Life & Arts

Inside the library of financial mistakes

Histories of bubbles, busts and bad debt offer cautionary tales to today's bankers and politicians

Ray Perman YESTERDAY

In 1772 Douglas Heron & Co, more popularly known as the Ayr Bank, after the town where its head office was located (aptly spelt "Air" in some contemporary documents), went spectacularly bust. It had been formed only three years before, backed by some of the largest landowners in Britain, and had used this seemingly solid foundation to expand rapidly. Using a mixture of discounted bills and cash borrowed from the London money markets, it quickly became one of the largest banks in the country. Its collapse bankrupted dozens of its shareholders and cast a black cloud over the Scottish economy for decades.

In 1857 the Western Bank of Scotland, which had ridden the industrial boom in Glasgow to expand its lending book aggressively — again using paper and borrowed money — was caught out by a downturn in the market that exposed the poor quality of its lending. In addition to the failure of its biggest customers at home, the bank had been caught up in the frenzy of the American railroad mania, investing in mortgages of dubious value. It was swamped by bad debts and brought destitution to many of its shareholders.

In 1878 the City of Glasgow Bank . . . but you get the picture by now. A seemingly solid bank, which had grown much faster than its rivals, suddenly failed, triggering a chain of bankruptcies among its shareholders and creditors. In 2008 the banks that went to the wall and had to be rescued by the taxpayer just months after posting seemingly healthy profit statements were RBS (now rebranded as NatWest Group) and HBOS, the unlovely conglomerate formed from the previously prudent Halifax and Bank of Scotland.

Stories such as that of Ayr Bank and the Western Bank of Scotland have been familiar to a small band of academics brave enough to specialise in financial history, but they are seldom taught as cautionary tales in business schools or economics faculties and are practically unknown in the City of London or on Wall Street.

Institutional memory is also short in government. Prime Minister Rishi Sunak was not even in parliament, let alone in government, during the financial collapse of 2008. His administration's intention to soften regulatory requirements and remove the cap on bankers' bonuses to make London's financial services more competitive shows no understanding of the role weak regulation played in the banking collapse only 14 years ago, nor the failure to claw back the vast bonuses paid to top bankers on the basis of profits that proved to be illusory.

The man at the heart of the administration who had experienced the crash at first hand, Sir Tom Scholar, was sacked as permanent secretary at the Treasury in September. The move was described as "challenging Treasury orthodoxy", but it might just as well have been labelled "history has nothing to teach us".

Does it? If the politicians, the regulators or the boards and executives of any of the banks and other financial institutions on both sides of the Atlantic that were brought down by the subprime crisis of 2008 had known about past banking failures, would it have made any difference?

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Russell Napier, founder and keeper of the Library of Mistakes

"Absolutely yes," says Russell Napier, founder and keeper of the Library of Mistakes, a financial history library in Edinburgh. "What these banks had in common with the casualties of 2007-08 is that they were expanding their balance sheets much faster than their peers. Had their boards known a little history, they would have learnt that an institution that grows like a weed is a weed. Any bank that consistently grows faster than the economy in which it operates must be at risk. It is an indicator only lately recognised by regulators, but there are plenty of historical precedents."

Napier, the son of a butcher from Donaghadee in Northern Ireland, came to finance

via law degrees at Queen's University Belfast and Cambridge. After graduation he joined the Edinburgh fund management partnership Baillie Gifford. "I was trained as a lawyer, I knew nothing about investment management. The textbooks and courses were based on economic theory and the efficient markets hypothesis, they didn't draw on practical experience or give any historical examples. So I started to read history."

Traders in New York during the financial crash in September 2008, a time when UK Prime Minister Rishi Sunak was not even in parliament © Seth Wenig/AP

What his reading gave him was a scepticism about the growing fashion for the "mathematisation" of finance — the belief that human behaviour (the buying and selling of stocks and bonds) could be reduced to an equation. That faith persisted even after the collapse in 1998 of the hedge fund Long-Term Capital Management, despite having two Nobel Prize-winning economists on its board.

Napier's studies convinced him that there were lessons to be learnt from the past. Despite innovation, very little is new in finance: someone, somewhere, will have faced similar circumstances before. We could learn by their experience, yet too often fail to do so — the same patterns of causes and effects are repeated time after time. Napier is fond of apposite quotations. One of his favourites is from the American author James Grant: "Progress is cumulative in science and engineering, but cyclical in finance."

