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# Dealing with Risk: Underwriting Sovereign Bond Issues in London 1870-1914

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**Abstract:**

Using the records of several leading 19th century issuing houses, this paper analyses the transformation of underwriting practices in London's primary sovereign bond market from 1870 to 1914. It shows how underwriting risk developed from being a liability, which market intermediaries sought to avoid, to becoming a valuable financial commodity. The impetus for this development was increased competition in the loan business from the 1880s onwards, which weakened the negotiating position of issuing houses and forced them to shoulder an increasing share of the underwriting risk. Issuing houses had to find methods to deal with this risk, but they were initially hamstrung by public perception of underwriting as detrimental to the interests of ordinary investors. Firms began to adopt informal underwriting arrangements, with limited scope, but these only allowed for a relatively limited distribution of underwriting risk to third parties, the danger of which was exposed during the Baring crisis. Consequently formal underwriting syndicates were developed, allowing for a greater dissemination of underwriting risk. This meant that the risk associated with issuing loans could be broken down into sufficiently small tranches so that no underwriter had to shoulder a risk greater than what he desired. As a result underwriting risk came to be seen as a profitable investment opportunity, a financial commodity in its own right, and a means of patronage for issuing housesB

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# Dealing with risk: Underwriting sovereign bond issues in London 1870-1914

Between 1870 and 1914 there was a dramatic change in how underwriting risk associated with issuing sovereign bonds was viewed and dealt with in the London market. *Underwriting risk* is the risk that a loan will not be taken up by the public at the time of issue and it comprises the risk that the issuing house has mispriced the bonds, as well as credit-spread-risk and interest rate risk.[1] In the 1870s this risk was mainly borne by borrowing governments. Only when a relatively weak negotiating position compelled issuing houses to assume part or all of the underwriting risk were they willing to do so. In contrast, during the years immediately preceding the outbreak of war in 1914 the situation was quite reversed. Issuing a loan where the government shouldered the underwriting risk no longer held any great attraction for issuing houses, all of which preferred to take loans firm (that is buy the bonds outright from the government before issuing them to the public). The reason for this change lay in the development of underwriting practices occurring between 1870 and 1914, a development that is not satisfactorily explained by the existing literature. Using the records of several leading issuing houses such as Barings, Hambros, Morgans and Rothschilds, as well as the contemporary financial press, this paper analyses the transformation of underwriting practices in London during this period.

## *The role of issuing houses and underwriting risk*

The first witness to give evidence to the 1875 Select Committee on Foreign Loans was George Henry White, a senior clerk from Barings who took a principle part in the firm's issues of foreign government loans during his 39-year career with the firm.[2] White identified two separate roles that issuing houses could take; either that of an agent, or that of a

[1] Dattatreya R., F., Fabozzi, F. J., and Focardi, S. M., 'Risks Associated with Investing in Fixed Income Securities', in F. J. Fabozzi (ed.), *The Handbook of Fixed Income Securities,* eighth edition, (New York, McGraw Hill, 2012), 22-23, 25.

[2] Towards the end of his career he effectively performed the tasks of a Junior Partner. Orbell, J., 'George Henry White', *Oxford Dictionary of National Biography*. *Report from the Select Committee on Loans to Foreign States; (House of Commons, 1875),* Minutes of evidence, George Henry White, Q. 1-2.

contractor. The central distinction between these two roles was the allocation of underwriting risk; whether the issuing house actually incurred any direct liability for the loan it issued, or whether the whole underwriting risk was borne by the government of the borrowing country. In terms of underwriting risk, the role of agent was risk free. The bank acted merely as an intermediary for the government, the underwriting risk effectively being borne by the borrower.[3] In contrast, an issuing house assuming the role of a contractor became a principal in its own right and incurred an underwriting risk proportional to the value of the bonds it took from the government.[4] The two roles could be combined with an issuing house taking part of a loan firm and acting in the capacity of an agent for the rest, a method used by J. S. Morgan & Co. for the French loan in 1870, when it took the first 25 per cent firm, while the rest was issued for account of the French government.[5] Alternatively, loans could be broken into two or more tranches with a contractor taking the first tranche firm and retaining an option to take further tranches within a given period of time. The initial firm subscription could range from just a few per cent to well over half of the full amount of the loan.[6] Such practices effectively allowed a deal to be structured, so that the underwriting risk assumed by an issuing house could range from nothing to the full amount.

[3] If the full amount of the loan could not be allotted the government would simply have to make do with the amount taken up, or try to sell the rest through private channels or in the secondary market. See for example Baring Archive (BA) HC 14.13; Letter from Portuguese financial commission to Barings, July 3, 1877. And Rothschild Archive London (RAL) XI/142/5; Brazilian Letter Copy Book (BLCB), September 14 and 28, November 16 and December 28, 1894.

[4] *1875 Report,* MoE, George Henry White, Q. 12, 34-41, 78-80.

[5] Carroso, V. P., *The Morgans, Private and International Bankers, 1854-1913, (*Cambridge, Harvard University Press, 1887), 131-132.

[6] BA HC 5.8.6; Letter from M. N. Rose to J. Stewart Hodgson Esq. 20 Dec.1872. (Letter containing many of the details of the 1871 US loan). RAL 000/401D/2; Contract for part of 1873 US loan. RAL XI/111/11; Contract for part of 1877 US loan. Sherman, J., *Recollection of Forty Years in The House, Senate and Cabinet. An Autobiography Vol I*, (Chicago, The Werner Company, 1895), 566-568, 571-573.

*Competition and the changing distribution of underwriting risk*[7]

Sovereign loans were often large compared to the capital of issuing houses, meaning that taking a loan firm could potentially mean staking a house's future on the loan's success. It is therefore not surprising that firms favoured methods of issuing that allowed them to minimise their underwriting risk.[8] In the 1870s and the early 1880s, London issuing houses were broadly speaking successful in prevailing on governments to shoulder most or all of the risk. The role of agent appears to have been dominant, especially for the most prestigious issuing houses, notably Rothschilds and Barings, and even when firms did act as contractors, the amount taken firm was normally less than 50 per cent and seldom amounted to the full issue.[9] This was because of the relatively favourable international setting in which London firms were operating during this period. The early 1870s saw London achieve a position in which it possessed what *The Economist* triumphantly described as 'a manifest monopoly of every new issue of any importance'. This resulted from the Franco-Prussian War and the subsequent indemnity payments temporarily paralyzing Paris as a centre for foreign issues, while the fact that smaller financial centres were oversaturated with securities left London as the only market for new loans.[10] London's rise was curtailed in the mid-1870s by a drastic contraction of its loan market due to a string of defaults of small Latin American sovereign borrowers. Subsequent revelations of the Select Committee's report of 1875 uncovered the disgraceful practices often used by the new and less reputable firms that had issued the defaulted loans, resulting in the concentration of the remaining loan business within the hands of a small

[7] For a more detailed account of the topic discussed in this section see Mikkelsen, A. L., *The Market Practices and Techniques of London Issuing Houses in connection with Sovereign Bond Issues and their role in facilitating access of Sovereign Borrowers to the London Capital Market, 1870–1914,* (PhD, King's College London, 2014) Chapter 3.

