

**A COMPARATIVE APPROACH TO  
CAPITAL MARKETS, NON-BANK INTERMEDIARIES, INFORMATION AND TRUST**

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*NOTE TO KIND READERS : this was originally written as a short position paper to frame a series of workshops on financial intermediation. It has evolved into a longer positioning paper/framework for potential contributors to a special issue journal/edited volume.*

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## INTRODUCTION

The question of how different intermediaries contribute in different capital markets has concerned us for quite some time. This concern was explored in two workshops in 2010 and 2012 (in Utrecht and Riverside, CA respectively) on intermediation & information in capital markets. The papers presented at these workshops demonstrated that even in comparative contexts where we could observe lags in institutional development, we saw comparable behavior among economic actors. The shopkeeper in the Argentine pampas created credit histories in his ledgers in ways that would be completely familiar to a personal banker today, or in 18<sup>th</sup> century Antwerp.

The workshops also brought to light underlying questions and concerns about inequality – inequality of wealth, development, access to education, health, social mobility that underlie the differences among the societies and countries we were reading about. This led us to continue to explore the role that intermediaries played in generating or reducing these inequalities. If capital markets are important to development, then understanding the role, function and differences among the financial intermediaries that preceded banks would also shed light on the how and why of some of these inequalities.

At the heart of our exploration is a concern with the mechanisms of development in all societies and the determinants that make societies behave differently, or grow and develop in a specific way. Some historians, anthropologists and other colleagues in the Humanities have

termed these particularities ‘cultural determinants’, and the concept of ‘culture’ has also been adopted by economists when explanations for why societies differ, or why not every country chooses to invest in education, or why corruption seems to be so rampant in others become impossible to model. Acemoglu and Robinson<sup>1</sup> and Timur Kuran<sup>2</sup> provide recent examples of the sometimes persuasive, sometimes deeply flawed assumptions that are made in order to explain the differences between societies and economies.

Our starting point is a bit different – we start from the premise that most people and economic actors will respond in similar ways to social and market conditions – the differences in the outcomes have more to do with circumstances and local conditions than with cultural determinants. We also start from the premise that an assumed absence of market mechanisms or institutions needs to be second-guessed. The absence of banks in Mexico in the 19<sup>th</sup> century did not mean there was no credit. Similarly, the official prohibition of interest rates in the Muslim world did not preclude loans or trade. The institutions some scholars assume must exist for a certain type of economic growth to happen, and which in their presumed absence become the explanation for a lack of economic growth - are often in existence, they just look different.

This leads us to another pillar/constraint of this work: comparisons between systems cannot measure outcome in a comparable way, for example - assessing the contribution to growth of Mexican notaries in the 19<sup>th</sup> century is not be comparable to an assessment of the contribution of Lombardy money lenders in 13<sup>th</sup> century Flanders.

However, comparable entities forces a narrow definition of comparative history and comparative growth, and our goal is to find a way in which we can explore points of comparison that contribute to developing a super structure, or an exoskeleton, that allows a productive comparative view. The best example to date is Rosenthal and Wong’s “Before and Beyond Divergence” model<sup>3</sup>. Their comparison of China and Europe is rooted in a deeper concern for what it is that makes societies do what they do, and what they have done. For example, how did these two societies deal with problems and constraints? What explains the

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<sup>1</sup> Acemoglu & Robinson, 2005 & 2012

<sup>2</sup> Timur Kuran, 2012

<sup>3</sup> Rosenthal & Wong, 2011

great inequalities of the world, and how can we approach these problems by looking at lags in institutional development and reactions to sudden economic change?

Their book articulates the conceptual model we are trying to develop. In their view, European industrialization could be reinterpreted as an institutional response to capital deepening. Demographic control cannot simply be defined as population policies and birth control technologies, but it needs to include infanticide. Infanticide is not a cultural marker, it is a response to an institutional prerogative. Similarly, the definition of rent-seeking, which is so often attributed to capitalist behavior, also extends to communist party leaders and municipal officials who continuously engage in rent seeking – there it is called corruption, but essentially it is the same thing. In this light, where to with the cultural division between soviet (or contemporary) Russia, Confucian China and 21<sup>st</sup> century Mexico or the US?

So, in order to work out a feasible comparative exoskeleton, we need to identify the elements that are conceptually coherent and empirically plausible in both or all places. Rosenthal and Wong do this by focusing on the political system: not the traditional difference between autocracy and democracy (as Acemoglu & Robinson do) but on the way the system deals with responsibilities - like the cost of war. Rulers will either tax judiciously or they will tax punishingly. They will either be frugal or excessive. They will either exist in a system that constrains them and reduces incentive for nefarious behavior, or they will not. In which case, they will either create the conditions of their overthrow or not. The conceptual heart of the book is that there is no one institutional recipe for growth. There are a mix of institutions that affect growth and no single proportion of optimal informal to formal institutions to guarantee it.

Institutions, and by that we mean the North-ian definition of institutions<sup>4</sup>, gets us closer to an answer about the difference among societies and across time that does not rely on facile explanation (like culture or homogeneity). Instead, it identifies incentives and norms in society that have contributed to making things so for a long time – culture in this sense may just be the habit of responding to certain incentives even after those incentives are no longer visible.

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<sup>4</sup> North, 1990

Another earlier example of thinking institutionally is Ken Sokoloff and Stanley Engerman operationalized work exploring the lack of focus on public education in Latin America. They identified that this had much to do with the political composition of the early independent republics. Where the homogeneity among the ruling class in a very heterogeneous society did not translate into education being seen as a public good worthy of investment for the majority or for the poor (or both)<sup>5</sup>.

In that same way, Sokoloff & Engermann explained that the prevalence of slavery in Brazil and the Caribbean had everything to do with the agricultural and climatic endowments of the region that favored large scale plantation crops – it was not a cultural predisposition towards inhumane treatment, it was an economic incentive that conflated into a despicable more.

