MERCHANT BANKING IN THE MEDIEVAL AND EARLY MODERN ECONOMY*

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ABSTRACT: This paper describes the evolution of merchant banks–merchants who specialized in remittance and credit. It examines the sources of their funds and the use to which they put them in exchange trading, commercial credit, and sovereign lending. It discusses the methods the banks used to manage liquidity and risk and the crises that resulted from sovereign defaults.

JEL Categories: F31, F34, G15, N23

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PREFACE

There are two classes of question one might ask about financial systems. The first and broader class relates to their role in the economy: What is their contribution to economic development and growth? What is their impact on the way business is organized? On the organization and behavior of government? The second and narrower class of question relates to financial systems themselves: What is their economic function? How do they evolve? What are the causes and consequences of financial innovation?

History is perhaps the most promising source of answers to both classes of question. This paper is a draft chapter in a planned work that draws on the economic and financial history of the period to 1600. The section of the work to which this chapter belongs focuses on the narrower class of question about the financial system itself during this period. Other sections will take up the broader class of question. Draft chapters of this section are available as the following working papers[1]:

1. Finance before the Industrial Revolution: An introduction
2. Medieval and early modern coinage and its problems
3. Early deposit banking
4. Bills of exchange and the money market to 1600
5. Merchant banking in the medieval and early modern economy
6. The capital market before 1600
7. Risk instruments in the medieval and early modern economy

The financial system is part of the institutional structure that facilitates economic transactions. Specifically, the financial system facilitates lending, payments, and trade in risk. While lending often steals the limelight, the role of the financial system in facilitating payments and trade in risk is no less essential. Before 1600, because of the poor quality and inadequate quantity of coin, the payments function was particularly important (Paper 2 discusses the problems of the coinage in this period). As commerce expanded, the pressing need for adequate means of payment prompted a great deal of financial innovation–in particular, the emergence of the deposit bank and the bill of exchange. The deposit bank (Paper 3) provided a means of payment–the transfer of deposits–that minimized the need to use actual cash. The bill of exchange (Paper 4)

[1]Copies may be downloaded from: http://www.dartmouth.edu/~mkohn

provided a means of remittance–of transferring funds from one place to another–without having to ship specie or bullion. The bill of exchange was also an instrument of credit, the basis on which merchant banks (the subject of the current paper) built an efficient international system of commercial credit. While the bill of exchange satisfied the need for short-term finance, the growing need for long-term finance was met by a developing capital market (Paper 6). Trade in risk was still in its infancy, but the period saw the development of marine insurance and the beginnings of futures and options (Paper 7). Paper 1 provides some general background on saving and investment during the period, on the effects of the prohibition of usury, and on the extensive system of 'informal' finance', out of which specialized financial institutions and markets evolved.

INTRODUCTION

All merchants were involved in finance–as givers of credit, as receivers of credit, or usually as both. Credit, mainly sales credit, was an intrinsic part of commerce. Indeed, managing his finances was commonly a merchant's primary concern–where to borrow, to whom to extend credit, how to ensure that obligations could be met. However, for most merchants, finance–important as it was–remained but an adjunct to their commercial business. For a few, finance developed into a business in its own right: these were the merchant bankers.

Merchant bankers entered finance through remittance–transferring funds from place to place for others–using bills of exchange. Their trading in bills of exchange created a well-integrated international exchange market. The exchange business drew them into lending, and they became the principal financiers of international commerce. Merchant bankers also played a pivotal role in bringing sovereign borrowers into the international money market. For many, however, their involvement with sovereign borrowers proved to be their downfall.

WHO WERE THE MERCHANT BANKERS?

Why did some merchants become merchant bankers? Often, it was a case of one thing leading to another. Large trading companies with permanent branches or correspondents in many places found it easy to transfer funds for other merchants, so becoming merchant bankers. Because of the delay between the time a merchant bank accepted funds in one place and the time it paid them in another, it necessarily became the recipient of a loan. In this way, remittance provided a merchant bank with funds that it could in turn lend and so drew it into finance.

There was another reason why some merchants came to specialize in finance. Commerce, when successful, could generate enormous profits. As a successful merchant's wealth grew, he found it necessary to increasingly devote his time to managing his wealth. Opportunities for further investment in his own business were limited, and considerations of diversification made it anyhow undesirable. Good financial assets were hard to find. In many cases, the wealthy merchant's best alternative was to lend his capital–to become a financier. The move was an easy one–he would already, as a merchant, have been well versed in finance. While he would start by lending his own capital, he might soon find that good opportunities for lending exceeded his capacity to fund them. It was then a natural step to increase the funds at his disposal by borrowing. The career of Francesco Datini of Prato, born in 1335, is typical of this progression from commerce to finance. Following a year of apprenticeship to a merchant in Florence, he set up business in Avignon, the home of the papal court. There, for over thirty years, he traded in armor, cloth, religious articles, paintings, jewelry, and other goods. Having made his fortune, he returned to Florence to become a merchant banker, opening additional offices in Pisa, Genoa, Barcelona, Valencia, and Majorca and engaging correspondents in Bruges and London.