[8] The capital of Rothschilds was £6.5 million in 1873 and £7.8 million on the eve of WWI. (Rothschilds were the ones with the largest capital), a figure often surpassed by the size of sovereign bond issues. Ferguson, N., *The Worlds Banker: The History of the House of Rothschild*, (London, Weidenfeld & Nicholson, 1998), 1043-44.

[9] Mikkelsen, *The Market Practices and Techniques,* Chapter 3.

[10] 'The Rush of New Foreign Loans', *Economist*, December 27, 1873. Crick, W.F. and Wadsworth, J. E., *A Hundred Years of Joint Stock Banking,* (London, Hodder & Stoughton, third edition 1964), 308.

group of prominent firms that still commanded the trust of the investing public.[11] For the rest of the 1870s, given the lack of alternatives, these firms were in a strong position to insist on their preferred method of issuing.

The competitive environment changed during the 1880s, first with the re-emergence of Paris as an international loan market and later with the rise of Berlin as a real competitor to London and Paris.[12] London's issuing houses also faced increased competition domestically. British joint-stock banks started challenging the traditional monopoly of merchant banks in the sovereign loan business more forcefully and foreign banks opened agencies or branches in London, enabling them to issue loans in the British capital as well.[13] Emboldened by the knowledge that any proposed loan would likely be met with interest from several different houses, some countries abandoned the traditional method of negotiating their loans.[14] Instead, they invited issuing houses to compete in a process of open bidding or initiated negotiations

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[11] Mikkelsen, *The Market Practices and Techniques,* Appendix 1.

[12] London Metropolitan Archive (LMA) MS19,063/19, Hambros to Gapelet, April 9, 1878. Klovland, J. T., 'Chapter 4–Bond markets and bond yields in Norway 1820-2003', *Norges Bank Occasional Papers*, No 35, no year of issue., 6, 8-11. LMA MS28178/003-4, Prospectus for 1881, 1882 Argentine Loans. Contracts for 1884 and 1886-87 Argentine and 1888 Russian loans. Bussière, E.; *'1872-1992, Paribas: Europe and the World'*, (Antwerp, Fonds Mercator, 1992), 64-68. Young, G. F. W., 'Anglo-German Banking Syndicates', 3-4. Cassis, Y., *Capitals of Capital*, (Cambridge: Cambridge University Press: 2006), 108-110, 113. Pohl, M., *Deutscher Kapitalexport im 19. Jahrhundert*, (Frankfurt, Börsen-Zeitung, 1977), 81-124.

[13] Suzuki, T., *Japanese Government Loan Issues on the London Capital Market 1870-1913,* (London, The Athlone Press, 1994), 31-44. Pohl, M. and Burk, K., *Deutsche Bank in London,* (Munich, Piper, 1998), 13-22, 30-37, 39-41.

[14] Normally governments would simply negotiate with their traditional London bankers and only if rebuffed here seek out alternatives. Jenks, L. H., *The Migration of British Capital to 1875,* (London, Jonathan Cape, 1938, first published 1927), 272-, 273. Marichal, C., ''Rivalry and Collaboration': Relations between Buenos Aires Merchant Bankers and European Bankers in the Issue of Argentine Government Bonds in the 1880s', in L. Quennouèlle-Corre and Y. Cassis (eds.), *Financial Centres and International Capital Flows in the Nineteenth and Twentieth Centuries,* (Oxford, OUP, 2011), 81-82.

with several houses simultaneously, allowing them to play houses off against each other.[15] During the 1870s borrowing countries had refrained from inviting competition out of fear that unsuccessful bidders would talk down the issue.[16] However, the return of French banks to the international loan market reduced this concern in the eyes of borrowing governments because, unlike their English competitors, French banks were willing to take loans firm.[17] According to Marichal and Flores, it was this willingness that accounted for the success of French banks in obtaining the Argentine business in the early 1880s.[18] When German issuing houses entered the international loan market in the second half of the 1880s, they also embraced the practice of taking loans firm, thus increasing the pressure on London issuing houses to do the same.[19] This competitive pressure only intensified as the period progressed, with New York joining the list of international financial centres competing with London after the turn of the century.[20] In fact, *The Economist* reported in 1911 that the rivalry between issuing houses was more intense than ever before. [21]

In response, from the mid-1880s onwards, London firms increasingly took the full amount of loans firm. Issuing loans as agents continued to be used to a smaller extent during the rest of the 1880s and into the 1890s, though mainly when governments were in a

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[15] Marichal, 'Rivalry and Collaboration', 82. Young, 'Anglo-German Banking Syndicates', 12, 30. RAL XI/144/0, Chilean Letter Copy Book (CLCB), May 27, 1889 and August 22, 1892.

[16] Jenks, *The Migration of British Capital*, 273-274.

[17] The reasons for the greater willingness of French and German banks to take loans firm is discussed in Mikkelsen, *The Market Practices and Techniques,* Chapter 3.

[18] Marichal, ''Rivalry and Collaboration'', 82. Flores, J. H., 'Lending Booms, Underwriting and Competition: The Baring Crisis Revisited', *Law and Contemporary Problems*, Vol.73, No.4, 2010, 139, 143.

[19] Flores, 'Lending Booms, Underwriting and Competition', 139.

[20] 'Offerings of Foreign bonds', *The New York Times (NY Times),* June 24, 1900. Carosso, V. P., *Investment Banking in America,* (Cambridge, 1970), 79-82. Suzuki, *Japanese Government Loan Issues,* 100.

[21] RAL XI/III/48; Telegram no. 37 signed Isquierdo. 'Argentine Finance', *The Standard*, June 11, 1911. BA Partners File (PF)-1909 Argentine Loan, Part I, various letters, 278-279, 290-291, 310-312. BA Partners File; Argentinean 1911 Loan part I, various letters, 202-204, 253, 319. 'Stock Exchange Underwriting', *Economist*, June 3, 1911.

relatively weak negotiating position. After the turn of the century the rule was for all loans to be taken firm, with only Rothschilds continuing to act as agent in connection with Brazilian and Chilean issues.[22] Barings' correspondence regarding negotiations for an Argentine loan in 1911 testifies to the fact that issuing loans as an agent had mainly become a thing of the past. In the course of negotiations, Barings and their fellow syndicate members were asked by the Argentine government to consider acting as agents, to which Deutsche Bank replied:

> 'Method sale on commission repeatedly employed by Rothschild for Chili and Brazil[,] although proposition on commission basis not favourable for future business[,] German group has in principle no objection ...'.[23]

That Deutsche Bank felt it necessary to point out Rothschilds' continued use of this practice is a clear indication that by this time it was seen as somewhat of a curiosity. This point is further supported by the clear refusal of the French members of the syndicate to issue the loan on such terms and the fact that Barings '[were] not enamoured of the idea and ... discouraged further consideration of an arrangement on such lines.'[24] What explains this change of attitude among issuing houses against issuing loans as agents? The driving force was the change in underwriting practices that occurred — allowing for risk to be more widely distributed.

