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Towards an assessment of the benefits of unlimited liability structures in international banking: The case of Berenberg.

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Towards an assessment of the benefits of unlimited liability structures in international banking: The case of Berenberg.

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Abstract

This paper examines the implications of Berenberg Bank's unlimited liability ownership structure for the Bank's shareholders, other stakeholders, and society at large. It is a case study which draws on interviews with Berenberg Bank's senior London management, Berenberg is one of the very few remaining financial institutions with an unlimited liability ownership structure. Berenberg prospered during the 2008-9 financial crisis, and has since thrived by expanding in several niche businesses. The paper argues that the Bank's success during the downturn appears to have been a function of its particular 'culture', which in turn appears to be significantly influenced by its unlimited liability capital structure. The paper concludes with some discussion of the relevance of our findings on the debates surrounding the value of such structures and the degree to which they can provide an example to other banks as well as on the implications for the social costs of banking.

Keywords: Banking culture, financial crisis, private banks, Berenberg, unlimited liability.

JEL Codes: G21, G28.

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1. Introduction

A growing literature describes how banks have changed their culture since the 2008-9 Global Financial Crisis (GFC) and addresses the value of incentive structures that it is argued could result in long term benefits to both bank shareholders and to the public interest.[2] In this context, unlimited liability structures have attracted attention along with significant additional capitalisation and a number of similar structures. However, firms that exhibit some of these desired characteristics and behaviours have existed for centuries, offering the opportunity to examine their value. In this paper we focus on the role of unlimited liability equity as a form of ownership and its relevance to all stakeholders – clients, shareholders, employees and the taxpayer.

Joh. Berenberg, Gossler & Co. KG (Berenberg, or the Bank) has been an unlimited liability partnership since 1590, making the Bank the second oldest in existence. The oldest bank with a continuous existence is Banca Monte dei Paschi di Siena (MPS). That MPS has been in serious financial trouble while Berenberg has only strengthened its position since 2007-08 provides an interesting and potentially important contrast. In addition, while some unlimited liability banks no longer can be considered banks in the modern sense as they do not make loans (e.g. Bankhaus Metzler), Berenberg does operate in four traditional financial market areas – private banking, investment banking, asset management and corporate banking.

This paper discusses the role of unlimited liability in banking as opposed to the standard limited liability shareholder model. It uses interviews with management at Berenberg as its primary source, supplemented with a comparative analysis of financial results at Berenberg and its competitors. With Berenberg as our example, this study set out to determine: firstly, whether or not Berenberg has a particular culture as a result of its unlimited liability structure: and, secondly, if any such culture was beneficial to Berenberg's immediate stakeholders – shareholders, employees and clients. A further issue that we explore is the degree to which the unlimited liability structure for banks might be also beneficial to society at large, especially to global taxpayers.

In consequence, this paper attempts to answer the following questions:

i. How is Berenberg different from other banks?

ii. Have these differences translated into absolute success for the key stakeholders?

iii. Could such a particular culture be replicated by other sorts of international universal and banks?

[2] See, for example, Ian W. Jones, and Michael G. Pollitt. "How UK banks are changing their corporate culture and practice following the financial crisis of 2007-08." *Centre for Business Research Working Paper* (2016).

iv. The final question is whether or not increasing the number of banks structured like Berenberg would contribute to national and wider financial stability, and reduce the implicit taxpayer subsidy to the global banking system.

Our analysis suggests that Berenberg's culture and results can be explained at least partially by its unlimited liability structure, and that this structure has benefited its stakeholders in the past, including the recent past. We are not in a position to predict the future for Berenberg but discuss the benefits of unlimited liability structures in general as well as some potential downsides in the concluding sections.

Looking more widely, one can envisage new smaller banks opting for unlimited liability. However, it is doubtful whether Berenberg's development path and current structure can be replicated by management and directors of existing 'traditional' banks who are concerned with establishing an ethical culture while improving financial performance. Berenberg as it operates today is a unique product that is derived from a long and distinguished history as well as of a particular ownership structure. Further, the evidence from this case study suggests to us that it is unlikely that an unlimited liability structure, while theoretically able to mitigate instabilities in modern finance, can be applied more broadly to international banking.

These last issues are discussed more fully later in the paper and in the conclusions.

2. Berenberg and its Banking History

There are very few banking organisations with the pedigree and structure of Joh. Berenberg, Gossler & Co. KG. Berenberg is a privately-owned bank with a substantial deposit base (2016: EUR 3.72 billion)[3] that is in the midst of a long-term plan, begun twenty years ago, to transform itself from a Hamburg-based domestic lending institution focused on northern Germany to an international securities research, trading and advisory firm.

The original Berenberg banking family were Protestant traders who lived and worked in and around Antwerp.[4] Following anti-Protestant threats from the Counter-Reformation, the family moved to Hamburg after 1585 and established a trading house corporate entity in 1590. The Bank has had a continuous base in Hamburg and North Germany ever since. During the late 17th and early 18th century, Berenberg was increasingly active in banking activities. That transformation continued over the next 150 years with banking becoming the dominant business activity.

Berenberg was a family-run business until the mid-18th century when external partners were appointed, initially via marriage and then by external recruitment. Family involvement as managing partners continued until the mid-20th century, but with increasing participation by recruited non-family professionals. The Berenberg family retains a 30.4% stake in the business and a family member, John von

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[3] Unless otherwise mentioned, all data is sourced from Berenberg Bank's 2016 *Annual Report and* 2016 *Disclosure Report*, available at https://www.berenberg.de/en/publications/

[4] See Berenberg website for a short history of the development of the bank from the 1590s.

Berenberg-Consbruch, is a member of the Advisory Board[5]. However, the management of the bank has now become fully external (unlike the family-controlled C Hoare, the only otherwise equivalent UK independent private bank).

