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# The Separation of Information and Lending and the Rise of Rating Agencies in the United States

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## Abstract

This paper provides a new interpretation of the early rise of rating agencies in the United States (initially known as 'Mercantile Agencies'). We explain this American exceptionality through an inductive approach that revisits the conventional parallel with the UK. In contrast with earlier narratives that have emphasized the role of Common Law and the greater understanding of American judges that would have supported the rise of an ethos of 'transparency', we argue that Mercantile Agencies prospered as a remedy to deficient bankruptcy law and weak protection of creditor rights in the US. The result was to raise the value of the nation-wide registry of defaulters which the Mercantile Agencies managed. This ensured the Agencies' profitability and endowed them with resources to buy their survival in a legal environment that remained stubbornly hostile.

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In 1979, biologists Steven Jay Gould and Richard Lowentin warned their colleagues of the dangers of mistaking an entity's present function for an explanation of its origins. By way of illustration, their article 'The Spandrels of Saint Marco and the Panglossian Paradigm' discussed the spandrels – the triangular shapes that emerge at the conjunction of two arches – in the dome of the Venetian Cathedral of St. Marks. Spandrels, Gould and Lowentin noted, were formed by the necessary conjunction of the arches upon which the central dome rests. Spandrels are not there because the architect wanted spandrels, but because the architect wanted a dome and arches, and the spandrels were an inevitable by-product of this architectural design. In the end, however, 'each spandrel contains a design admirably fitted into its tapering space' and its 'design is so elaborate, harmonious, and purposeful that we are tempted to view it as the starting point of any analysis, as the cause in some sense of the surrounding architecture.'[1]

The advice Gould and Lowentin offered to biologists is relevant to historians researching the evolution of modern financial institutions. Because today rating agencies sell grades in an effort to quantify default risk, we are tempted to conclude that they emerged because selling grades was uniquely useful: to observe the beauty of the spandrel and assume that is why it was created. In fact, rating emerged because of American hostility to the development of European-style banking institutions and European bankruptcy law. By preventing these institutions from taking root in the US, space was created for an institution capable of resolving issues of credit-allocation and debt-collection, and the mercantile agencies emerged to fill that space.

In this article, we present the argument by revisiting the early development of modern rating agencies focusing on the period between the creation of the first agency and the financial crisis of 1907, which opened a new era. The rise of rating agencies, known initially as 'mercantile agencies', raises an important question of comparative financial history, as the US was unique in developing this institution. This American exceptionality, noted by contemporary observers such as Peter Earling, has been explained in a variety of ways, with most explanations stressing the role of ideas and culture. According to the most recent work, by business historian Rowena Olegario, the key phenomenon that has to be explained is the reason why credit opinion came to be 'sold' as an entity independent from the lending relation. In other parts of the world, it is said, credit information was typically collected by banks or credit cooperatives and used 'internally' to assist lending or protect members. What mercantile agencies achieved ('invented'?) was a form of separation of information and lending that Olegario has called the 'commoditization of credit'. Why did this happen in the US but not in other places such as the UK?

According to Olegario, the rise of rating was enmeshed with the coming-of-age of a modern ethos of transparency that grew slowly but steadily in the 19th century, against premonitory 'concerns about the strict accuracy of credit reports.'[2] This focus on transparency seems legitimate. Provision of information is ostensibly what rating agencies do, and today their lawyers emphasize what they view as the agencies' right to free speech.[3] Yet the view of rating agencies as developing through the commoditisation of business transparency has a 'spandrel-like' quality against which Gould and Lowentin warned their colleagues. The Mercantile Agencies' elaborate, harmonious designs fascinate, especially the way their discourse of transparency has been elegantly embroidered into their success. Yet the extent to which they 'resulted' from the advent and propagation of a putative 'ethos of transparency' is an altogether different matter.

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[1] Gould and Lewontin, 'The Spandrels of San Marco and the Panglossian Paradigm: A Critique of the Adaptationist Programme' (1979), 581, 582,.

[2] Olegario, *A Culture of Credit* (2006), 2

[3] See Nagy, 'Credit Rating Agencies and the First Amendment.' (2009) for a recent critical survey.

To make this point, we elaborate on the Anglo-American divergence. The comparative financial systems literature usually presents British and American financial systems as falling into the same category, [4] but historically, British and US finance differed radically in one critical respect at least. Nothing like the successful American Mercantile Agencies of the 19th century ever grew in Britain. The conventional explanation is either the greater ingenuity of the New Yorker, or the greater sophistication displayed by US Judges. According to the latter view, Judges allowed mercantile reporting firms to prosper while their conservative British counterparts repressed attempts to put credit publicity at the heart of the credit system. While in the US Mercantile Agencies supplied transparent credit information, in Britain creditors must have struggled with the assessment of credit risk. This view is not limited to American scholars. The belief that early financial systems such as Britain's 'lacked' rating agencies is found in the UK as well, as illustrated by a recent paper by Collins and Baker emphasizing the hurdles of bank lending in the UK '*in the absence of today's easy reference to credit rating agencies*'.[5]

Yet as we discovered by exploring the litigation archive of one leading Mercantile Agency (Dun), the average 19th century US Judge was deeply sceptical of 'transparency' and the business model of the Mercantile Agencies.[6] To the extent Mercantile Agencies succeeded in the US they owed it to their determination, when faced with inflexible judges and juries, to step *over* the boundaries of the law. Their success had little to do with the benevolence of the judiciary. It had a lot to do with ruthless, sometimes mafia-like, techniques: hardly an ethos of transparency. But if this is so, then the reasons for the development of mercantile credit reporting and rating in the US are as mysterious as ever. In this article, we get back to this issue and, by inductive reasoning, provide a new hypothesis for why credit reporting took radically different forms in the US and in the UK.

Our alternative hypothesis to the conventional story of American judicial sophistication is that Mercantile Agencies emerged essentially because of US political and regulatory hostility to creditors in general and banks in particular, which caused the adoption of statutes that prevented US banks from developing the kind of credit reporting that their counterparts could do in the UK (and elsewhere in Europe). The mercantile agencies succeeded because they offered a set of services that substituted for missing institutions. This set included centralized monitoring of borrowers and defaulters, the ability to track commercial reputation, and an alternative to the 'commoditization of credit' as it was actually done in Europe. In other words, in our article the birth of rating in the US is not explained by Common Law, enterprising Yankees, and their intelligent judges, but by a problem of financial architecture for which original solutions had to be designed. In essence, therefore, there is a kinship between our hypothesis and Gershenkron's

[4] We have in mind Allen and Gale, *Comparing Financial Systems* (2001). for theory and Bordo and Sylla, *Anglo-American Financial Systems* (1995) for history. Another popular use of the ''Anglo-American'' category is the series of influential papers by La Porta, Lopez-de-Silanes, Shleifer, and Vishny ''LLSV'' which emphasize ''legal origins'' (which the UK and US would share). For instance La Porta et al., 'Law and Finance' (1998). This tradition, however, is largely discredited among financial historians and is mostly used today as a convenient straw man or expositional device. For compelling evidence of the lack of fundamental ''original'' legal differences between European countries, see Sgard, "Do Legal Origins Matter?" (2006). Our own paper will argue that *different* protection of creditors within the Anglo-Saxon group is what explains the rise of rating in the US in contrast with the UK.

[5] Our italics; Baker and Collins, 'English Financial Markets,' (2011), 59. Again, pp. 56-57, ending required ''a myriad of risk assessments and credit rating decisions being made every day, and this at a time when no established credit rating agencies existed.''

[6] Flandreau and Geisler Mesevage, 'History of Transparency,' Forthcoming, 17-21.

famous theory of 'relative backwardness', which encourages thinking of financial innovation as a form economic catch-up.[7]

Yet establishing the origins of rating is not our only goal, for this paper is also about methodology. Our approach, which the Mercantile Agencies example illustrates, argues that it may be more promising to look at the *general architecture of information flows* in the financial system rather then focusing on specific segments. In the case of the origins of rating, we argue that it is the exclusive focus on rating that has led previous students to mistake selling grades for the reason why the agencies emerged. We claim that a proper history of finance ought to devote itself to determining how what we call the *information architecture* is being designed. We advocate this concept as a heuristic tool in comparative financial history. It is distinct from the micro-economic focus on *information asymmetries*, which studies bilateral credit relations, given existing asymmetries, without seriously looking at the forces that generate the asymmetries. It is also distinct from approaches that start with a simple description of legal constraints. Last, thinking in terms of *comparative information architectures* provides a way to think about who owns information and as a result may serve as the basis for a new information architecture based political economy. The focus on architecture also determines the way to proceed in this article: the best way to visit a monument is to take a tour. Therefore, in order to show how a number of divergent features of the financial economies of the US and UK 'fit together' in their respective settings, we take the reader for a tour and the rest of the paper will guide her through the sights.

**I. Two Countries Divided by a Common Law?**

The mercantile agency was pioneered in 1841 by merchant and anti-slavery campaigner Lewis Tappan, and a number of competitor agencies followed soon after. However, the market consolidated, and three and then two agencies came to dominate, known as Bradstreet and Dun & Co. (the latter being the descendent of Tappan's original 'Mercantile Agency').[8] Contemporary and modern accounts describe their core business as the monitoring of the credit of distributors of 'Dry Goods' (textile, ready to wear clothing, hosiery etc.) who operated across the country. Reports were produced for the benefit of highly capitalized wholesale firms located in New York, the nation's import hub. Bradstreet and Dun worked by collecting opinions ('soft' information) and figures ('hard' information) on local distributors who worked on credit from the wholesaler. Mercantile Agencies revolutionized the former mode of operation whereby Dry Goods wholesalers employed their own travelling agents to assess clients. Instead, Mercantile Agencies provided centralized information from their correspondents around the country and made that information available for a price.[9]

Typically, the correspondents of mercantile agencies were local managers and lawyers. The lawyers found their compensation through referral to creditors for litigation and collection work, and this made them willing to volunteer reports for free. In practice, the local lawyers were 'salaried' by the agencies, and as a result, the agencies' business model ended up combining credit reporting with debt collection. Charges for collection work could represent a substantial part of revenues, according to Olegario as much as a quarter in 1900 for one agency.[10] Among the main features that the agencies documented in their reports were the capital or 'estimated

[7] Gerschenkron, *Economic Backwardness in Historical Perspective* (1962).
[8] A third prominent agency was McKillop and Sprague, Meagher, *The Commercial Agency System.*(1876) and Carruthers and Cohen, *Calculability and Trust* (2010). McKillop and Sprague failed in 1878.
[9] See Sylla, 'An Historical Primer' (2002), Sandage, *Born Losers* (2006), Olegario, *A Culture of Credit* (2006).
[10] Olegario, *A Culture of Credit* (2006), 62.

pecuniary strength' and the 'general credit' of businessmen (which, at Dun, and around the turn of the century, went by 'high' 'good' 'fair' and 'limited'). Among the features that the 'general credit' sought to distil was, beyond the pecuniary strength per se, an assessment of the 'character' of the borrower.[11]