*Syndicates as a means of reducing underwriting risk*

From the mid-1880s, London issuers of sovereign loans faced the twin challenge of increased competition and heightened underwriting risk. The first threatened to render loan operations less profitable, while the second could potentially endanger the very existence of a firm. A way in which issuing houses dealt with these challenges was through increasingly forming issuing syndicates, though collaboration between issuing houses was by no means a new development and the use of syndicates nearly as old as the loan business itself.[25] Evidence presented to the 1875 Select Committee clearly showed a link between the practice of using syndicates and that of taking all or part of a loan firm, the primary objective being the

[22] Mikkelsen, *The Market Practices and Techniques,* Chapter 3.

[23] Taking loans on commission was contemporary shorthand for acting as agents of the government. BA Partners File (PF) 1911 Argentinean Loan, Part I, Deutsche Bank to Barings, June 13, 1911, 290.

[24] BA PF-1911 Argentinean Loan, Part I, Barings to Deutsche Bank, June 12, 1911, 284-285.

[25] *Report 1875*, MoE, Albert Grant, Q. 5010 and Samuel Herman de Zoete, Q. 137-139.

division of underwriting risk among members.[26] According to banker Albert Grant, this also explained why syndicates were normally not adopted for first class issues, when issuing house usually acted as an agent of the government.[27] The validity of this rational for the adoption of syndicates is strongly confirmed in the case of loans in which Rothschilds and Barings were involved during the 1870s and early 1880s. The vast majority of contracts these houses entered into during these years they entered into alone, or in the case of Rothschilds together with their Paris house. However, once they were asked to take part or all of an issue firm, they did so as part of larger syndicates comprising several other houses, domestic as well as foreign.[28] Issuing houses also recognized that beyond reducing underwriting risk, such collaborative combinations reduced the level of competition.[29]

The nature of loans issued by Rothschilds from the mid-1880s onwards clearly shows how issuing houses turned to syndicates when faced with increased competition and underwriting risk on sovereign issues. The Egyptian loan of 1885 was the first loan after 1870 (ignoring the large French and US loans of the 1870s), which Rothschilds contracted together with a non-Rothschild house. The non-Rothschild house in this case was Bleichröders, which had served as Rothschilds' Berlin agent since the 1830s, but in spite of this long-standing relationship the inclusion of Bleichröders owed more to its close relationship with Bismarck than Rothschilds. Germany, France and Britain guaranteed the Egyptian loan, and Bismarck used this fact to insist on the inclusion of Bleichröders.[30] The fact that Bismarck's intervention was necessary in order to compel Rothschilds to include its long-standing agent in a loan stands in sharp contrast to the experience of the following decade, when the London house contracted no less than seven loans together with various non-affiliated houses. In all

[26] *1875 Report*, MoE, Albert Grant, Q. 5014, 5074 and E. Erlanger, Q. 3986. *Economist* argued in 1911 that there had always been various forms of underwriting agreements. 'Stock Exchange Underwriting', *Economist*, June 3, 1911.

[27] *1875 Report*, MoE, Albert Grant, Q. 5076.

[28] See Contracts for loans listed in Mikkelsen, *The Market Practices and Techniques,* Appendix 4.

[29] LMA MS19,063/19, Hambros to Gapelet, April 9, 1878. Carroso, *The Morgans*, 179. BA HC 5.8.6; Notes 157-158.

[30] Stern, F., *Gold and Iron: Bismarck, Bleichröder, and the Building of the German Empire*, (New York, Alfred A. Knopf, 1977), 6-9, 322-326. RAL 000/401D/7; Contract for 1885 Egyptian loan.

of these loans the issuing houses took either part or the entire amount of the loan firm, (though the Chilean loans of 1886 and 1887 were taken firm and not shared with outside houses).[31] Similarly, loans for which Rothschilds acted as agents during this period were all kept within the family. In fact, from the mid-1880s up to 1914 there seems to be a clear link between Rothschilds decision to take all or part of a loan firm and contracting for the loan with any non-Rothschild houses. Looking at other houses, there is also evidence of an increasing use of syndication, with a trend towards larger syndicates, often including several houses from the same country, a fact that is best explained with the desire to diversify underwriting risk, eliminate competition, or both.[32]

When a syndicate agreed to take a loan firm it could do so in two ways: Firms could either collectively take up the loan, or each firm could subscribe for a specific share of it, without taking any responsibility for the rest. The former method was used in connection with the 1888 and 1890 Egyptian loans, which Rothschilds issued together with one and two German banks, respectively. In these cases the underwriting risk to the individual firm was reduced because responsibility for any bonds that the syndicate failed to place was shared between the members of the syndicate. Yet, individual houses were liable for the overall success of the issue, so that even if the loan was a success in a firm's domestic market, a failure in other markets could leave it and other members ending up holding a significant amount of bonds. Furthermore, in the event that one or more of the participating houses were unable to meet their obligations, the rest of the syndicate could be called upon to meet the shortfall. It is thus not surprising that this method seems to have been used only in connection with smaller syndicates, where all participants could be reasonably assured of the other participants' financial solidity.[33]

Larger syndicates were normally organized on the basis of 'sans solidarité', which meant that each firm was only liable for the specific share of the loan that it had taken firm. Thus as long as a firm successfully placed its share in the market, it was absolved of all direct

[31] The loans were the 1888 and 1890 Egyptian loans, the 1889 Hungarian loan, the 1891 and 1894 Ottoman Loans, the 1894 Russian loan and the 1895 US loan. See contracts in RAL 000/401E/6, 10, 11, 12 and RAL 000/401F/2, 4.

[32] Mikkelsen, *The Market Practices and Techniques,* Appendix 1 and contracts listed in Appendix 4 of same.

[33] RAL 000/401E/6, 11; contracts for 1888 and 1890 Egyptian loans. For underwriting groups see below.

liabilities for the loan, even if other members of the syndicate were less than successful.[34] This latter method effectively limited the liability that the individual syndicate members incurred in connection with a loan. From a reputational point of view, it could however still be risky. If another house was unable to place all of its bonds, it could attempt to sell the reminder at a discount, driving down prices, and hurting the reputation of all the syndicate's members.