So – back to our general question: how do these differences in political, historical, social and physical context affect how credit market develop? How do economies generate credit, confer trust, transfer credit and reputation across time, across generations, across people and across distances?

#### NON-BANK FINANCIAL INTERMEDIARIES AND THE ROLE OF INFORMATION AND TRUST

In order to have some sense of coherence about what we are talking about, and some hope of empirical comparisons, we have work towards a definition of what we mean by non-bank financial intermediaries and what we mean when we talk about their role. Notaries are highly represented among our research group, but they are by no means the primary or preferred intermediary. But in the context of the French, Dutch or Mexican credit markets, notaries happen to perform an intermediary role that is critical. Who else performs this role elsewhere? When do notaries, nuns, innkeepers, shopkeepers, brokers do what they do?

Without information, our intermediaries, or any intermediaries, wouldn't have anything to do. Intermediaries are hubs of information, they are the spoke and the wheel and sometimes even the bicycle. In more concrete terms, the traffic and management of information that intermediaries oversee is at the root of the market we are talking about. Understanding this flow of information, the incentives that lubricate it, the obstacles that impede it and the people

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<sup>5</sup> Sokoloff & Engermann, in Haber, 1997.

that manage it – that is one of the elements we would like to focus on. Because we know that intermediaries exist almost in every circumstance and we know they provide a myriad of services in different contexts with different outcomes – the context, circumstances and outcomes are different, but what of the information flow that supports any of these interactions? Is it different in all these cases? If so, does that difference matter? How can we model these flows to better understand the role of intermediaries in developing economies?

The foremost role of an intermediary is to aid in a transaction between two actors. Some intermediaries are mere matchmakers who aid in the relationship between two actors, and as is the case of notaries, formulate the contract that binds them without necessarily being part to that contract. Other intermediaries, like present-day brokers, are responsible for the fulfillment of the contract. Either way, intermediaries add value to the transaction, but their existence also raises another issue: would the transaction have happened without the intermediary? These two issues – the added value of the intermediary and the necessity of the intermediary - are intrinsic to the existence of the intermediary.

Here the function of intermediaries as conveyors of trust and legitimacy might bear on one aspect of the explanation of their role and function. Intermediaries have access to information and they manage and distribute this information, but they are also, usually, imbued with trust. Intermediaries act on behalf of multiple parties to a transaction because these parties trust the intermediary. In fact, perhaps the most important task of financial intermediaries is not simply that of the acquisition and distribution of information, but that of safe-keeping of information.

Trust is key to intermediation. Intermediaries may manage other people's money, sometimes they will also use their own money, but in the role of intermediary, they are first and foremost concerned with having and using the correct information about their clients. Whether we look at intermediaries in seventeenth century Amsterdam or nineteenth century Yucatan – the analytically relevant questions that need to be explored are 1) how do different intermediaries (in different regions and time periods) acquire and distribute the information, 2) how do intermediaries confer and preserve trust and 3) how are these differences reflected in the institutional structure in which they operate.

CAPITAL MARKETS AND INTERMEDIATION: THE FORMAL AND THE INFORMAL

Capital markets are a locus of intermediation, especially in markets where banks do not exist, and capital markets are the core of our focus. Banks as we know them today integrate a host of intermediary functions, which prior to the existence of banks, were fulfilled by other financial intermediaries. As such, banks are a relatively recent innovation, and for the better part of human history, banks were not the most important or relevant financial intermediaries<sup>6</sup>. Even in our contemporary context, banks may still not be the most important financial intermediaries, especially in remote or less developed parts of the world, or better-developed parts of the world where foreclosures and bankruptcies marginalize borrowers from formal bank credit. The absence of bank credit creates incentives for lenders and borrowers to interact via non-bank intermediaries, such as payday lenders, rotating savings associations or micro-finance companies, or in extremis, loan sharks and pawnshops<sup>7</sup>.

Historically, non-bank intermediaries have been very important in capital markets. Merchant credit, personal loans and store credit constitute but a small number of the financial intermediaries that predate banks, and wherever we look in history we find financial intermediaries aiding in transactions before banks ever existed. Worlds without banks are therefore not necessarily worlds without credit. The relevance of non-bank financial intermediaries and how they did what they did – both today and in history – motivates this project.

It is crucial to this project that we be able to compare results across time and space. By this we do not mean that we want to deflate every currency or measurement, but we want to remain aware of the opportunities warranted by the data when we can express certain transitions and realities in terms that are relevant across regional or temporal divides. This is the most challenging of the tasks, and yet we need to at the very least, note our desire to express the size and relevance of the Dutch credit market in terms that will resonate in Argentina, and vice versa for example.

As this comparative work will demonstrate, the fundamental problems that intermediaries helped solve were identical across time and place, another reason we will emphasize comparability. We want to understand how the different local contexts shaped the outcomes,

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<sup>6</sup> The Genoese Bank of Saint George was founded in 1407 and is one of the oldest chartered banks in the world. Thomas A. Kirk, *Genoa and the Sea: Policy and Power in an Early Modern Maritime Republic, 1559-1684* (Baltimore, 2005).

<sup>7</sup> Muhammad Yunus, *Banker to the poor. Micro lending and the battle against world poverty* (New York, 1999).

and to do this we will transcend the case-study level and develop a clear framework in which similarities and differences will be formalized.