After a period of experimenting with various charging schedules, a typical subscription to a Mercantile Agency gave access to a set of information services communicated in three possible ways.[12] First, subscribers had the right to make a number of inquiries and receive in return as many reports, handwritten, typed or oral, all *confidentially* made. Inquiries above that number were charged at a pre-agreed rate. Second, the subscriber would receive the latest edition of the annual Reference Book, which had been started in the late 1850s, and which contained a comprehensive list of individuals, with summary information. The Reference Books contained alphabetical lists of merchants arranged according to location, along with an abbreviation that indicated the type of trade and letters/figures that documented credit. These were known as 'keys' and the keys could be translated in verbal assessments.[13] Finally, the subscriber was entitled to so-called Notification Sheets, which completed the reference books by providing higher frequency updates. If the status of a given entity changed, the sheet would list its name with a mention such as 'insolvent' or 'call at office'.[14]

The value of the information provided by the agencies is at the heart of narratives explaining their ascent: Summarizing in 1889 the reasons for the rise of mercantile agencies since the 1840s, Peter Earling wrote: 'Taking up again the origin of the agencies, we find the purpose of its promoters to have been to collect and obtain information on the financial standing and responsibility of traders doing business with New York merchants… *The idea having much in it to recommend it, the list of patrons soon increased, and with it the scope and value of the institutions were increased also*.'[15] Indeed, the growth of the American Mercantile agencies was phenomenal and they soon began to cater to other parts of the US mercantile and trading system beyond the Dry Goods industry – in particular to banks.[16] From its beginning in 1859 to the end of R.G. Dun's tenure over his eponymously named organization in 1900, the company expanded from 1 office in New York to 135 offices.[17] Each of these offices maintained their own network of correspondents, stretching the web of reporters into the small towns of the US. Available data on Dun shows it was an extremely profitable corporation. Figures reported by Norris show Dun's net profits soaring from $ 39,479 in 1866 to $211,621 in 1877. Working with Dun's balance

[11] Madison, 'The Evolution of Commercial Credit' (1974), Olegario, *A Culture of Credit* (2006), Lauer, 'From Rumor to Written Record' (2008).
[12] Examples of general contracts are reproduced in Meagher, *The Commercial Agency System* (1876) and Chinn, *The Mercantile Agencies Against Commerce* (1896); See also Cohen, 'Constructing an Uncertain Economy' (2012), 993-4 for details on subscriptions schedules.
[13] Madison, 'The Evolution of Commercial Credit' (1974), Olegario, *A Culture of Credit* (2006), Lauer, 'From Rumor to Written Record' (2008).
[14] Dun and Bradstreet Archive, The Mercantile Agency Notification Sheet, p. 1, July 20, 1878. Failure related issues include ''assigned'' (3), ''bankruptcy'' ''in the hands of receiver'' or ''failed'' (6) or ''in sheriff's hands'' (2). Liquidation includes ''selling out at cost to retire'', ''dissolved'' and ''quit business''. Lawsuit is mentioned as ''suit'' or ''sued''.
[15] Earling, *Whom to Trust* (1889), 299.
[16] Norris, *RG Dun & Co.* (1978). Olegario, *A Culture of Credit* (2006), 157.
[17] Olegario, *A Culture of Credit* (2006), 160.

sheets show the corresponding average net profits for the years 1886 to 1890 to be $476,700 and this converts into two-digit real rates of return.[18]

Like many others, Earling described mercantile reporting as a 'purely American institution' that 'flourishes solely on American soil'.[19] Indeed, students of mercantile agencies who have looked abroad for a counterpart to the mesmerizing patterns of early American rating, report being unable to identify anything comparable. It is not, of course, that those 'notions' that are necessary to the distribution of credit information were lacking elsewhere. Historian James D. Norris gives to the 'rating keys' that would eventually be developed by American mercantile agencies a British origin.[20] The fact is that referring to rating scales was common City vernacular: for instance, a wealthy and creditable individual was said to be 'A1'.[21] Commercial, investment and central banks all developed grading systems. Yet all this production of reports or even grades was happening inside banks and banking establishments rather than being outsourced to specifically devoted institutions and subsequently bought as was the case in the provision of business information by mercantile agencies in the United States.[22]

Because of this focus on Mercantile Agencies as specifically designated institutions, a conventional British counterpart to mercantile agencies has been hypothesized to be the so-called 'Trade Protection Societies' (TPSs). TPSs were established beginning in the 1770s as credit cooperatives whose members agreed to share exclusively with one another, on a not-for-profit basis, information on 'swindlers and sharpers'. TPSs were mutual societies that shared information on debtors amongst merchants. Like mercantile agencies, TPSs collated information on debtors, centralized it, and enabled subscribers to submit requests for information on the names of specific business partners. However, the story goes, TPSs were never a match for

[18] Norris, *RG Dun & Co.* (1978), 98. Norris' figures show that Dun's net return was never below 50%. Authors' calculations from Box 18, f. 1-7, Dun and Bradstreet Corporation Records.

[19] Earling, *Whom to Trust* (1889), 303.

[20] Norris, *RG Dun & Co.* (1978), 53 states that ''apparently, [it] was copied completely from a London credit-reporting firm, Sedy's'' (sic). Norris must be referring to Seyd, discussed below. He adds that Seyd himself used a key found in Lloyd's register of ships. As far as we understand, Lloyd's register of ships and foreign shipping, established 1834, gave three types of ships A (''first class''), E (''second class'') and I (''third class''). The A category was split between A (''first description'') and AE (''second description'').

[21] Reflecting the widespread use of ratings, in 1852, the British financial journalist David Morier Evans could expect to be understood when he was writing that one financier '*stands A 1 in point of wealth*' Evans, *City Men and City Manners* (1852) 154.

[22] Existing evidence on European rating include the following. Britain: Since the first half of the 19th century, the Bank of England kept registers called ''Rating Books'' where clients were reported with an indication of their credit line ''range'' (the registers are kept in the Archives of the Bank of England, see Flandreau and Ugolini, 'Where it all Began' (2013)). The example of Baring's rating of US merchants in the first half of the 19th century is another well-known example, see Hidy, *The House of Baring* (1935). ''France: Since the beginning of the 19th century, the Bank of France appears to have been routinely providing ''grades'' Prunaux, *La classification des crédits* (2009); evidence of the continuation of the technique is found in late 19th century minutes of board meetings; new clients admitted to the discount window were ''quoted'' using a scale of credit: 1 was outstanding, 2 very good, 3 good, and they rarely dealt with people standing below 4 (Archives Bank of France, Minutes Procès Verbal du Conseil Général). Around the same period, the French bank Crédit Lyonnais organized a score-card for sovereign borrowers and ranked countries in three credit groups Flandreau, 'Caveat Emptor' (2003). Germany: banking historian Monika Pohle Fraser found that between 1857 and 1859, Openheim, a German bank, kept a list of ''101 bankers, speculators, money changers, cashiers, and brokers'' with whom they did business and rated them by marks ''ranging from 1aa through 1a, 1b, 2a, 2b or 3'' Pohle Fraser, 'The Role of Reputation' (2007), 191. Of interest is the article by Berghoff, 'Civilizing Capitalism?' (2009) who provides some limited detail on the success of a large Berlin credit reporting firm, Schimmelpfeng (more recently absorbed by Dun and Bradstreet).

Mercantile Agencies, neither in scope, in ambition, nor in success.[23] This claim goes back to an article published in 1911 by the *Encyclopedia Britannica* which placed Mercantile Agencies above TPS, stating that whereas in 'Great Britain and some European countries trade protective societies, composed of merchants and trade men, are formed for the promotion of trade, and members exchange information regarding the standing of business houses [...] the mercantile agency in the United States is a much more comprehensive organization.'[24]

The 'superiority' of the mercantile system has been put in relation to its nature as a for-profit business. TPSs could be distinguished from Mercantile Agencies through their approach towards 'selling' the grade or opinion: TPSs distributed their information on a not-for-profit basis. The TPS system was an information club. By contrast, Mercantile Agencies have been described as pioneers in the commoditization of information because they *sold* the information they collected. This difference in profit motive is posited as explaining the more muted success of TPSs. According to Olegario, for instance, TPSs lacked a competitive drive, whereas US credit-reporting agencies, 'because they were for-profit ventures [...] competed with one another…. …Competitive pressures led credit-reporting firms to attempt the broadest coverage possible. Both the Mercantile Agency [Dun] and Bradstreet gathered information on a wide array of businesses, not just those that were of interest to particular subscribers.'[25]

Previous scholars have hypothesized that the difference between Mercantile Agency commoditization of information and the not-for-profit TPS model might stem from differences in the two countries' legal regimes. Protecting commercial reputation was a longstanding principle within both American and British common law. From the 18th century onwards, it was established that suggesting a merchant had poor credit was actionable. As late as the early 20th century a standard textbook argued that 'any printed or written words are libellous which impeach the credit of any merchant or trader by imputing to him bankruptcy, insolvency, or even embarrassment, either past, present, or future, or which impute to him fraud or dishonesty or any mean or dishonourable conduct in his business, or which impugn his skill or otherwise injure him in the way of his trade or employment.'[26]

However, there existed a legal remedy known as 'Qualified Privilege' that offered the potential of absolving Mercantile Agencies from liability stemming from factually inaccurate reporting. Within the Anglo-American legal tradition, Qualified Privilege was a protection from libel law that arose in situations in which the reporting party could argue that it had been compelled – out of duty, by contract, or in the public interest – to provide the report. In the context of credit reporting, a commonly admitted test for Privilege was that the report had been confidentially made: if made publicly, then the report also reached individuals who had no need for it, thus invalidating the claim that the reporter had been 'compelled' or 'duty-bound' to make the report. With this reasoning in mind, previous scholars have conjectured that commoditization

[23] Olegario, *A Culture of Credit* (2006) 35.
[24] Chisholm, 'Mercantile (or commercial) Agencies' (1911) 148. It was the first time ''mercantile agencies'' appeared in the Encyclopedia. It is noteworthy that this 11th edition had been abridged and focused on the North American market, where it was published.
[25] Olegario, *A Culture of Credit* (2006), 78. This view is also forcefully argued by Grieg, *The Growth of Credit Information* (1992), 19 who puts the lack of a profit motive at the heart of the decline of TPS in the more recent period arguing: 'There is no doubt that a major factor in the decline in the fortunes of many [Trade Protection] Societies was the failure of [their governing] Committees generally to understand the fundamental need of any business (and especially a trade protection society) to make a profit'.
[26] Odgers and Eames, *A Digest of the Law of Libel and Slander* (1905), 30. For earlier opinion, see e.g. Folkard, *The Law of Slander and Libel* (1876), chapter 9.

of credit information in the US might have resulted from American judges' more generous granting of Qualified Privilege protection where the British remained stingy.[27] The logic of information circulation among like-minded individuals adhering to a TPS reputedly met the narrow test of privileged communications.[28] By contrast, Mercantile Agencies, whose annual volumes publicized the grades of hundreds of thousands of merchants for everyone to see, would have been exposed to substantial legal risk. Thus, previous scholars have reasoned, the success of Mercantile Agencies must have had to do with US judges' tolerance for transparency, itself stemming from their greater appreciation for the needs of a mercantile economy.