While finance became an important line of business for the merchant banker, he did not, as a rule, abandon commerce altogether. Unlike the deposit banker, the merchant banker did not specialize exclusively in finance. For example, the great Italian merchant bankers in England, the Bardi and the Peruzzi, also traded in wool, cloth, wine, and lead, and were not above trading in horses.[2] Apart from the benefits of diversification, finance and commerce were complementary. With a presence in many markets and good information, the banker was well positioned to buy low and sell high, and he had the resources to exploit opportunities when they occurred: “He could easily shift his capital from investment in bills to investment in trade.”[3] Moreover, the ability to provide finance was a significant advantage in trade. The trade in commodities–grain, precious metals, wool–was among the most profitable. However, it was often controlled by princes. Access could frequently be obtained by providing the prince with credit. The enhanced ability to grant credit to suppliers and to customers could also be an important advantage.[4] In the thirteenth century, Italian merchant bankers took over the English wool trade from English and Flemish competitors largely because of their ability to pay in advance–commonly a year, but sometimes as much as twelve.[5]

Merchant banking was predominantly an Italian business, first emerging towards the end of the twelfth century out of exchange with the Fairs of Champagne. Early merchant

[2] Prestwich (1979)

[3] de Roover (1949) p166

[4] “In order to obtain a favourable price a man like van der Molen, [the Antwerp] commission agent of Italian firms, was in a strong position in relation to the poor draper or tapestry weaver, since he could, when giving an order, show gold or silver coins or even talk of an advance. On the other hand when he sold Italian products, payment facilities of six to twelve months certainly stimulated business.” (Van der Wee (1963) p 338)

[5] Prestwich (1979) By the end of the thirteenth century, the Italians were buying up the output of 49 of the 74 Cistercian monasteries that were the main producers.

bankers were from Asti, Piacenza, Siena, and Lucca.[6] Then, in the fourteenth and fifteenth centuries, the Florentines came to the fore, and in the sixteenth it was the turn of the Genoese. Other nationalities were represented–Catalans, Flemish, English, Portuguese, and Spanish–but for most of the period the Italians dominated. The one exception is the brief prominence of the South Germans in the early part of the sixteenth century. This episode is interesting because it illustrates the second of our motives for entry into merchant banking–the need to find employment for accumulated wealth. The South German companies had become prodigiously wealthy through their involvement in the Central European mining boom of the late fifteenth century and it was the need to employ their capital that drew them into finance. Even so, their importance was largely limited to sovereign lending: exchange remained in the hands of the Italians.

Merchant banks varied greatly in size. Some were enormous: the Bardi, Peruzzi, and Acciauoli of the fourteenth century and the Fuggers of the sixteenth century were the largest firms of their time. The Peruzzi had 15 branches across Western Europe and the Levant, and they employed some 120 partners and factors (in comparison, the papal curia, the largest existing government bureaucracy, employed about 250).[7] At the other extreme, many relatively modest trading companies were involved in exchange as a profitable sideline. The typical merchant bank was somewhere in between. It was large by the standards of the day–larger than most deposit banks, for example–yet not enormous. The Medici bank of the fifteenth century, despite its fame, was much smaller than the 'supercompanies' of the fourteenth century. It was no more than the 'first among equals' of some 140 Florentine merchant banks that operated in Lyons at the time.[8]

One reason merchant banks were relatively large was that in order to be a merchant bank a company had to have an international presence. To engage in exchange, it had to operate in at least two places but preferably in many more. Lending, too, required an international presence: the least expensive source of funds might be in one place, the best opportunities for lending in another. Moreover a local office helped to instill confidence in the bank's creditors and made it easier to keep tabs on its debtors. Lending-especially to governments–was relationship lending: constant monitoring was required to secure repayment. While a small English merchant bank might operate only in London and

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[6]The first large merchant banks, in the thirteenth century, were Sienese. It was the failure of the largest Sienese merchant bank–the *Gran Tavola* of the Bonsignori– in 1298 that opened the way for the Florentines to take over. (de Roover (1963))

[7]Hunt (1994)

Antwerp, the Medicis, a more typical operation, had offices in Florence, Venice, Pisa, Rome, Milan, Geneva (later moved to Lyons), Avignon, London, and Bruges. The Peruzzi, among the largest, had offices in Florence, Naples, Sicily, Avignon, London, Bruges, Paris, Barletta, Cyprus, Rhodes, Sardinia, Tunis, Majorca, Venice, and Pisa.[9]

The scale and complexity of their operations presented merchant banks with significant problems of organization. While smaller enterprises, including deposit banks, were usually sole proprietorships, merchant banks were typically large partnerships. Not only could a partnership deploy a greater capital and share the risks more widely, but it could also mobilize the skills and knowledge of many individuals with different backgrounds and experience. The successful management of such a large enterprise required a system of control that allowed considerable independence to the man on the spot while ensuring that he acted in the interests of the company as a whole. To this end, merchant banks experimented with different forms of business structure. They also developed methods of accounting, both to control their agents and to keep track of complex transactions; the demands of accounting stimulated advances in mathematics. The merchant bankers' need for rapid communication among their offices drove them to organize efficient private mail services.[10]

SOURCES OF FUNDS

In their lending, merchant banks relied on two sources of funds–their own capital and the funds they borrowed from others. Merchant banking firms were generally partnerships. At the creation of the partnership, each partner subscribed to the 'official' capital–the *corpo*. In addition to the *corpo* was the *sopracorpo*–normally, a much larger amount. Some of the *sopracorpo* came from additional funds contributed by the partners beyond their required subscription (good investment opportunities were scarce). These additional funds were a form of subordinated debt: the partners earned interest on them rather than profits, and then only after other debts had been settled. The remainder of the *sopracorpo*–the majority of it–came from retained profits. Profits were often substantial, and they were generally retained until the partnership was wound up and the accumulated profits were divided up among the partners. It was customary to wind up the partnership after a limited number of years–from one to twelve, with six typical. Normally, the partnership would then be reconstituted with the same partners, plus or minus a few. In

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[8] Abulafia (1997) Braudel (1982)

[9] While the larger firms maintained a presence in many markets with branch offices or subsidiaries, smaller firms relied more on correspondents.

this way, a firm might continue in business for decades: the Medici firm, for example, was founded in 1397 and continued in business until 1494.