2.1 Berenberg's assets and operations

Berenberg's private banking – and therefore deposit taking - operations are focused in Switzerland, Hamburg and London. Commercial (loan) operations are focused on Hamburg, while excess liquidity is generally invested in short term zero-risk weighted German bonds. Its asset management business specialises in quantitative strategies for both institutional and retail (private) accounts. Investment banking has recently been the fastest growth area in terms of revenue, with expansion focused on broking and research in London and, more recently, the US.

The firm has also expanded its activities through its development of newer business lines, in particular in its use of research. In consequence, while Berenberg won an award in 2015 for best private bank in Germany, it also scored highly in research and trading. It gained a Euromoney award for best equity house in Germany the same year.

Berenberg Bank is in the process of completing a 'strategic orientation towards services-based lines of businesses'.'[6] Even before 2007-08, Berenberg was shifting its strategy from being a niche private bank to competition with big banks in some very select research and trading markets. Since 2008, there has been a particular (and growing) emphasis on Berenberg's in-house research as a source of revenue as well as providing a basis for the bank's other main activities. The research is considered the most important client service, as opposed to practices common to larger firms, such as proprietary trading and/or facilitation of larger client transactions using risk capital.

The success of the strategy is evident in the fact that Berenberg's assets under management (AUM) and net commission income have grown faster than the (primarily domestic) loan book over the past ten years. Indeed, commission income was seven times larger than net interest income as at the end of 2015 and exceeded interest income even in the loan-heavy corporate division in that year. Hence, the bank does not currently need to rely on wholesale funding: client deposits are 75% of total assets.

Though recent expansion has pushed into new markets in Switzerland, the UK and the US, 75% of all Berenberg's income derives from Germany.

While Berenberg's net commission income and assets under management (AUM) have almost tripled between 2006 and 2016, the loan book has grown much more slowly. It has less than doubled over the 2006-16 period, and actually shrank for the three years after 2007-8[7]. This pattern of activity differs significantly from most other banks, where loan volumes often dominate brokerage and other capital markets

[5] *Annual Report* 2016.

[6] *Disclosure Report* 2012. p. 12.

[7] *Annual Report* 2016.

activity. These features are illustrated in Table 1 below which also provides available data for the 10 years up to and including 2016.

Table 1: Berenberg financial performance since 2007

		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Net Profit	EUR million	61	47	65	62	56	60	66	40	104	161
Equity	EUR million	155	177	212	213	217	221	223	219	234	265
Deposits	EUR million	2,983	3,236	2,456	2,326	2,874	3,083	3,390	3,199	3,570	3,721
ROE	% (before taxes)	56.2	37.5	53	45.3	40.1	43.8	46.9	28.8	67.3	95.8
AUM	EUR billion	19.1	20.3	21.9	25.5	26	28.2	30.1	36.1	40.1	40.7

All four of Berenberg's business lines (private banking, investment banking, asset management and corporate banking) have grown rapidly over the past ten years.

Berenberg's private banking activities were restructured in 2014 to meet the more international needs of their customer base. It provides investment and banking advice and services to high net worth individuals.

In the asset management arm, it has been focusing on quantitative investment strategies for institutions. AUM volumes have doubled to EUR 40.7 billion as of 2016 relative to around 20 billion post-crisis.

Berenberg's corporate banking business specialises in the shipping, infrastructure and energy industries, yet the loan book, while growing, is only 5 times equity at EUR 1 billion. Berenberg seems now only to use its own risk capital now used for loans/etc where they perceive that they have an informational comparative advantage.

The most publicised area of Berenberg's growth in recent years is in equity broking, in Germany, Europe and now in the United States. David Mortlock, head of Investment and Corporate Banking, is responsible for this effort from his base in London.

At the same time that the bank has substantially expanded its investment banking and asset management businesses it has grown its loan book substantially less quickly. This is all part of a long-term plan that was developed began before the 2007-08 crisis.[8]

[8] *Annual Report* 2016.

2.2 *Berenberg's current governance arrangements*

The unlimited liability managing partners are currently (July 2017) Dr Hans-Walter Peters and Hendrik Riehmer. These two unlimited liability partners purchased shares from NordLB during the crisis. Between them, they currently (September 2017) hold 26.1% of the voting shares – subject to unlimited liability - and the Berenberg family own 30.4%[9].

Berenberg's head office is in Hamburg, and there are seven other German branches, Internationally, Berenberg has branches in London, Luxembourg, Paris and Vienna, with offices in Zurich, New York, Boston, Chicago and San Francisco..

Berenberg is almost without comparators. There are very few unlimited liability banks that have survived into the 21st century as going concerns. Although MPS is older than Berenberg, it was converted into a listed shareholder bank in the 1990s. C Hoare is an unlimited liability bank in the UK, but it is in all respects a traditional *private* bank, with few asset management, corporate banking or investment banking activities. Swedish firm Handelsbanken is often compared to Berenberg in its culture and has significant employee ownership, yet it is a large universal bank which operates as a widely held limited liability company.

It is clear from press reports and from Berenberg business results that the firm continues to be held in very high regard by its clients. Berenberg has also experienced strong growth in all markets as well as in its earnings. [10]