As Madison summarizes: 'In the two decades after the Civil War, credit agencies met most of the legal threats directed against them and earned the courts' recognition and sanction for their major activities. The legal uncertainty of the early years gave way as judges defined more clearly the status and obligations of the new enterprises.'[29] In this account, the plasticity of Common Law lay at the origin of a divergence between the two countries' informational architectures, with Britain lagging the US. Olegario claims that this is how 'a system of credit reporting… by profit-seeking firms' was born.[30]

**II. Down with Whig History**

Our recent study of Dun's legal archive has led us to challenge this Whiggish interpretation of rating history as the triumph commercial transparency (Flandreau and Geisler Mesevage 2014). At no point during the 19th century did American Mercantile agencies experience diminished liability risks for libel, nor did their legal position become more secure. We computed that Dun alone faced at least 100 libel cases in the two decades between 1880 and 1900, and we suspect that to be a significant underestimate. Calculations from the Dun archives reveal that the average amount of damages sued for in libel cases against Dun was $22,400 (1890 USD). In 1903, a court decision in the US made it legal to sue a Mercantile Agency for libel damages up to $100,000.[31] As late as 1914 the Idaho Judge Ailshie was still finding against the agencies' right to provide adverse reports on merchants.[32]

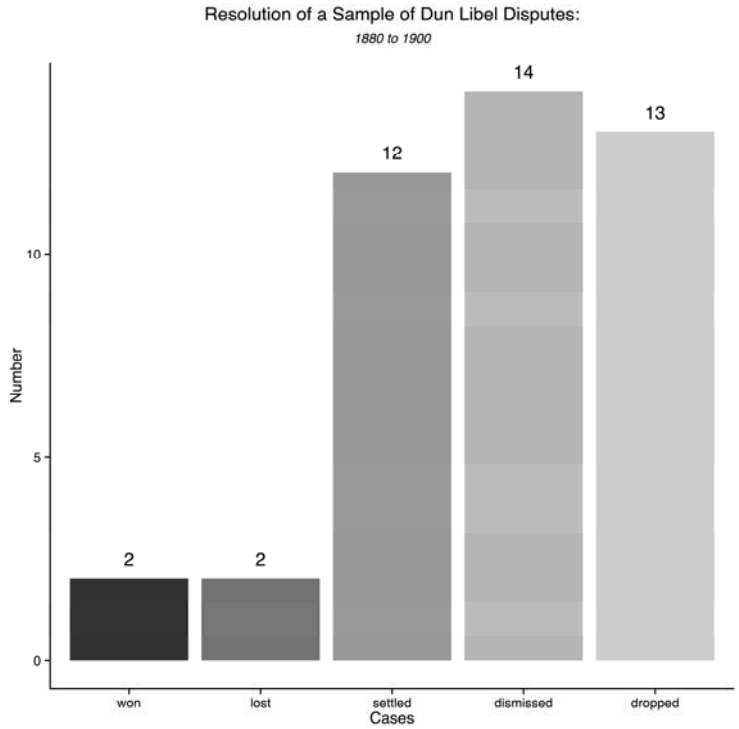
An internal memo prepared by Dun's defence team for *MacIntosh v. Dun*, an international libel suit being tried in the UK in 1908, provides telling evidence on how Dun's own counsel assessed the situation. The brief outlined the various products churned out by mercantile agencies (confidential inquiries, annual reference books, and notification sheets), and commented on the level of judicial protection afforded to each product. Dun's lawyers found that only for confidential inquiries, or reports 'where the publication was made to a subscriber upon his special request' had the judges 'held the publication privileged.'[33] For the rest, they found trial results to have been damning: neither in the one case they identified as involving a reference book nor in any of the seven cases involving a notification sheet had the communication been held to be privileged. In other words, the only part of the Mercantile Agencies' products that were protected against libel were the confidential credit investigation reports. Ironically, these were, as we saw,

[27] Madison, 'The Evolution of Commercial Credit' (1974); Olegario, *A Culture of Credit* (2006), Smith 'Conditional Privilege for Mercantile Agencies' (1914) I and II.
[28] Greig, *The Growth of Credit Information* (1992) has an interestign discussion of how judicial opinion was sought to ''design'' early TPS in a libel-proof fashion''.
[29] Madison, ''The Evolution of Commercial Credit Reporting'' (1974), 180.
[30] Olegario, *A Culture of Credit* (2006), 6.
[31] Minter v Bradstreet (1903) 174 Mo. 444, 73 S.W. 668.
[32] Pacific Packing Co. v. Bradstreet (1914) 139 P.1007.
[33] Dun and Bradstreet Corporation Records, pp. 2-3, v. 23, Dun and Bradstreet Corporate Records, Baker Library.

protected in British courts, too. In the end, what was protected was not uniquely American (confidential reports), and what was uniquely American (the listing of grades in books) was not protected.

If Mercantile Agencies in the US were not protected from legal liability, than how did they grow and prosper? Examining how the agencies dealt with libel disputes, we found that they drew on a vast arsenal of techniques ranging from legal chicanery to outright bullying of plaintiffs or suborning of their lawyers. Put briefly, the agencies recognized that their business model was not protected by law, and thus coped with repeated libel suits by preventing the libelled party from reaching a courtroom. If the case did make it to court, the Agencies worked to ensure the case would be dropped, and if this did not suffice, then to ensure that publicity for the outcome would be minimized. This was accomplished by mobilizing their network of lawyers, drawing on their ability to threaten commercial reputation, emphasizing to plaintiffs their relationship with important wholesalers, and hiring the best legal talent. An examination of Dun's archives reveals spirited management of libel cases using techniques like threatening plaintiffs by organizing their creditors, colluding with Bradstreet to persuade opposing attorneys to drop suits, and intimidating witnesses into withholding testimony by threatening their credit rating. This was merely in addition to the normal advantages that large corporations with dedicated legal teams enjoy when contesting with small and inexperienced litigants.[34]

Figure 1




Source: Flandreau and Geisler Mesevage, 'History of Transparency' (Forthcoming 2014).

[34] Flandreau and Geisler Mesevage, 'History of Transparency' (Forthcoming 2014), 26-34.

Based on a sample of 43 libel disputes arising in the US in the period 1880 to 1900, we were able to reassess the degree to which Dun's ability to survive the libel threat stemmed from the protection of the law as opposed to other techniques. Figure 1 shows that of 43 cases, only 4 made it to trial (2 won, 2 lost). The rest were either settled for small amounts, dragged out until the plaintiff dropped the case, or dismissed on technical grounds (usually due to the plaintiff's difficulty in formulating the correct charging documents). What made it possible for Dun to avoid court judgment for most of its cases was an elaborate network of lawyers and an ocean of correspondence, lobbying, and monitoring for potential threats that was conducted by Dun's highly effective in-house counsel Charles Wagner.

To expand despite a hostile environment, mercantile agencies also developed additional survival tricks. They avoided giving bad grades in their printed reports since these were not protected at all. Poring through their Reference Books (which as widely-circulated documents were exposed to libel risk) one mostly finds merchants of very good, good, and fair credit. 'Limited' credit firms are rare. 'Limited' was the most pejorative rating, and the category took time to emerge. The 'limited' grade was typically used for small merchants with a capital of 500 dollars or less, making the statement hardly a libel. In other words, rather than spanning the universe of merchants, the volumes may be seen as giving lists of merchants for whom the agencies vouched. Likewise, rather than printing negative information, Notification Sheets would urge subscribers to 'call at office' where they could receive confidential information (of course, because of the evident stigma, the Notification Sheets were an invitation to libel suits).[35]

This combination of self-censorship in public statements and greater freedom of speech in private communications is quite a departure from the much-vaunted ethos of transparency. In fact the managers of mercantile agencies felt that even confidential reports entailed risk and sought to control their content to avoid alienating juries with strong language in case of a lawsuit. The result was an attempt to govern the language of reporters and is probably one reason for the rise of grades.[36] The entry 'language' in Dun's *Reporters' Manual*, first published in 1897, reads:

> It is useless to deal in strong expressions pro or con. The same impression can always be conveyed by the use of moderate language. Reporters are reminded that it is improper to use the phrase 'is a man of the strictest integrity', when it is just as easy to say 'he is reported to be a man of integrity'. The phrases 'we believe,' 'we think', and 'we understand' must never be used; it is better to say 'it is believed', 'it is thought', or 'it is understood' omitting the personality of the firm. When reports are cautionary it is very unsafe to say 'we advise caution', or 'we believe they are in trouble'. The words 'caution is deemed expedient', or 'trouble is reported' would do just as well. Etc.[37]

We are not aware of a similar document in British credit reporting. Moreover, the paper by Baker and Collins, quoted earlier, documents British bankers rejoicing over the freedom of language provided by their confidential communications.[38]

But then, if it was not differences in the legal regime that prompted the growth of US rating, and if US rating grew in a context of hostility that was not profoundly different from that

[35] Flandreau and Geisler Mesevage, 'History of Transparency' (Forthcoming 2014); See also Cohen, 'Constructing an Uncertain Economy' (2012) for evidence of managerial worries about notification sheets.
[36] Norris, *RG Dun & Co.* (1978) makes a similar conjecture.
[37] Dun and C°, *Reporter Manual* (1902), 7.
[38] Baker and Collins, 'English Financial Markets' (2012) 60. In the 1830s for instance, banker Glyn wrote to a contact at the Bank of Liverpool ''it is a great advantage to be able to communicate with you confidentially''.

prevailing in the UK, how can we explain the divergence that nonetheless occurred at that point between British and American financial architectures and the rise of rating only in the latter? Answering this question requires an exploration of British information architecture. As we proceed to argue, British credit reporting involved (unlike it US counterpart) not a unified instrument, but a set of participants that catered to different segments of the market.

## III. British Information Architecture: A Precis

We now provide a more thorough perspective on British credit reporting. Our goal is to reverse the conventional approach, and – rather than assess the British record in the light of the American invention of rating – build an understanding of American information architecture reflected in a British mirror. This will lead us to make two claims. First, we offer a more nuanced picture of the performance of TPS than the caricature found in earlier accounts. Second, and more fundamentally, we underscore the existence of a wealth of alternatives which did not exist in the US. As we proceed to show, several of them can legitimately be called ways to 'commoditize information'.

*Trade Protection Societies Redux*

The conventional picture of failing TPS requires qualification. In a recent paper, historical geographer Robert Bennet has drawn on a number of primary sources, and on the unpublished dissertation by historian of credit Neil Wood, to provide the most complete account of the subject. He underscores the rising popularity and national scope of TPSs, as well as their incorporation into a national structure of information-sharing during the 19th century.[39] Bennet documents the transition in TPSs from 'disconnected' regional societies in the early 19th century into a centrally organized National Association of Trade Protection Societies (NATPS) in the early 20th century, a process which therefore was not unlike that of the 'centralization' of mercantile reporting in the US.