Another issue we want to highlight is that it is not always straightforward to recognize informal or traditional financial intermediaries. While some intermediaries self-identify as such – for example, a seventeenth century Dutch broker would recognize his function as provider of a financial service – others, such as notaries, were not at the origin trained to do be financial intermediaries. In this same vein, innkeepers who provided hospitality services in Amsterdam during the seventeenth and eighteenth centuries acted as financial intermediaries under circumstances that may not have been easy to detect, but are essential to identify. Both the notaries and the innkeepers and many other intermediaries we will discuss here had privileged access to information and they had privileged networks of information dissemination. In some places the markets these “traditional” intermediaries serviced were even quite large. In eighteenth-century Paris, for example, notaries were the most important financial intermediaries, and in rural France, they continued playing this role through the nineteenth century. The same is true in Mexico, which did not have banks or a stock market until the late nineteenth century, but did have an active credit market operated out of the office of notaries.

The solutions, institutions and markets these intermediaries created and supported can be re-contextualized outside of their historical and regional context: they were all responding to demands that the law and the social expectations of their original function allowed them to do. For example – the Dutch innkeepers would not have thought of themselves as credit intermediaries or providers, nor would the Dutch East Indian Company think of itself as a small loan guarantor. And yet, when potential Company employees ran up debts with inns while awaiting the departure of their ship, the inn keepers became lenders and the contracts issued on the back of their employment contract with the company, made the payroll office of the Company part of the transaction. The Mexican notaries were like the inn-keepers and the Company, in a position of trust and responsibility, with the added effect of reputation and connections. Notaries connected borrowers with other lenders – unlike innkeepers, they did not have a their clients under their roofs, nor would their clients travel to the end of the world and probably die. Notaries had mostly local clients with average life-expectancies. These different conditions led to the difference in systems. There is no effect of religion or culture at play here – it is all fairly transparent and obvious.

In a similarly detached and ahistorical way, we can summarize the demand for financial services, and the problems faced in financial market by individual actors as:

1. search costs (i.e. finding the suitable counterparty to a transaction),
2. information costs (i.e. determining an adequate price) and
3. transaction costs (i.e. contracting and enforcing the terms of the transactions).

Financial intermediaries – whether personal or institutional – have always solved these three information problems, which are at the root of the asymmetry issues in credit transactions. As such, financial intermediaries performed the five basic functions that banks currently dominate: they mobilized savings; allocated resources; exerted corporate control; facilitated risk management; and they eased the trading of goods, services and contracts<sup>8</sup>. Banks internalize all these functions today, but financial intermediaries performed these functions historically.

Our task then is to identify the financial intermediaries that provided one or a combination of these services, and develop an understanding of how intermediaries became intermediaries, and what circumstances – be they legal, political, economic or simply accidental – put them in a position to provide intermediation service. Who were the people who solved asymmetric information problems, bridged legal and geographic obstacles and embodied the trust that may otherwise be lacking between parties? Which services did they provide? What did they have in common with each other? What overarching incentives and mechanisms drove their participation in markets? How and why did these services change or develop over time? The type of government (absolute or representative) and religion (e.g. Christian or Muslim), the legal context (e.g. common law, Roman law, Shari' a), and economic function, level of urbanization, ethnic homogeneity and wealth inequality are all variables that were of key to how this intermediation functioned and how intermediaries arose in a given place at a given time.

Last but not least: the alleged absence of widespread economic growth during the pre-bank period poses questions about the efficacy of these “traditional” intermediaries – this has undoubtedly been one of the greatest obstacles to studying non-bank financial intermediaries

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<sup>8</sup> Ross Levine, ‘Financial Development and Economic Growth: Views and Agenda’, in: *Journal of Economic Literature* 35 (1997), 688-726, there 690-691.



in the context of financial development. But there is increasing evidence that non-bank financial intermediaries could mobilize significant capital, and we want to explore the extent to which they facilitated the financing of growth-generating projects or conspicuous consumption (or both). Understanding the interplay between intermediaries and the economy is crucial as it is an almost undisputed fact that well-functioning capital markets help generate and support economic development<sup>9</sup>.

#### TRUST, INFORMATION AND NOTARIES

Asymmetric information in contracting produces an imbalance of power, and this can lead to adverse selection and/or moral hazard problems, all of which are obstacles to market interaction. Even a lender and a borrower who agree to a loan contract still have basic conflicting interests. The lender's need to be repaid and reduce the risk of default may be in exact opposition to the borrower's need to get a loan and hide his history of bad debts or the existence of outstanding loans. The lender's need for information about a borrower and the borrower's need to withhold details about his credit history is the essence of asymmetric information. Similarly, the borrower may wish to reveal positive aspects of the credit history or the quality of the collateral, which the lender may not have had access to or may disbelieve. The disparities caused by asymmetric information and the risks associated with them can be at least partly resolved through intermediation by a third party who is privy to details about each party or the commodity in question. As a prerequisite to bridging the information gap, the intermediary needs to have had access to better or more information and have the trust of his clients. If we want to understand intermediaries, it is essential that we understand how intermediaries were able to collect information and establish trust.

There are multiple ways to create trust. Trust is a social asset, one that is gained by multiple positive interactions. Kinship is one of the easiest and most obvious mechanisms of trust, and it can be expanded by including close friends who by virtue of familiarity and repeated multiple interactions have become ingrained in the extended kinship network. Naomi Lamoreaux's analysis of the early days of pre-banking in the US demonstrates how investment groups attracted capital because their depositors were aware that the principals of

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<sup>9</sup> Levine, 'Financial Development', 703-720.

the investment groups would only lend to people they knew personally and trusted. These investment groups lent significant amounts of deposits to themselves, and they were not reviled for essentially practicing insider lending. On the contrary, lenders trusted that people inside the network were much more creditworthy than anyone outside of it<sup>10</sup>. In the US, the screening mechanism allowed a process that eventually led to the development of banks, although we can imagine many cases in which this kind of screening mechanism would limit the scope of the credit network (as has often been suggested is the case for interlocking directorates where crony capitalism is the norm)<sup>11</sup>.