3. Financial measures of success

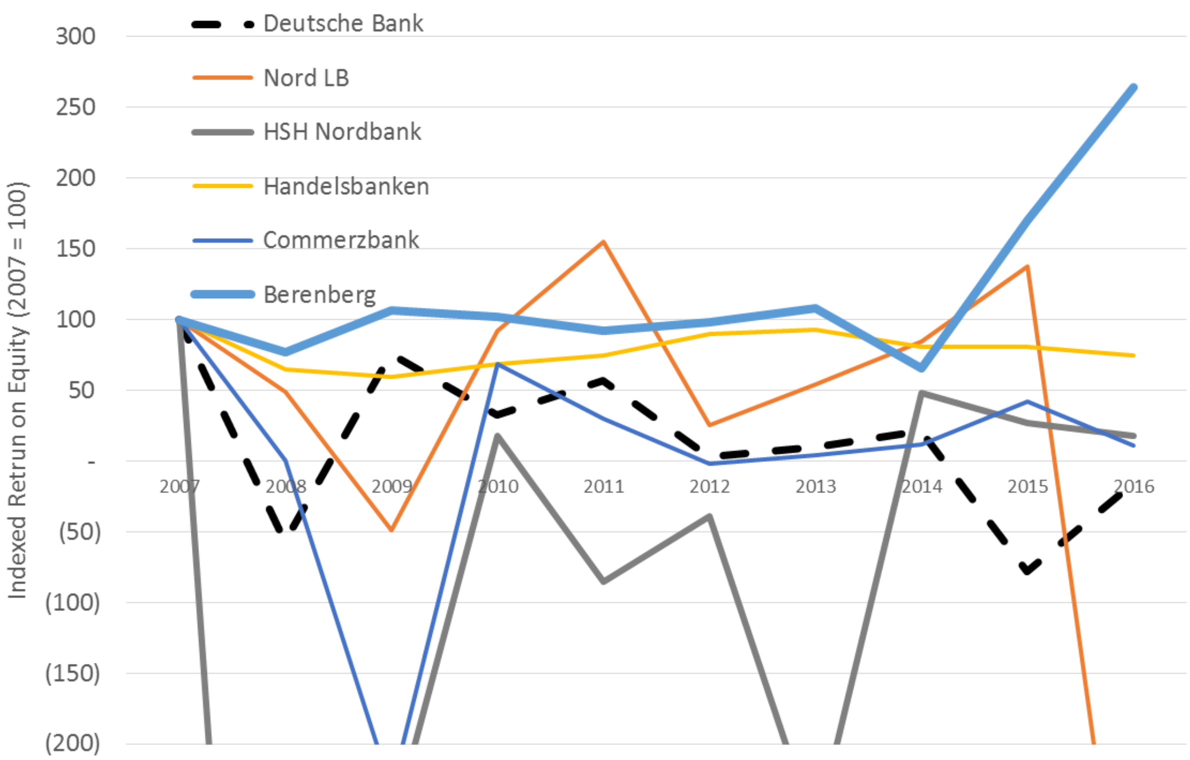
In order to ascertain whether or not Berenberg has been successful for its shareholders on a non-risk adjusted basis, we examined the key financial measures at Berenberg as compared with other European banking institutions. (See Table 2 below for some income comparisons). On that basis, Berenberg clearly performed better than these other banks during the crisis of 2008-9. Over the past ten years, the results are less clear-cut. However, we note that Berenberg now has a very low risk profile. It now has a much reduced loan book, with less than EUR 1 billion in corporate exposures on a deposit base of nearly EUR 4 billion. Berenberg also has a conservative capital cushion, utilising only 34% of 'risk-covering potential' as at 31 December 2016.[11]

Many European banks have experienced net losses over many years since the crisis (and even before, in the case of UBS), with some banks continuing to be in the red in 2016 (e.g. Deutsche Bank, RBS and Credit Suisse). Table 2 below reports some relevant performance information on Berenberg relative to some of its more obvious comparators.. These data reveal that only Handelsbanken has enjoyed similar low volatility in earnings to Berenberg. However, Berenberg's apparently very strong performance in 2016 was significantly augmented by the disposal of its stake in

[9] *Berenberg website* September 2017.
[10] *Annual Report* 2016.
[11] *Disclosure Report* 2016. p. 7. See also page 32 where total capital was shown to be well in excess of statutory requirements.

Universal-Investment (a large German fund house), for an undisclosed amount "in the nine-figure range"[12].

Table 2: Berenberg 10-year income trend versus competitors (Indexed to 2007 = 100)



4. Unlimited liability banking structures - Issues for analysis

Section three examined the financial results of the Bank – Did the firm deliver positive returns to its shareholders? Establishing whether or not Berenberg has operated in an ethical and otherwise socially responsible manner is much more difficult as it depends on what ethical standards are chosen. Because of this we confine ourselves to providing information on Berenberg's stated ethical standards and how far it seems to us that it meets them, but we do not go further.

Based on the theory of the firm and recent observations on where problems may arise and where 'agents' of the shareholders and other stakeholders act in ways counter to the interests of such 'principals', it is easy to establish that, in principle, unlimited liability structures should (other things being equal) result in a lower risk banking concern, and this may benefit society by reducing systematic risks as well as predatory lending that risks crisis and/or financially-catastrophic lawsuits.

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[12] See https://www.bwls-goerg.de/en/_modul_weiterleitung_/pressemitteilungen/berenberg_bank_sells_the_asset_manager_universal_investment_to_the_financial_investor_montagu.44975.html. See also https://www.ft.com/content/1a2e1e2e-ec82-11e6-ba01-119a44939bb6

The relevant literature outlined in Section 6 provides an important distinction between (a) the limited liability ownership structure (with its potential to foster short-termism and irresponsible actions that could place both the bank and society at risk); and (b) the unlimited liability structure: a return to Bagehot's 'gentlemanly capitalism'. It has been argued that unlimited liability can significantly help reduce and/or avoid moral hazard so that decisions are more likely to be beneficial to the wider society as well as to the bank.[13]

Post-2008 recommendations to address systemic risk, taxpayer subsidies and unethical banking (e.g. LIBOR fixing) attempt to solve many problems at once, with the ultimate goal of making finance safer for society. Berenberg as a profit seeking institution, of course, is primarily concerned with its own performance and is only indirectly focused on the overall implications of its structure and culture for society in general.

The first question worth considering with regard to Berenberg's unlimited liability ownership structure is how well the interests of the managers are aligned with those of customers and other stakeholders. As set out below, it appears that Berenberg is more aligned with other stakeholders than more traditional banks.