While merchant banks did lend their own capital, this accounted for only a small part of their lending: most if their lending was financed by borrowing. Merchant banks were financial intermediaries: they borrowed in their own name to re-lend to others. The borrowed funds, by increasing leverage, greatly increased the returns on their owners' capital and, of course, greatly increased the risk to which they were exposed. As we have seen, the primary source of borrowed funds was the remittance business. Customers included not only other merchants, but also nobles and churchmen. For example, the remittance of papal taxes was an important source of funds for merchant banks operating in England in the thirteenth and fourteenth centuries. Merchants who regularly used a merchant bank to remit and to receive funds often found it convenient to maintain a working deposit with the bank rather than having constantly to make and to receive payments. In places where there was no deposit banking, as in London, these working deposits were also used for clearing–for settling payments among merchants.[11] In places where there deposit banking did exist, such as Florence, merchant banks often registered officially as deposit banks. Even when they did not register, merchant banks often provided much the same service–without the restrictions imposed by official supervision.[12]

Remittance was not, however, the only source of funds. Merchant bankers also borrowed directly, initially by accepting time deposits. These deposits were usually *depositi a discrezione*: to avoid the charge of usury, the interest paid was 'voluntary' rather than contractual. However, the rates were generally set by custom–depending, of course, on market conditions. Moreover, a bank that failed to pay the anticipated 'voluntary' interest raised serious doubts about its soundness and could expect to see its funding evaporate. The maturity of time deposits typically varied from six months to a year. The depositor received from the bank a *scritta*, a sort of certificate of deposit. This was not transferable and early withdrawal was not generally possible. Depositors came mainly from the ranks of the wealthy–nobles and churchmen as well as merchants and deposit bankers. As always, widows, orphans, and dowries were a good source of funds. Sometimes merchant banks accepted small deposits from craftsmen, servants, and even farm hands. Often, it was brokers who brought merchant banks and depositors together.[13]

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[10]On accounting, see de Roover (1944) ; on the development of mathematics see Swetz (1987) .

[11]Prestwich (1979)

For some merchant banks, foreign branches could be an important source of deposits. Although the great merchant banks of fourteenth-century Florence gathered most of their deposits at home, they took in significant amounts at their branches in Naples and Rome.[14] Rome was also a major source of funds for the Medici in the fifteenth century: deposits at their office there amounted to four times the total capital of the bank.[15]

In the sixteenth century, merchant banks began to rely increasingly on borrowing in the money market rather than on deposits as their principal source of funds. Such borrowing was, of course, not new: it went back to the well-developed market for inter-fair deposits at the Fairs of Champagne. However, it was only in the sixteenth century, in Antwerp, Lyons, and Bisanzone, that money-market borrowing came to be the predominant source of funds for merchant banks. At Antwerp, this borrowing largely took the form of inter-fair *deposito* loans. Merchant banks mainly sold their paper to other merchants, but the best credits–the *ditte di Borsa*–also issued paper in small denominations to attract small investors. The credit of the Fuggers was so good that they could circulate their paper, the *Fuggerbriefe*, almost like currency. At the Bisanzone fairs, Genoese merchant banks raised funds with *ricorsa* bills. The lenders were again mostly other merchants, but there was active participation by non-merchants. In Genoa, Venice, and other Italian cities, the money market became a favorite short-term investment for institutions, trustees, and small investors.[16]

USES OF FUNDS

Merchant banks used the funds they raised in three principal activities–exchange trading, commercial credit, and sovereign lending.

EXCHANGE TRADING

The exchange business meant, first of all, remittance. This provided a steady income from charges on exchange and transfer. However, the big profits in exchange lay in trading. The simplest form of exchange trading was ‘triangular arbitrage’. With three currencies, A, B, and C, the cost of converting A into C should be the same as the cost of converting A into B and then B into C. If it is not, then a riskless arbitrage is possible. “If

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[12] de Roover (1944)

[13] See Hildebrandt (1990) on practices in South Germany.

[14] Hunt (1994)

[15] de Roover (1963)

the pound sterling happened to be cheaper in Paris than in Bruges, the exchange-dealers would profit by selling sterling in Bruges and buying in Paris, and they did not fail to do so. The effect of arbitrage transactions was to keep all exchange rates on a parity. Temporary discrepancies did occur, but they were promptly adjusted."[17]

Merchant banks also tried to profit from anticipating fluctuations in exchange rates. For example, if they expected the sales of English cloth at the forthcoming Brabant fair to be good, they would buy up as much sterling as possible ahead of the fair so that they could resell it to the Merchant Adventurers at a profit. The effect of this was to raise the exchange rate before the fair and lower it (relative to what it would have been) at the time of the fair, smoothing the impact of a fluctuations in the balance of trade on the exchange rate. Merchant banks also anticipated the impact of political events on exchange rates: for example, when news of Wyatt's Rebellion reached Antwerp in January, 1554 there was an immediate drop in sterling.[18]

Some fluctuations were easy to anticipate, because they recurred in a regular seasonal pattern. The schedule of fairs and the departures and arrivals of fleets induced a predictable pattern in the local scarcity of bullion. For example, before the galleys left Venice for the Levant in July and August, the demand for bullion was strong. Money was scarce relative to money at other times and in other places. This raised interest rates–the price of immediate money relative to money later–as well as exchange rates–the price of money on the spot in Venice relative to money elsewhere.[19] However, once the galleys departed, the demand for bullion collapsed, and exchange rates and interest rates dropped. Similar seasonal patterns were common elsewhere. Bruges experienced a shortage, or *stretezza*, in June and December before the galleys departed and a glut, or *largezza*, in August and September when merchants arrived from northern and central

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[16]As early as the late fifteenth century, ordinary Venetians found the money market an attractive alternative to the other popular investment of the time–the local *colleganza*–as it involved substantially lower transactions costs. (Mueller (1997) Ch 8)

[17]de Roover (1949) p137

[18]de Roover (1949) p159. Sir Thomas Wyatt led an abortive Protestant rebellion after the accession to the throne of Mary Tudor, a Catholic zealot.