The organization of TPSs into a national structure enabled the flow of information across the network and shows the degree to which the NATPS echoed the institutional form of the Mercantile Agencies – surpassing it in some respect as TPSs integrated individual consumer credit supervision into their business model. The scale of NATPS activities was by no means negligible, and growth trends, until the late 19th century, mirrored those of Mercantile Agencies.[40] It is difficult to find proper measures of comparative 'performance' given differences in business models and the limitations of sources. But a relevant benchmark for the extent of their respective coverage may be the number of branch offices the two systems established (Figure 2). The chart shows the parallel rise of Mercantile and NATPS coverage. It shows that only in the late-19th and early-20th century did a divergence in trend growth appeared.

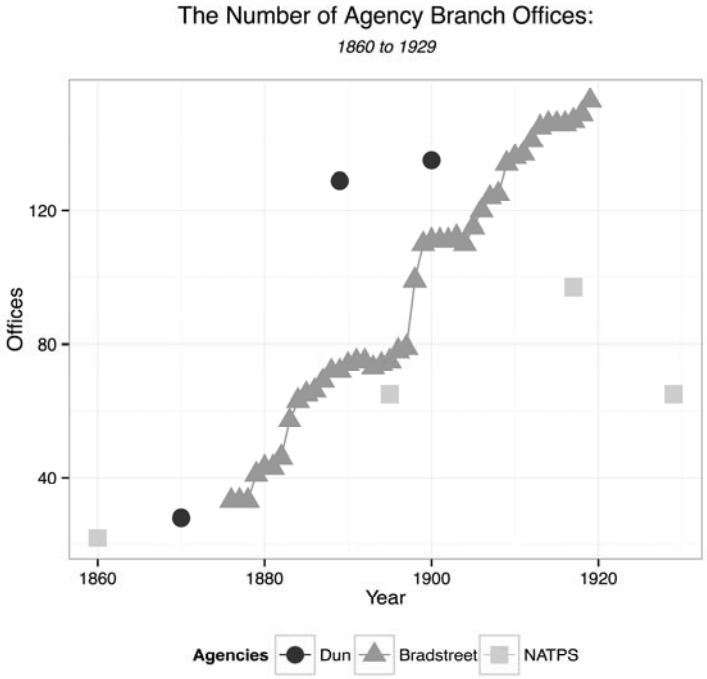
The vibrant growth experienced by NATPS until the late 19th century can be explained in referenced to the role that lawyers played in the promotion of NATPS. As Coase (1974) forcefully emphasized in the context of lighthouses, public goods need not always suffer from a problem of under provision. Since lawyers associated with TPSs were interested in collection work they saw to it that the NATPS was efficient. Efforts were made to place the managerial part of TPS under the orbit of accounting best practices (by hiring individuals connected to the

[39] Bennett, 'Supporting Trust' (2012), Wood, *Debt, Credit and Business Strategy* (1999).

[40] Bennet, ''Supporting Trust'' (2012), 132 gives details on the scope of NATPS reporting activity. In 1868 the NATPS was fielding 77,800 status enquiries a year, managing 66,000 debts, and recovered 246,000 pounds through its collection work; by 1920 this had risen to over 700,000 enquiries, 140,000 debts, and 1 million pounds recovered.

Institute of Chartered Accountants).[41] Profits were made not at the TPS level, given their association set up, but by their counsels. Also, according to Wood's study of the Leicester TPS (LTPS), the link between TPSs and the legal profession conferred status on the TPS: 'the personnel and professional connection between the law profession and the LTPS also reinforced the legitimacy of the society amongst the commercial community.'[42] Recalling that Mercantile Agencies were also closely associated with lawyers, who played an important role in promoting them, and that debt collection work was directly or indirectly an important source for funding for the Agencies', we see that part of the traditional contrast with the pro-bono TPS and the profit-oriented Mercantile Agency deserves reconsideration.[43] In both cases, the effective suppliers of information and debt collection services were profit-motivated lawyers.[44] In the end, the evidence suggests that TPSs may not have lacked a profit motive.

Figure 2.




Source: Data on Dun is from Madison, Olegario and letters in D&B Archives. Data on Bradstreet is from account statements in D&B Archives. Data on NATPS is from Bennet Table 1. (note that the chart compares NATPS with each Mercantile Agency rather than with the sum of their network, because each mercantile agency network replicated the other – a given city had typically two branch offices for Dun and for Bradstreet)

[41] The associations owned valuable information and corruption was a problem, as illustrated by the attempted suicide of the manager of the Leicester TPS (LTPS) Thomas Flavell in 1863, Wood, *Debt Credit and Business Strategy* (1999), 35.
[42] Wood, *Debt, Credit and Business Strategy* (1999), 61.
[43] This is the aspect of the business that Wood, *'Debt, Credit and Business Strategy* (1999)' emphasizes, as he views it as competing on cost with the debt recovery services offered through the local courts. See in particular pp. 43-91 and appendix 3.1. Compare also with Bennet, ''Supporting Trust'' (2012) in particular Figures 4 and 5 p. 132 for information on the amount of debt under management.
[44] See Wood, *Debt, Credit and Business Strategy* (1999), 61.

*Commercial Agencies: Baden-Powells and Sherlock Holmes of Trade*

We have shown (Figure 2) that although differences between Mercantile Agencies and TPSs have typically been exaggerated, a gap nonetheless began to appear in the late-19th century as measured by branch coverage. However, the NATPS was not the only source of credit information on offer in the UK. A number of firms specialized in bespoke credit reporting. While the history of private reporting in Britain is yet to be written, some elements are known and they draw the contours of a significant sector, whose contribution to credit reporting was recognized. In 1900, the *Daily Mail* called private credit reporting firms 'Scouts in the City' and described their work as that of the 'Baden-Powells and Sherlock Holmes of trade'. The article mentioned in particular Stubbs and Kemps,[45] although another significant house was Seyds. The latter was a firm created by Ernest Julius Seyd (1830-1881) a commercial traveller of German origin whose rating key would be 'completely copied' by Mercantile Agencies' rating codes.[46]

Stubbs, Kemps and Seyds were substantial operations. Like the American mercantile agencies, leading British credit reporters were organized by regional sub-divisions and sought to cover the territory and also provided assistance for foreign reporting. Stubbs is reported to have been operating on a large scale by the 1850s, and by 1900 it had a head office in London and 32 branch offices and 26 sub-offices across the UK. Britain also boasted a number of smaller operations that developed in symbiosis with local communities (typically, with chambers of commerce) or were spun off from the non-profit trade association model. An example is the London-based United Mercantile Agency, which operated in the second half of the 19th century.[47] This firm, which in the 1870s was run by Cooper, Craig and Craig, pledged to make 'all proper and necessary enquiries as to the mercantile status, respectability, and any person concerning whom customers might wish to have information'. For this purpose, it sold customers a 'status cheque-book' made of vouchers where they would inscribe the particulars of persons 'about whom they wished inquiries to be made'. The United Mercantile Agency then investigated and reported confidentially. It provided such information as advice on the maximum amount of safe lending.[48]

The products these credit reporters developed were not unlike those of US Mercantile Agencies. An interesting example was the creation, in 1893 of the Credit Index Company Ltd, also referred to as Seyd and Kelly's Credit Index.[49] The firm appears to have resulted from a partnership between the credit reporting firm created by Seyd, and the franchise of a leading brand of trade directories known as Kelly's Directories. Frederic Festus Kelly had been a senior official from the British Post Office and he became the author of city directories containing lists of tradesmen.[50] The firm's business model built on their complementarities, as Kelly's Directories spanned the 'universe' of firms that Seyd could investigate. Together they could thus create a valuable product and provide their own variant on the commoditization of credit reports.

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[45] Daily Mail, 7 June 1900; Quoted in Bennett, ''Supporting trust'' (2012),138.

[46] Norris, *R.G. Dun & Co.* (1978), 53.

[47] They come up in Tarling vs. Cooper, *Law Times Reports* in Errant, *The Law Relating Mercantile Agencies* (1889), 57. We found traces of the offices of a United Mercantile Agency having been located in Glasgow, 92, Vincent St. in 1878-9. A United Mercantile Agency located in London, 145 Cheapside, is mentioned in the *London Gazette* of June 13, 1884. The papers of Messrs. Winser Brothers, Grocers, Drapers and Ironmongers of Hadlow, at the Institute of Kentish Studies, hold ''Receipts for subscriptions paid by Messrs, Winser to The United Mercantile Agency, Chamber of Commerce, 145 Cheapside, London, 1875, 1877''.

[48] See Errant, *The Law Relating Mercantile Agencies* (1889), 58 for an extract of the Agency's output.

[49] British National Archive, Registry of Joint-Stock Companies, Company No: 39793; Credit Index Company Ltd. Incorporated in 1893.

[50] See Williams, *The Development and Growth of City Directories* (1913).

Around 1892, the firm made an attempt to publish directories that reported statistical information on merchants. A Mr Saunders, upon examining the book, determined that it contained inaccurate information about the state of his credit, and upon advice from his lawyer (who also solicited other clients whose names appeared in the Index) sued Seyd & Kelly on the grounds that the untrue information might be libellous and damaging to his professional interests. He asked for a 'farthing' in damages (a symbolic penalty). Interestingly, Saunders' lawyer was a crucial character not only in bringing up the lawsuit but in seeking to organize other plaintiffs, a very different outcome from what was observed in the US since Flandreau and Geisler Mesevage (2014) emphasized instead the Mercantile Agencies' ability to co-opt lawyers.[51] Arguments we develop later may explain why the legal profession and the public of rated firms reacted in such radically different ways in the two countries.

Saunder's lawyer was successful, and yet this did not kill the project but led instead to product adjustment.[52] Seyd and Kelly discontinued the printing of reports, but it turned to a new device for spreading information known as 'card indices,' an ingenious alternative to the Ratings Manuals. Card indices permitted to both avoid being sued for libel and yet benefit from industrialized distribution of reports. As described by Grieser (1940) a card index was a contract between an investor and a provider of information whereby the investor subscribed to specific data on specific firms. The manufacturer of the index could industrialize the production of cards. One only needed a sorting system that enabled the cards to be addressed to those asking for them. At the other end, investors received the updates by mail and filed them in a drawers system specially provided to the investor, facilitating reference. The legality of the card index was backed by a contract where the investor *explicitly* required information on a specified list of companies and mailing the reports ensured confidentiality.

*The Market for Acceptances*

While the previous discussion shows that there were ways to walk around the limitations of libel law, and that the differences in outcome may have had more to do with demand for law (the willingness of lawyers in Britain to litigate) than with the supply (the judges' attitude), consideration of the British information architecture also highlights the use of radically different instruments to 'commoditize' credit whose development was virtually unheard of in the US. Understanding their logic requires a detailed discussion of the securitization of commercial credits in both the UK and the US.

In the US, like in the UK, 'bills' formed the staple instrument of the short-term money market: a business-to-business credit instrument. Typically, a seller of goods drew a bill on the buyer, who 'accepted' the bill (which meant endorsing it). Then, either the creditor would keep the bill, or he would try to sell it to a third party, typically some kind of money market investor. In the latter case, the bill would then circulate from investor to investor until it was paid back. In the US, the most prevalent arrangement was the former one, where the creditor kept the bill with him. The US bill market was typically a business-to-business market as reflected by the expression 'commercial bills'. High quality commercial bills did circulate somewhat, and were traded by brokers. Evidently, in such a system, isolated agents had to worry about the quality of their debtor. They would send agents across the country to report on debtors and collect claims, or, better still, since the sending of agents was costly and involved a lot of duplication, they could

[51] Saunders vs. Seyd & Kelly's Credit Index (1896) 75 L.T. 193. The case refers (in vague language) to the index having started in 1892. But based ont he incorporation date it might have been started in 1893 or later.