Though syndicates could reduce the underwriting risk incurred by individual firms, they were a less than perfect solution. The reduction in underwriting risk that could be obtained through organising issuing syndicates came at a significant cost. Issuing houses combining to form an issuing syndicate shared not only the underwriting risk associated with an issue but also the profits and prestige. Even when issuing syndicates were organised on the basis of 'sans solidarité', the reduction in underwriting risk achieved by the individual houses came at the price of the loss of a commensurate share of the spoils. The use of issuing syndicates therefore did not bring issuing houses closer to detaching the profitable and prestigious role of issuing a loan from the risky role of underwriting it. The reduction in underwriting risk achieved was offset by a commensurate reduction in the rewards accruing to the individual house.

*Red List Participations*

Issuing houses could only rid themselves of the underwriting risk associated with issuing a loan, without the benefits being diluted, if they could find a method of subcontracting this risk to other parties. What was needed was the separation of the role of issuing a loan from the role of underwriting it. Suzuki has argued that the crystallization of the roles of issuing syndicates and underwriting groups into two distinct syndicate groups took place during the 1880s.[35] It would, however, seem that the use of a syndicate merely to guarantee an issue dated back further. This can be seen by Rothschilds' use of a syndicate to guarantee the success of a bond issue in 1871 for the South Austrian & Lombardo-Venetian Railway

[34] See for example contracts for 1889 Hungarian, 1889 Argentine, 1891 and 1894 Ottoman and 1888, 1894 Russian loans in RAL 000/401E/10, 12. RAL 000/401F/2, 4. BA HC 10.56. and BA 201824.

[35] Suzuki, *Japanese Government Loan Issues,* 28-29.

Company. The terms upon which the members of this syndicate participated were nearly identical to those of later underwriting groups.[36] Similarly, Erlanger formed a syndicate that guaranteed the placement of part of the 1872 Costa Rican loan.[37]

When issuing houses incurred any form of liability for a loan, they often sought to sub-contract part of the underwriting risk. But during the 1870s and 1880s, this was normally not achieved through the organization of underwriting groups in the form that would become common for the last twenty years up to 1914. Instead, the most common way by which issuing houses outsourced part of their underwriting risk was to offer their *friends* among other issuing houses a participation in the loan as silent partners. Such participations will here be referred to as 'red list participations' following the *Bankers' Magazine*, which in 1892 reported that houses like Barings kept 'red lists' containing the names of the friends to which they offered such participations.[38] The Victorian use of the term 'red-list' has passed out of common currency, but readers of the *Bankers' Magazin*e in 1892 would recognize the reference to mean a list of a chosen few—a specially selected and favoured inner circle. Each house participating in a red list syndicate would get a certain part of the issuing house's share of the loan, which it could then either keep for itself or further distribute among friends or clients.[39] The price at which such participations took place was normally slightly above that paid by the original house, which was normally granted a small commission of around ¼ per cent for organizing the issue—similar to the praecipium earned by modern lead managers

[36] RAL 000/401C/11; Confirmation letter from Société Générale to Rothschilds, May 13, 1871. RAL 000/401C/11; List of Syndicate.

[37] *1875 Report*, XXXII. and MoE, R. Foster, Q. 3543.

[38] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

[39] LMA MS 19,063/15, Morgans to Hambros, June 7, 1876; Raphael & Son to Hambros, March 29, 1878. LMA MS 19,063/20, Hambros to Stern Brothers, December 1, 1880; Hambros to Mildred Goyeneche & Co, December 1, 1880; Morgans to Hambros, December 2, 1880. (see also similar letters in above). Cottrell. P. L., *Investment Banking in England, 1856-1881,* (Abingdon, Ruthledge, 2012 reprint, first published 1985), 505.

today.[40] In fact, the distinction between participating in the issuing syndicate or the red list syndicate resembles the one between lead managers (or co-lead managers) and co-managers of modern bond issues, the former being more prestigious and receiving a higher remuneration, while the latter can still be profitable and, for less distinguished firms, may serve as a useful way to gain a reputation.[41]

Offering other firms red list participations held certain advantages for the issuing house over admitting them as full members of the syndicate. First, the issuing house benefitted from the small commission paid by its friends on the part of the loan taken. Second, it retained full control over issuing the loan and enjoyed the prestige associated with this role.[42] Given these advantages it is not surprising that the practice of using red list participations was widely adopted when all or part of a loan was taken firm. According to the *Bankers' Magazine*, offers of red list participations were not open to negotiation, but were considered an act of grace on the part of the issuing house to be accepted with humility, refusal being unthinkable.[43] The widespread use of this practice during the 1880s and early 1890s is reflected by the large number of issues in which J. S. Morgan & Co. either participated as a sub-contractor or invited other firms to assume this role in connection with its issues.[44] From the point of view of the issuing house, this method of distributing underwriting risk was clearly preferable to the use of an issuing syndicate, but it failed to offer the same protection against competition, since not all rivals were likely to accept an

[40] van Agtmael, A. W., 'Issuance of Eurobonds: Syndication and Underwriting Techniques and Costs', in (eds.) George A. M. and Giddy, I. H., *International Finance Handbook,* (New York, John Wiley & Sons, 1983), Chapter 5.2, 19.

[41] Flandreau, M., Flores, J. H., Gaillard, N. and Nieto-Parra, S., 'The Changing Role of Global Financial Brands in the Underwriting of Foreign Government Debt (1815-2010)', *Graduate Institute of International and Development Studies, Working Paper* No: 15, 2011, 18. Shearlock, P., and Ellington, W., *The Eurobond Diaries,* (Euroclear, 1994), 54. Carosso, *The Morgans,* 204.

[42] LMA MS 19,063/15, Hambros to Morgas, May 30, 1876. LMA MS 19,063/20, Stern Brothers to Hambros, November 30, 1880.

[43] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

[44] LMA MS 21,793,1, and 2 ; Loans and Options. BA H.C. 3.126, Morgans to Barings, Dec. 8, 1885.

inferior position. Red list participations therefore in many cases co-existed with issuing syndicates, with each member of the syndicate having its own red list of friends and clients.[45]

The practice of offering red list participations was effectively a system of underwriting, and the underwriting risk associated with the loan was distributed to a network of sub-contractors in the same way as in subsequent periods through the organization of formal underwriting groups. But, as will be shown below, it only allowed issuing houses to distribute the risk to a limited extent compared with what would eventually be achieved.[46] In fact, the limited extent to which red list participations allowed issuing houses to outsource the underwriting risk associated with an issue, was to prove the Achilles-heel of the system.