The intermediary needs to embody trust, and reputational mechanisms are key in this area. An impeccable reputation – and the wish to maintain it – gave some banking houses (e.g. Hope in eighteenth-century Amsterdam and Rothschild in nineteenth-century London) an advantage over others.<sup>12</sup> In cases where an intermediary had not yet attained an impeccable reputation creditors were keen to include control mechanisms. The rise of English deposit-banks during the seventeenth and eighteenth centuries illustrates this. By only dealing with a banker with whom one also had non-financial contacts (e.g. family, political friend, co-parishioner), depositors made sure that the banker carefully screened his borrowers. The social consequences – on top of the financial costs – of not carefully screening clients compelled the banker to pick the best borrowers.<sup>13</sup> Again familiarity, knowledge and information – this time

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<sup>10</sup> Naomi Lamoreaux, *Insider Lending: Banks, Personal Connections and Economic Development in Industrial New England* (Cambridge, 1996).

<sup>11</sup> Steven Haber argues both that interlocking directorates allow for credible commitments between private capital and governments, and that these arrangements support the development of crony capitalism, where growth is fostered but not distributed. See Stephen H. Haber, *Industry and Underdevelopment: The Industrialization of Mexico, 1890-1940* (Stanford, 1989); Stephen H. Haber, Armando Razo and Noel Maurer, *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876-1929* (Cambridge, 2003).

<sup>12</sup> Marten G. Buist, *At spes non fracta. Hope & Co. 1770-1815. Merchant bankers and diplomats at work* (The Hague, 1974); Marc Flandreau and Juan H. Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820-1830', in: *The Journal of Economic History* 69 (2009), 646-684; M. Flandreau, J.H. Flores, N. Gaillard and S. Nieto-Parra, 'The End of Gatekeeping: Underwriters and the Quality of Sovereign Bond Markets: 1815-2007', in: *CEB working paper* 10/017 (July 2009).

<sup>13</sup> Also note that since these early deposit banks were not limited liability companies, bankers also had an additional incentive to carefully screen borrowers. See Margaret Gay Davies, 'Country Gentry and Payments to London, 1650-1714', in: *The Economic History Review* 24 (1971), 15-36; J. Keith Horsefield, 'The "Stop of the Exchequer" Revisited', in: *The Economic History Review* 35 (1982), 511-528; D.M. Joslin, 'London Private Bankers, 1720-1785', in: *The Economic History Review* 7 (1954), 167-186; Anne Laurence, 'The Emergence of a Private Clientele for Banks in the Early Eighteenth Century: Hoare's Bank and Some Women Customers', in: *The Economic History Review* 61 (2008), 565-586; Frank T. Melton, *Sir Robert Clayton and the Origins of English Deposit Banking, 1658-1685* (Cambridge, 1986); Stephen Quinn, 'Goldsmith-Banking: Mutual Acceptance and Interbank Clearing in Restoration London', in: *Explorations in Economic History* 34 (1997), 411-432; Peter Temin and Hans-Joachim Voth, 'Riding the South Sea Bubble', in: *The American Economic Review* 94 (2004), 1654-1668; Idem, 'Credit Rationing and Crowding Out during the Industrial Revolution: Evidence from Hoare's Bank, 1702-1862', in: *Exploration in Economic History* 42 (2005), 325-348; Idem,

between depositors and intermediary – created a network, but one of which the reach may have been restricted.

Besides these private solutions, public institutions can also provide trust. The office of the notary was recognized by Roman and Napoleonic code legal regimes as the civil pillar of society. Notarial deeds in these regimes constituted unquestioned legal proof of legitimacy, and the ability of the notary to draw up such documents generated the trust with the public. This trust became an asset to the notary who could subsequently use it to act as an intermediary. In fact, notaries are a very good example of a pre-bank financial intermediary.<sup>14</sup>

Notaries could act as such not only because of the legitimacy of their recorded contracts, but because by virtue of their civil obligations they also possessed valuable information about the society in which they operated. They gathered this information in the course of their daily duties. The staple of a notary's daily business included wills and guardianships, marriage contracts, transfers of bonds, land sales and mortgages. All these contracts provided them with significant amounts of information about their clients, their potential client base and market conditions – information that was central to their relationship with those that they provided their intermediary services to.

For example, the notaries that recorded the lending transactions of eighteenth-century Peruvian convents – who lent out the dowries of their members at interest – knew with great accuracy when these loans would mature. When those loans were repaid, there would often be requests from potential new borrowers – and the ones with the timeliest information obviously had better chances of being lent the money. The notary that had drawn up the initial loan contract could counsel his trustworthy clients about the moment at which to approach the

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<sup>14</sup> 'Banking as an Emerging Technology: Hoare's Bank, 1702-1742', in: *Financial History Review* 13 (2006), 149-178; Idem, 'Interest Rate Restrictions in a Natural Experiment: Loan Allocation and the Change in the Usury Law in 1714', in: *The Economic Journal* 118 (2008), 743-758; Idem, 'Private Borrowing during the Financial Revolution: Hoare's Bank and its Customers, 1702-24', in: *The Economic History Review* 61 (2008), 541-564.

<sup>14</sup> On this topic, see: Philip T. Hoffman, Gilles Postel-Vinay and Jean-Laurent Rosenthal, 'What do Notaries do? Overcoming Asymmetric Information in Financial Markets: The Case of Paris, 1751', in: *Journal of Institutional and Theoretical Economics* 154 (1998), 499-530; Idem, 'Information and Economic History: How the Credit Market in Old Regime Paris Forces Us to Rethink the Transition to Capitalism', in: *The American Historical Review* 104:1 (1999), 69-94; Idem, *Priceless Markets. The Political Economy of Credit in Paris, 1660-1870* (Chicago, 2000); Juliette Levy, 'The Marriage Penalty: Women, Property Rights, and Credit Markets in Yucatán, 1850 – 1900', in: *Hispanic American Historical Review* 88 (2008), 427-454; Idem, 'Financial intermediation before banks: notaries as handmaidens of finance in nineteenth century Yucatan', in: *Business History Review* (2010; forthcoming); Juliette Levy (2011; forthcoming).

convent and could vouch for that client to the convent.<sup>15</sup> Whether it was in Cuzco, in eighteenth-century Paris<sup>16</sup> or nineteenth-century Mexico<sup>17</sup>, information was the notary's main asset, and it was also the most important currency in their client interactions. It is therefore not surprising that notaries in The Netherlands often used to sell their protocols – the documents that embodied this information – to the notary that would take over their office<sup>18</sup>.

