation by the actor as dangerous (i.e. influenced by external, non-controllable dangers) or as risky (dependent on one's own decisions and actions) (Hahn 1998, 49; Akerlof and Shiller 2009, 205). Risk, according to this definition, is always connected to one's own actions and one's own decisions. Different options for action have to exist, providing the actor with a choice. He or she could easily avoid the risk by taking an alternative course of action (e.g. not to invest), but in this case he or she would also lose the chance of winning something.

While uncontrollable dangers have to be avoided, consciously getting involved in risks can be profitable and desirable, as entrepreneurs can profit from the contingency of future developments by being repaid for the taking on of risks (risk premium). This is especially the case for bankers, who are responsible for the compensation of time differences in the economy. They deal with payment promises in a contingent future and have to secure the safety of payments through continued rescheduling and thus deal with various kinds of risk: risk of fraud, risk of insolvency, risk of illiquidity or risk of loan loss (Baecker 2008, VIf., 108-112).

So banks continuously have to take on risks and consequently develop risk strategies (Kahneman 2011, 340). Their business is unimaginable without risks. The most important aim for bankers was (and is) not to be taken in by an illusion of security because this would damage the chances of identifying and allocating risks. This is even more important because bankers often have to represent themselves to politics and the public as being risk averse (Pohle Fraser 1999, 2, 48). However, they have to clearly identify risks and use risk management to put themselves in a position that is as advantageous as possible in terms of risk-taking. In this process, banks must reduce the complexity of 'noise' in their environment (Pohle Fraser 1995, 28) and thereby differentiate between important and insignificant information in order to make investment decisions possible. Risk management works on three levels: firstly, the observation of markets to identify profitable business opportunities; secondly, risk management within the organisation to organise the conditions of risk-taking; and thirdly, the design of financial instruments to split risks (Baecker 2008, 126). The allocation of partial risks between reliable partners was (and is) one of the most important techniques of risk management. All three levels of risk management can be reconstructed using banks' archive materials.

However, even with elaborate risk management complete knowledge of one's counterpart, including the prognosis of his/her actions is not possible in business relationships, as indeed is the case in any other social interaction. The actions of the counterpart are always contingent (Simmel 2013, 268, 274). Increasing control over a business partner always involves rising transaction costs due to the provision of information. A reduction of these transaction costs is only possible by confidence (Berghoff 2004, 59). Confidence can be defined as a mechanism to stabi-

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lise insecure expectations and to reduce the complexity of human action (Ripperger 2005, 9). It reflects contingence, whereas hope eliminates it (Luhmann 2009, 29). Political science, sociology, anthropology and economics have developed various approaches to the term 'confidence' (or trust) in recent decades, without arriving at a consensus (Fukuyama 2001). The operationalisation of the term also remains difficult in historical research (Frevert 2013). Perhaps the most usable approach is that of new institutional economics, elaborated on by Tanja Ripperger. She defines confidence not as an end in itself or a moral aim, but as a competitive factor in business life due to the possibility of saving transaction costs (Ripperger 2005, 262). Francis Fukuyama similarly argues that it is the level of confidence inherent in a society which makes it successful in economic terms (1995, 150). Especially within the principal-agent relationship, confidence is a sine qua non of economic interaction. The principal has to intentionally bypass his/her lack of information concerning the intentions of the agent, for example by generalising his/her experiences with other members of the same group. But in the end confidence is always a voluntary act. All the reasons that may be mentioned as underlying it are only ways of legitimising a decision which cannot be based on pure rationality (ibid.). The decision to bestow confidence, after all, seems to possess many of the characteristics of a black box in historical research, as is the case for many other banking decisions.

In this unsatisfactory situation, behavioural psychology can provide new options for historians interested in the motives of decision-making. Choice theory intensively researches factors relevant to decision-taking and 'has uncovered substantial and systematic regularities in how people make decisions' (LeBoeuf and Shafir 2012, 243; Allingham, 2002). The rational choice model has been shown to be insufficient because it cannot explain many aspects of human decision-making. The assumption that individuals always choose the most profitable alternative has lost ground vis-à-vis more differentiated models. Behavioural finance transfers these approaches to the field of financial markets with the aim of explaining the decisions taken by individuals. It is especially concerned with questions of risk perception, the process 'by which an individual is in search of preeminent clarification of sensory information so that he or she can make a final judgement based on their level of expertise and past experi-

ence' (Ricciardi, 2008, 86). The main finding of behavioural finance is that risks are perceived very differently by different individuals and that 'objective' mathematical quantification is unhelpful in making sense of the decision taken in a certain situation by a certain actor on a certain financial market (ibid.). These results are gained mostly by empirical test series carried out in laboratories with selected probands. Here is the point where historians can enter with their qualitative methods and enrich the discussion with the results of their historical source-based research. How did bankers in the past perceive risk and how did they try to manage it? The analysis of archive material can produce valuable case studies and can therefore augment the behavioural finance perspective on investment behaviour. It is important to carefully investigate the question of whether the decision-making processes of actors today are comparable to those of actors in the past and the nature and significance of possible differences. Even if the differences indeed prove to be predominant, a new perspective on archive material can be gained. The explicit aim is to overcome a perspective in which the bankers are described either as responsible investors or as foolhardy speculators, depending on the outcome of their business decisions (Priemel, 2013). Instead, analysis of their state of knowledge and information at the moment of the decision is required.