David Mortlock summarised as follows the differences of Berenberg relative to other banks:

> We are privately owned, with no publicly quoted equity or debt. Our managing partners, Hans-Walter Peters and Hendrik Riehmer, have a significant shareholding and are personally liable. As a result, the management team and shareholders are completely aligned. We also try to keep the overall management of the business as streamlined as possible. We have a very flat structure.[14]

Mortlock contrasted Berenberg's structure to the traditional publicly-traded bank, which splits ownership and management.

The issues discussed above were pursued in interviews with key members of the management team and risk control groups in the firm's London offices. The goal was to understand the firm's management objectives and results, and attempt to identify any and all relationships between the business strategy and the firm's underlying corporate structure and philosophies. We raised the following issues (listed in the order addressed in section five):

1. The role of compensation structure on incentives within the Bank;
2. The impact of unlimited liability in short term risk management and longer-term decision making;
3. The identification of any mitigation of classic principal agent problems; and

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[13] Andreas Dombret, a member of the Executive Board of the Deutsche Bundesbank, summarized the arguments in 2015 at https://www.bundesbank.de/Redaktion/EN/Standardartikel/Press/Contributions/2015_09_01_dombret_boez.html.

[14] David Mortlock Interview.

4. The overall culture of the Bank.

Finally, we examined the overall structure and business model of the bank in order to attempt to identify the influence of the unlimited liability structure on the elements above. The goals of this investigation were to identify any possible causation between the structure of the bank and its culture and if such culture contributed to the bottom line and if it seemed generally aligned with the interests of stakeholders.

5. Interview data

This study focuses on interviews with three of Berenberg's senior employees in London: David Mortlock, Richard Brass, head of Private Banking UK, and Nick Anderson, a senior analyst. In all of the interviews the most emphasised aspect of Berenberg culture was its ability and desire to take the long-term view and engage in countercyclical expansion.[15] Even before the 2007-08 crisis, the Bank set out to diversify away from commercial lending and to focus on areas using less capital, such as wealth management, asset management and (traditional) investment banking.

David Mortlock pointed out that 'being a private company allows us to take a long term perspective and make decisions counter-cyclically. This is a massive advantage, and one of the key reasons our expansion post the financial crisis has been successful'.[16] Mortlock points out that, after 2008, 'the narrative amongst management teams in publicly-traded banks and financial companies at that time is we need to cut, we need to slim down'.[17] Given its ability to take a longer-term view, Berenberg was able to take the opposite approach.

Berenberg's management views a few select businesses where the traditional banks are in retreat as ideal areas of expansion. These businesses tend to require little capital and involve little overnight market risk. They are 'simple' businesses: Equity research, stockbroking, raising capital for corporate clients, fund management and private banking advisory services. That simplicity is driven by both client and bank management needs.

Berenberg uses its capital within the investment bank primarily to facilitate client business.[18] Mortlock observed;

> We try to align ourselves with clients. That's all. We constantly ask "what do clients want?" what they want [and] try to provide it to them as best we can. I think leading up to the financial crisis, there was too much balance sheet creativity. Which lead to the growth in mortgage-backed securities. We keep things very simple. We are an advisory business at our core.[19]

[15] Mortlock Interview: 'it also allows you, if you're private, to invest counter-cyclically'.

[16] David Mortlock email correspondence 17 August 2017.

[17] Mortlock Interview.

[18] Nick Anderson Interview.

[19] Mortlock email correspondence 17 August 2017.

A focus on smaller investment banking clients, however, has little to do with simplicity or conscientious risk management. Berenberg management believes that this long-term perspective is just good business: 'We're much more willing to back smaller clients and engage with them, because we look at business cycles longer-term'.[20] It is not simply an ethical decision to be focused on these underserved areas, 'it's that you can look at it through an ethical lens, [and] then you can look at it through an … opportunity lens.' [21] However, again, the long-term focus appears to be a function of the fact that the owners are also the managers.

Where Berenberg's business lines require balance sheet support, risk management is key. Mortlock pointed out that;

> When a bank is involved in proprietary trading, it is almost inevitable that conflicts arise with the banks clients. The regulatory burden on banks now is acute, and understandably so. When you have an unlimited liability structure, you naturally manage your own risk.[22]

Even for the more simple businesses, new regulatory requirements as well as the acute awareness of risk that accompanies unlimited liability has spawned intense scrutiny. Mortlock reports; 'in the private bank there are very rigorous processes now, a lot of which is dictated by regulation, but a chunk on top would be our own'. [23]

When it comes to rewarding staff, Berenberg believes in a discretionary bonus model. In Mortlock's view,

> With any compensation model, you have to be very aware of the incentives you are creating, and the potential for unintended consequences. Commission-sharing compensation models can create internal conflicts, as well as behaviours which are not in the clients best interests.[24]

The formulaic strict commission model,

> breeds unintended consequences that undermine aspects of what you're trying to do, and it creates a more selfish kind of disruptive [influence on the business] in that it breeds a culture of protectionism internally.[25]

The simplicity in terms of products carries over into the Bank's organisational structure. Mortlock attributes both at least partially to the unlimited liability structure:

> Hendrik and Hans-Walter have their own money and wealth invested in Berenberg. So they, as owners, are directly and financially involved in the business. Again, it means you can plan for the longer-term. It also means shareholders and management are 100% aligned. As an example, I run one

[20] Mortlock Interview.

[21] Mortlock Interview.

[22] Mortlock email correspondence 17 August 2017.

[23] Mortlock Interview.

[24] Mortlock email correspondence 17 August 2017.

[25] Mortlock Interview.

> half of Berenberg, the Investment Bank, and speak to Hendrik five times a day. We could not be more connected and aligned. This also brings a speed in decision-making. So if we want to do something, I'm a phone call away from Hendrik or Hans-Walter from doing it. Whatever it might be, we can move quickly because the decision-making tree is that much more consolidated. This can be a massive advantage.[26]

While some management control stems simply from the flat structure, the implication is that it's the unlimited liability partners who are seen as the key and legitimate risk managers. As Mortlock adds,

> There is no better approach to risk-management than that, and it comes back to this divorce of providers of capital and those who are running the capital. It's possibly in the interests of bigger publicly-quoted financial institutions just to be big.[27]

Mortlock further explained that 'We are not focused on being big, but return on equity. I think this differs from many publicly quoted financial services firms'.[28]

There is little room for layers of management and bureaucracy at Berenberg, although to some extent, this seems to be a function of the size of the firm as much as the ownership and management structure[29]. (We discuss below the inter-relationship between these factors.)