[52] The British Library has only one volume (September 1894) of ''Seyd & Kelly's Credit Index'' in a Manchester and Liverpool variant (the Manchester Credit Index and the Liverpool Credit Index).

rely on the support of delegated monitors. The Mercantile Agency system was valuable to them through its provision of quick reports and monitoring of both debtors and commercial travellers.[53]

In contrast to the American arrangement, banks in Britain played a special role in supporting the development of the bill market (known in Europe as bills of exchange). In Britain, the dominant arrangement that emerged was one where banks acted as intermediaries, in effect substituting their credit for that of the debtor, and selling their signature or endorsement. This action of 'accepting' the bill amounted to banks selling their reputation, and the resulting secured bill was known as an 'acceptance'. The banks secured the bill and removed the concern of the creditor who was now provided with an insurance that the bill would be paid, one way or another. In practice, this worked as follows. The buyer instructed the seller to draw a bill on him and to have it accepted by a reputable bank, which the seller, or the seller's bank, knew. Specialized money market participants (the bill brokers and a number of money market funds) eagerly purchased the accepted bill when they recognized the signature of the accepting bank. In summary, the accepting bank in the British arrangement played the certification role of the Mercantile Agency in the US system, except that this certification took the form of an insurance pledge towards the creditor, not that of a grade with no responsibility towards the creditor (but a litigation risk with the debtor).[54]

The acceptance business was a very profitable one, because banks charged fees while immobilizing a small amount of capital, since the acceptance was just a kind of insurance policy and someone else held the bill. It was therefore sought after by those banks that had enough reputational credit to be able to securitize the bills, namely the London based elite of merchant banks and increasingly, as the century progressed, the large commercial banks with a domestic and international deposit network. The result was that a considerable amount of information regarding merchants and industrialists both in Britain and abroad was owned by institutions involved in the market for acceptances. Indeed, the existence the Acceptance system tiered information problems: the seller only needed to be informed about the quality of the Accepting bank. In contrast, the Bank itself needed to be well informed about the merchant whose bill the bank was endorsing. In short, the problem of credit assessment was concentrated within the banking system itself. Credit assessment was conducted through the banking system by having individual acceptors build strong informational profiles of their customers.[55]

*Information and the British Banking System*

To complete our comparative architecture, it is now necessary to take a deeper look at credit reporting as it was done by British banks. Indeed, one cannot help being struck by the parallel between the work of banks in Britain and the work of mercantile agencies in the US. For instance, in their study of credit allocation within the Sheffield Union Bank, Galassi and Newton describe the process of production of a de facto rating system, noting that the English Joint-Stock Bank could use its position as banker to assess the property of the client, but also relied on the Bank's directors' insider knowledge of the local business community to assess borrowers' reputation, very much in the way mercantile reporters worked. As a result, the Union Bank effectively created an internal credit rating, and this rating determined the degree of collateral any

[53] See Temin, *The Jacksonian Economy* (1969), 31 ff.

[54] There were some cases where the creditors sued the Mercantile Agency for inadequate reporting, but if we are to believe Errant, *The Law Relating to Mercantile Agencies* (1889) this liability was easily managed by the Mercantile Agencies by altering the terms of their subscriber contracts to absolve them of responsibility.

[55] Galassi and Newton, 'My Word is My Bond' (2001) especially section 1.2 ''Credit assessment in the nineteenth century''.

given client would be required to post against a bill – thus pricing the default risk. This system was analogous to a credit rating system. The numerous 'internal rating systems' that business historians keep coming across when they study British bank archives bear witness of these efforts.

The growth of commercial bank networks towards the latter part of the 19th century (a feature that was uniquely European since banking concentration did not take place in the US until the 1930s) occurred at a time when the Mercantile Agency system pulled ahead in the US and became the predominant source of credit information for all economic sectors. While the two leading American Mercantile Agencies achieved predominance and completed their coverage of the country in the 1890s, mergers and acquisition in the UK enabled banks to expand their geographical coverage. Bank network expansion, we argue, was an instrument for achieving a better coverage of credit reporting. A bank's increased scale and geographical scope enhanced the attractiveness of its information repository.[56] At the end of the day, the concentration of banking that occurred achieved the centralization of information that was taking place in the US through Mercantile Agencies. In summary, the reports which the banks made were not 'sold' in the way rating agencies commoditized their information, but it would be incorrect to assume that they were not valued. Rather than a second best, British credit reporting was a different system: Britain ended up with a few large banks, America with two gigantic Mercantile Agencies. And if we worry about the lack of competitive pressure that might have resulted from the expansion of bank networks, then what should be said of the evidently non-competitive mercantile agencies?

## IV. Financial Repression in the United States

The previous section has outlined the many substitutes to US-style mercantile credit reporting that were available the UK. Thinking of the British set-up as a second best, adopted in the absence of a Mercantile Agency, and pointing to the lesser development of TPSs as evidence of an efficiency gap as is conventionally done, overlooks the fact that information acquired by banks was chargeable, either through acceptance fees, or – as was the case for the large deposit banks that grew throughout the 19th century and expanded dramatically during the 1890s via extensive mergers – through attracting customers who were indirectly charged for getting access to this information. In what follows we reverse the conventional perspective and, rather than wondering why the UK did not develop mercantile agencies, we ask why the US did not develop acceptances and branch banking. This is a legitimate question theoretically, but also historically: around the turn of the century – in effect in the aftermath of the crisis of 1907 – a campaign developed in the US for the promotion of acceptances and the lifting of prohibitions that were perceived to prevent the growth of this market. In other words, contemporaries were under the impression that something useful existed in the UK that was missing in the US.[57]

### *Regulatory constraints*

We begin by emphasizing regulatory constraints on banks that prevented the commoditization of information through the mechanisms that were used in Britain. An obvious example is the statutes that constrained US banks, whether they operated under a National or a

[56] Nishimura, *The Decline of Inland Bills* (1971) has emphasized the substitutability between the size of banking networks and the size of the market for *domestic* acceptances. The decline of the latter in the late 19th century coincided with the consolidation of large banking networks.

[57] Jacobs, 'Bank Acceptances' (1910), Ferderer, 'Institutional Innovation' (2003), Eichengreen and Flandreau, 'The Federal Reserve' (2012).

State Charter, to at most intra-state branching. The situation persisted until the Banking Act of 1933 permitted nation-wide banking. While the existing theoretical and historical literature principally addresses this subject to determine whether geographic diversification could limit vulnerability to crises, we emphasize the fact that the lack of a nation-wide network of information constrained the ability of the banking system to document the entire territory. In other words, a little mentioned effect of restrictions to nation-wide branching was the check it put on the accumulation of credit information by banks.[58] With banks limited to branching *within* a given state, there was no way for the banking system to pursue the creation of large repositories of nation-wide financial information as they were able to eventually do in Britain. Given that British banking consolidation accelerated in the 1890s simultaneous to the accelerated growth of Mercantile Agencies above TPSs, a natural inference would be that 'missing coverage' was provided by the concomitant expansion of branching. Bank branching was not feasible for the US economy for regulatory reasons, and this explains why local banks, which by definition lacked a national network, became important customers of the mercantile agencies from whom they secured credit reports on entities located beyond their orbit.

It could still be, of course, that despite lacking a national reach, regional banks could have pooled their information to obtain national coverage. An obvious candidate for this would have been a national market for acceptances as it occurred in the British case. This might have been promoted by private banks, which were typically less regulated and could have done essentially the same thing their European peers had done for centuries, namely the origination and distribution of acceptances. The US could, in principle, have done just the same: the advantages of acceptances were perfectly understood in the US, and in the first half of the century, several bankers tried to promote their use. The most egregious attempt was that of Nicholas Biddle, who instructed the Second Bank of the United States to try and support the market for acceptances. However, Jackson's successful victory over Biddle, which conspicuously relied on anti-bank rhetoric, led to the slaying of the Bank of the United States as an American central bank. This was swiftly followed by the Second Bank's bankruptcy in 1841, the year of the creation of Tappan's Mercantile Agency.[59]

*The Impossible Market for Acceptances*

Beyond anti-bank rhetoric, the enormous obstacle that stood in the way of the development of acceptances was the fragmentation of the US legal system itself. In Europe, the law applying to bills of exchange resulted from a centuries-long evolution of the so-called Law Merchant, which had been gradually incorporated into national commercial codes. This had enabled the early integration of domestic and international money markets resulting in a striking convergence of regional interest rates in Europe. Nothing like that existed in the US, and in fact regional interest rate convergence would have to wait until after the Great Depression.[60] The Law Merchant set rules for the payment of credits, for actions in case of non-payment, and provided procedures for

[58] Calomiris, 'Is deposit insurance necessary?' (1990); Wheelock, 'Regulation and Bank Failures' (1992); The prevalent view when the Act of 1933 was adopted was that limitation of branch banking had hurt diversification, see Stratton, *The Banking Act of 1933* (2013); Empirical assessments of the counter-factual ''effects'' of branch banking on bank resilience in the Great Depression must rely on evidence from banks that diversified at the state level since there is just no example of a bank with a national network, e.g. Carlson, 'Are Branch Banks Better Survivors?' (2004).

[59] Catterall, *The Second Bank* (1903); Myers, *The New York Money Market* (1931); Hammond, *Banks and Politics in America* (1957); Ferderer, 'Institutional Innovation' (2002), 667 fn 7.

[60] Breckenridge, 'Discount Rates' (1898), Bodenhorn and Rockoff, 'Regional Interest Rates' (1992) Bodenhorn and Rockoff, 'A More Perfect Union' (1995); Flandreau et al., 'Monetary Geography' (2009).

collection. This technology was gradually embedded into pro-creditor bankruptcy procedures.[61] In such a context, it is natural that in Europe, banks were willing to underwrite private claims since they could secure swift collection of their credits. By contrast, their counterparts in the US did not have access to such a technology. In effect, a frequent pattern in 'debtor' states was one where out-of-state creditors were treated as foreign entities and given junior status. This was reflected for instance in the law regarding commercial bills drawn in one state from another state. They were 'foreign bills', thus complicating rules for collection across state jurisdictions. It is not surprising in this context that banks in New York were unwilling to sell their signature to traders from Ohio and turned instead either to local networks and family links or to the finance of long distance trade with Europe.[62]

Efforts were made by the Supreme Court to bring into being a 'dichotomy between local law and 'general' commercial jurisprudence' and promote a 'forum' of commercial order.[63] As described by Tony Freyer, a landmark decision was *Swift v. Tyson*, which came before the Supreme Court for final decision in January 1842, reflecting again the frantic search for solutions to contractual uncertainty during the period when Mercantile Agencies were invented. The *Swift* decision (which was about an out-of-state claim) ruled that 'in a country like ours, where so much communication and interchange exist between the different members of the confederacy, to preserve uniformity in the great principles of commercial law, is of much interest to the mercantile world'.[64] The decision began to take hold, albeit slowly, with diversity jurisdiction enabling creditors to rely on the Supreme Court's willingness to overrule state statutes.[65]

This might have paved the way for a subsequent development of a market in acceptances, and there are indeed traces of the partially successful efforts made by some New York firms within sub-networks of trusted customers. Unsurprisingly, the chief operators of this market were houses with European connections. For instance, in 1876, Meagher described the business done in New York by Schroders & Co (which were connected to Schroders in London) and suggested that this was a useful alternative to the Mercantile Agency system and should be promoted.[66] Other US houses with European connections included Browns, Seligmans, Morgans, or Belmonts (Rothschilds's correspondents in the US). These houses continued with the age-old tradition pioneered by Barings, who investigated themselves the credit of American merchants and then substituted their signature selling the resulting acceptances on the London market.[67] However, these networks remained focused on foreign trade and sought to concentrate information securitization in Europe where debt enforcement problems could be dealt with easily.