The framework of this volume is defined by the three terms 'decisionmaking', 'risk management' and 'confidence'. The aim is to present carefully designed case studies that use different methodological tools to illuminate the black box of bankers' decision-making.

3 First Part: Recruitment of Personnel and Partners

Maybe the most delicate decisions that have to be taken in banks concern the recruitment of the next generation or adequate business partners. They are dealt with in the first part of this volume. Decisions made in this field involve high risks for the entire enterprise. This is true whatever the governance structure of the bank in question, be it a family bank or a joint-stock company. Susie J. Pak analyses the risks associated with the recruitment of non-family members to the House of Morgan from 1895 to 1940, when the family was no longer able to fill all the positions itself. She discusses how and according to which characteristics possible candidates were recruited, how they were judged, and how they were incorporated into in-house and broader social networks to make them more reliable. The resulting structures were still comparable with the preceding ones when belonging to the family was the essential characteristic. Pak includes all the non-family members of the House of Morgan in that period in her research, based on detailed tabular material which offers an analytic overview.

Daniel **Wylegala** also deals with the question of how an organisation's higher hierarchical levels can be filled and how the associated risks can be managed. Using Niklas Luhmann's system theory he views top careers as a process of selection and socialisation, in which a candidate has to prove his eligibility and ability to manage risks time and again. In a case study on Karl Klasen, President of the German Bundesbank, Wylegala demonstrates how a system theoretical perspective can be used to develop a consistent narrative of a top manager's biography.

Not only is the recruitment of in-house personnel a risky business for banks. The selection of cooperation partners also takes place under conditions of uncertainty and is connected with high risks. Friederike **Sattler**, after careful consideration of the methodological challenges, designs a model of experience-based expectation formation to explain the post-1960 decisions of German universal banks to enter the US-American market via club banking rather than alone. Sattler demonstrates a special interest in the banks' perceptions of the chances and risks of this kind of multilateral cooperative governance.

4 Second Part: Risk Management Techniques

Of course the recruitment of staff and partners is only one field of bankers' decisions. Another one concerns the question of investments. Close cooperation here can help to manage risk too, for example when issuing state loans. Anders L. **Mikkelsen** opens the second part of the volume by analysing the way in which British issuing houses dealt with underwrit-

ing and reputational risk from the 1880s onward when the gatekeeper positions of the banks weakened for certain countries. Their reaction was to cooperate by issuing syndicates and forming underwriting groups in which the underwriting risk could be spread over several strong shoulders and the position towards the creditor strengthened.

Such risk management always took place in a certain cultural and economic setting, in this case the British one. Is the national environment of any importance? Andrew Dilley instead proposes the financial centre as a unit of analysis. He understands it as a field in the sense of Bourdieu's praxeology, his 'theory of practice', causing a certain 'habitus' of risk perception. Habitus is understood here to refer to the structure of mind and emotions of the individual, socialised through education and social environment. Using, in addition, the new institutional economics perspective, Dilley argues that this habitus was influenced by economic and business structures, the role of states, social networks and cultural factors. He thus opens up a wide field for international banking historians to look beyond their own noses and examine cultural differences in banking more closely.

This was well demonstrated in Monika Pohle Fraser's analysis of the risk management techniques of German and French banks in the nineteenth century. Her focus was on the question of how bankers' justifications of investment decisions in these two different countries developed in this period. Sebastian Knake summarises the results of her unpublished dissertation and compares it with Thévenot and Boltanski's convention theory. He puts his results to the test in a case study on the risk management of the Braunschweigische Staatsbank in the 1950s and shows that it is very likely that some elements of risk management survived in banking practice until the first half of the twentieth century.

Matthew **Hollow** also deals with twentieth-century risk management. He researches how Barclays Bank dealt with the risks inherent in lending to small and local businesses. His results are in many points comparable with those of Knake and of Pohle Fraser of the nineteenth century: despite all the technical innovations, interpersonal relationships and networks remained very meaningful for the lending decisions.

Does this situation change with the emergence of computer technology in financial institutions? Bernardo Batiz-Lazo asks about the expectations of decision makers and shareholders in applying these new methods to retail deposit-accepting financial institutions and their outcome for the decision-making process. He is also interested in the impacts of these changes on the social composition of the bank's staff and the education of bankers.

5 Third Part: Methodological Tools for Historians: Network Theory, Principal-Agent Relationships, Behavioural Finance and Social Capital

In addition to the approaches already mentioned, the third part of the volume deals with further methodological tools with which historians can research risk perception and decision-making processes in banks. Nadia **Matringe** emphasises the role of networks in the decision-taking of early modern bankers. Networking was so important to the bankers (her case study is the banking house Salviati) that profit maximisation could actually be of subordinated importance. The integration into social networks could prevent the bankers from acting opportunistically.