[19]"In short, demand for money (*danaro*) meant at one and the same time demand for specie of for bank balances convertible into specie when the need arose, demand for exchange, and demand for credit.

Europe for the fairs, bringing with them large amounts of bullion.[20] In London, money was scarce in the season that exporters of wool had to find money to pay producers, and it was plentiful after the exporters were paid at the Brabant fairs.[21] Since these seasonal fluctuations were predictable, they provided merchant banks with relatively safe and easy profits. For example, in anticipation of the seasonal *stretezza* in Venice, merchant banks built up stocks of bullion, not only in Venice itself, but also in Bologna and Pisa from where they could send it to Venice relatively easily.[22] Once again, their actions tended to smooth exchange rates and interest rates.

Differences in interest rates between two places were another source of arbitrage. If interest rates were higher in one place than in another, merchant banks could earn a net return by borrowing where the interest rate was low and lending where it was high.[23] Of course, this was not free of risk: an adverse movement of the exchange rate could turn a potentially profitable ‘arbitrage’ into a loss-making speculation. However, to the extent that they were willing to bear this risk, merchant banks arbitraging interest rate differentials helped to integrate the money market internationally and to equalize interest rates across markets.

Interest-rate arbitrage also facilitated balance-of-payments adjustment. A trade deficit of country A with country B generated a flow of bullion from A to B. This tended to lower prices in A and raise them in B, so helping to eliminate the trade deficit.[24] However, the flow of bullion also affected interest rates–and much faster than it affected price levels. The outflow of bullion raised interest rates in A, and the inflow of bullion lowered interest rates in B. Merchant banks responded to this by borrowing in B and lending in A. This transfer of funds from B to A tended to reduce the actual flow of bullion. As a result, transitory fluctuations in the balance of trade could be accommodated without the expense of moving bullion from one place to another and without disruptive changes in respective price levels.[25]

Exchange rates reflected all these factors; they rose when money was tight; they fell when money was easy.” (Mueller (1997) p310)

[20]de Roover (1948) Ch 4.

[21]Postan (1973) Ch 1.

[22]Day (1987) , Mueller (1997) Ch 8

[23]de Roover (1948) Ch 4.

[24]This is known as the ‘price-specie-flow mechanism’ (see Kohn (1999a)).

While the effects of these various forms of arbitrage and speculation were generally beneficial, there may also have been cases in which merchant bankers manipulated markets to their own advantage and to the detriment of others. One notorious case in particular did much to tarnish the reputation of the Antwerp money market. In 1540, it was widely known that the King of Portugal was about to roll over a large amount of debt in Antwerp. In anticipation, the Pistoian Gaspare Ducci formed a ring to accumulate a large sum of money in Antwerp by selling bills on associates abroad. When the King's agent came to the market to refinance, he found no funds available except those controlled by Ducci, who presumably exploited his position to the maximum. Contemporaries condemned Ducci's action as manipulation and he was banned from the Bourse for three years.[26] It seems likely, though, that tales of manipulation were much overdrawn (as they are today). It is difficult for the casual observer to understand, or accept, that arbitrage and speculation can be stabilizing and beneficial. For example, the accumulation of funds, both in advance and from other centers, to accommodate an anticipated large refinancing would generally spread the impact and so provide the borrower with funds at a lower rate. Of course, if the accumulator of funds thereby acquires market power, he may be able to exploit it to the borrower's disadvantage. The best protection against the acquisition of market power is a large market. Since Antwerp was a very large market, Ducci's success in this respect is somewhat surprising.

While the profits from arbitrage and speculation could be extremely large, the risks were commensurate. And the key to controlling risk was information:

> To deal in exchange required extensive knowledge of monetary standards, mint regulations, shipping charges and insurance rates, commercial practices, the credit standing of business firms in all parts of the world, the currents of trade, and, above all, 'the ebb and flow' of the exchange, that is to say, the pattern of seasonal fluctuations in the money market.[27]

Exchange rates were very sensitive to new information, and traders were not above manipulating the market by spreading false rumors or by withholding news. To obtain the information he needed, a merchant banker needed reliable sources in all the important

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[25]de Roover (1949) Ch. 3. The role of merchant banks in the balance of payments was noted by Davanzati in the sixteenth century de Roover (1948) Ch. 4.

[26]The ban was not enforced, because it was revoked by the authorities in Brussels, where Ducci had powerful friends. (de Roover (1949) Ch. 3)

[27]de Roover (1949) p166

banking places and a means of communicating with them rapidly. The great bankers had important advantages in their extensive networks of branches and in their being able to afford their own private mail services.

COMMERCIAL CREDIT

The predominant form of commercial credit throughout the period was sales credit. Sales credit was ‘informal’: it involved only the parties themselves, without the intervention of intermediaries or organized markets. Sales credit worked well within a community, where the parties knew one another other well, and where they had strong incentives to honor their debts. Sales credit among strangers was more problematic, since information was relatively poor and the incentive to honor debts was weaker. However, the expansion of commerce required increasing trade among strangers, and trade was impossible without credit. It was largely the merchant bankers who provided the necessary credit.[28]

Merchant bankers acted as credit intermediaries: they borrowed in their own names and re-lent to others. They had the capital and the credit to be able to borrow easily in their own names. They also had the information and the specialized skills that allowed them, more effectively than an ordinary merchant, to lend to others. However, they rarely relied solely on the credit of the borrower: normally, they required security–either real (usually merchandise) or personal (guarantees from third parties).

