

*When reputation is not enough –
the great default of the London
Corporation in 1683*

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D-DEBTCON 2020 ONLINE CONFERENCE

Geneva, September 10, 2020



Introduction

When and why do reputable sovereign borrowers default?

Reputable borrowers default only in bad states of the world
(Grossman and Van Huyck, 1988)

Do reputable sovereign borrowers behave opportunistically?

Introduction

Our contribution historical case study – one of the earliest well documented default – that of the London Corporation in 1683

We show:

Reputation lowered the cost of capital

Default was triggered by a bad state of the world – the London Fire of 1666.

Reputation does not resolve moral hazard issues. Reputable borrowers can rip-off (uninformed) lenders (Dejong et al, 1985).

Monitoring of the sovereign (accountability and transparency) is necessary to prevent moral hazard.

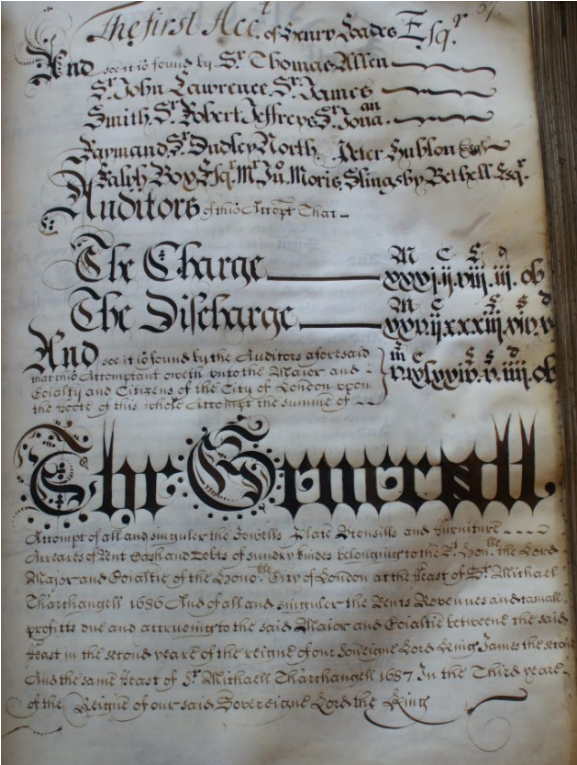
The City of London Corporation as a sovereign borrower

- Early medieval origins before Magna Carta
- A legal entity: “Mayor and Commonalty and Citizens of the City of London”
- The City was not autonomous but enjoyed privileges and rights, especially lack of control by Parliament and lack of accountability to any other institution in England.
- Dominated by guilds.
- Net worth today estimated at 1.3 Bln Pounds.



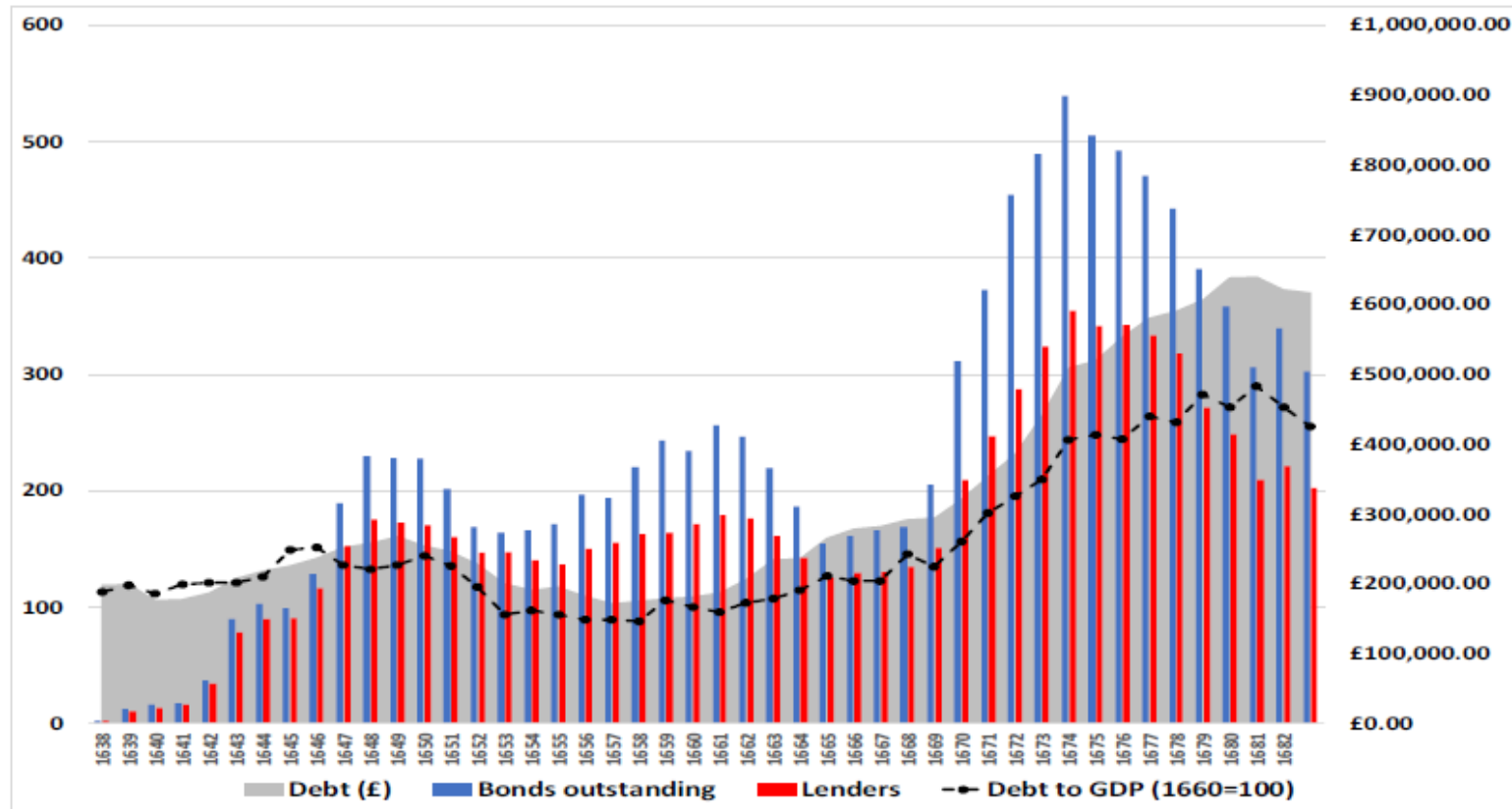
Our Data

- Based on the archived accounts of the London Corporation:
- A series of cash accounts and loan accounts from 1628 to 1692
- A series of accounts related to the Coal Cash Fund (1667-1687).