*Further Blows*

Continuing with the logic that had led to the dismantling of the Second Bank of the United States, policy makers and sectional interests, especially in Western States, saw to it that public

[61] One implication of this is that as far as creditor protection is concerned European countries (Continental and UK) had more in common with one another than with the US, belying the most important assumption of the legal origins view. For data supporting intra-European ''likeness'' in the 19th century, see Sgard, 'Do Legal Origins Matter?' (2006).
[62] Lamoreaux, *Insider Lending* (1994); Perkins, *Financing Anglo-American Trade* (1975)
[63] Freyer, *Forums of Order*, (1979), 81.
[64] Freyer, *Forums of Order* (1979), 90.
[65] As illustrated by two decisions in 1847 and 1856; Freyer, *Forums of Order* (1979).
[66] Meagher, *The Commercial Agency System*.(1876), 107-111 discusses the advantage of the system of credit insurance provided in New York by ''English'' houses such as J. H. Schroder as well as the house of Frühling and Goschen (which he spelt Freeling and Goshen). On Schroders in New York and their acceptance business, Roberts (1992).
[67] Hidy, *The House of Baring* (1935).

opinion was averse to European finance. Historian Bertrand Gille tells the significant episode of the visit Salomon de Rothschilds paid to the United States in 1859-60 (Salomon spoke admiringly of the 'incredible' case of Dry Good wholesalers and the 'immense scale' of their operations), which led to a poster campaign in Cincinnati. Rothschilds were accused of having come with millions to 'purchase a US President to their taste'.[68] While such political hostility already provided tight boundaries to the growth of acceptances, a further blow came in the shape of the National Banking Acts of 1863/4, which expressly prohibited national banks from selling their name, and this nipped in the bud any prospect of this market developing at the same scale as in the UK. The rationale was that bankers would misuse their rights unless prevented. Subsequent court rulings declared that the sale of acceptances was nothing but the sale of credit and thus came in contradiction with the National Banking Acts.[69] Although the Acts applied to national banks only, if we return to the British point of comparison, it is clear that a key factor in the development of the British market for acceptances in the 1850s and 1860s was the multiplication of banking vehicles involved in the origination of mercantile information and its distribution through acceptances. A large share of the new firms that joined this trade in the 1850s and 1860s were joint-stock. If private banks were insufficient to provide for a vibrant acceptances market in bank-friendly Britain, how could they possibly be sufficient in America's more hostile context? Something had to be developed to keep up with the needs of a growing economy, and private bankers alone were not able to respond.[70]

**IV. Weak Property Rights, Registries, and the Architecture of the 'Church Commercial'**

Yet all these hurdles on the supply of substitutes to mercantile reporting may have been overcome, had it not been for another compelling force that drove the demand for the services of mercantile agencies (as opposed to the demand for substitutes). In the last analysis, this is what put US financial development on a different track than its European counterparts. The force in question stemmed from the 'pro-debtor' stance of US legislation, which impeded the collection of debts and demanded a commercial solution.

Starting from what has been described as a 'humanitarian concern' with the treatment of bankrupts, American states in the early 19th century took an openly 'pro-debtor' stance and increasingly limited imprisonment for debt to cases of gross fraud, and exempted from bankruptcy many important personal effects. This feature of the US legal system struck contemporary specialists and foreign visitors alike. In the first half of the 19th century, Alexis de Tocqueville was struck by the fact that 'the Americans differ, not only from the nations of Europe, but from all the commercial nations of our time' in their 'strange indulgence shown to bankrupts'. Half a century later, Peter Earling remarked: 'Laws for the collection of debts were on the statute books, and in some States were quite severe, but as regards any benefit for the creditor they were practically dead letter… To collect by process of law from a trader in the Territorial governments of the then Wild West, was, of course, impractical from a business standpoint, if not impossible.'[71]

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[68] Gille, *Histoire de la maison Rothschild* (1967), 585-6.
[69] Nat. Bking Act § 5202. Seligman v Charlottesville Nat. Bank, 3 Hughes 647, 21 F. Cas. 1036, in 1879.
[70] For concurring views see Myers, *New York Money Market* (1931) 424 who argues that the 1863 Bank Act accounts for the non-development of the market in the latter half of the 19th century; and Ferderer, 'Institutional Innovation' (2003), 667 and especially footnote 7.
[71] Tocqueville quoted in Balleisen, *Navigating Failure* (1996); Earling, *Whom to Trust* (1889), 298. On the difficulties of debt collection see also Balleisen, *Navigating Failure* (1996), 481-482.

Modern scholars have strongly emphasized the difficulties that the US experienced in developing a national bankruptcy regime. 'Debtor' states resisted the emergence of national procedures in the same way they resisted collection of commercial debts by out-of-state creditors. Repeated attempts to introduce national bankruptcy laws were short-lived. Typically, when at last a national bankruptcy code was permanently introduced in 1898 it would be again described as favourable to debtors.[72] Comparison with Britain underscores a drastic contrast. There, creditors could easily imprison debtors falling into the category 'insolvent'. Imprisonment for debt was only officially abolished in 1869, but it persisted unofficially in the practice of holding debtors in contempt of court and jailing them on that basis.[73] Beginning in the 1840's, small debts were treated through the newly established County Court system that could compel debtors to pay. The evidence required to imprison a debtor was scant, and frequently rested upon 'hearsay evidence combined with the judge's personal attitude.'[74]

The combined effects of fragmentation and leniency evidently created further obstacles in the US for bank-led initiatives to organize a nation-wide system for monitoring debtors. Banks in the UK could rely on legal technologies to assist them, but did not have access to such instruments in the US. And the situation generated peculiar needs to which the Mercantile Agency system turned out to provide relevant solutions. As a long tradition in economics has emphasized, failures in contract enforcement can entail a failure in the ability to transact. The idea, which is associated with the work of institutional economists, is that creditors cannot trust debtors who can run away. This problem was observed in the first half of the 19th century as that of the so-called 'migratory bankrupts' failing in on jurisdiction and moving on to the next.[75] To handle this situation, the technologies developed by Mercantile Agencies provided a fix – as their motto that they both 'protected and promoted trade' emphasized. We argue that transactional hazards provided a proximate cause for the rise of Mercantile Agencies.

The difficulties in which creditors found themselves in dealing with debtors in case of failure made it particularly valuable for them to be able to select debtors *ex ante* with confidence and also to be sure that dubious behaviour would result in penalties *ex post*. In this respect, Mercantile Agencies provided a unique technology in the shape of a nation-wide registry system that enabled lenders to screen for debtors without 'social capital' or an established financial record. By creating a system of nation-wide rewards and penalties, Mercantile Agencies thus assisted creditors and debtors. This was their key value, the reason why their publications were eagerly sought after, and, ultimately, the reason for their industrial success. In sum, it is probably not coincidental that the short-lived national bankruptcy Act of 1841 was passed by Congress literally a few days after Tappan's Agency was launched.[76]

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[72] Balleisen, *Navigating Failure* (2001), 12, Coleman, *Debtors and Creditors in America* (1974), Hansen, 'Commercial Associations' (1998), 88, Skeel, *Debt's Dominion* (2001).

[73] Johnson, 'Small Debts and Economic Distress' (1993).

[74] Hoppit, *Risk and Failure* (2002), 32-37. Wood, *Debt, Credit and Business Strategy* (1999), 44, 54; Johnson, 'Small Debts and Economic Distress' (1993), 67 estimates that a debtor summoned to a County Court sometime between 1857 and 1913 had approximately a 1:100 chance of having the case decided in their favour.

[75] Balleisen, *Navigating Failure* (2001), 8.

[76] For previous statements consistent with this view, Meagher, *The Commercial Agency System* (1876); Norris, *R. G. Dunn & Co.* (1978). See also Balleisen, *Navigating Failure* (2001), 270 who argues that ''Tappan's aim [in creating the first Mercantile Agency] shared much in common with the goals behind national bankruptcy legislation''. We think this insight is central to the understanding of the success of Mercantile Agencies. Balleisen, *Navigating Failure* (2001), 146-51 offers a lucid discussion of the affinities between bankruptcy and the rise of registries. For theoretical underpinnings of the idea, the reader is directed either to the work of scholars such as Olson, *Power and Prosperity* (2000) who emphasized the importance of stability in interaction, or of Kocherlakota's suggestion that a system that

The evidence on American bankruptcy leads to a new hypothesis on the origins of rating agencies that draws on modern theories of debt enforcement in situations of weak creditors' rights. A critical intuition of this literature is the importance of repeat play and reputation accumulation in sustaining borrowers' cooperation.[77] This helps explain the added value of Mercantile Agencies in the American context. As a registry of past default, they provided valuable information that made sanctions (through the exclusion from future credit relations) feasible. In particular, with the development of the Mercantile Agency registry, it became difficult for a debtor to borrow, default, and move to another state without his reputation following him. Likewise, by indicating the amount of capital that the individual was worth and recommending a safe amount for lending (typically a small one when the individual was new to a place and had little credit yet), they helped coordinate lenders. Ratings remained imperfect predictors of bankruptcy as, in fact, inclusion in the registry merely indicated some minimal standard of reputation. In other words, and despite the impression that previous researchers have had, we argue that the information that was valuable to lenders was not the Mercantile Agencies' 'forecast', but the 'memory', which they managed.[78]

Comparing the emergence of the registry for bankrupts in the UK and US provides one illustration of the point we are making. In the UK, bankruptcy law was uniform and centralized and this served as a foundation for technologies permitting the circulation of information on failures. The initiation of bankruptcy proceedings were reported in the *Gazette* – a centralized and government supported publication that provided the official record on instances of insolvency. The production of this information, factual and matter-of-fact as it was, was not subject to libel litigation due to its 'official' character. *Gazette* notices could be reproduced in newspapers, and private publications collected and disseminated the official information it contained. By contrast, attempts at introducing a similar system in the US were delayed, as historian Edward J. Balleisen has shown.[79] Relying on state-level legislation, some registries existed but they remained local. An effort at producing a national database occurred as a response to the Federal Bankruptcy Act of 1841, which both helped with the centralization of information and conferred on bankruptcy information a public and national character. However, with the repeal of the Federal Bankruptcy Act in 1843 the prospect of such a scheme became much more remote and fraught with liability risks as it no longer entailed the reproduction of an official source. Lists of bankrupts were still produced at the city level, when a convenient and reliable source of legal information existed.[80] But if a private business was to step in and supply the required information at the national level, it would have to be prepared to shoulder the legal risks: it eventually came to the Mercantile Agencies to provide that job and deal with the lawsuits. This explains why, as may be surprising to European readers, while the key statistical source of information on bankruptcy in Britain was

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records the memory of past transactions can be seen as providing a kind of money, see 'Money is Memory' (1998). The mercantile agency system did precisely this (creating a form of money), since it enabled successful completion of local transactions in exchange for their recording it into a central registry.