Mortlock reveals that;

> Having a flat structure means Berenberg employees are aligned towards our clients. Not on internal politics. When you have a hierarchical structure, often this encourages more complicated and political behaviour. [30]

The flatter smaller firm has huge advantages in that employees 'naturally want to help us run the business' and 'sense-check things' while in a larger bank, you would have 'hierarchies.' [31]

A key issue in appraising the role of unlimited liability is: firstly, assessing the relative contributions for Berenberg of (a) unlimited liability and (b) a flat management structure within a small firm and, secondly, assessing whether, in practice, these attributes need to be combined. These issues are discussed further below.

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[26] Mortlock email correspondence 17 August 2017.

[27] Mortlock Interview.

[28] Mortlock email correspondence 17 August 2017.

[29] We were told that other comparable companies of this size had rather more layers of management than Berenberg.

[30] David Mortlock email correspondence 17 August 2017.

[31] Mortlock Interview.

6. Analysis

The relevant economics and finance literature outlined below section by section claims that interests can be aligned through;

1) more effective compensation schemes (see section 6.1);

2) increasing the liability for poor risk decisions (see section 6.2);

3) solving the principal-agent problem (section 6.3);

4) reforming the general culture within banks (See section 6.4); and

5) much higher capital cushions (see section 6.5).[32]

Originally for historical reasons, but now by choice, Berenberg relies on unlimited liability managers to solve the principal agent and moral hazard problems.

There is a general agreement in the relevant literature that unlimited liability can in theory align the interests of all stakeholders. In contrast, it is also well understood that maximising shareholder value of banks, to the extent that directors have the information to do so, may not necessarily be in society's best interests.[33] That is, social costs may exceed private costs either in a small way or more pervasively, especially in the cases of taxpayer-provided deposit insurance and the too-big-to-fail (TBTF) subsidy.[34]

We know that financial instability can and sometimes does have direct costs to society, for example by rationing credit at inopportune moments.[35] As a result, the challenge for regulators and policy makers is to (re)align the interests of the financial institutions with those of society at large – for the firms to internalize the social costs. Regulators have so far focused on the first (remuneration) while theoreticians and policy makers have attempted to influence the ethical and risk cultures within banks (point 4).

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[32] Peter O. Mülbert. "Corporate governance of banks". *European Business Organization Law Review (EBOR)* 10, no. 3 (2009): 411-436.
(2009): 411-436. See also David Walker. *A review of corporate governance in UK banks and other financial industry entities - Final recommendations*. (London: HM Treasury. 2009)

[33] Marc Schneiberg, and Tim Bartley. "Regulating or redesigning finance? Market architectures, normal accidents, and dilemmas of regulatory reform", in *Markets on Trial: The Economic Sociology of the US Financial Crisis: Part A*, pp. 281-307. (Emerald Group Publishing Limited, 2010).

[34] Jonathan R. Macey, and Maureen O'Hara. "The corporate governance of banks". FRBNY Economic Policy Review (April 2003), pp. 92-4; George Hanc. "Deposit insurance reform: state of the debate". FDIC Banking Review 12 (1991), p. 3.

[35] Carmen Reinhart, and Kenneth Rogoff. *This time is different: Eight centuries of financial folly.* (Princeton: Princeton University Press, 2009).

However, since 2008, there has been an increasingly vocal minority calling for a restructuring of ownership structures for banks to align incentives with social needs. As such, the overriding - and so far, unanswerable - question is whether or not unlimited liability structures could result in optimal internalizing of societal costs within banks. We do our best to provide some suggestions on this issue below.

6.1 Remuneration

One of the most commonly proposed solutions to the agency problem within banking businesses is the use of deferred bonuses and/or claw-backs.[36]

If bankers are making decisions that have long-term uncertain consequences, compensation should be structured accordingly. Before 2008, traders could book upfront profits, and obtain incentive payments (bonuses) for those returns while saddling the institution and by default the taxpayer with the costs in the event of major failure arising from their actions. The proposed answer of deferring or even reversing such payments is welcomed by many regulators, policy makers and academics.[37] What is interesting in this case study is that such structures are *not* used at Berenberg.

At Berenberg, employees are paid bonuses annually in cash, without resort to crude financial handcuffs. Interestingly, some of the closest comparators to Berenberg such as C. Hoare or Handelsbanken, bonuses are almost non-existent. Perhaps the requirement for cash bonuses at Berenberg is related to its focus on capital markets business. Indeed, we note that, even at Handelsbanken (which otherwise eschews their use), certain market-oriented staff are paid bonuses. However, much-maligned bonus structures are, of course, perfectly legitimate ways to reward performance in the appropriate circumstances.

Bonuses in Berenberg at both the private bank and the investment bank are fully discretionary.[38] The bonus structure weighs individual contribution, the team's contribution, the performance of the unit and the performance of the firm.[39] The trend in banking is for deferred compensation models, with these often being the preferred policy option. Berenberg currently has a bonus claw-back policy, which is industry standard, but, for now, does not have a deferred compensation model. Berenberg argues that deferred compensation also risks the problem that unmotivated workers remain and harm the firm's culture.[40]

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[36] R. G. Fryer, S. D. Levitt, J. List, and J. S. Sadoff. "Enhancing the efficacy of teacher incentives through loss aversion: A Field experiment". National Bureau of Economic Research Working Paper 18237 (2012).

[37] Michael Power, Simon Ashby, and Tommaso Palermo. *Risk culture in financial organisations: A research report.* (2012).