The London Corporation emerged as a significant borrowers in the 17th century

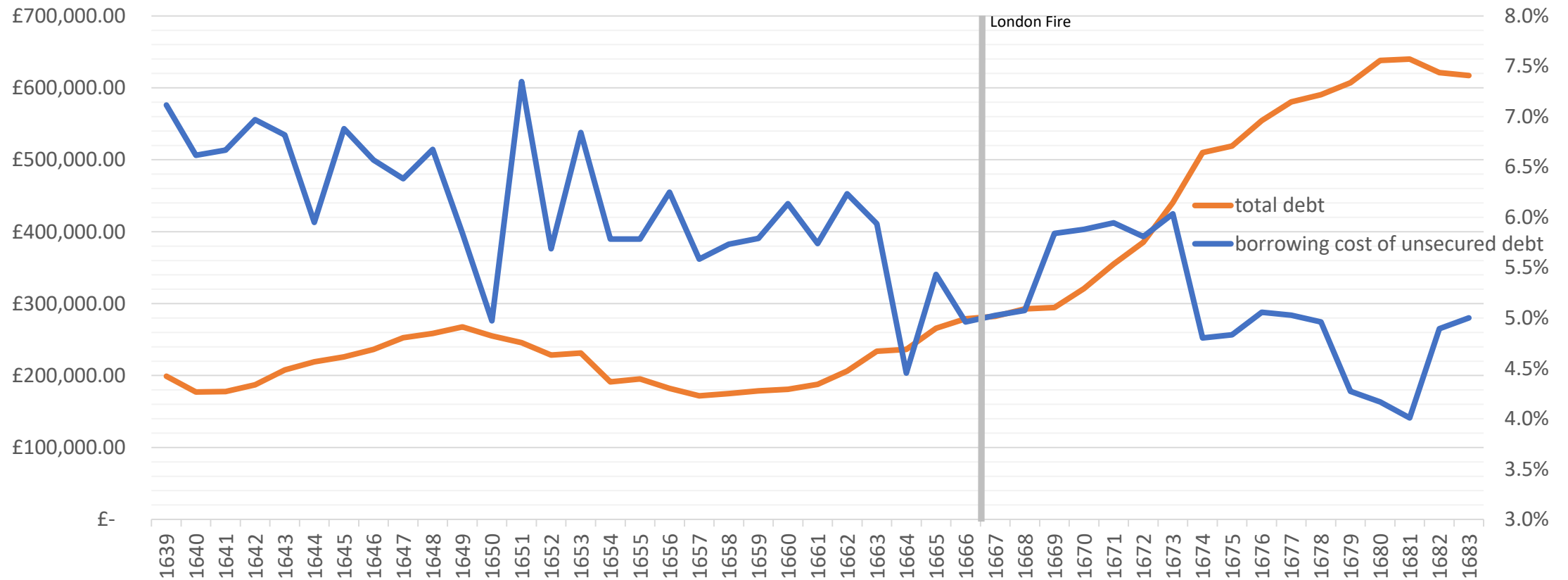
Measures of financial deepening: Debt volumes, debt to GDP, number of loans outstanding and number of lenders: 1633-1683



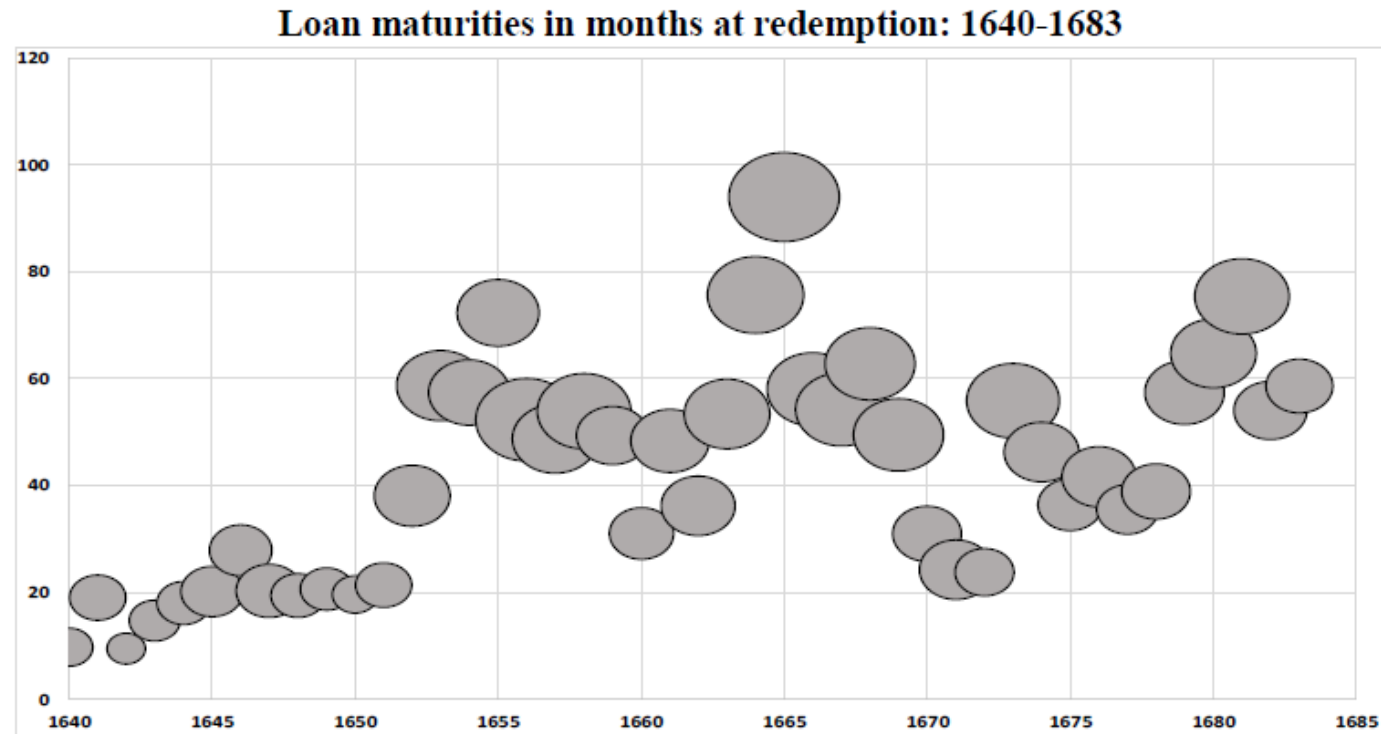
Sources: COL/CHD/CT/001 to 019; COL/CHD/LA/001 and 002.