[77] See Eaton and Gersowitz, 'Debt with Potential Repudiation' (1981) for a seminal contribution.

[78] Carruthers and Cohen, 'Calculability and Trust' (2010) for an attempt at correlating ''forecasts'' and ''results''. In essence, we argue that the results in Carruthers and Cohen, which point to a weak predictive power of ratings may under-estimate the true value of mercantile reporting. The point of mercantile reporting was less about the assessment as about the establishment of a track record.

[79] On the specific difficulties encountered by these attempts, see Balleisen (2001, p. 149).

[80] This was the case in New York City, Philadelphia and Pittsburgh and in some states such as Massachusetts, see Balleisen, *Navigating Failure* (2001), 149 and 151.

the quasi-official *Gazette*, the primary source for recording the same phenomenon in the US was supplied by a private business – R.G. Dun's mercantile agency.[81]

At the heart of the business of mercantile agencies, therefore, was the rise of a form of private order – substituting for the protection of the owners of capital that was supplied by the judiciary in other countries. This substitutability between formal protection of creditors and the universal registry of borrowers' behaviour, which was the essence of the Mercantile Agency system, is illustrated by a much discussed article in the *Dry Goods Record*, which argued in 1847 in favour of the repeal of *all* collection laws, since they were so inept anyway and only created havoc through their inconsistency. The argument was that in the 'absence of any legal redress for the creditor, a higher moral responsibility would be developed in the buyer by trusting entirely to his moral sense, and having it so understood'.[82]

*Hunts' Merchants' Magazine*, the mouthpiece of the mercantile community, reprinted the article and while it was careful to distance itself from such a radical proposal as the scrapping of all bankruptcy law, it nonetheless forcefully endorsed the rating of 'character' as a complement, and in effect substitute, for inadequate bankruptcy procedures. This paved the way for the journal's 'conversion' to the virtues of the Mercantile Agency and the important article it published in 1851 endorsing the system itself.[83] In the following years, the theme of replacing collection laws with reporting was echoed repeatedly in the mercantile press. For instance, in 1853, the *Magazine* reproduced again another article, this one from the *New York Evening Post*, where a writer, who claimed to have twenty years of experience in mercantile credit and a record of several million dollars lent, again argued for the repeal of laws on the collection of debt. Collection, he argued, cost too much money to be worth the merchant's while. The experience of the oldest merchants proved, he felt, 'that more money, including the value of time spent in law suits, has been expended during the past thirty years than has been recovered by the aid of collecting laws.' The surest policy was to lend on character only, and in case of problems to resort to amicable arrangements with debtors based on character: 'I have made it a rule to credit no man any more in amount than I would have done had there been no law. I have, in common with other merchants, had my share of bad debts – but have invariably compromised without a lawsuit. My aim has been to deal with men who valued character more than money.'[84] Thus the first value of the Mercantile Agency's registry: in a world where debt-collection was challenging, it provided some support by enabling traders to invest in 'character', i.e. showing good behaviour and constructing a track record, which they notarized. In our story, therefore the 'character' which the Agencies constructed was less the creation of a cultural 'norm' – as previous historians have emphasized – and more of a concrete economic solution: an enforcement technology.

Of course in the real world, since laws for the collection of debts were never repealed, they still existed, messy and dysfunctional as they were, alongside the Mercantile Agencies' attempt to bolster the security of transactions via its accumulation of information. This, however, was to provide a subsidy on which the growth of Mercantile Agencies prospered. Being located at the centre of a web of lawyers, and taking their cut from their referral of collection work, the Mercantile Agencies benefited from the complex process of debt-collection under state law. We would like to emphasize that this organic link with the legal profession was evidently essential

[81] See e.g. *Historical Statistics of the United States, Colonial Times to 1957*; Series V 1-3 ; ''Concerns in business, failure rates, and average liability per failure, 1857-1957''.
[82] ''Laws for the collection of debts'', reprinted in *Hunt's Merchants Magazine*, 17 (1847), p. 440. For previous discussion of this article, see Earling, *Whom to Trust* (1889), 298; Balleisen, *Navigating Failure* (2001), 256.
[83] ''The Mercantile Agency'', *Hunt's Merchants Magazine* (1851), 46-53.
[84] ''Of abolishing laws for the collection of debts'', *Hunt's Merchants' Magazine* (1853), vol. 28, pp. 650-1

for a business that was resolutely intent on stepping beyond the boundaries of the Law. And thus it is that, while Europe had its 'Law Merchant', the American mercantile community, which Freeman Hunt called the 'Church Commercial,' found its salvation in the morals of commerce.[85] These morals were materially bolstered by what critics described as a private 'Inquisition,' that had books, agents, and myriad lawyers, and took it upon itself to ensure that, regardless of whether doing so was legal or not, the deeds of merchants would be known to the community. The difference between their behaviour and the behaviour of their counterparts in the UK, who upheld the protections of libel law, can thus be explained by the fact that the latter could rely on effective enforcement of property rights. In sum 'transparency' in the US was the heir to weak property rights.

## V. Beyond Pangloss: Some Costs, Benefits and Future Research Directions

The previous discussion has revolved around the idea that there were different forms of informational capitalism, yet we are not arguing that all is always for the best in the best possible world. Indeed, our perspective on comparative informational architecture lends itself to both positive and normative assessments. The limited space left in this article does not allow us to fully evaluate the merits of the two systems, however, we provide in this section a brief sketch of the underlying analytical issues focusing on two aspects of the costs and benefits.

*Conventional Comparisons*

In the existing literature, the conventional approach has been to start from the contention that mercantile reporting did not exist in the UK and then to infer the economic consequences of not having such an arrangement. The suggestion is that whilst bankers in the UK acquired valuable information on debtors, they did not commoditize this information because libel law prevented them from printing the information. The information they had obtained was thus sequestered: a social loss.[86] The costs would have been felt in two ways. First, there might have been a social loss from duplication and redundancy of monitoring systems making the cost of monitoring larger than it would be in a market with Mercantile Agencies. Second, because a bank's scope of coverage may have been smaller, there might be blind spots, with small distributors not covered and small wholesalers unable to access relevant information, compared to what might be achieved under the Mercantile Agency system. This argument, taken up by Olegario, rests on a contemporary pro-Mercantile Agency literature that argued that the 'smaller [Dry Goods] houses were, of course, deficient in the knowledge necessary to their success in business, while the larger ones purchased their information at too high a cost.'[87]

But this reasoning is only valid if we assume that the hypothetical economy considered is bound to operate in the American way. In that case, the choice is between a Mercantile Agency and having each wholesale merchant create his own team of agents/credit reporters. Duplication of the reporting work at the level of each wholesaler will inevitably entail a social cost compared to relying on the service of a few large Mercantile Agencies (provided, however, that the agencies remain competitive and do not charge above marginal cost, an unlikely eventuality given the concentration of the industry and the rent-like profits). But if banks are allowed to branch widely, and they have networks, and they are able to sell acceptances, then the information they have acquired on individual debtors, while not printed in books, is nonetheless

[85] For an origin of the expression ''Church Commercial'', see Balleisen, *Navigating Failure* (2001), 99 ff. 82.
[86] Olegario, *A Culture of Credit* (2006), 72.
[87] Anonymous, ''The Mercantile Agency' ('1851), 47; See Olegario, 'Credit Reporting Agencies' (2003), 38 and 121 for a modern formulation of the argument.

commoditized, as we have argued. For instance, British contemporary banking wisdom suggested a ratio of 1 to 3 or 1 to 4 between a bank's capital and the amount of acceptances it underwrote, thus enabling it to market its information on a large scale.[88] We are sceptical therefore of previous reasoning that there was a British deadweight loss in the non-invention of rating.

*The Cost of Mercantile Capital*

As we have shown, the conventional argument about the lack of mercantile agencies in the UK is that it must have resulted in higher credit monitoring costs, both in general and in particular for smaller firms, which would have been under-documented. If true, the consequence of this should be a higher cost of mercantile capital, other things being equal, for both the best and the worst or smallest firms (the later group being more severely penalized). Evidence for smaller firms is tremendously difficult to establish because of possibly insurmountable matching problems. But a comparison of the best firms, assuming, as can be reasonably done, that they represented comparable low risks, is possible. And on this count, as financial historians who have studied British and US short term interest rates before WWI are well aware, the existing evidence points exactly to the contrary. Figure 3 documents this by showing the evolution of interest rates on the best commercial credits in the US and UK between 1850 and 1940. As can be seen, there was a large, significant, and persistent spread between the two rates until roughly the creation of the Federal Reserve in 1913, with the US rate being systematically above the one prevailing in the UK (about 250 b.p. in the 1880s and 1890s and 200 b.p. in the 1900s, or an average of 2.19 for the period before the founding of the Fed).[89]

This spread, however, cannot be directly converted into a difference in the cost of capital. The reference rate for Britain is an 'open market' rate for first class acceptances, endorsed by the best bankers and trading in Lombard Street. The reference rate for the US is a so-called 'commercial paper' rate, i.e. 'single name' drafts issued by first class (highest grade for general credit according to Mercantile Agencies) US commercial firms and traded in Wall Street. In other words, the British benchmark is essentially a 'structured product' combining a commercial debt (analogous to the US counterpart) *and* default insurance (acceptance) provided by the endorsing banker. In order to transform the British rate into a rate for 'unsecured' paper one needs to discount the acceptance fee. Acceptance fees were negotiated over the counter and depended on the risk insured. But a conservative upper bound may be inferred from data for Schroders (who was insuring US borrowers). For the period 1890-1910 revenues from acceptance fees represent about 1-1½% of the insured amount. Deducted from the 219 b.p. spread between prime US commercial paper and prime UK bills, this still leaves a 69-119 b.p. cost advantage to British mercantile capital. Whether this advantage for the best signatures disappeared for more speculative debt, making the mercantile agency system a preferable arrangement for smaller borrowers, we cannot say. But there is no clear empirical ground for such a claim, and in fact the best connoisseur of the American commercial paper market, economic historian John James, argued precisely the opposite, claiming that acceptances 'gave even small traders access to the market'.[90]

It is possible to go beyond this result and construct an estimate of the *return* from investing in a safe, short-term asset, in both countries. The 'open market' rate for first class acceptances in the