[38] Richard Brass Interview; Mortlock Interview.

[39] Mortlock Interview.

[40] Mortlock Interview.

6.2 Shareholder capitalism and moral hazard

There is little agreement within the economic and financial literature as to what ownership structures could best align bank management with both shareholders and society at large.

As Mulbert states, 'With the exception of remuneration, the few published reports suggesting changes to banks' corporate governance concentrate on the almost complete failure of risk management at most banks. The list of causes advanced is long'.[41] Yet, it remains unclear what the optimal banking system should look like in order to limit systemic risk and costs to society.

One issue is shareholders as managers (see section 6.3). There is no doubt that there are significant issues in allowing limited liability owners to take decisions that can threaten the viability of major financial institutions, national financial systems and the global economy. However, under current fiduciary laws in Anglo-American systems, directors and managers are obligated – subject to legal and regulatory requirements - to consider the interests of shareholders alone.[42]

One solution often proposed is to have stronger outside directors (NEDs).[43] Yet, it is difficult to see how NEDs could *both* be incentivised to act in the interest of broader society; *and* have access to the information required to determine the risk profile and ethical stance of management and the bank as a whole. The role and practical influence of NEDs has been discussed in the context of the global financial crisis with a number of major questions arising about how far they can *in practice* carry out this wider externally oriented monitoring and enforcement role[44].

In consequence, some have argued that increasing owner liability in banks - as was common pre-1914 - could reduce risk taking by banks to levels more aligned with wider economic stability and social obligations as a whole. For instance, finance professor Jonathan Berk articulated the demand for a return to unlimited liability in a 2011 editorial for *Bloomberg News*, arguing that, as it is 'impossible to regulate a banker', unlimited liability is the only solution: 'by changing [bankers'] ownership structure, we spur them to act responsibly.'[45]

Holding bank directors to a higher standard than their corporate counterparts has a long historical pedigree. Unlimited liability banking in Britain and Ireland, common

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[41] Peter O. Mülbert. "Corporate governance of banks". *European Business Organization Law Review (EBOR)* 10, no. 3 (2009): 411-436, p. 433.

[42] Macey, Jonathan R. and Maureen O'Hara "The corporate governance of banks." FRBNY Economic Policy Review (April 2003), p. 94.

[43] D. Walker.*A Review of corporate governance in UK Banks and other financial industry entities: Final recommendations*. (London: HM Treasury, 2009.).

[44] See FSA Board Report on the failure of RBS at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf

[45] J. Berk. "Bank reform needs unlimited liability for owners". *Bloomberg News*, 15 December 2011. See also Andrew Haldane's 2011 Wincott Lecture "Control Rights (and Wrongs)"

in the middle of the 19th century, came under attack by Walter Bagehot in several articles in the *Economist* in the 1850-60s, arguing that ownership in unlimited liability banks would end up in the hands of those without the 'property' to guarantee bank deposits.[46] Studies have shown, however, that unlimited liability banking did not suffer from the flaws that Bagehot theoretically identified.[47] As such, there is good reason to believe that unlimited liability could, in principle, be an effective solution to the main moral hazard issues in banking.

However, unlimited liability can only properly align interests if those with the liability if the owners have the knowledge, ability and control to properly optimise the risk profile of the organization. That is, ignorant unlimited liability shareholders (such as many of those from the 19th century) would not be able to provide effective and sound supervision of the banks' management. This is commonly known as the principal-agent problem, and it is addressed in the next section.

Importantly, and in contrast to recent recommendations from HM Treasury,[48] it appears the Berenberg emphasises the controlling power of the two unlimited liability partners and the business unit heads rather than the NEDs. Additionally, Berenberg's structure requires Board re-approval of share sales as well as enforced a post-sale liability period of seven years. As such, Berenberg's structure appears perfectly designed to optimise the strengths of unlimited liability.

Unlimited liability clearly has not evolved at Berenberg for reasons to do with meeting new regulatory pressures – it was the norm for banks from 1500-1900. The reality is that almost all formerly unlimited liability organizations have either converted to limited liability companies or have fallen by the wayside.[49] The key point is that crisis-hit unlimited liability banks *either* fail to bankruptcy *or*, if they survive, become limited liability companies (like MPS) or are taken over by conventional limited liability companies. Berenberg is a rare survivor of the processes that have led to the disappearance (or limited liability transformation) of its 16th-19th century competitors.

However, it is clear that Berenberg is aware of these issues. As our interview data shows, in recent years, it has chosen a competitive strategy that avoids problems arising from TBTF/moral hazard issues, or conflicts of interest arising from the firm acting as principal. The firm made a strategic decision to diversify away from lending as principal and towards broking and other less capital intensive businesses, such as

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[46] W. Bagehot. *The collected works of Walter Bagehot*. (London: The Economist, 1976).

[47] Charles Hickson and John D. Turner. "The trading of unlimited liability bank shares in nineteenth-century Ireland: the Bagehot Hypothesis". *The Journal of Economic History* 63 (2003): 931-958. The theoretical arguments for this phenomenon are in Jack L. Carr, and G. Frank Mathewson. "Unlimited liability as a barrier to entry". *Journal of Political Economy 96* (1988): 766-784, p 769; and Henry Hansmann, and Reinier Kraakman. "Toward unlimited shareholder liability for corporate torts". *Yale Law Journal* (1991): 1879-1934: p. 1893.

[48] Anthony Salz and Russell Collins, *Salz Review: An independent review of Barclays' business practices*. (2013).

[49] Oppenheimer was purchased in distress. MPS, like many of the Swiss banks, became a public company

asset management. Indeed, Berenberg appears to be very successful in its niche markets with its newest activities focused a significant way from traditional lending activities – which raises the interesting question of whether and how far it is still a 'bank' as conventionally understood.