One thing to keep in mind is that many civil servants were called notaries, but that not all of them did the same thing and that notaries did not behave similarly everywhere. In Dutch towns for example, the average notarial office was much smaller than those in eighteenth century Paris. The information base that notaries could dispose off was therefore also much smaller, and this obviously affected their ability to operate as intermediaries.<sup>19</sup> This not only begs the question why people registered so many contracts in Paris – or so few in the Netherlands – but also who then provided this service in the Netherlands? We should also not confuse the Roman law notaries with the notaries in common law countries (like England and the US) where witnessing the signing of legal documents and administering oaths was about all notaries were allowed to do. Intermediation would develop differently in England since notaries did not have the broad contractual and recording role seen in Roman law countries. In England scriveners and attorneys played the role of intermediary, and between the two of them they managed the information and legal experience that in Roman law countries was the purview of notaries. This information was acquired, amongst others, by their ability to trace title in the complex network of English courts and to accurately assess the value of land through conveyancing.<sup>20</sup>

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<sup>15</sup> Kathryn Burns, *Colonial Habits: Convents and the Spiritual Economy of Cuzco, Peru* (Durham, 1999).

<sup>16</sup> Hoffman, Postel-Vinay and Rosenthal, 'What do Notaries do?'; Idem, 'Information and Economic History'; Idem, *Priceless Markets*.

<sup>17</sup> Levy, 'The Marriage Penalty'; Idem, 'Financial intermediation'.

<sup>18</sup> Christiaan van Bochove (work in progress).

<sup>19</sup> Christiaan van Bochove (work in progress).

<sup>20</sup> See B.L. Anderson, 'Provincial Aspects of the Financial Revolution of the Eighteenth Century', in: *Business History* 11 (1969), 11-22; B.L. Anderson, 'The Attorney and the Early Capital Market in Lancashire', in: François Crouzet (ed.), *Capital Formation in the Industrial Revolution* (London, 1972), 223-255; C.W. Brooks, R.H. Helmholtz and P.G. Stein, *Notaries Public in England since the Reformation* (Norwich, 1991); D.C. Coleman, 'London Scriveners and the Estate Market in the Later Seventeenth Century', in: *The Economic History Review* 4 (1951), 221-230; Peter Mathias, 'The Lawyer as Businessman in Eighteenth-Century England', in: D.C. Coleman and Peter Mathias (eds.), *Enterprise and History: Essays in Honour of Charles Wilson* (Cambridge, 1984), 151-167; Melton, *Sir Robert Clayton*; M. Miles, 'The Money Market in the Early Industrial Revolution: The Evidence from West Riding Attorneys', in: *Business History* 23 (1981), 127-146; Albert J. Schmidt, 'The Country Attorney in Late Eighteenth-Century England: Benjamin Smith of Horbling', in: *Law and History Review* 8 (1990), 237-271.

The key issue then, when thinking about the role that intermediaries play is to identify the means and mechanisms by which they 1) create trust and 2) acquire information. In some cases, the information will lead to the trust (as in the case of the New England investment group). In others, the institutional role will embed trust, which will be strengthened by reputational mechanisms and the information provided by the institutional role. We need to be able to disassemble these connected and mutually reinforcing incentives.

#### THE LEGAL CONTEXT OF INTERMEDIATION

The trust that generates intermediation and holds people and contracts together does not develop in a vacuum – governments and laws are an essential component of the process. Understanding the subtle rules of the game (to paraphrase Douglass North) like social norms and legal practice is key to understanding economic incentives and constraints. These social and legal norms vary across time and place but break down in large categories such as common law countries, Roman law systems, and Shari’ a law societies. Legal systems are the backbone of the credit world, and understanding the doctrine of each system is essential to understanding many of the transitions and institutions of the economies we look at. As we have seen for example, notaries did not play an important part in the development of financial markets in England because the common law system did not include the figure of the notary and handed off that role to a broader set of legal and civil actors.

Property rights are perhaps the most important legal element in credit – without strong property rights, the ownership of collateral will be weak, as will be the credit market. The property rights of women in both common law and Roman law countries provide an excellent test case to this. It really is not until the twentieth century that women obtain equal property rights, and studying women in credit markets provides a fascinating example of how property rights differences affect credit markets and the role of intermediaries. Women in nineteenth century Mexico, for example, paid higher interest rates because their husbands maintained control over them and their property. This created a distortion in the seamlessness by which property could be transferred as collateral.<sup>21</sup> Societies could also develop rules, however, to

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<sup>21</sup> Levy, ‘The Marriage Penalty’.HAHR, 2008.

mitigate such distortions. During the pre-industrial period the status of femme sole trader gave married women in The Netherlands, for instance, considerable leeway to operate businesses.<sup>22</sup>

Eighteenth and nineteenth-century Russia provides an additional illustration of how important it is to think about property rights when analyzing credit markets and intermediation.<sup>23</sup>

When the Czar stipulated that serfs could not hold property and they could not have access to the courts, it exerted a negative impact on the functioning of markets since it excluded a significant number of the population from them. In some estates, however, the lords came up with ways to side step these rules. They would hold the serf's land in their own name, but signed a notarial deed waiving all claims to it and giving the serf full authority over the property. In exchange for a fee, the lords also gave their serfs access to the courts that upheld the contracts. In time, this provided a strong impetus to the development of capital markets in some Russian estates.<sup>24</sup>

Once unequivocal property rights are established and people can mortgage their property, it is crucial for creditors to be able to verify these rights. The work of Hernando De Soto on Peruvian land ownership provides a clear illustration of how property rights can be difficult to assess for outsiders in the absence of certain institutions (such as a cadastral system).<sup>25</sup> The English case (discussed above) showed that where such institutions were lacking, intermediaries could come to play a role in verifying title. It is the obscurity about property rights and the asymmetries that it generates that creates a need for intermediation, so when government regulation provides clarity, it reduces information asymmetries.