Specialization in lending broke the link that existed in sales credit between credit transactions and trade transactions. Rather than receiving goods on credit, a merchant could now purchase the goods outright with money that he borrowed from a specialized lender. Moreover, specialized lending made credit less expensive and more readily available:

> Although the mutual dealings between merchants which had characterised exchange operations in the later Middle Ages lasted on into the sixteenth century, by that time, especially in great trading centres, the buying of bills, and other forms of advancing money, were increasingly taken over by bankers… They relieved the trader of the necessity to find his opposite number and they supplied a much-needed element of confidence. There was much defaulting on bills: payers continually refused to honour them, often alleging that they had never heard of the drawers. A merchant who dealt with a well-known firm which had agents or correspondents in all the chief centres was less likely to encounter this difficulty

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[28]Braudel (1982)

> and consequently found it easier to persuade creditors to accept bills in payment.[29]

The availability and the flexibility of credit in Antwerp made it easy for commodity dealers there to borrow as needed to finance their inventories. In this way, ready finance helped to stabilize the commodity markets.

The money market was not solely a substitute for private sales credit: it was also a complement. The system of private sales credit was inherently vulnerable to liquidity risk. A slump in trade could make it difficult for some merchants to pay on time; their delay in payment would make it impossible for others to pay; and so on. Now able to borrow in the money market, merchants could meet their obligations even when sales were slow. Moreover, they could also lend in the money market when they had an excess of funds. Their holding of money market instruments provided them with liquid assets that they could assign in payment or turn into cash as needed. In these ways, the money market strengthened the system of sales credit among merchants, so that a slump in trade no longer had to lead inevitably to a general collapse of credit.[30]

The separation of credit transactions from trade transactions in the money market had the additional effect of opening the credit market to non-merchants. The money market drew in new lenders: as we have seen, money-market instruments became a favorite short-term investment, not only for merchants, but also for non-merchants. And the money market also drew in new borrowers. In particular, like any potential new source of finance, it attracted governments.

SOVEREIGN LENDING

While most merchant banks limited their activities to exchange and to commercial lending, some, especially the largest, also lent to governments. Given the unhappy history of this lending, the question arises as to why they chose to do so. The primary reason was that on the whole it was profitable.

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[29] Bindoff (1958)

[30] "The ordinary short-time loan had for its object to satisfy immediate want of cash. Sudden liabilities which could not be met from the regular resources of the business, payments impending before the corresponding receipts fell due, promptitude of creditors and procrastination of debtors–in short, all the maladjustments of the regular system of sale credits–would create a demand for short loans. In a sense these maladjustment could be described as emergencies, but in so far as selling and buying was generally based on credit, they were both frequent and inevitable, and the 'emergencies' were therefore part of the normal commercial routine." (Postan (1973) p 11).

In lending to governments, merchant banks were performing the same function of financial intermediation as they performed in their commercial lending. They borrowed in their own names and re-lent to governments at a higher rate than they themselves paid for their funds. One reason merchant banks could borrow mere cheaply than governments was that their credit was better. The debt of a territorial government was essentially the personal debt of the prince: if he died, his successor had no obligation to honor it; if he defaulted, there was no recourse against him in his own courts. As we shall see, merchant banks developed ways to mitigate the risk of lending to princes, and this enabled them to profitably substitute their own credit for that of the princes to whom they lent. The second reason merchant banks could borrow more cheaply than governments was that their debt was more liquid. Government debt was illiquid because it was ‘relationship’ debt: its value depended on the ability of the lender to ensure repayment. Government debt was also highly heterogeneous: each loan had differing security, the value of which was generally hard to assess. On the other hand, the debt of merchant banks was ‘market debt’. It was unsecured, relying only on the general credit of the issuing firm (the *Ditta di Borsa*) and it was issued in large amounts. So intermediation by merchant banks effectively transformed illiquid government debt into circulating bills. Finally, the liabilities of merchant banks came in relatively small denominations, in contrast to the underlying government loans which were sometimes very large. So intermediation broke sovereign debt down into pieces of a size that appealed to a much wider class of investor.

The profitability of sovereign lending did not, however, derive solely or even principally from the economies of intermediation. The main reward, especially for large loans, generally came in the form of favors the government granted the merchant bank in return for its lending–commercial concessions, monopolies, and tax farms.[31] Sovereign lending in such cases was something of a ‘loss leader’: indeed, earlier in the period, loans were often interest-free, it being understood by both parties that there would be a different *quid pro quo*. The great Italian merchant banks of the thirteenth and fourteenth century gained access to the grain of Naples and Sicily and to the wool of England through their lending to the respective rulers.[32] The Fuggers gained control of the mines of central Europe in the late fifteenth century through their lending to the Hapsburgs.[33] And the Genoese, the successors of the Fuggers as bankers to the Hapsburgs, gained

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[31]“there are no known examples of large-scale continuous financing of monarchs unaccompanied by important commercial privileges.” (Hunt (1994) p 64)

[32]Hunt (1994) Prestwich (1979) Goldthwaite (1973)

control of the trade in American silver in the sixteenth and seventeenth centuries in much the same way.[34] On a smaller scale, the English regulated companies (Staplers, Merchant Adventurers, etc.) obtained trade monopolies in exchange for loans to the king. And many a merchant banker gained an appointment as a tax farmer or a mintmaster in exchange for a suitable loan.[35]

A final reason merchant banks engaged in sovereign lending was that they lacked good alternatives. With the potential for commercial lending limited, they had little choice but to turn to other possible borrowers. This tendency was especially pronounced when trade was slack–usually because of war. Political tension and warfare could increase the risks of commerce to the point that trade became unprofitable, drying up the demand for commercial credit. Happily, the same circumstances increased the demand on the part of governments for loans to finance their military expenditures. When peace returned and trade became profitable once again, the demand for commercial credit recovered and the willingness of merchant bankers to lend to governments correspondingly declined. This was the pattern in Bruges and Antwerp in the first half of the fifteenth century, and it recurred in Antwerp in the first half of the sixteenth.[36]