### *The bad name of underwriting*

The widespread use of red lists, despite their limited ability to distribute underwriting risk, was due to their discreet nature, which gave them a distinct advantage over the more formal methods of underwriting where the underwriting risk was better distributed. Contemporary advocates considered underwriting a service to the investing public providing a seal of approval attesting for the quality of the issue, arguing that men of finance were unlikely to underwrite a bad loan.[47] In spite of such arguments, the investing public identified underwriting (and to a lesser extent also issuing syndicates), at best with sharp practice, and at worst with fraud.[48] It was partly this impression that a journalist writing for *Truth* in the late 1870s sought to dispel when arguing that 'It is by no means clear to me that a syndicate which "underwrites" a foreign loan is necessarily an assemblage of thieves.'[49] That public perception of underwriting had not dramatically changed by the early 1890s is shown by the *Bankers' Magazine's* derogatory description of underwriting in 1892 as: 'a regular branch of

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[45] Examples include the 1878 Norwegian and 1880 Portuguese loans. Compare Mikkelsen, *The Market Practices and Techniques,* Appendix 1 to correspondence referenced above.

[46] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

[47] O'Hagan, H. O., *Leaves of My Life*, (London, John Lane The Bodley Head Limited, 1929), 151.

[48] 'Syndicates', *Economist*, August 16, 1873. 'The Revival Of Syndicates', *Economist*, November 29, 1873. 'The Dissolution Of The Egyptian Syndicate', *Economist*, January 17, 1874.

[49] 'Syndicates', *Truth,* October 3, 1878.

the company promoter's art'.[50] Public knowledge that a firm used underwriting in connection with a loan might therefore damage its reputation, in many ways its most important attribute, and could also negatively affect subscriptions for the loan. It is therefore not surprising that during the 1870s and 1880s, issuing houses seem to have preferred the more discreet method of underwriting a loan by offering their friends red list participations, over organising a formal underwriting group. This reliance on red list participations as the main method for underwriting sovereign loans came to an end, however, once the danger of relying on such a system, one that offered only limited scope for distributing underwriting risk, was brutally exposed through the Baring Crisis of November 1890.

*The effect of the Baring crisis*

Over the course of the 1880s, Barings had increasingly moved from acting as an agent of the Argentine government (or a London agent of French or German contractors for Argentine loans) to taking Argentine loans firm, either by themselves or as a member of an international syndicate.[51] In spite of Barings use of the red list system to limit its own exposure to risk, the firm ended up with £4.16 million in Argentine securities by October 1890.[52] After investor confidence in Argentina evaporated, these securities became unsalable except at a heavy loss, leading to the Baring Crisis of November 1890.[53] If the red list system had allowed Barings to outsource the underwriting risk associated with its issues to a much greater extent, then the house would not have had to carry itself what nearly proved a fatal share of underwriting risk. There can be little doubt that Barings used every possible means to divest itself of the toxic securities it held on its books. *The Economist* commented in November 1890 that: '[Barings]

[50] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 47. For the bad name of company promoters see Nye, J. G. D., *The Company Promoter in London 1877-1914*, (PhD, King's College, 2011), 11, 18-19.

[51]Baring contracts for Argentine loans listed in Mikkelsen, *The Market Practices and Techniques,* Appendix 4.

[52] Ziegler, P., *The Sixth Great Power,* (New York, A. A. Knopf, 1988), 244-245. 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

[53]'The Crisis of the Month', *IMM*, November 30, 1890. Marichal, C., *A Century of Debt Crisis in Latin America,* (Princeton, Princeton University Press, 1989), 150.

did not neglect to use all the means in their power to rid themselves [of the securities].'[54] *The Economist* was referring to attempts to induce investors to buy the Argentine securities, but Barings also seem to have stretched the red list system to its limits, as according to the *Bankers' Magazine,* those 'un'-fortunate enough to have been on the firm's red list, had been served an 'indigestible feast' of securities.[55] Yet Barings still ended up shouldering a large enough share of the underwriting risk to necessitate its rescue. Even though it was realised that Barings had been imprudent, the embarrassment of Barings likely sent a shiver down the spine of every issuing house in the City.[56] Barings was far from the only issuing house which was weighed down by unsold securities in the late 1880s, with *The Statist* arguing in July 1889 that 'the great houses ... were already carrying a load [of unsold securities] almost as large as they could safely manage'.[57] Other issuing houses would therefore undoubtedly have taken heed. The crisis highlighted the possible consequences of taking loans firm without resource to an effective way of outsourcing the underwriting risk, not least in connection with sovereign loans, which were often larger than the capital of the house(s) involved.

*The Bankers' Magazine* in 1892 stated that red lists, inner circles and select syndicates were now 'as dead as Queen Anne', but from the ashes of the red list system arose a system of underwriting groups which revolutionized the loan business.[58] Rather than abandoning the red list system altogether, issuing houses appear to have expanded and formalised it, leading to the practice of forming underwriting groups to underwrite sovereign loan issues. The notion that the Baring Crisis precipitated this transformation from red list participations to underwriting groups is strongly supported by the timing of the shift. It occurred in the years

[54] 'The Liquidation of the Barings', *Economist,* November 22, 1890. See also Ziegler, *The Sixth Great Power*, 242.

[55] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

[56] 'Argentine Borrowings', *The Statist,* October 15, 1887, 429-430. Ford, A. G., 'Argentina and the Baring Crisis of 1890', *Oxford Economic Papers, New Series*, Vol. 8, No. 2 (Jun., 1956), 134-135. Ziegler, *The Sixth Great Power,* 246.

[57] 'The Great Houses', *The Statist, July 27, 1889.*

[58] 'The Financial outlook in 1892', *Bankers' Magazine,* January 1892, 46.

immediately following the crisis, with underwriting groups becoming common practice from the mid-1890s onwards.[59]

*From red list participations to underwriting groups*

The organization of an underwriting group was a device by which issuers could ensure that an issue was successfully placed, even if the public did not readily take up the loan. In advance of the public issue, the issuing house, or syndicate responsible for its management, would offer participation in the underwriting group to potential underwriters on a given set of terms. If participation was accepted, an individual underwriter guaranteed the placement of a certain part of the loan in exchange for an underwriting commission, the size of which varied depending on how risky the issue was thought to be. The size of the commission was usually 1-3 per cent for sovereign issues, though after 1900 it dropped to generally 1-2 per cent. In the event that the public took up the entire loan, nothing further was demanded from the underwriters and they could pocket their commission as profit. However, if the whole loan could not be sold to the public, the underwriters would be called upon to take a share of the remaining bonds proportional to their participation in the underwriting group.[60]