The London Corporation's reputation allowed to borrow at a lower rate despite rising debt volume

Stock of debt and borrowing cost of the Corporation of London 1639-1683



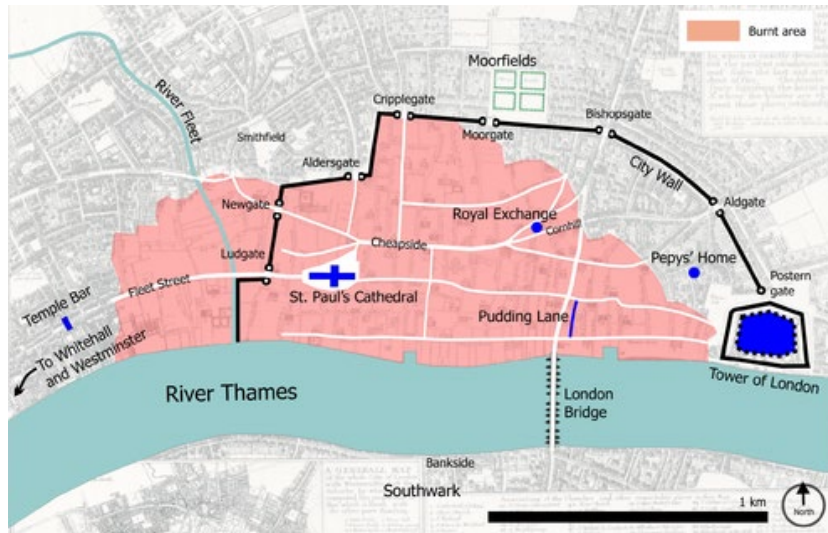
Reputation increased loan maturities



Sources: COL/CHD/CT/001 to 019; COL/CHD/LA/001 and 002.

Note: We plot the median duration of loans redeemed in each year. The size of the bubble indicates the total amount of debt redeemed each year.

The London Fire of 1666 as an adverse fiscal shock

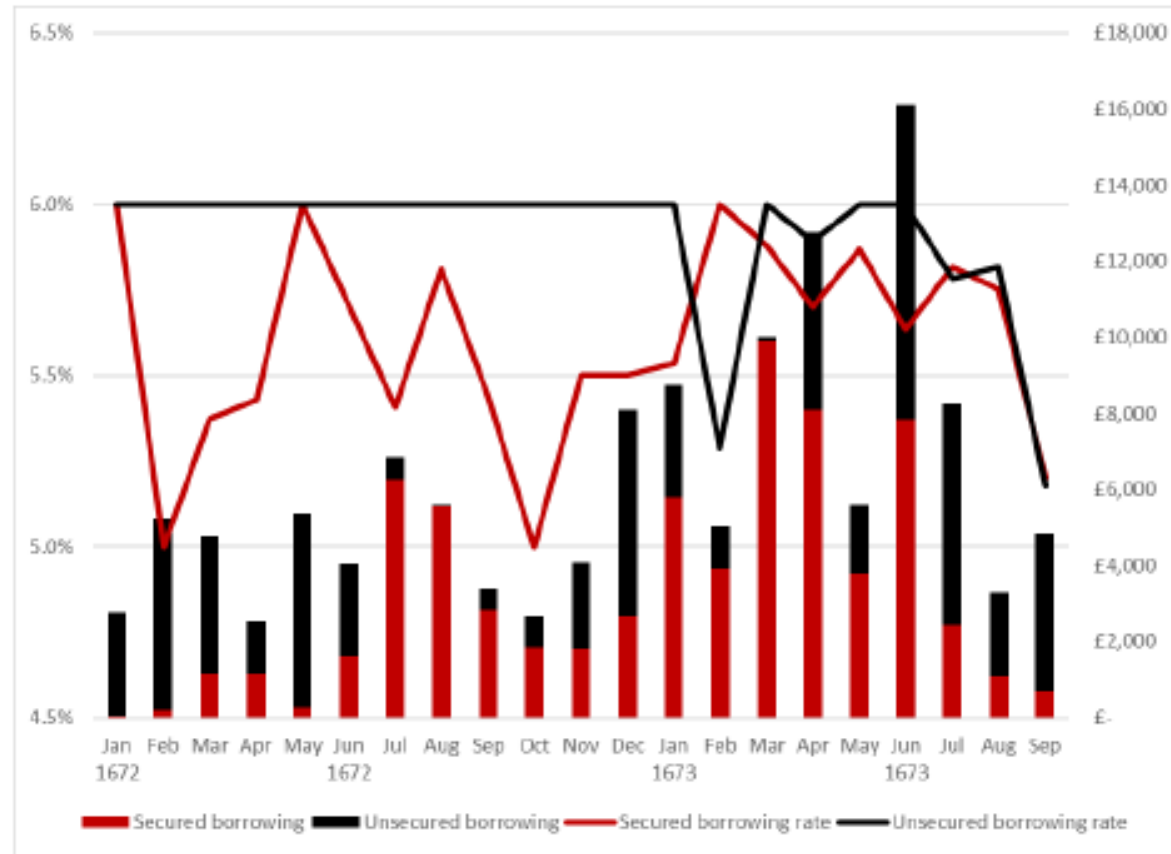


13,200 houses, 87 parish churches, The Royal Exchange, Guildhall and St. Paul's Cathedral – more damaging than the Blitz in WWII.