Opportunistic behaviour of business correspondents is but one of the multiple risks early modern bankers had to deal with. Based on the archive of the Antwerp banker de la Bistrate, Daniel **Velinov** examines risk mitigation in the context of payments via bills of exchange in 17th century Europe. The close analysis of exchange transactions shows that it is the complex relationship between principals and agents that is the source of the important variety of risks that both principals and agents faced. Therefore, risk mitigation relies on procedures that regulate the principal-agent relationship or – to put it differently – that are inherent to the system of commission trading. Also the notions of credit and reputation relate intrinsically to the principal-agent relationship. This finding challenges the commonly attributed importance of familial, city-based, regional, national, ethnic or religious affiliations to generating trust, credit and risk mitigation.

The variety of motives that can contribute to investment decisions is the subject of the following chapter by Victor **Ricciardi**. As a researcher in financial management, he presents the basics of behavioural finance

for banking historians, covering overconfidence, representativeness, anchoring, worry, herd behaviour, group polarisation and groupthink. In an interdisciplinary approach, Ricciardi considers the chances and challenges of behavioural finance for the research of bankers' investment decisions in the past, discussing the new and interesting perspectives that it opens up for work with archive material, despite the methodological snares that have to be negotiated.

This idea is put to the test by Korinna Schönhärl in the following chapter. She uses the behavioural finance approach to analyse the decision by the French bank Comptoir d'escompte to get involved in the construction of a maritime canal at Corinth in Greece (1882-1893). She shows that it is probable that 'belief in experts' and 'overconfidence', caused by imperial overestimation of French technical and financial capabilities, were meaningful for this investment decision. The behavioural finance approach opens up a new perspective on the archive material and helps to construct a narrative from the research.

But can attempts like this make banking history more attractive for 'general' historians? Morten **Reitmayer** is sceptical. Even if he judges the concept of social capital, which he explains in detail, to be a promising methodological approach, he does not believe it will bring banking history very much closer to the historical mainstream. Reitmayer instead proposes a range of subjects and themes where the expertise of banking and more general business historians are required where they could fruitfully contribute to historical and social discussion in general. He thus opens up the field for consideration of the future of banking history and the challenges with which it will be confronted.

Main Results of the Book 6

Addressing the questions of how bankers took their decisions and what their risk management looked like, the volume provides a couple of interesting results. On the one hand, it becomes clear that from the seventeenth to the twentieth-century new risk management techniques were continuously developed, employed and advanced. For early modern times the procedures of commission trading or the construction and care of networks of personal confidence are worthy of mention. In comparison to the observance of the rules of the game of commission trading or to the elaborate maintenance of networks, profit maximisation was often less important for early modern bankers. Later on, with the evolution of the banking business, risk management techniques also became more sophisticated. In the nineteenth century, the era of 'the banking revolution' (Cassis, 2009, 43; Chapman, 1984; Kynaston, 1994), banks made accessible new sources of capital by becoming joint-stock enterprises. With their new, completely revised governance structures they started the financialisation of a globalising industry. The challenges connected with this forced not only joint-stock but also more traditional family banks to adopt new methods of risk calculation and management. At this time several new mechanisms were proven as responses to new challenges: the construction of issuing groups as a method of risk sharing, the development of scientific expert systems, and, in the twentieth century, the employment of computer technology. But alongside these innovations other key elements of risk management like personal reputation, connecting elements like memberships in certain universities or clubs, shared contacts and confidence continued to be of importance throughout the centuries. Even if the bankers claimed to practise modern and technically up-to-date risk management, they de facto still relied on the second-order observation of colleagues, business partners and even scientific experts, checking their reputations and middle-class virtues as the basis of confidence. Even in-house careers in banks can be interpreted as the long-lasting probation of candidates, their gradual involvement in decision situations and the establishment of their reliability. The risk management techniques used by bankers alongside these traditional approaches often served more to legitimise decisions afterwards, as far as it is possible to distinguish between these two purposes at all.

It becomes clear that risk perception is a deeply culturally conditioned process, one that can be analysed only when embedded in the context of its social, political and cultural background, something that is indeed a challenge for banking historians. Culture, language and local habits do matter when considering bankers' investment decisions. Alongside this group level, some of the chapters of this book also prove the importance of the individual level, because they show that the decision-making of bankers is

a highly individual process that can be understood only by considering the value background, the expectations and the past experiences of the actors involved. Another person might have made a different decision in an identical situation—an observation that has to be taken seriously.

So the research of bankers' risk management and investment decisions is not possible without an elaborate methodological approach that focuses on the evaluation of sources in the decision-making process. This volume offers a variety of proposals about how this focusing can be put into effect, taking one's own blind spots as a historical researcher seriously and trying to shed light on them. The broad field of methodological approaches from modern cultural history (Arcangeli, 2012; Burke, 2004; Daniel, 2001) thus becomes indispensable for writing the history of banks.

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Part I

First Part: Recruitment of Personnel and Partners