The use of underwriting groups instead of red list participations offered issuing houses two advantages. The first and less significant one was the difference in remuneration, as a fixed commission replaced a share in the overall profits commensurate with the size of participation. In most cases this meant that relative to the share of the underwriting risk

[59] LMA MS 21,793,1, 2 and 3; Loans and Options. A similar shift to more formal underwriting groups also appears to have taken place in the colonial loan market in the wake of the Baring Crisis. Attard, B., 'The London Stock Exchange and the colonial market: the City, internationalisation and power', in C. Dejung and N. P. Petersson (eds), *The Foundations of Worldwide Economic Integration: Power, Institutions, and Global Markets, 1850-1930* (Cambridge University Press: Cambridge, 2013),107

[60] Singleton, C. C., *'Stock Exchange Underwriting: Its principles and Practice',* (London, Underwriting News Ltd, 1928), 9, 11. RAL XI/III/36; Letter to Rothschilds, March 6, 1907. 'Underwriters and Subscribers', *IMM*, 31 October 1910. 'Stock Exchange Underwriting', *Economist*, June 3, 1911. LMA MS 21,793,1, 2 and 3; Loans and Options.

assumed, the formation of an underwriting group was often the more cost effective choice for the house organising the issue.[61] On the other hand, for other issuing houses it was *ceteris paribus* more attractive to be offered a red list participation in a loan compared with membership of an underwriting group. Issuing houses therefore continued to reward their closest *friends* among other issuing houses with what was essentially red list participation throughout the period up to 1914, even when the whole underwriting risk was outsourced to a separate underwriting group.[62]

The second and more important advantage offered by underwriting groups was that they allowed issuing houses to divest themselves of the underwriting risk to a much greater extent than under the red list system. In the latter case, the issuing house normally always retained a much larger share of the loan for itself than it offered to any of its friends.[63] This is hardly surprising, since red list participations were mainly limited to other issuing houses, each of which was expected to take a significant part of the loan.[64] These houses would have viewed their participation in the loan in much the same way as the original issuing house. An issuing house could therefore hardly invite its friends to take up part of the underwriting risk in connection with one of its loan issues if the house itself was not willing to lead by example and take the largest share of the risk.

This same sentiment also seems to have prevailed in connection with early underwriting groups such as the one formed by Rothschilds when it issued the 1895 Brazilian government loan. Here the underwriters were also mainly other issuing houses, as it was not until later that other institutional investors like insurance companies came to play a

[61] For example, Hambros had only taken ¼% commission in 1876 for issuing the Swedish loan of that year, while in connection with the 1895 Brazilian loan Rothschilds earned an issuing commission of 2% plus expenses for issuing the loan in addition to the underwriters' commission of 2%. LMA MS 19,063/15; Hambros to Morgans, May 30, 1876. RAL 000/401F/6; Contract for 1895 Brazilian Loan.

[62] LMA MS 21,793,1, 2 and 3; Loans and Options. BA PF-1909 Russian Loan, Part II, Barings to E. Cassel, January 15, 1909, 25.

[63] See for example LMA MS 19,063/15. & LMA MS 19,063/19. The letters indicating the participations of individual houses indicates that the largest share of the loans was retained by Hambros themselves.

[64] Participations of £50.000-£250.000 seem to have been the norm. LMA MS 21,793,1; Loans and Options.

substantial role in underwriting.[65] In the case of the 1895 Brazilian loan, none of the underwriters apart from Rothschilds underwrote a nominal value of more than £250,000, while Rothschilds underwrote nearly six times that amount. The use of an underwriting group nevertheless allowed Rothschilds to distribute part of the underwriting risk associated with the issue to a large number of different underwriters. Rothschilds was therefore able to reduce its share of the underwriting of the loan to less than a third of the total £4.96 million underwritten.[66]

For smaller loans, red list participations could allow issuing houses to reduce their share of the risk associated with taking a loan firm to a similarly low level. In connection with several smaller Scandinavian loans in the 1870s and 1880s, Hambros was able to reduce their share of the risk from taking the loans firm to between a quarter and a third of the total, by offering participations to their friends both at home and abroad.[67] However, the fact that Barings and Hambros ended up taking £3 million out of the £6.5 million unsold bonds of the 1882 Italian loan onto their own books, is a clear indication that the same level of reduction in risk could not be achieved for larger loans by relying solely on red list participations.[68] Compared to the risk assumed by issuing houses in connection with later sovereign issues were underwriting groups were used, the share of risk incurred by issuing houses in connection with all of these loans were nevertheless still significant. For the 1913 Brazilian

[65] RAL 000/73/111/127; 1895 Brazilian 5% Loan, list of underwriters' participation. 'Stock Exchange Underwriting', *Economist*, June 3, 1911.

[66] RAL 000/401F/6; Contract for 1895 Brazilian Loan. RAL 000/73/111/127; 1895 Brazilian 5% Loan, list of underwriters' participations.

[67] These loans were all for less than £2 million. MS 19131 and 19187; Lists with participating firms. MS 19133; 3 1/2% Norwegian 86 Syndicate.

[68] The other members of the syndicate took a combined £1.4 million, this means that £2 million must have been taken up by Barings and Hambros red list participants. Bramsen, B. and Wain, K., *The Hambros 1779-1979,* (London, Michal Joseph, 1979), 312-316. MS 19.111 Part 2 of 3; Account of meeting on Sep 22, 1882. BA 201522: Contract for 1881-82 Italian loan. BA 202250.5: Prospectus for 1881-82 Italian loan.

loan Rothschilds underwrote less than two per cent of the loan, while Barings assumed no share of the underwriting risk for the 1907 Argentine loan.[69]

That underwriting groups became such efficient mechanisms for subcontracting underwriting risk was due to the fact that from the mid-1890s onwards, stockbrokers and their clients, as well as institutional investors, came to play an increasingly important role, with the result that participation in underwriting groups came to be viewed differently.[70] The importance of institutional investors in the market for foreign government bonds grew significantly during the last quarter century before the war, with the amount of foreign government bonds held by UK life offices increasing from just £3.5 million in 1890 to £24.6 million in 1913. This seven-fold increase compares favourably with the two and a half fold increase in the total value of investments by UK life offices, indicating that institutional investors increasingly invested in foreign government bonds.[71] The presence of institutional investors was felt especially strong in connection with the underwriting of loans. Withers commented a few years before the war that for gilt-edged securities institutional investors normally took up much of the underwriting.[72] Often institutional investors participated in underwriting groups in order to effectively get bonds they desired at a lower price. Frequently, they would therefore underwrite their part of the loan firm, which meant that they took a given part of the loan at a price equivalent to the issue price minus the underwriting commission.[73] For such underwriters, participation in an underwriting group was thus not viewed as incurring risk, but rather as a way of obtaining an effective discount on the bonds they wished to take. Stockbrokers on the other hand shared their underwriting participation

[69] RAL XI/III/57; 1913 Brazil Loan, alphabetical list of Underwriters. BA PF-1907 Argentine Loan Part II, account, 152. Cassis, Y., La City de Londres, 1870-1914, (Berlin, 1987), 120.