Parliament assigned revenues from a Coal Tax on London to finance the rebuilding

In normal times reputation is as good as collateral

Secured versus Unsecured Borrowing by the Corporation of London: 1672-1673

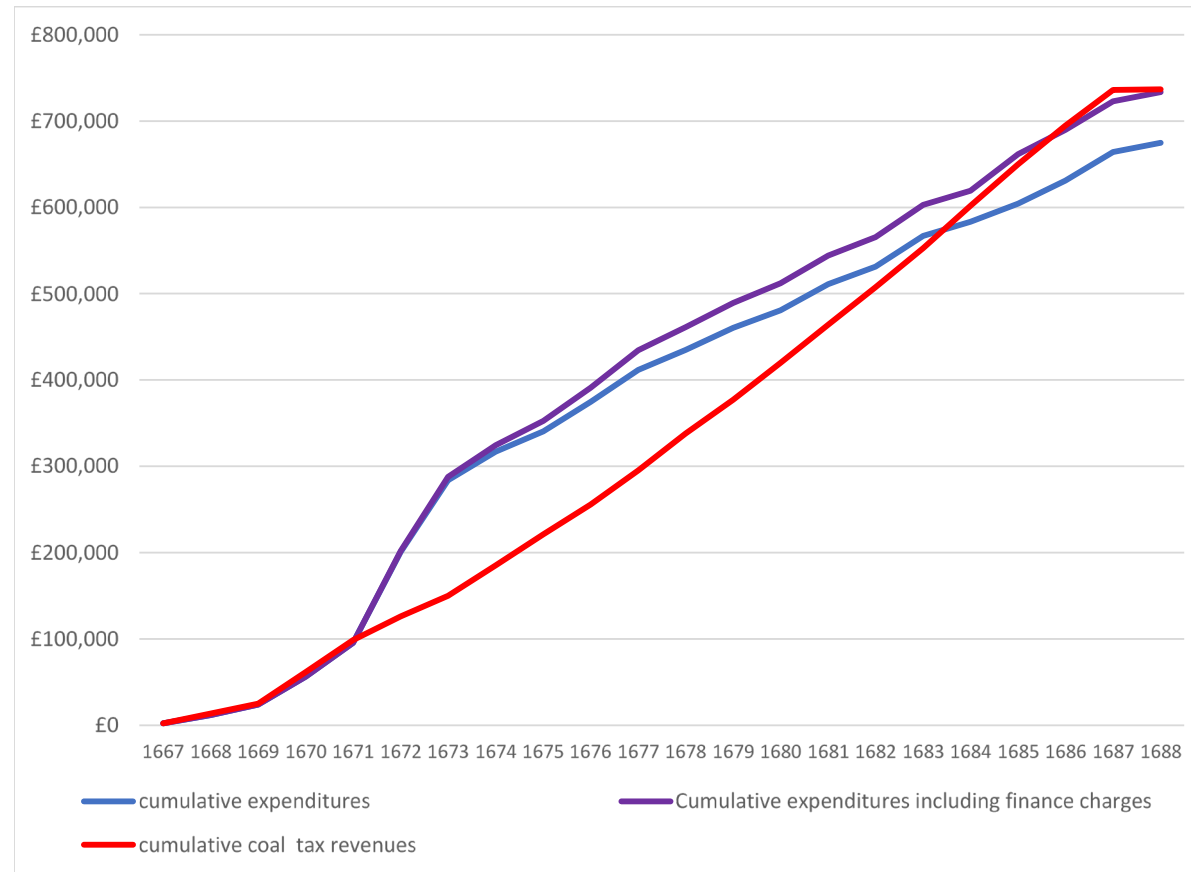


Sources: COL/CHD/LA/01/001 and COL/CHD/DM/01/001.