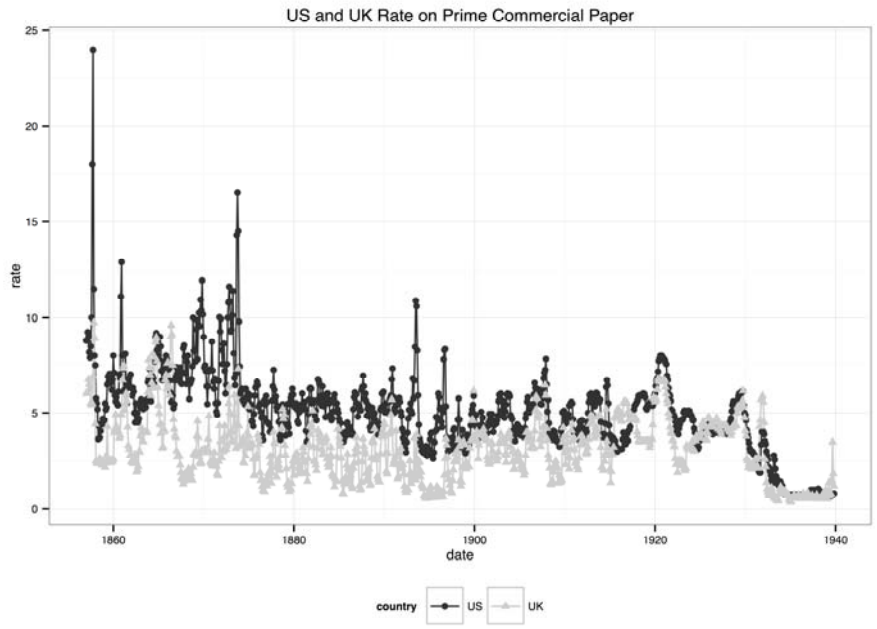
[88] Morton, *British Finance* (1979), 34. Roberts, *Schroders: Merchants and Bankers* (1992), Appendix IV gives the following acceptances/partners' capital ratios: 1861: 2.8; 1872: 3.65; 1906: 5.06.

[89] This feature has puzzled previous macro-econometric historians because it is highly unlikely that the difference is capturing macroeconomic phenomena such as exchange risk, as dollar devaluation risks only existed in some periods, see Calomiris, 'Greenback resumption and silver-risk' (1993).

[90] James, 'The Rise and Fall' (1996), 220.

UK provides exactly this, being secured by a banker. But because US commercial paper bore solely the name of the firm that had issued it, investors were exposed to idiosyncratic risk. One possibility would have been to purchase credit insurance, which existed in the US, following the patenting of the idea of by one Levy Maybaum in 1891. [91] In essence, the scheme amounted to selling credit default swaps and it was typically only offered for commercial paper enjoying the highest grades by one of the two leading Mercantile Agencies. Available data shows that mercantile credit insurance contracts came at 5% per year, a heavy charge that may be explained with respect to the fact that the business faced considerable moral hazard. Now, deducting this 5% insurance charge from the average interest on first class commercial paper essentially annihilates the returns from such an investment, perhaps explaining the preference of money market investors for repo ('calls') on the New York Stock Exchange. The high charge is a reminder of the considerable frictions that existed in the US information system. The message (which the recent sub-prime crisis re-emphasized) may be that the separation of rating and lending results in large informational diseconomies. The conventional portrait of an American financial system perfectly documented by all-knowing Mercantile Agencies must be seriously qualified.

Figure 3




**Source: NBER Historical Macroeconomic Data Series. A LOESS smoother with a 95% CI has been added.**

*Information Insensitive Securities and Financial Panics*

Another intriguing aspect of the alleged superiority of the Mercantile Agency system is that one of its proclaimed goals was the purification of financial air and the prevention of panics (the context of their creation, as we mentioned, was the crisis of 1837-9). Contemporary critics such as Meagher noted this ironically and emphasized that by its own objectives the system was a blatant failure, for violent crises had recurred with almost clockwork regularity. Britain's financial system displayed more financial resilience. Following the crisis of 1866, the country entered a long phase of financial stability, and the crises that nonetheless occurred were dealt

[91] See Flandreau, "The first weapon of mass destruction" (2012) for details on this subject .

with successfully. Can it really be that the financial system that experienced fewer crises was running on poorer information?

As we have described, while the system of credit insurance that prevailed in the UK substituted the credit of well-known banks for the credit of myriad individuals, the US set-up generated a situation where the precise quality of the bill issuer – unless it were an extremely prominent merchant – would be virtually unknown (beyond the grade and the credit report). Each bill would present a unique informational problem, requiring the careful investigation of the bill issuer's standing. A contemporary economist and student of the American system highlighted the problem, writing: 'The safety of the usual form of credit used in this country – the promissory note – depends upon the standing of the maker, varying as widely as the standing of men and industrial concerns all over the country. Obviously, then, *our commercial paper has no uniform quality or security*, and consequently the rate of discount varies as much as the standing of the borrower.'[92] In addition to this, mercantile rating was fraught with conflicts of interest – 'the recklessness of statement' as Meagher called it.[93]

In contrast, British bills that had been endorsed by major banks were uniform instruments. Moreover, given that they had pledged their own money in case of default, banks had more incentive to devote resources to information acquisition. In the language of Meagher (who emphasized the statement himself), '*the information on which risks are taken is collected by the risk-taker, and preserved by him from outside parties as his permanent capital*'.[94] Thus, it is logical that financial distress in the UK did not cause the same frantic search for idiosyncratic information that it did in the US, because the guarantee from a well-known bank was understood to provide a hedge. Compared to commercial paper in the US, British prime bills in the open market were, to use the expression recently coined by economist Gary Gorton 'informationally insensitive.'[95] We also speculate that this set up facilitated the development of lending of last resort, enabling the Bank of England to provide liquidity support during crises and relying for this on the due diligence of the banking system, which had 'skin in the game.'[96]

Nothing that orderly took place in the US. Contemporaries realized that periods of monetary stringency triggered scrambles for information and rightly felt that credit insurance was the solution out of the conundrum. Despite repeated schemes, efforts and proposals (going back at least to 1837), credit insurance never developed to any significant extent.[97] The idea surfaced again with Meagher's 'Commercial Assurance' scheme (Meagher 1876).[98] The Maybaum scheme in the later part of the 19th century was yet another attempt, but its success was partial at

[92] Laughlin, *Banking Reform* (1912), 92, our italics. A similar statement is found in Jacobs, 'Bank Acceptances' (1910), 5: ''In the case of our promissory notes or commercial paper there is no [uniformity of security], the strength of the paper depending on the standing of miscellaneous mercantile and industrial concerns.''

[93] *Commercial Agency System* (1876), 108.

[94] Meagher, *Commercial Agency System* (1876), 108.

[95] Gorton, *Slapped by the Invisible Hand* (2012).

[96] Flandreau and Ugolini 'Where is all began' (2013).

[97] In 1837, an early scheme was William L. Haskins' ''Guaranty Company'' conceived to relieve merchants from the doldrums of depression. The Guaranty Company would ensure payment of creditors and then take care of collecting debts from defaulters. From the booklet published by Haskins, *Considerations on the Project* (1837) the Company dealt with moral hazard by asking purchasers of insurance for a collateral deposit and this really makes of the Haskins scheme a forerunner of central banking. See Morgan, 'The History and Economics of Suretyship' (1927) for a discussion of the legal underpinnings of the Haskins proposal.

[98] Meagher, *The Commercial Agency System* (1876), 107-111. Meagher conceived it as replacement of the Mercantile Agencies. This essentially meant reinventing the acceptance business as Meagher appears to have understood (although he called it ''commercial assurance or guarantee of business risks').

best as illustrated by the fact that only a few firms operated in this market and insurance premia remained high.

Finally, following the crisis of 1907, with which this story ends, some prominent financiers and US policy-makers began advocating the creation of a market in acceptances modelled on the British set-up.[99] We are not aware of British policy makers having, at the same date, advocated the creation of Mercantile Agencies. In conclusion, beyond political opposition to central banking, it remains an open question as to whether the US economy could have safely evolved a lender of last resort function on the basis of the mercantile agency system. We doubt it could. If a large-scale credit insurance scheme had been developed and had relied on mercantile agencies, it would have exposed itself to enormous moral hazard, as the sub-prime crisis reminds us. In an age when massive government bail-outs were not yet a political option, rating agency based credit insurance was a non-starter.

**Conclusions**

Previous students have told the history of 19th century comparative financial development in the UK and US as one of the absent rating agency (in the UK). Instead we have told it as one of the absent market for acceptances (in the US). Proceeding that way leads one to emphasize the role of banks and their insurance function in Britain, contributing to the creation of 'information insensitive' securities. Britain's informational architecture removed the problem of credit assessment from the individual merchant and placed it within the banking system. This was made possible by the acceptance, a form of credit insurance completely legal within the English system but not so in the US. English banks priced the acceptance on the basis of their credit assessment of the person on whom the bill was drawn. The resulting product was then distributed according to the value of the bank's own signature. In turn, the origination of acceptances was facilitated by a bankruptcy regime that made it possible for banks to realize a return on the assets of bankrupt individuals. Nothing like that existed in the US, a feature that surprised generations of European visitors who instead admired the amazing development of the Dry Good trade and rightly recognized the role that Mercantile Agencies played in this development. This underscores the parallels that exist between the commoditization of information through acceptances (Europe) and through reporting by Mercantile Agencies (United States). Both commoditization processes were tied to the respective information systems, and both were remarkable in more than one way.

Political factors, on which future research should concentrate, did the rest: one reason why the US ended up with Mercantile Agencies is because of the hostility towards banking, which prevented acceptances from taking hold beyond the narrow perimeter of private banking, New York and the finance of trade with Europe. Mercantile Agencies succeeded, not because they innovated, but because they recreated the information function of banks outside the banking system. This does not detract from their admirable features, but it suggests that the 'separation of information and lending,' which they achieved, was really governed by the general architecture of US capitalism, itself a product of politics and regulation. It is in politics and regulation that the origins of the pro-debtor stance of US capitalism can be found: hostility to banks and 'foreigners' (the archetypical creditors) led to the weakening of bankruptcy law and made the process of collection difficult.

In this vacuum the business of mercantile reporting took hold and prospered, offering a reduction of transaction costs. Local lawyers found affiliation to one of the two reporting titans extremely valuable, and so did commercial and industrial creditors who found in this institution a technology (the only technology) to secure improved collection and track errant debtors across

[99] Jacobs, 'Bank Acceptances' (1910).

time and territory. This novel interpretation of Mercantile Agencies as national instruments for managing creditor-debtor relations offers a way of reconciling the modern literature with its emphasis on the positive contributions of the Mercantile Agency system, and contemporary criticism, which likened the Mercantile Agencies to a private Inquisition. As godfathers of US capitalism, Bradstreet and R.G. Dun could be alternately and aptly described as ruthless, violent firms solely interested in extortion, and as the benevolent providers of order. The previous business history literature has favoured the second part of the narrative. We suggest both parts are equally valid. The last word goes to Gould and Lowentin: "One must not confuse the fact that a structure is used in some way… with the primary evolutionary reason for its existence and conformation".[100]

[100] Gould and Lewontin, "The Spandrels of San Marco," p. 590.

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