Usury is perhaps one of the oldest obstacles to efficient credit markets. Usury was prohibited in Cannon law in both Roman and common law countries, and it was so reviled in Islam that interest rates were entirely prohibited. The debate as to how well these usury restrictions were respected and enforced still rages on – there is sufficient evidence in the Islamic literature that

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<sup>22</sup> Danielle van den Heuvel, *Women and entrepreneurship Female traders in the Northern Netherlands c. 1580-1815* (Amsterdam, 2007), 56-69.

<sup>23</sup> Tracy Denison, 'Contract Enforcement in Russian Serf Society' (Paper, September 2009); Idem, 'Institutions and the Russian Serf Economy: A Tale of Two Landlords' (Paper, May 2010).

<sup>24</sup> Such restrictions on capital markets existed elsewhere as well. In the Swiss canton of Luzern, for example, people were not allowed to raise loans with people from outside the canton without the consent of the authorities. See Andreas Ineichen, 'Bäuerliche Verschuldung im Ancien Régime: das Beispiel Ebikon (bei Luzern) um 1690', in: *Schweizerische Zeitschrift für Geschichte* 42 (1992), 69-93.

<sup>25</sup> Hernando De Soto, *The Mystery of Capital. Why capitalism triumphs in the West and fails everywhere else* (New York, 2000).

the interest rate prohibitions were circumvented by the use of the waqf, which is very similar to the common law trust. The profits generated by the waqf remained within the waqf, which allowed the waqf to charge interest rates – as they often did in eighteenth-century Istanbul, for example.<sup>26</sup> Similar debates exist in European literature about the efficacy of bans on usury.<sup>27</sup> And there is evidence that the Church was occasionally quite lenient about enforcing the usury laws.<sup>28</sup> Innovation also circumvented usury laws – bills of exchange were one of the early financial innovations created to, among other things, avoid interest rate constraints<sup>29</sup>

As usury restrictions were evaded, intermediaries were probably crucial to the prevarication. But more specifically, when usury bans were lifted in Mexico, this propelled notaries to become financial intermediaries. As of 1857, liberal reforms in Mexico significantly abrogated ecclesiastical power, confiscated Church assets and repealed civil support of usury. The reform extricated the Church from mundane financial transactions and more importantly repealed usury bans and freed the price of credit. In the absence of banks, and in the wake of an agricultural export boom in Mexico and a growing demand for credit, these reforms were a legal precursor to the notaries' role in the Mexican credit markets.<sup>30</sup>

It should be kept in mind that regulations need not necessarily be this strict in order to create different intermediary outcomes. In early modern Amsterdam brokerage was organized in a guild relatively early because of the importance of trade in that town. In nearby Utrecht, where trade had not been that important, there had not been a need to organize brokers in such

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<sup>26</sup> See Fariba Zarinebaf, 'From Mahalle (Neighborhood) to the Market and the Courts: Women, Credit, and Property in Eighteenth-Century Istanbul', in: Jutta Sperling and Shona Kelly Wray (eds.), *Across the Religious Divide: Women, Property, and Law in the Wider Mediterranean (ca. 1300-1800)* (\*\*\*, 2009). For the broader context of the waqf and capital markets in the Islamic world, see A. Udovitch, *Partnership and profit in medieval Islam* (Princeton, 1970); A. Udovitch, 'Bankers without banks: commerce, banking, and society in the Islamic world of the Middle Ages', in: *The Dawn of Modern Banking* (New Haven, 1979); Ibrahim Warde, *Islamic finance in the global economy* (Edinburgh, 2000); Hiroyuki Yanagihashi, *A history of the early Islamic law of property. Reconstructing the legal development, 7th-9th centuries* (Leiden, 2004); Timur Kuran, *Islam and Mammon, the Economic Predicaments of Islamism* (Princeton, 2006); Mahmoud A. El-Gamal, *Islamic finance. Law, economics and practice* (Cambridge, 2006).

<sup>27</sup> Many historians consider this such a truth that they do not even address it. In the words of Thomas Lockett: 'There probably never was a time in European history when usury laws actually prevented lenders from charging interest. Certainly the note itself contains no indication that interest has been charged.' In: *Credit and Commercial Society in France, 1740-1789* (\*\*\*, 1992), \*\*\*. John H. Munro, 'The medieval origins of the financial revolution: usury, rentes, and negotiability,' in: *The International History Review* 25 (2003), 505-62. Temin and Voth, 'Interest Rate Restrictions', suggest, however, that the following of maximum interest by bankers in eighteenth-century England led to credit rationing.

<sup>28</sup> Jacques Louis Le Goff, *Your Money or Your Life: Economy and Religion in the Middle Ages* (New York, 1988).

<sup>29</sup> Cf Elaine Tan

<sup>30</sup> Levy (2011; 2012).

a way. Utrecht instead regulated brokerage through a set of town ordinances. This opened opportunities for various types of people – among which notaries apparently were the most important – to start providing brokerage services. Whereas in Amsterdam notaries wrote the deeds and brokers executed transactions, in Utrecht the notary-broker did both.<sup>31</sup> In this respect they were very similar to notaries in Merida (Yucatán) during the nineteenth century.