The dynamics: coal tax revenues lag expenditure

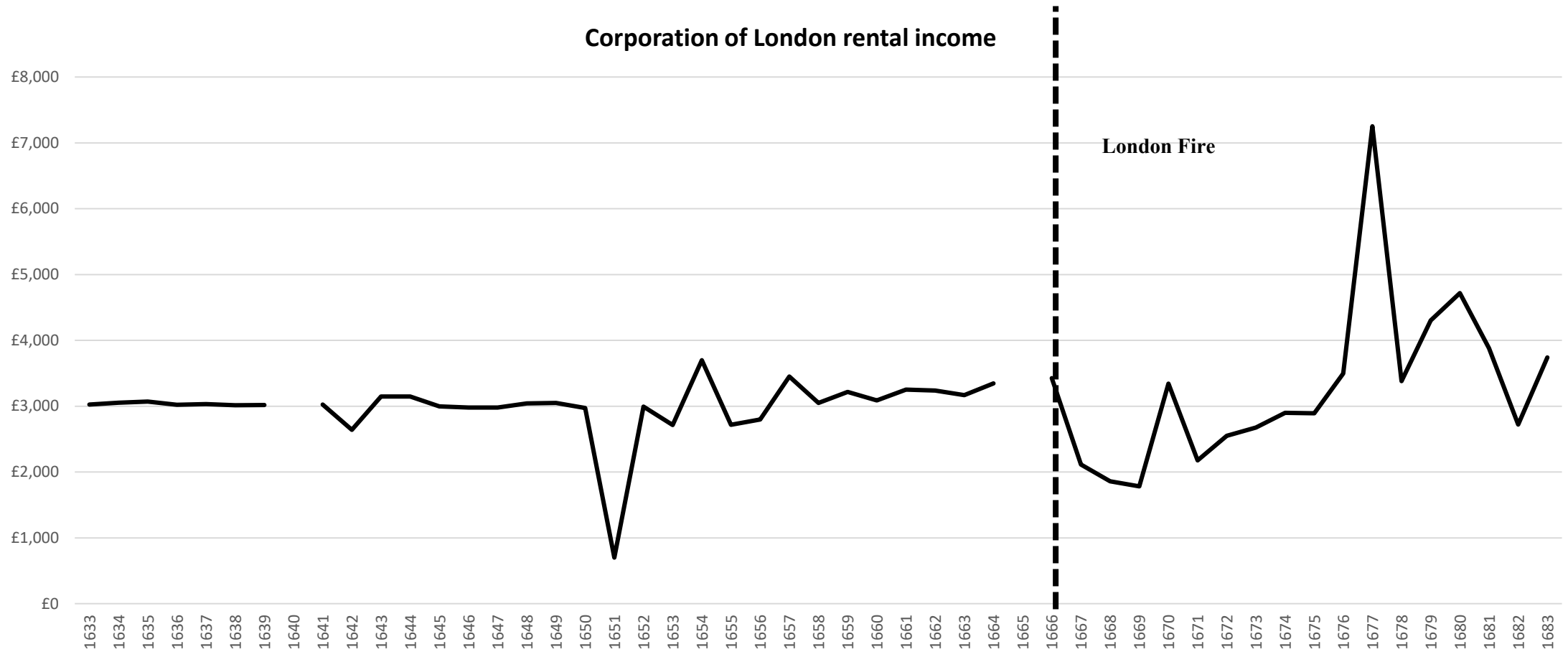
The cumulative expenditure on reconstruction and coal duties income

Coal Cash Fund: 1667-1688



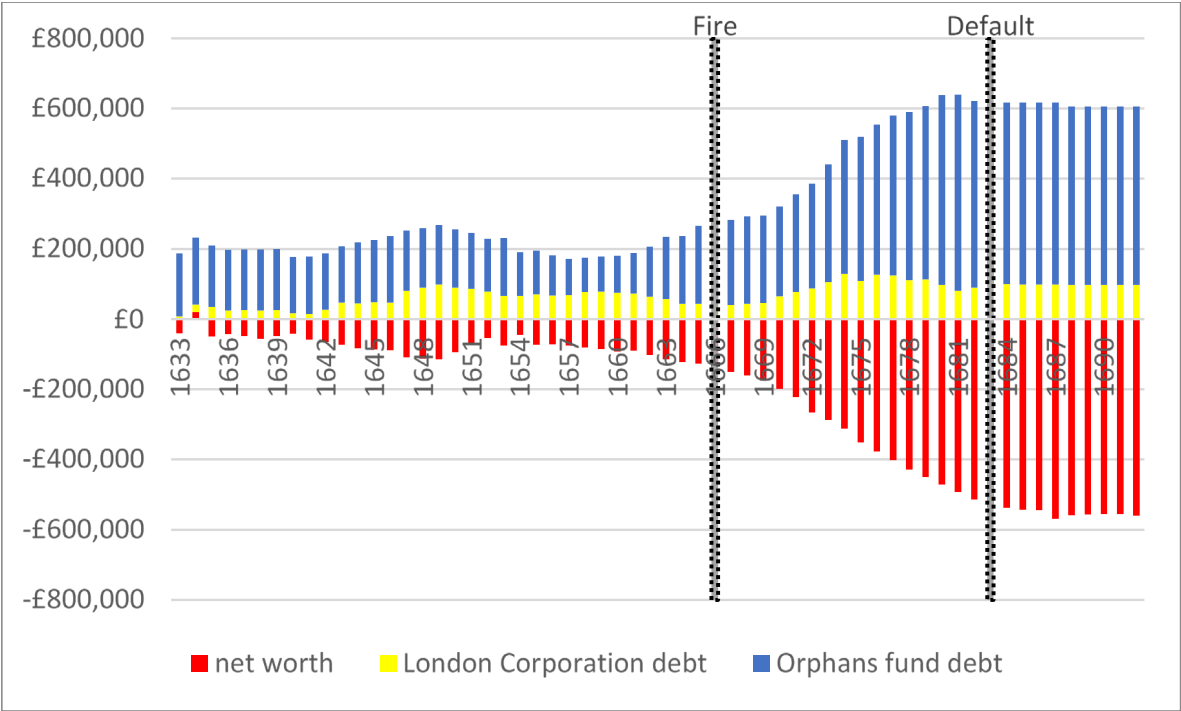
Note: Years are fiscal years (Michaelmas to Michaelmas).
Sources: COL/CHD/DM/001-3.