[70] 'Stock Exchange Underwriting', *Economist*, June 3, 1911. RAL XI/III/57; 1913 Brazil Loan, alphabetical list of Underwriters. Cassis, La City de Londres, 120.

[71] Supple, B., *The Royal Exchange Assurance,* (Cambridge, CUP, 1970), 332.

[72] 'Underwriters and Subscribers', *IMM,* October 31, 1910.

[73] 'Stock Exchange Underwriting', *Economist*, June 3, 1911. Singleton, *Stock Exchange Underwriting*, 12-13.

with their clients, which meant that, apart from institutional investors who deliberately wanted large shares of the underwriting, individual participations were relatively small.[74]

The inclusion of stockbrokers and institutional investors drastically expanded the capital available for underwriting and also meant that underwriting risk could easily be spread to such an extent that no individual member of the underwriting group had to accept a participation that could in any way tie its continued financial solvency to the success of the loan. This in turn effectively allowed the risk to be assessed, priced and traded as a financial commodity in its own right. Since participations in underwriting groups thus came to be seen as financial commodities, there was no longer any reason for issuing houses to take the lead by underwriting the largest part of their issues themselves. In fact, the opportunity to participate in underwriting groups seems generally to have been so much in demand that issuing houses could limit their share of the underwriting to whatever degree they wished.[75] Using underwriting groups, issuing houses were able to divest themselves of underwriting risk to a much greater degree than had been possible when relying on issuing syndicates or red list participations. As already noted, in some cases issuing houses bore no share of the underwriting risk and for others their underwriting commitments were much smaller than the share of some of the individual underwriters.[76]

While the growing use of underwriting groups by reputable houses undoubtedly made the practice more accepted from the mid-1890s onwards, it nevertheless continued to be viewed with some suspicion with *The Economist* defending it in 1911 as being of distinct advantage when it was not abused.[77] Its acceptance is evidenced by the fact that in spite of Lord Rothschild's reported sceptical attitude, Rothschilds started using underwriting

[74] RAL XI/III/57; 1913 Brazil Loan, alphabetical list of Underwriters. RAL XI/III/57; Letters to Rothschilds from Browning, Todd & Co and Wassermann, Plaut & Co.

[75] BA PF-1906 Russian Loan Part I, Barings to Mendelssohns, April 10, 1906; Revelstoke to Cassel, April 15, 1906, 75, 134. RAL XI/III/57; Letters to Rothschilds from Browning, Todd & Co and Wassermann, Plaut & Co.

[76] RAL XI/III/57; 1913 Brazil Loan, alphabetical list of Underwriters.

[77] 'Mr. Seligman Describes Underwriting Methods', *The New York Times,* April 26, 1906. 'Stock Exchange Underwriting', *Economist*, June 3, 1911.

routinely in its issues from around 1905.[78] In fact, by the end of the first decade of the twentieth century the use of underwriting had become the norm to such an extent that choosing not to have an issue underwritten was in itself newsworthy.[79]

*The use of underwriting in connection with sovereign loans*

The use of underwriting groups meant that even in cases where an issuing house acted as an agent, it would be possible for the government to rid itself of the underwriting risk. This happened with the Brazilian loans of 1895, 1908, 1910 and 1911, the only difference from other Brazilian loans (where no underwriting was arranged) being the additional expense to the government of an underwriting commission.[80] In fact, during the last decade before the war, the question of whether a loan was taken firm or not sometimes boiled down to whether a government was willing to pay the underwriting commission. This was the case with the Chilean loans, where Rothschilds gave the government the choice of saving the underwriting commission and having the house issue the loan as an agent, or Rothschilds taking the loan firm, but at a lower price, allowing for an underwriting commission.[81]

In most cases, governments were not involved in the matter of underwriting. Loans were simply taken firm by an issuing syndicate, which then chose to either pay underwriters a commission in order to eliminate the risk of the loan not being taken up, or to bear the risk itself and retain the commission. This was the case with the 1909 Argentine loan where no underwriting was arranged by the syndicate, while in connection with both the 1906 Russian loan and the 1907 Argentine loan, underwriting groups were organised. In neither of the two latter loans did the contracts with the governments make any specific provisions for

[78] 'Lord Rothschild Memoir', *The Times*, April 1, 1915. See Rothschild contracts from 1905 listed in Mikkelsen, *The Market Practices and Techniques,* Appendix 4. The 1895 Brazilian loan was a special case.

[79] 'Underwriters and Subscribers', *IMM,* October 31, 1910. 'The Chinese Loan Next Week', *The New York Times,* May 15, 1913.

[80] Contracts for 1895, 1908, 1910 and 1911 Brazilian Loans in RAL 000/401F/6. RAL 000/401H/10. RAL 000/401I/3,4.

[81] RAL Xi/III/26; Copy of message to Chilean government, March 18, 1906. RAL XI/III/50; Rothschilds to Chilean Finance Minister, January 4, 1911.

underwriting.[82] For loans where the underwriting risk associated with an issue was borne by an underwriting group, the distinction whether issuing houses acted as an agent of the government or took the loan firm became practically meaningless. In either case, the issuing house would only incur a liability for the issue to the extent that it participated in the underwriting group. Risk remained if the loan was taken firm and no underwriting group could be formed, but there is no evidence of major issuing houses ever facing such a situation.

As with red list participations, issuing houses had lists of underwriters to which they offered participation in their underwriting groups, and to be on the underwriting lists of first class houses was seen as being in 'the circle'. According to Singleton, a solicitor and one time managing director of The Underwriters Trust, underwriters who failed to accept any share of the underwriting they were offered were quickly struck off the list and found that they were not invited to share in the underwriting of future issues.[83] In this last aspect, the practice in New York appears to have been identical to that in London.[84] Underwriters therefore had to balance the possibility of short-term losses stemming from having to take up bonds of a failed issue against the long-term profitability of being invited to participate in the underwriting of a firm's future issues.

Often a condition for participating in underwriting groups was that the underwriter agreed to refrain from selling bonds directly or indirectly in the market until allotment had taken place. It was also expected that if an issue failed, underwriters would not rush to relieve themselves of their share of unsold bonds by sales in the market, and that any sales they did

[82] Contracts for 1906 Russian, 1907 and 1909 Argentine Loans in BA 201852, BA PF-1906 Argentine Loan Part I, 190-196 and BA PF-1909 Argentine Loan, 594-595.