If we know the mistakes made in the past, can we avoid them in the future? Napier believes so. After working for CLSA in Hong Kong, where for several years he was voted top Asian equities analyst, he returned to Edinburgh to find that his own belief in the lessons of history was still not widely shared in the financial communities of Britain and the US. His response was to call on friends and acquaintances to help him teach a week-long course for practising fund managers — the Practical History of Financial Markets.

Among those recruited to write and lecture were Andrew Smithers, an expert on asset allocation, Gordon Pepper, broker turned academic who had advised Margaret Thatcher on monetary policy, and Barry Riley, former investment editor of the FT. The course covered the valuation of stock markets, investing in periods of inflation, disinflation and deflation, the monetary theory of asset prices, behavioural finance and the history of institutional investment.

'Market myopia' suppressed demand, few were interested in the failures of the past when it was easy to make money

It ran with moderate attendances in Edinburgh, London and New York until the subprime crash, when enrolments shot up, only to subside again during the long market boom that followed. "Market myopia" suppressed demand, and few were interested in the failures of the past when it was easy to make money. But Napier is hoping that enrolments will be stimulated by the present uncertainty, coupled with the fact that the course is now available online (renamed as Advanced Valuation in Financial Markets) as well as face-to-face at Heriot-Watt University, Edinburgh.

The financial history course led to the Library of Mistakes. "People were asking, 'where can we read about this stuff?' But books of financial history had largely disappeared from libraries. You can do a course in finance at almost any business school without having to learn any financial history at all," says Napier.

The library was established in 2014 in a mews flat leased from the venerable Scottish Investment Trust, which then still occupied the same Georgian townhouse in which it began life in 1887. By passing the hat round Edinburgh fund managers both active and retired, Napier raised the £100,000 needed to refurbish the building and buy the books. “It was much easier than it would have been in London or New York,” he says, “Edinburgh still retains a distrust of mathematisation and rival firms are more willing to work together.” The donors’ names were inscribed on the wall, next to a portrait of Charles Ponzi, after whom the pyramid fraud is named. The lavatory was papered with the banknotes of failed currencies from all over the world.

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The opening ceremony was performed by Lord Norman Lamont, who had been the Conservative party chancellor of the exchequer on “Black Wednesday”, when Britain had exited the European Exchange Rate Mechanism in 1992. Looking around the shelves, he began his speech “I must be in here somewhere,” which of course he was.

The success of the library has required a move to larger premises. With a neat political symmetry, Lord Alistair Darling, who was Labour chancellor during the 2008 crash, opened the new building with a speech exhorting politicians as well as finance professionals to learn the lessons of history.

The library has inspired others in Pune, India, and another in Lausanne, Switzerland, and there are discussions under way for one in London. But has it been effective in encouraging more people involved in finance to learn the lessons of previous experience?

John Turner, a professor at Queen’s University Belfast, thinks it has been part of a growing trend to teach financial history more widely, but just as the Library of Mistakes would be less attractive to readers if it was plainly branded as the Financial History Library, so courses in business schools sometimes have to be “smuggled in by

the back door". Queen's Management School has a course on bubbles and crashes, the subject of *Boom and Bust*, Turner's latest book with colleague William Quinn.

"I'm a believer that there should be a place in the curriculum for history," Turner adds. " In asset pricing or insurance, for example, the long-run experience is really important. There is growing interest in the UK and the US in long-run data series — the prices of stocks, corporate bonds, government securities and so on — and the longer the series, the more its value. The problem is that once you go back further than the 1980s, then definitions start to change and the way of doing things was different. That's where you need a historian to help you understand the data."

The question asked at the beginning of this article has been posed before. "There are several questions banks should ask themselves. Do they really pay attention to the lessons of history — for example the property crisis of the early 1970s? Did they really monitor the credit criteria which had served them well in the past?"

The speaker was the governor of the Bank of England, but not in 2008 or following recent scandals such as the collapse of Greensill or of Wirecard. It was Robin Leigh-Pemberton in 1993, shortly after another banking crisis. His answer was clearly "no". In finance, knowledge is cyclical.

Ray Perman is author of 'The Rise and Fall of the City of Money', a financial history of Edinburgh. His latest book is 'James Hutton: The Genius of Time'

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