The Fire caused a decline in rental revenues



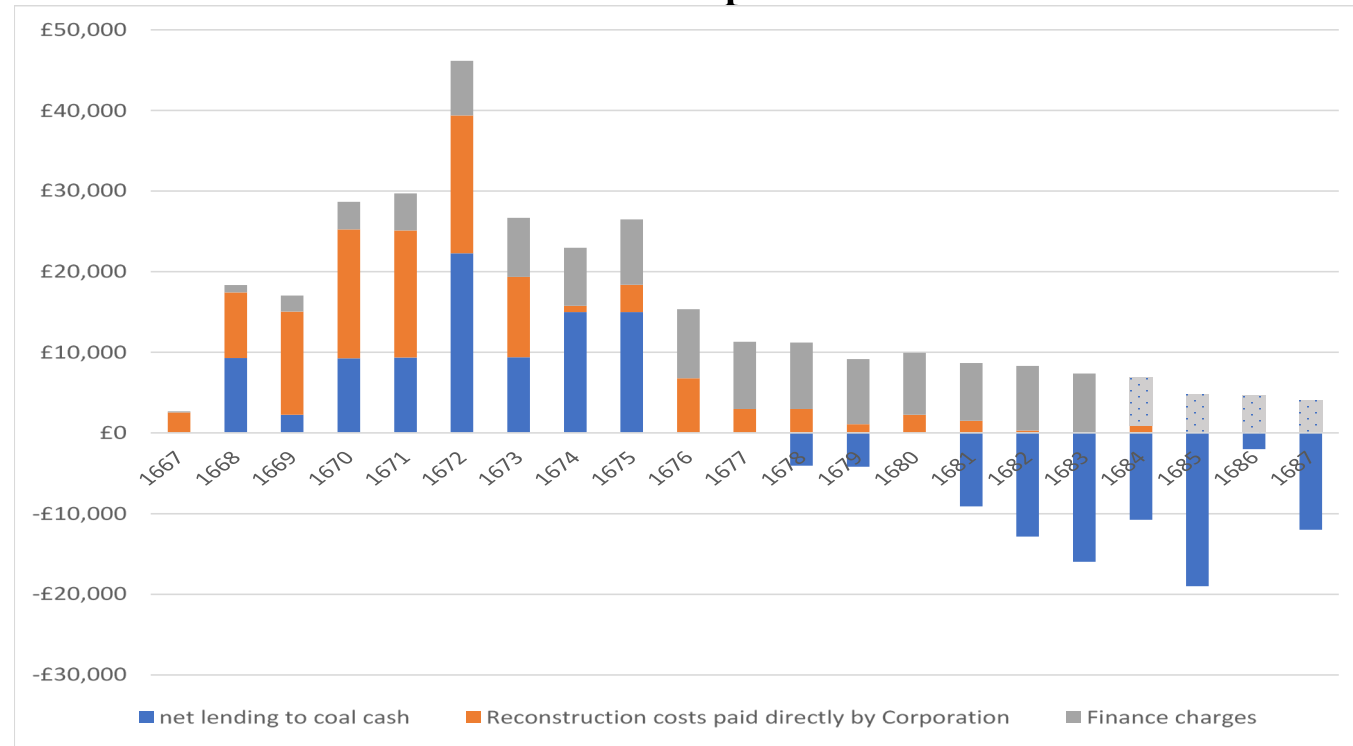
The road to bankruptcy

The debt burden of the London Corporation: 1633-1692



Notes: Years are fiscal years (Michaelmas to Michaelmas).
 Net worth is financial net worth (Financial assets minus financial liabilities) reported in the London Corporations accounts.
 Sources: COL/CHD/CT/01-019 and COL/CHD/CM/10-004 for 1667.

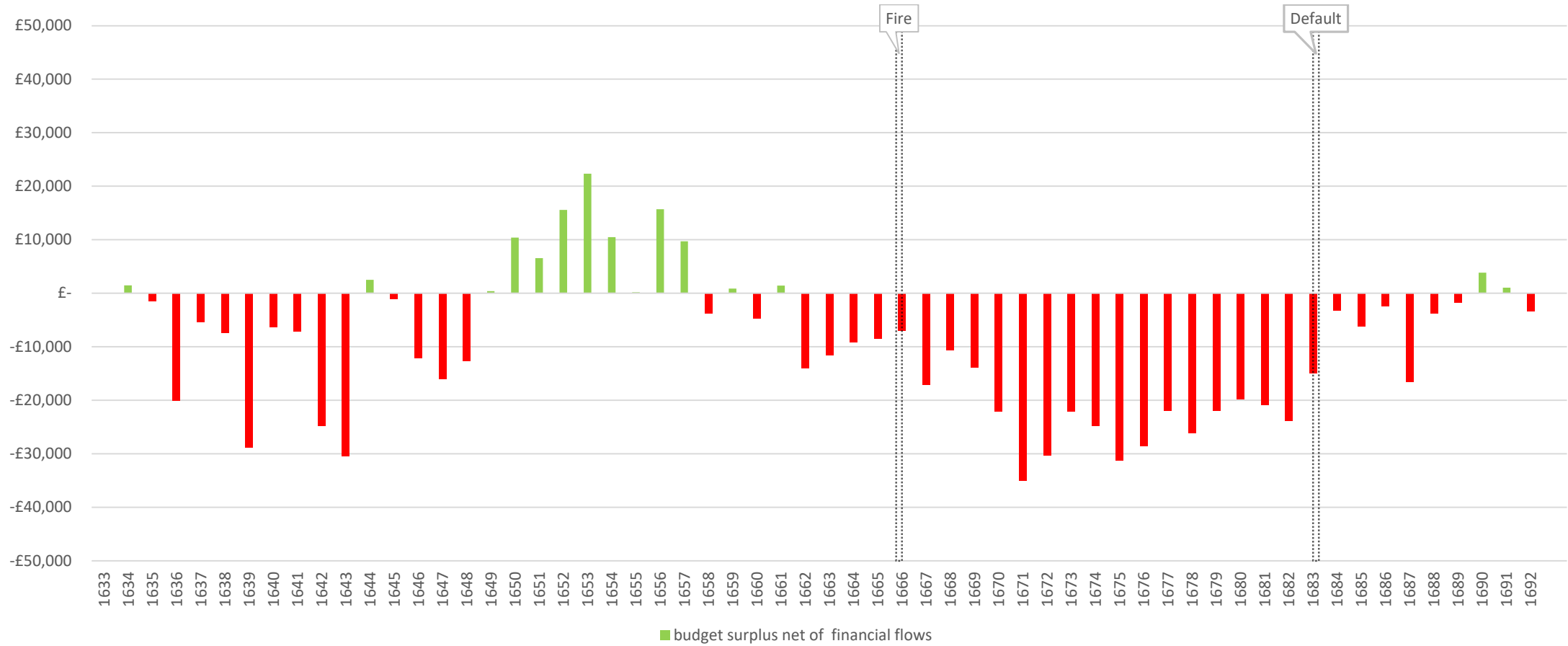
A heavy budgetary burden and large finance charges fell on the London Corporation



Notes: Finance charges attributed to reconstruction are calculated as the interest cost weighted by source of borrowing (see **Error! Reference source not found.**) times the debt accumulated as a result of net lending to Coal Cash Fund and spending on reconstruction. Finance charges after 1683 are shaded because the London Corporation suspended interest payments on its debt.