6.3 Principal agent problems

It is well understood that the traditional corporate business model can suffer from serious principal-agent problems – for all businesses, not just for banks. Unlimited liability on its own does not necessarily solve these problems.

One of the frequently proposed solutions is to incorporate direct shareholder control, yet, in banking, this solution has been shown to lead to reactionary management choices such as overly-large dividends.[50] Importantly, Berenberg's unlimited liability managing partners have chosen direct control rather than board oversight of executive managers, following Mark Twain's advice to 'put all your eggs in one basket, and watch that basket!'.[51]

Of course, it is entirely likely that such direct control could only be appropriate in companies much smaller than the large international TBTF banks that regulators often see as the primary risk to financial stability. This is because of:

(i) The problems of motivating and monitoring large numbers of staff, especially if one medium level employee or team can take risks which could bankrupt the firm:[52]

(ii) Significant capital is required to participate in large financial markets transactions. Large capital bases are difficult for unlimited liability companies to raise and manage. (This issue seems to have been a significant factor in Goldman Sachs 1999 public offering which replaced the traditional partnership model);

(iii) Knowledgeable and competent managers with deep enough pockets to take on such unlimited liability obligations are likely to be very rare; and

(iv) Staff that are compatible with unlimited liability cultures are not the norm – particularly in banking and financial services - and, because this is not a readily observable characteristic, they may be difficult to recruit.[53]

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[50] M. Burkhart, D. Gromb, and Faust Panunzi. "Large Shareholders, Monitoring and Fiduciary Duty". *Quarterly Journal of Economics* 112, no. 3 (1997): 693-728.

[51] Mark Twain (Samuel Langhorne Clemens). *Pudd'nhead Wilson.* (1894), p. 197.

[52] See history of Barings – 1890-92 bail-out as well as Nick Leeson in 1990s at https://en.wikipedia.org/wiki/Barings_Bank).

[53] We were told that Berenberg staff tended either to leave relatively quickly or to stay for long periods of time.

Finally, these characteristics must continue to be in place – along with more than a little luck - for an unlimited bank to continue and to prosper over decades and centuries.

6.4 Incentives and culture

One well-publicized line of defense for society is for banks to create an internal ethical culture. This is where much of the energies of policy makers, practitioners and academics have been recently focused. Yet, it remains very unclear how to establish such a culture at a financial institution.[54] Generalist work has addressed the culture issue (e.g. Michael Power at the LSE) and some banks have attempted to make inroads in this regard, but a solution involving changing a firm's culture in order to make it both more long term profitable (by avoiding large fines and negative publicity) and ensuring that systemic risk is reduced) remains highly elusive.[55]

Berenberg has no dealings with high-street retail clients, so - unlike many large retail banks - many of these types of questions do not apply here. However, Berenberg is aware of the most obvious of the pitfalls in general. For instance, 'Compliance plus' is practiced when it comes both to onboarding clients and providing them with 'suitable' advice. Like most private banks, client relationships are chosen carefully.[56]

When it comes to Berenberg's private banking business, staff are not incentivized to 'cross sell' asset management product. The Bank focuses primarily on cash stocks and bonds allocations in their discretionary and advisory businesses.[57] However, with respect to both asset management and investment banking, cross-selling is common. For example, Berenberg's strong reputation in overlay asset management and European equity research are two key marketing tools.[58] Additionally, the compensation system is designed so that clients are managed at every 'touch point' in the (long term) best interests in the firm. The best 'product' is selected by the firm as opposed to having the firm's client coverage personnel fight for access.

The fact that Berenberg's corporate strategy overlaps with some theoretically very attractive structures for limiting societal risk provides the material for a very interesting case study. This also leads to the important – but much more difficult - question as to whether or not the structure and operating style of Berenberg can offer

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[54] Ian W. Jones, and Michael G. Pollitt. "How UK banks are changing their corporate culture and practice following the financial crisis of 2007-08". *Centre for Business Research Working Paper* (2016); Jens van t'Klooster, and Marco Meyer. "Ethical banking: The key concepts". Cambridge Judge Business School (2016). See also Michael Power, Simon Ashby, and Tommaso Palermo. *Risk culture in financial organisations: A research report*. (2012). This is an area where the UK Banking Standards Board have been active, trying to codify and propagate improvements in bank culture.

[55] Michael Power, Simon Ashby, and Tommaso Palermo. *Risk culture in financial organisations: A research report.* (2012).

[56] See C. Hoare *Annual Report* 2016 for a comparison.

[57] Brass Interview.

[58] Brass Interview; Mortlock Interview.

any lessons as to the benefit of unlimited liability partnership structures in wider banking reform discussions.

Can such a structure and its implementation in the 'Berenberg way' lead to both enhanced profitability as well as a safer financial system? If so, are these key characteristics transferable to similar banks? Can this be applied to the banking system more generally?

6.5 Capital buffers

One of the most popular solutions in the academic literature for reducing systemic risk in banking is simply to increase regulatory capital requirements, especially for TBTF banks.[59] Yet here Berenberg is not quite as conservative as one would expect.

As at 31 December 2016, Berenberg was utilising only 34% of its risk bearing capacity.[60] However, with EUR 277.8 million in common and tier 1 equity (CET1) and risk weighted assets (RWA) of EUR 2.1 billion, Berenberg is well within its peer group with at CET ratio of 13.0. Indeed, Handelsbanken has nearly double the CET ratio, and HSH Nord is also substantially above Berenberg at 18.7. It may be, however, that high capital ratios are more an indication of the riskiness of the bank rather than a conservative philosophy. That is, capital ratios are high because risk is high and not vice versa.

It does appear from our interviews with Berenberg senior management (as well as the financial data reported in section 3) that the much larger capital requirements envisioned by Lord Turner and Admati and Hellwig would not seriously impact Berenberg's business model. This is primarily because traditional lending has been (and still is) being reduced within Berenberg's business activities. However, we suspect that the capital increases envisioned by some policy makers and academics might encourage banks to expand and promote less capital-intensive business, which are precisely those into which Berenberg is expanding. It is not clear how strong this effect is but we conjecture that it could significantly increase the competitive pressures on Berenberg and its financial returns. At the limit, this might provide a serious threat to Berenberg's current business model[61].