LMA MS 21,793,3; Loans and Options, 69. BA PF-1906 Russian Loan, Part I, Revelstoke to Cassel, April 15, 1906.

[83] Singleton, *'Stock Exchange Underwriting'*, 11-12. For Singleton see 'Levity the Cause for Evil', *FT,* July 29, 1929.

[84] Carosso, *Investment Banking in America*, 59-60.

make would be done through the issuing house.[85] A breakdown of discipline by one or more underwriters in this area could potentially undermine attempts by the issuing house to support the pre-allotment or secondary market, with offending underwriters essentially selling their bonds back to the issuing house.[86] The condition that underwriters abstain from engaging in the market and channel any business through the issuing house resembles the syndicate discipline imposed by the modern practice of fixed price re-offer. Adopted in the Eurobond market in 1989 to combat the practice by which weaker members of selling syndicates recycled bonds back to the lead manager through the grey market, the fixed price re-offer model required the whole syndicate to agree to sell bonds at a common price fixed by the lead manager.[87]

In spite of the conditions attached to participation in underwriting groups and the fact that in some cases underwriters were called upon to take significant parts of loans, there generally seems to have been no shortage of interest in participating in the underwriting of sovereign issues. In fact, eminent issuing houses often received letters from underwriters begging for a bigger slice of the underwriting than usual when news of an impending loan spread through the City.[88] By the 1900s, the use of underwriting groups thus resulted in a situation where issuing houses could take loans firm without having to incur any liability greater than that which they themselves chose to undertake. Furthermore, since participations in underwriting groups were sought after, underwriting a loan allowed issuing houses to reward their friends and clients by offering them participation in the underwriting almost as a form of patronage. In the case of other issuing houses it also offered the prospect of

[85] RAL XI/III/33; Underwriting prospectus 1905 Japanese Loan. RAL XI/III/36; Letter stating terms of underwriting participation. RAL XI/III/43; Underwriting prospectus 1909 Chilean Loan. Singleton, *Stock Exchange Underwriting,* 12.

[86] For intervention in support of the market see Mikkelsen, *The Market Practices and Techniques,* Chapters 8-10.

[87] Shearlock and Ellington, *The Eurobond Diaries*, 57-65.

[88] 'The Brazilian Loan', *The Financial Time,* May 8, 1913. 'The Underwriters' Understanding', *Economist*, October 18, 1913. BA PF-1906 Russian Loan Part I, Barings to Mendelssohns, April 10, 1906; Revelstoke to Cassel, April 15, 1906, 75, 134. RAL XI/III/57; Letters to Rothschilds from Browning, Todd & Co and Wassermann, Plaut & Co.

reciprocal inclusion into their underwriting groups. The value of dispensing participation in underwriting groups is highlighted by Barings' decision to underwrite a larger share of the 1906 Russian loan than originally intended, simply in order to increase the amount of underwriting available to satisfy its many applicants.[89]

Indeed, failure to satisfy the desire for underwriting participation could have a negative impact on the success of a loan. In 1910, the *Daily Mail* reported that the Argentine loan was being boycotted on the stock exchange by jobbers quoting very wide prices and thus discouraging trade in the bonds. Owing to the small size of the loan, the underwriting had been taken up purely by the big financial houses, which displeased members of the stock exchange. This was not merely an isolated incident as the *Daily Mail* described the situation as 'remarkable ... but not so very uncommon'.[90] It is worth noting that this sense of entitlement on the part of the stock exchange had developed even though the involvement of stock exchange firms in underwriting was a relatively recent development.

Thus in the last years leading up to the Great War, the earlier preference amongst issuing houses for issuing loans as agents of governments had been reversed. By this time issuing houses clearly favoured taking loans firm or, what could effectively amount to the same thing, issuing them as agents with an underwriting group shouldering the risk.[91]

## *Conclusion*

The Period 1870–1914 saw a major change in how underwriting risk associated with sovereign bond issues was viewed and dealt with in the London capital market. Increased competition resulted in issuing houses progressively shouldering the underwriting risk associated with their issues from the mid-1880s, requiring firms to adapt their market practices to the new situation. In this, they were nevertheless hamstrung by the public perception of underwriting, which meant that issuing houses initially turned to the less than

[89] BA PF-1906 Russian Loan, Part I, Revelstoke to Cassel, April 15, 1906 and various telegrams, 154-155.

[90] 'Chat on Change', *Daily Mail,* December 7, 1910.

[91] RAL XI/III/50; Unsigned and undated note. RAL XI/III/50; Draft, Rothschild to Chilean Finance Minister, January 5, 1911. BA PF-1911 Argentine Loan, Part I, Barings to Deutsche Banks, June 12, 1911; Barings to Tornquist, June 16, 1911, 284-285, 324-325.

optimal solutions of issuing syndicates and red list participations to mitigate underwriting risk. These methods only allowed for a partial outsourcing of the risk and only partially overcame the fundamental problem that an issuing house, when taking a loan firm, merged the prestigious and profitable role of managing a loan issue with the more risky role of underwriting it.

The potential dangers of this situation were brought home to London issuing houses by the Baring Crisis. This led issuing houses to develop the existing red list system into a system of formal underwriting groups, which in turn allowed for underwriting participations to be extended beyond the relatively narrow circle of a firm's friends. The expansion of underwriting groups to include other types of underwriters was in part facilitated by the increasing interest of institutional investors in foreign government bonds from the 1890s onwards. Seeing underwriting as an excellent opportunity to gain an effective discount on bonds they wished to buy for investment purposes, institutional investors came to play an increasingly important role in the underwriting of sovereign bonds between the 1890s and 1914. This together with the inclusion of stockbrokers and their clients in underwriting groups, led to a drastic increase in the number of individual underwriters and the capital available for underwriting. The result was a system of underwriting which allowed risk to be far more widely distributed and eliminated the need for any one underwriter to bear a risk beyond what could safely be managed. This development of the practice of sub-contracting underwriting risk resulted in two important developments: first it allowed issuing houses, whether they acted alone or as part of an issuing syndicate, to separate issuing a loan from underwriting it. And second, it transformed the way in which the underwriting risk associated with a loan was viewed, namely from being seen as a distinct liability preferably to be avoided, into being perceived as a valuable financial commodity, one to be traded, and one that issuing houses could allocate as a form of patronage to their friends and clients.

The development of underwriting practices between 1870 and 1914 shows that the loan industry was a dynamic and evolving business, with market practices adapting to meet the challenges posed by changing market conditions. Though market suspicion could limit innovation, its ability to do so was limited. Once the Baring Crisis exposed the necessity for a more effective method of underwriting, formal underwriting groups were relatively quickly adopted and within two decades were considered standard practice by all.

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