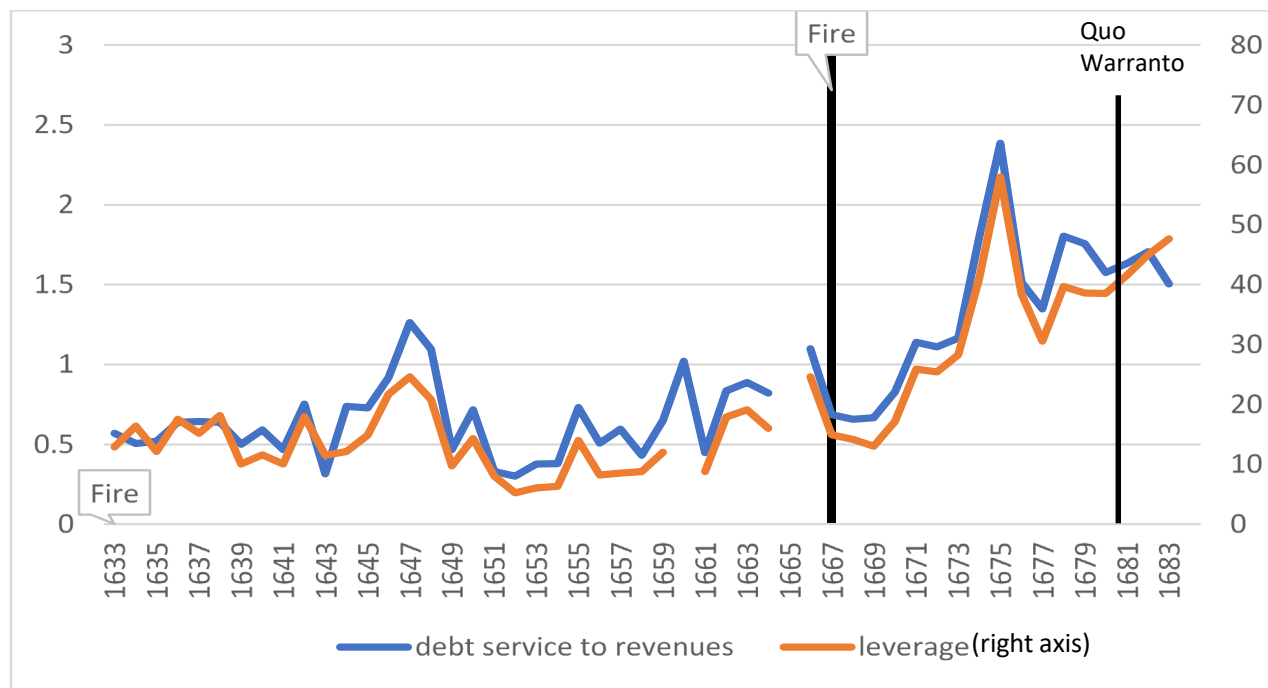
Sources: COL/CHD/CT/013-019 and COL/CHD/CM/10-004 for 1667.

Chronic deficits before default



Financial distress indicators point to default – moral hazard and Ponzi scheme

Financial distress measures of the London Corporation: 1633-1683



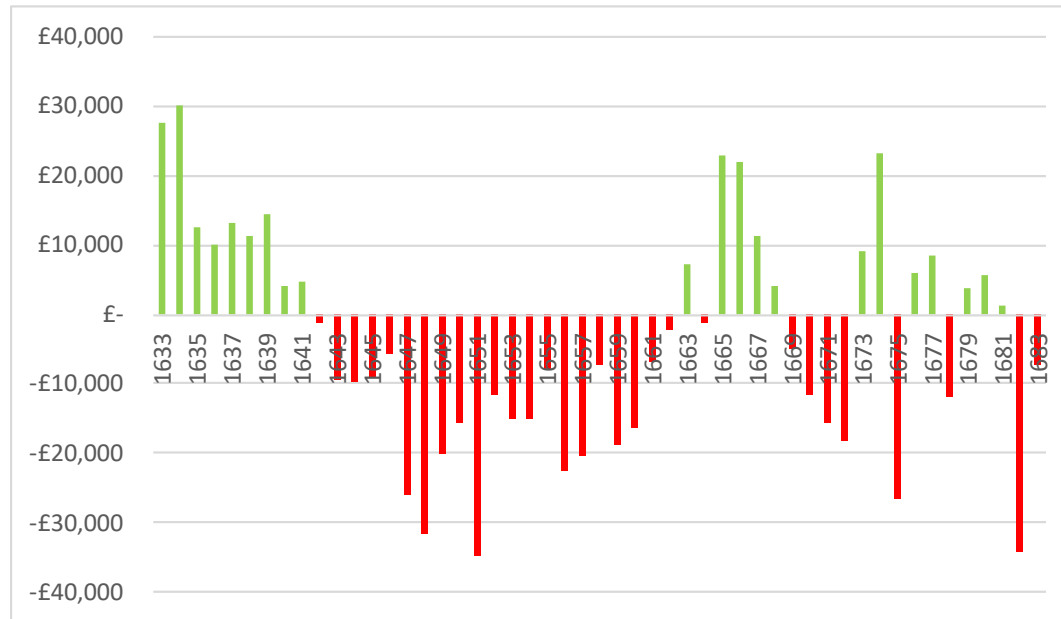
Notes: Years are fiscal years (Michaelmas to Michaelmas).

Debt service to revenues is calculated as the annual interest payments on the debt of the London Corporation divided by its annual revenues. Leverage is calculated as the ratio of debt to income.

Sources: COL/CHD/CT/01-019 and COL/CHD/CM/10-004 for 1667.