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[59] Anat Admati, and Martin Hellwig. *The bankers' new clothes: What's wrong with banking and what to do about it*. (Princeton: Princeton University Press, 2014); Adair Turner. *Between debt and the devil: Money, credit, and fixing global finance*. (Princeton: Princeton University Press, 2015). See also Elizabeth Warren's arguments for higher capital requirements in, for example, David Dayen. "Financial reform is about to catch a second wind". *New Republic* 21 November 2013.

[60] Berenberg *Risk Report* 2016.

[61] On the other hand, we note that the more stringent regulatory oversight could reduce competition in these areas.

7. Conclusions and Implications

Recent studies have examined how banking cultures have changed or can change.[62] Yet Berenberg does not currently appear to be an institution in need of change. Berenberg's niches seem to complement its structure well, providing strong growth with little capital at risk. It combines unlimited liability with a flat management structure and highly focused decision-making along with careful choice of business activities and avoidance of unnecessary risk taking.

Looking back, unlimited banking was suitable until well into the 20th century in a world where all banking activities involved only a relatively small proportion of better-off people[63].

Most private sector unlimited liability banks disappeared because of some combination of:

- Banking crises, war, rapid inflation and similar[64];
- Incompetence or bad judgment;
- Bad luck;
- From the late 19th century, they were overtaken by transformation/takeover to meet needs of larger financial markets; and
- Post-1920, the growth of banking controls and regulations.

The survivors were a small number of (up-to-now) well-managed firms operating with a strong identity in a supportive financial environment. The Hamburg financial community and support system as well as the Hamburg commercial culture seems to have been very important for Berenberg at crucial times in its history.

There is no doubt that Berenberg's plan to diversify away from commercial and retail banking and towards wealth management and investment banking has been successful to date. ROE was 95.8% in 2016 (2015: 67.2%), with other key metrics at all time highs. Berenberg did not suffer during the GFC, and, indeed, some of the firm's recent success can likely be attributed to its resilience during and after the GFC. While quite possibly some of the conservatism that allowed for such performance was determined by the unlimited liability structure, the larger question is whether such experience holds any lessons for the banking industry in general.

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[62] Ian W. Jones, and Michael G. Pollitt. "How UK banks are changing their corporate culture and practice following the financial crisis of 2007-08". *Centre for Business Research Working Paper* (2016); Boon Cheong Chew, Lay Hong Tan, and Syaiful Rizal Hamid. "Ethical banking in practice: a closer look at the Co-operative Bank UK PLC". *Qualitative Research in Financial Markets* 8, no. 1 (2016): 70-91.

[63] See Forrest Capie. "Money and Banking". *Refresh No 16* (1993); and M. Collins. *Money and Banking – A History*. (Croom Helm, 1998).

[64] See appendix in Reinhart and Rogoff on historical record of banking and commercial crises.

It is interesting to note that the other main UK unlimited liability bank, C Hoare & Co., had a very similar experience during and after the crisis, with AUM and total assets growing by similar levels since 2005.[65] However, the two firms differ markedly in their compensation structure, with C Hoare adhering to a policy of small bonuses.[66]

Berenberg's activities and its marketing are primarily driven by its ownership structure. Yet at the same time, the fact that Berenberg is an unlimited liability company is not going to impact the decision of institutional investors to allocate commissions to the firm, or to underwrite a new offering. [67] Such businesses are hyper-competitive, and while stability of presence is important, financial stability is clearly a second order factor at best in determining with whom clients engage. [68] Nevertheless, Berenberg's reputation is important, particularly its research reputation. It seems to us that it relies significantly on the strength and reputation of its research product to leverage other business.[69]

We have earlier raised the question as to whether we should even consider Berenberg a bank given its aspirations and revenue growth lie in brokering. What is clear is that, although Berenberg is an unlimited liability bank - and regulated as such - most of the firm's activities cannot be described as traditional banking in the modern sense. Further, to the extent that Berenberg does engage in fractional reserve banking (and therefore money creation), it is very unclear whether let alone how far lessons from its experience could be drawn and then applied to the wider banking sector and the major banks.

It is interesting to note that it might well be that Berenberg's choice to migrate away from modern banking activities is a result of the unlimited liability structure and that this has helped motivate its expansion into business lines utilizing less leverage or involving less risk. Generally, equity broking, research, corporate advisory and asset management do not require anywhere near as much capital as commercial and (modern) investment banking. In fact, individuals and small firms often enter all four of the former businesses.

Alternatively, it may be that unlimited liability companies can not compete in businesses where there are state-supplied benefits (e.g. TBTF subsidy) combined with the moral hazard asymmetries and principal-agent problems of limited liability shareholding banks. That is, it might be impossible to remake commercial and retail banking in any recognisable form if unlimited liability was enforced for banking activities.

The other unanswered question has to do with scalability. 'Big banks' are underserving to mid-tier institutional investors. Is this because of their cost base more than anything else? Would Berenberg be able to scale up their business successfully if

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[65] C. Hoare & Co. *Annual Report* 2016.

[66] C. Hoare & Co. *Pillar 3 Disclosures* 2016.

[67] Anderson Interview.

[68] Anderson Interview.

[69] Brass Interview.

it were to face a very major increase in demand requiring a big expansion in staff numbers?

The concerns discussed above leave the conjecture that perhaps unlimited liability banking is applicable only to specialist niche banking businesses with small scope and size. Berenberg has ridden the waves well to date. One hopes – but there is no guarantee – that it can continue to do so. If not, future financial or other crises may reveal fragilities, particularly where decision making is so concentrated. However, with Berenberg, we currently observe a company that is successful, highly regarded, profitable and following the spirit of its long and distinguished cultural history.