Another contributing factor to an ‘oversupply’ of funds was a chronic imbalance of trade. For example, at Champagne, a persistent Italian trade surplus with the fairs made it costly to remit funds back to Italy (the exchange rate remained at the bullion export point). This made it relatively more attractive for merchants to lend their surplus funds at the Fairs. Some of this lending went to finance the working capital of Flemish cloth manufacturers, but much of it was lent to nobles, bishops, and princes. So deep was the market for interfair deposits at Champagne that the Ricciardi of Lucca, lenders to the English Crown, boasted they could raise 200,000 *livres tournois* at a single fair.[37]

The central issue in sovereign lending was default risk, and there were a number of ways to address it. Loans were generally in the form of bonds due at the next or

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[33] Strieder (1931)

[34] Conklin (1998)

[35] “Influence was one of the most precious of all forms of capital. In the days when economic concessions were showered upon the business world, those who were well connected with the Court went to the head of the queue.” “Loans might be instrumental in securing or retaining privileges, and these privileges in turn formed a tie of economic interest between the Crown and the recipient…” (Ashton (1960) p 193)

[36] Van der Wee (1963)

[37] Fryde and Fryde (1971)

subsequent fair. The short maturity was partly necessitated by the nature of the merchant banker's business–his short-term liabilities and his need for flexibility in the allocation of his assets. But it was also a way to keep the borrower on a short leash. For lenders to roll over their debt, or for others to take it over, the government had to satisfy them of its willingness and of its ability ultimately to repay. However, from the point of government borrowers, the constant need for refinancing or repayment imposed on them very high transactions costs. To administer its borrowing in Antwerp, the English Crown had to maintain a permanent agent there–in some style, so as to impress potential lenders. The constant refinancing involved significant issuing costs in the form of brokers' fees and the preparation and posting of new bonds. The extension of loans beyond their initial maturity often required the agent to pay significant 'rewards' to the lenders or bribes to their agents. The obvious urgency of refinancing reduced the bargaining power of the Crown's agent, and he was sometimes forced to accept a part or all of the loan in commodities (at an inflated price) rather than in cash. When the agent was unable to refinance the loan, he had to arrange for funds to be sent from England to repay the outstanding debt. The size of the sums involved meant at best an adverse impact on the exchange rate and at worst the costly shipment of bullion. All of this added significantly to the cost of borrowing.[38]

Government bonds were usually secured by guarantees from private individuals. Because of the lack of legal recourse, a sovereign's promise to pay was of little value in itself.[39] Consequently, lenders generally insisted on guarantees from individuals or bodies against whom they could obtain a judgment if the sovereign defaulted.[40] For example, at Bruges in the fifteenth century, the Duke of Hainault was able to borrow only after he obtained guarantees from various noblemen and towns in Brabant as well as a personal guarantee from a Lucchese banker.[41] In Antwerp in the sixteenth century, Henry VIII provided guarantees from the London branches of the Bonvisi and Vivaldi merchant

[38]Outhwaite (1966)

[39]In an age much more religious than our own, there were some non-legal incentives. A prince who broke his sworn bond could be excommunicated by the Pope. Of course, this was more likely to happen if the creditor was a merchant bank in favor at the papal court. Such favor could generally be gained through the extension of credit to the pope.

[40]In some cases, officials or dignitaries borrowed in their own names and passed on the proceeds to the government.

[41]Van der Wee (1963)

banks; they, in turn, were indemnified by English merchants.[42] Elizabeth relied directly on the credit of the merchant companies and of the Corporation of London. Had she defaulted, lenders would have been entitled to seize the goods and even the persons of members of these merchant bodies. Elizabeth was therefore under considerable pressure from her own merchants to meet her obligations to her creditors. Since the threat of seizing goods and persons was most effective outside the territory of the sovereign borrower, merchant bankers were generally reluctant to lend to their own rulers.

Most sovereign loans were also secured by the pledge of specific government revenue. In many cases, loans were explicitly or implicitly structured as advance purchases. For example, miners of copper and silver owed royalties to the territorial sovereign in the form of a fraction of their output. Duke Sigmond of Tyrol borrowed from the Fuggers, starting in 1487, against his expected royalties from the Schwaz mines; in exchange for their advances, the Fuggers collected the royalties until the debt was paid in full.[43] Loans to the King of Portugal from the Welsers and other German bankers in the early sixteenth century took the form of forward purchases of spices imported by the royal monopoly from the Indies. Tax farms operated on much the same principle: they were essentially forward purchases of tax revenue. For example, when Edward I of England established an export tariff on wool in 1275, he turned its collection over to the Ricciardi in exchange for an advance.[44]

The loan as advance purchase had a number of advantages. For the merchant banker, it provided a form of security: his control over a specific source of revenue gave him some assurance of repayment. An advance purchase also avoided the problem of usury: there was no need for explicit interest, since the interest could be built into the purchase price implicitly. For the sovereign, the advance purchase converted a stream of future income into a capital sum that could be spent immediately–usually on war. Moreover, governments generally lacked the administrative capabilities and the capital necessary to realize potential income. Merchant bankers could provide both. From the late Middle Ages, princes relied increasingly on merchant bankers for financial administration and management skills–as mint-masters, managers of silver mines, collectors of taxes, and administrators of state monopolies. This relationship facilitated lending. Close involvement in the affairs of the prince provided the merchant banker with valuable information on his credit. It also provided political information–on the prospects of war

[42]Outhwaite (1966)

[43]Strieder (1931)

[44]Goldthwaite (1973)

or peace–that could be of great value in his trading on the exchanges.[45] Of course, the dependence was reciprocal: merchant bankers with large loans outstanding to a particular prince had a strong interest in his political and military success. They could help to ensure it by providing intelligence and, above all, by providing additional credit.