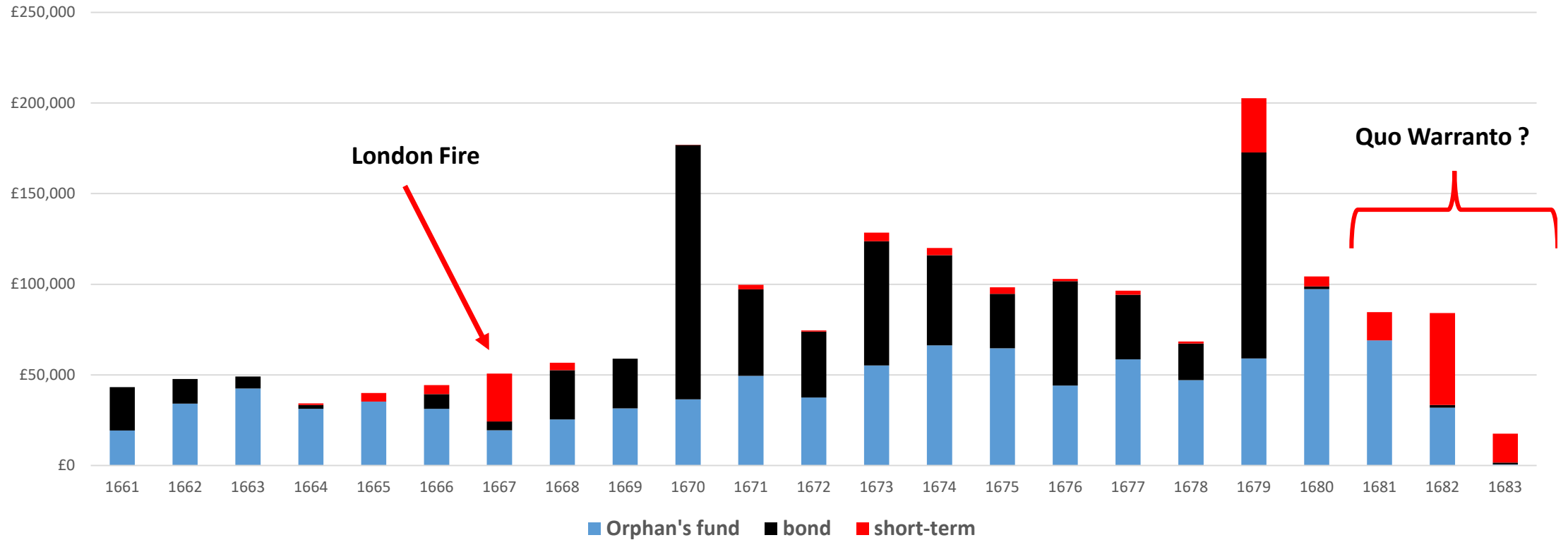
Liquidity problem before default

Figure 4
The cash flow of Corporation of London: 1633-1683



During crisis times and before default – the Corporation of London could borrow only short-term

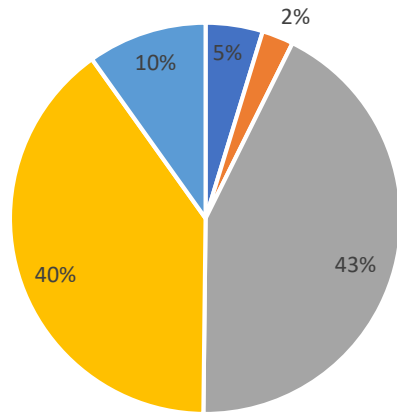
**Borrowing by type of loan
Corporation of London 1660-1883**



The informed and wealthy managed to bail themselves out before default

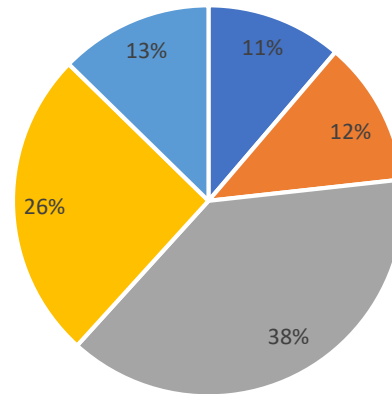
median	£300
mean	£794
loans	213
Total	£169,294

Debt 1680



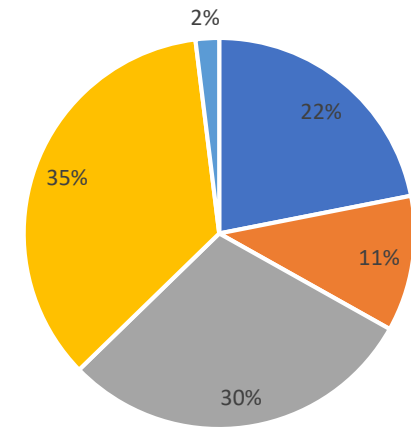
median	£300
mean	£468
loans	148
Total	£69,270

Lending 1682-3



median	£200
mean	£356
loans	278
Total	£94,336

Debt at Default



Epilogue

The Corporation of London defaults on September 1683

It was insolvent and illiquid

Quo Warranto (revoking sovereignty) case against the City started on September 1681 – trial ends June 1683.

Revoking the City charters means that the Corporation was no longer a legal entity responsible for its debts.

The Corporation of London's charter renewed after 1688 (Glorious Revolution)

Tax revenues assigned to the City and debts were mostly repaid with interest rate (coupon) reduction (to 3%) until 1730.

Most of the creditors sold their bonds to third parties and this initiated a market for the bonds.

Conclusions

Reputation allowed the Corporation of London to borrow at a low costs to finance large deficits during the rebuilding of London

Reputation led to moral hazard: Absence of monitoring , lack of accountability and transparency allowed the Corporation to continue to borrow at even lower costs despite increasing leverage and being insolvent

The public proceeding to revoke the City's charter – Quo Warranto – reduced long-term lending to the Corporation triggering a liquidity crisis and default

Challenging the sovereignty of borrower an **end to a repeated game** triggered the default

The default had distributional results as less informed lenders were mostly affected

Borrowing by the Corporation of London: 1638-1683