The legal context in which capital markets operated, thus (1) influenced the extent to which people participated in these markets and (2) determined the form that their operations took. The degree to which minority groups like non-burghers, religious minorities or women were included in the market established the information asymmetries that intermediaries needed to solve. The context also determined whether their services remained secretive or were registered in public or private contracts. If we want to understand intermediaries we need to identify the legal variables that shaped the contexts in which they operated. It should also be realized that changes in the laws within specific countries often had economic consequences, no matter what the legal regime was. Legal changes provide the subtext to understanding the financial opportunities that compel certain people to respond and provide intermediation, and understanding these legal changes within legal regimes is crucial to understanding the role of intermediaries, the timing of their role, as well as the political context of intermediation and its relationship to economic development.

#### POPULATION DENSITY AND INFORMATION HUBS

We have posited till now that demand for financial services is universal. However, this demand does not emerge homogeneously within societies or across countries. To discuss these differences, we want to address a number of the physical and material variables that determine the location and type of intermediaries.

Density is perhaps the most important variable in the creation of markets and thereby in rise of intermediaries. Because manufacturing and trade were concentrated in towns, the demand for financial services was most dynamic there. The risk associated with overseas shipping, for example, had a strong influence on the development of insurance mechanisms and

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<sup>31</sup> Christiaan van Bochove, 'Intermediaries and the secondary market for government bonds in the Dutch Republic' (Paper, June 2010).



intermediaries in sixteenth-century Antwerp and then later in Amsterdam.<sup>32</sup> Some towns may even have specialized disproportionately; the subsequent dominance of Amsterdam, London and New York in international capital markets is a prime example of this.<sup>33</sup>

The various characteristics of the inhabitants of a community will determine the type and amount of services that they require. Demand for services will increase not only because of population growth, but also because as population grows, personal networks become more diffuse and information asymmetries will arise as people are no longer familiar with each other. This in turn increases the demand for intermediaries to solve the interactions between partners who don't have perfect information about each other. The types of financial intermediation that will develop will depend on the way in which this society will transition from a small community to large society.<sup>34</sup>

Wealth and its (un) equal distribution will play an important role in the demand for financial services related to lending, borrowing, pooling and insuring, and in this respect life cycle preferences will also dictate who asks for what services and when. Younger people will typically need capital to set up a business or form a household, and they will transfer future earnings to the present by borrowing. Older members of society, who are at the other end of the age spectrum (like widows for example), might have excess funds that they are willing to invest in order to generate a stable stream of income.<sup>35</sup> There is a large literature in economics that analyzes life cycle behavior in contemporary capital markets, and it behooves us to use this research to better understand these mechanisms in historical markets.<sup>36</sup>

The heterogeneity of the society also figures in these distinctions – a society of ethnic and religious equals will have fewer obstacles to overcome than a society that is made of more than one ethnic and religious group. And when unequal property rights reinforce ethnic,

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<sup>32</sup> Sabine Go, *Marine Insurance in the Netherlands, 1600-1870. A comparative institutional approach* (Amsterdam, 2009); Dave De Ruyscher, 'Constraints, Contractual Freedom and Enforcement: Marine Insurance in Antwerp (16th-17th Centuries)' (Paper, January 2010).

<sup>33</sup> Youssef Cassis, *Capitals of capital: The Rise and Fall of International Financial Centres 1780-2009* (Cambridge, 2010).

<sup>34</sup> Ferdinand Tönnies, *Community and Society* (\*\*\*).

<sup>35</sup> Beverly Lemire, Ruth Pearson and Gail Campbell (eds.), *Women and Credit. Researching the Past, Refiguring the Future* (Oxford, 2001).

<sup>36</sup> \*\*\* Reference. \*\*\*

religious and gender differences, the heterogeneity of society will complicate the transparent and efficient working of the credit market.<sup>37</sup>

The economic functions that are determined by location will also influence the kind of financial services that exist. A first distinction is the urban and rural one, but one could also think of the different services that maritime towns will demand relative to land-locked towns. The demand for services in the countryside was mostly driven by agriculture. Rural areas also have low population density and this coupled to the agricultural participation of the majority of the population prevented the countryside from becoming a hotbed of innovation in financial services.

The locational effects of the availability of services determines the reaction of nearby towns who will be a source for alternative or supplemental markets for services that originated elsewhere.<sup>38</sup> This type of expansion depends on the mobility of people – this mobility will be a function of technology and wealth. Trams, trains and cars, as well as better roads and waterways allow for an expansion of markets. Similarly, elevated social status (via a religious or political position) expands the reach of a person. People that are mobile are much less constrained by distance and can transact in other markets. Historically, it was exactly for this reason that the elites of eighteenth-century Amersfoort – a small town in The Netherlands – could buy and sell government bonds in the nearby towns of Amsterdam and Utrecht.<sup>39</sup>

The two variables of distance and location also gave rise to traveling intermediaries. In towns that were too small or too far from larger agglomerations, intermediaries visited communities at regular times to provide an intermediation service. In nineteenth-century Mexico for example, small towns did not necessarily have a local notary and in these cases notaries would come by on a regular basis to record the deeds.<sup>40</sup> More recently a similar service was and continues to be provided by the Dutch Rabobank, which operates bank buses to provide financial services in rural areas in The Netherlands.<sup>41</sup>

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<sup>37</sup> \*\*\* Reference. \*\*\*

<sup>38</sup> Here we are inspired by economic geography. See, for example, Masahisa Fujita, Paul R. Krugman and Anthony J. Venables, *The spatial economy. Cities, regions, and international trade* (Cambridge [Mass.], 1999).

<sup>39</sup> Van Bochove, 'Intermediaries'.

<sup>40</sup> Levy, 'Financial intermediation'.