Sovereign lending by merchant bankers reached its height of sophistication in the 'Genoese system' of the late sixteenth century. The loans, known as *asientos*, effectively constituted an advance purchase of the 20% royalties–the *quinto real*–due the Spanish Crown on the silver mined in its possessions in the Americas. The lenders, or *asientistas*–were a consortium of merchant bankers–mainly Genoese, but also some Florentine, Flemish, German, and Spanish firms.[46] The *asientistas* raised the funds they needed at the Bisanzone fairs by means of *cambio con la ricorsa*.

The *asiento* contracts, however, involved more than just credit: they also provided a system of remittance that gave the Spanish government a solution to one of its most pressing problems–how to get funds to its army in the Low Countries. The *asientistas* advanced credit to the Spanish Crown in Medina del Campo or Madrid in the form of bills payable in Antwerp. The bills were paid in Antwerp in gold, which the agents of the Spanish crown used to pay the army. The agents in Antwerp repaid the lenders with bills drawn on Medina del Campo, to be paid in silver from the New World fleets.[47] The *asientistas* shipped the silver they received in Spain either to Lisbon, for the Portuguese oceanic trade with Asia, or to Genoa for the Venetian trade with Asia via the Levant. Control of American silver enabled Genoa to take over from Antwerp as Europe's principal bullion market. The Portuguese and Venetians paid for their purchases of silver with bills drawn on Antwerp, where both had substantial trade surpluses. The *asientistas* used the proceeds of these bills to cover the bills they had issued in Spain, closing the circle.

The dependence of the Spanish government on this system of remittance was crucial in providing the lenders with security for their loans. For example, when Spain defaulted in 1575, the transfers ceased and the Spanish government was unable to find any

[45]Körner (1995)

[46]In the period 1557-84, some 40 Genoese merchant banks had branches in Seville, and six also had branches in Medina del Campo. (Muto (1995))

[47]The uncertain arrival of the fleet caused delays in opening the fair. The Spanish government soon realized that it could put off the payment of its bills through the simple expedient of holding up the opening

alternative way of getting money to its army. The troops, still unpaid in November of 1576, mutinied and sacked Antwerp. The Spanish government quickly resumed negotiations with its creditors.[48]

MANAGING LIQUIDITY AND RISK

Merchant banks were obsessed with their liquidity. Of course, liquidity was an important concern for any merchant, but because merchant banks were financial intermediaries the concern was far more pointed. For the ordinary merchant, there was some flexibility in the giving and receiving of sales credit: if others were late in paying, a merchant might be able to obtain an extension from his own creditors. However, the liabilities of the merchant bank were more formal, and many of its creditors were non-merchants. These were willing to place their money with a merchant bank precisely because they could rely on its safety and liquidity. Any hesitation on its part in meeting its obligations would have destroyed their confidence.

To maintain their liquidity, merchant banks generally avoided 'maturity transformation'–borrowing short to lend long. Rather, they tried to match the maturity of their assets to the maturity of their liabilities–generally, from three months to a year. As we have seen, both their commercial loans and their sovereign loans were short-term. For example, the merchant bankers in Antwerp who lent to the English crown "expected to turn their capital over at least as often as in business, while if at any time commerce offered better openings, they expected to transfer the money without difficulty."[49] While short-term lending matched the needs of commercial borrowers well enough, it matched the needs of sovereign borrowers very poorly indeed. For sovereign borrowers, rolling over their debt often meant, not only re-pricing, but repayment–paying not only the interest but also the principal. Once the amount of debt outstanding became large relative to a government's income, any temporary fall in income could leave it unable to meet its obligations. So the insistence of merchant banks on the liquidity of their sovereign loans was to some extent counter-productive. While it protected their liquidity, it also increased the likelihood of default.

The concern of merchant banks for liquidity carried over into their commercial operations. For example, in the fourteenth century, the Peruzzi were heavily involved in the grain trade. However they owned little of the fixed capital this required: instead, they

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of the fair. As a result, the timing of the fairs became quite irregular, and this largely destroyed their usefulness for commercial purposes. Usher (1943)

[48]Conklin (1998)

hired the ships and wagons they needed and leased the warehouses.[50] Similarly, in the fifteenth century, the Medici were involved in cloth manufacture. But they invested very little in fixed capital, relying instead on a system of putting out.[51]

Risk was a concern for merchant banks both for its own sake and because it affected their liquidity. Because their liabilities had short maturities–an inability to roll them over or to refinance them could place a merchant bank in serious difficulties. It was therefore essential to maintain the confidence of creditors–the key to this was managing risk and avoiding major losses.

Merchant banks faced two major sources of risk–credit risk in their lending and market risk in their exchange operations. As we have seen, they protected themselves against credit risk by requiring security from their borrowers, both commercial and sovereign. The more cautious merchant banks, the Medici among them, avoided sovereign lending altogether: while it could be enormously profitable, it was also enormously risky. Bankers were well aware of the benefits of diversification: in their commercial lending they carefully limited their exposure to any one borrower. And in their sovereign lending, they limited their exposure through the use of syndication: for example, the Augsburg merchant banker Lucas Rem took a 10% share of a loan of 600,000 rhenish florins to Charles V organized by the Fugger in 1535.[52] Diversification helped, too, with market risk: merchant banks speculated not only on the exchanges but also on public debt and commodities–even on horse races. Exchange-rate futures were available in Antwerp, and options were available there and at the fairs of Castile and Lyons.[53] While there is no historical evidence, it seems plausible that merchant banks would have used these instruments to hedge their exposure to exchange-rate risk.