<sup>41</sup> Paul Brusse, *Leven en werken in de Lingestreek. De ontwikkeling van het platteland in een verstedelijkt land, 1850-2000* (Utrecht, 2002), Rabobank Bodegraven-Woerden and Rabobank Veenstroom, *Nieuwsbrief Nieuwe bank* 3 (2009) (available [here](#)).

Another aspect of the flexibility of intermediaries to the demands of the markets is that the intermediary service need not have been a full-time occupation. Using the French and Mexican notaries as an example again – these notaries were not constantly acting as financial intermediaries – their financial function was one of the many duties they performed. The notaries registered deeds – the primary function that they still occupy today – and they used the information about their clients that they collected to operate as credit intermediaries.<sup>42</sup>

We need to understand this type of less obvious intermediation if we want to fully understand historical credit markets. It is here that the functional perspective over intermediation becomes especially important. To a modern observer, the combining of various activities may make it more difficult to identify when someone is behaving as a financial intermediary.

Beyond all the variables discussed above, the density of the population will also lead to frictions in the goods and labor markets and these can also give rise to unexpected financial intermediaries. In this respect, the market for personnel for the Dutch East India Company (VOC) provides a good example of spillovers from the labor market to the capital market.

During the seventeenth and eighteenth centuries foreigners comprised a significant part of the VOC's total labor force. During the eighteenth century both the total number of employees and the share of foreigners in the VOC increased.<sup>43</sup> Foreigners who moved to Amsterdam to wait to be sent off with the VOC did not earn a salary until their ship departed for Asia. Most of them also did not have a safety net to fall back on and so they came to rely on advances from innkeepers. The innkeepers in Amsterdam gave them room and board in exchange for a bond backed by the foreigner's future income.<sup>44</sup> These bonds could subsequently be redeemed at the VOC's bookkeeper in Amsterdam while the foreigners were serving the Company in Asia. The risk of these bonds was high – mortality rates among VOC employees were high; at death the outstanding part of the principal could only be redeemed if the employee's account with the VOC had enough money; and spouses had priority claims on the salary. In light of such risks, the implicit interest rates must have been very high and this might account for the

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<sup>42</sup> Hoffman, Postel-Vinay and Rosenthal, 'What do Notaries do?'; Idem, 'Information and Economic History'; Idem, *Priceless Markets*.

<sup>43</sup> Jelle van Lottum, *Across the North Sea. The impact of the Dutch Republic on international labour migration, c. 1550-1850* (Amsterdam, 2007), \*\*\*.

<sup>44</sup> These bonds seem to be similar to the ones Michael Easterly studied among early twentieth-century US urban employees. See Michael Easterly, 'Your Job Is Your Credit: The Creation of a Market for Loans to Salaried Employees in New York City, 1885-1920' (unpublished dissertation, UCLA, 2008).

ill will shown to these innkeepers in the literature. And yet, many of these bonds were issued and they even spawned a secondary market.<sup>45</sup>

While innkeepers may seem to have been unexpected financial intermediaries, they actually had a long history of performing intermediary functions. In Medieval Bruges, for example, innkeepers provided a wide range of services to visiting merchants. These not only included housing and storage, but innkeepers also served as guarantor or factor and provided information about market conditions.<sup>46</sup> There must have been many more people that found themselves in a position to provide such services. Future research should identify these people and explain why and how they contributed to solving information asymmetries.

#### METHODOLOGY & THOUGHTS FOR THE FUTURE

Our approach to intermediation in credit markets is global and does not hew to a specific time frame. The comparative readings of the literature reveal that non-bank credit markets and the problems and incentives that give rise to intermediaries are fairly similar across the globe and across history: information asymmetries, legal constraints and economic growth and opportunity all create the need for financial intermediaries. The contexts in which intermediaries respond to these needs change, and the outcome of their responses does too.

This global approach requires many regional analyses, and it needs these regional analyses to speak to each other. Ideally, we would all be working on understanding intermediation using similar data sets, over similar time periods; but that would be too easy. The data we can work with is a function of local conditions when the intermediation happened (who recorded it? why?), local conditions that allowed the data to survive (why did the records survive?) – is it because they were left forgotten in someone’s attic, or because governments or other institutions (Church, notaries) were committed to protecting their part of the archives? In any case, the project needs data, and lots of it, and most of this data will require archive work.

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<sup>45</sup> \*\*\* Reference. \*\*\*

<sup>46</sup> J.A. van Houtte, ‘Makelaars en waarden te Brugge van de 13e tot de 16 eeuw’, in: *Bijdragen voor de Geschiedenis der Nederlanden* \*\*\* (1950), \*\*\*; Anke Greve, ‘Brokerage and Trade in the Medieval Bruges: Regulations and Reality’, in: Peter Stabel, Bruno Blondé and Anke Greve (eds.), *International Trade in the Low Countries (14th-16th centuries): merchants, organization, infrastructure* (Leuven, 2000). \*\*\* Reference. \*\*\*

The data we use can be both qualitative (e.g. private correspondence, newspaper advertisements) and quantitative (e.g. business ledgers, probate inventories and credit contracts), but ideally it will cover multiple years and locations, and allow each of the contributors to develop a comparative perspective over the issues explored above. The approach therefore also requires a commitment to the big picture. Every case is important and relevant, but only if we can make it relevant to the other cases. Mexico, Lombardy, Flanders or Russia – all of these cases will contribute to our understanding of intermediation in Amsterdam, Brazil, the United States and France. We have to continually think of individual historical research in a very broad context. Similar problems, comparable data and similar or different outcomes in a variety of locations and times – these are the components of what we expect will be not only an original and truly global project, but also one that will shed light on the nature and function of financial intermediation with lessons for historians, and also for current practitioners and scholars concerned with contemporary financial intermediation.