The final bastion against risk is capital: a firm with a higher ratio of capital to assets is less likely to fail in the event of losses. However, a higher ratio of capital to assets also means a lower return on equity, because it reduces leverage. As merchant banking developed, lending margins decreased: in the fifteenth century, the Medici paid 8 to 10% on their deposits, while rates on bills of exchange were no more than 12 to 14%.[54] The small margins meant that merchant banks had to increase their leverage–use more

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[49] Buckley (1924)

[50] Hunt (1994)

[51] Abulafia (1997)

[52] Hildebrandt (1990) p840

[53] Van der Wee (1977) See Kohn (1999b) for a more extensive discussion of futures and options.

borrowed money relative to their own capital–to earn a significant return. But higher leverage left them more exposed to the danger of insolvency. Merchant bankers were certainly aware of these tradeoffs. For example, as the Genoese increased their lending to the Spanish Crown after 1568, they cut back on their commercial lending, presumably to avoid overextending themselves (they had been the principal financiers of the Spanish trade with the Americas).[55]

Insolvency of the merchant bank meant personal ruin for the merchant banker: merchant banks were partnerships and the partners were fully liable for all the house's debts. Following the failures of the Bardi, Peruzzi, and Accaiuoli–the great merchant banks of the fourteenth century–merchant bankers did make some attempts to reduce their exposure to such liability. The three great merchant banks had been organized as unitary companies, so that the losses of a single branch were capable of bankrupting the whole operation. Their successors in the fifteenth century, such as the Datini and Medici companies, learned from this and set up each branch as a separate partnership, insulating the rest of the firm from its losses. However, reputational considerations made it hard to disown a branch completely.[56]

Unlike deposit banks, merchant banks were not regulated. There are a number of possible explanations for the difference. Merchant banks as such were not involved in moneychanging, a major reason for government interest in deposit banks. Failures of merchant banks were not generally as harmful to commerce, largely because there were so many more merchant banks. Indeed, the distinction between ordinary merchant and merchant bank was a fine one, and this was another reason that regulation would have been difficult. Also, the international nature of merchant banks made them harder to regulate: attempts at regulation would likely have led simply to their withdrawal from the market in question. Finally, governments depended on merchant banks for credit, and they did not wish to kill the goose that laid the golden eggs.

CRISES OF MERCHANT BANKING

There were two major crises of merchant banking during the period–the failure of the great Florentine merchant banks in the fourteenth century and the collapse of the South German merchant banks in the sixteenth. In both cases, sovereign lending played an important role, but in neither was it the sole cause.

[54] de Roover (1970)

[55] Braudel (1984)

[56] de Roover (1948)

The problems of the Bardi and the Peruzzi began with the default of the Florentine government on its debt in 1342 and the resulting collapse in its market value–by two thirds or more. As large holders of government debt, they sustained significant losses. Moreover, the government default created a liquidity crisis, causing Florentines to withdraw large amounts from their deposits with the merchant banks. At the same time, a deterioration in political relations between Florence and Naples caused depositors at the banks' branches in Naples to withdraw their funds, exacerbating the pressure on the banks' liquidity. The final blow came when Edward III of England defaulted on his debt to the Florentine merchant banks in 1343. Depositors completely lost confidence and refused to roll over their deposits. The Peruzzi failed in 1343, the Bardi in 1346, and others followed; in the liquidations that ensued, depositors recovered only 20% to 50% of their deposits. The collapse of the merchant banks had a major impact on the Florentine economy: it has been called the "Great Crash" of the 1340s.[57] Even before the collapse, however, the fortunes of the great merchant banks had been declining. The foundation of their prosperity had been their command of the grain trade, and this had become increasingly unprofitable since the 1320s. Indeed, this may have been a more fundamental reason for their demise than their losses to Edward III.[58]

There are strong parallels in the second major crisis–the collapse of the South German merchant banks in the sixteenth century. By the 1550s, the debt of Phillip II had become unsustainable: by 1555 debt service exceeded 60% of his income and continued to rise; the interest rate on the debt, which had been below 20% for Charles V in the 1520s, approached 50% in the 1550s. In 1557, Phillip was forced to default. The lenders, predominantly the Fuggers, Welsers, and other South German banks, had no choice but to accept conversion of seven million ducats of short-term debt into long-term government bonds at 5%. Since the market value of these bonds was well below par, the merchant bankers took a substantial loss. Neither the Fuggers nor the Welsers failed, but their credit was badly compromised. As a result, the system of sovereign lending centered on Antwerp, for which their intermediation had been crucial, came to an end, and the system centered on Bisanzone, intermediated by the Genoese, gradually took over. But here, too, the decline of the German merchant banks may have ultimately been more the consequence of the declining profitability of their commodity business than of their losses on sovereign loans. In their case, the commodity was silver. American silver began to flood the market in the 1550s, eroding the profitability of the Central European mines

[57]Cipolla (1982)

[58]Hunt (1994) p. 74

that had made the fortunes of the South German bankers. As the mines declined, the South German banks faded from the scene.

The Genoese, who took over from the South Germans their lending to the Hapsburgs, did not enjoy much better luck. One default followed another, and after a major crisis in 1627, the Genoese largely withdrew from sovereign lending. Once more, the declining profitability of commodity trade played a role: by then, silver had become so abundant that the 'Genoese system' no longer yielded much of a profit.[59]

Merchant bankers eventually learned the lesson of these repeated crises. While they continued to play a crucial role in commercial finance, they generally steered clear of sovereign lending. And governments, with their access to the money market cut off, turned increasingly to the capital market.

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[59]Nef (1941)

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