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Connected Lending of Last Resort

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Economic research has emphasized the importance of central bank design for monetary policy outcomes, largely focusing on how central bank independence affects monetary policy and thus inflation. However, considerably less is known about how design and governance influence central banks' role as lenders. Central bank charters typically specify the types of operations they can conduct, but additional aspects of their design may affect lending, including the composition of their boards, capital ownership, and ethical rules.

Today's central banks have strict rules to prevent conflicts of interest, as do other public administrations. Yet, given their role in the economy, central bankers cannot be fully isolated from private-sector influence; they might be tempted to rely on their personal or professional relationships with bankers to obtain better information about whom to lend to, especially during a crisis when informational problems are heightened. They might also be subject to political pressures about bank bailouts or influenced by their experience in the private sector. While research on connected lending has grown over the past two decades, little is known about whether central bankers draw on personal connections during lender of last resort (LOLR) operations or what the consequences are.

To answer these questions, one needs detailed and nonanonymous central bank lending data. Contrary to government loans or subsidies that have been the focus of research on connected lending, such data are impossible to obtain from recent LOLR operations because of privacy concerns and fears of stigma for commercial bankers that use emergency lending. Secrecy is the rule with central bank lending.

We turned therefore to previously unknown archival data from the central bank of France (Banque de France, or BdF), which contain the names and amounts borrowed by all the main French commercial banks from 1930 to 1931. While these data span only two years, they cover both 10 months before and the entirety of the most severe banking crisis in French history, which lasted 14 months.

We combined these hand-collected historical data with new information on the relationships between members of the BdF's board of directors and commercial banks to

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understand whether these connections were used during a banking panic and to examine what effect they might have had on the central bank's role as an LOLR. We demonstrate that once the banking panic began, the BdF's lending policy indeed relied on personal connections. However, its decision to draw on these during the panic meant that it failed to lend broadly to stop the panic. We show that selective lending during the panic had repercussions even beyond the scope of the panic, proving to be costly to the French government and leading to a major overall reform of the BdF's governance.

We used newly unearthed ledgers that recorded the BdF's lending to commercial banks in 1930–1931 and a unique data set on the connections between the BdF's voting shareholders and commercial banks to define commercial banks as connected or unconnected. This historical setting is especially well-suited to studying how personal links and private interests can affect the LOLR policy of a central bank. Of the more than 40,000 shareholders, only the 200 largest shareholders had voting rights, and these shareholders selected the BdF's directors. This governance structure had important implications for how the central bank reacted to two waves of banking panics in the autumn of 1930 and summer of 1931.

Our research shows that once the panic commenced, the BdF lent disproportionately more to connected banks. Banks that had ties to the BdF's 200 largest shareholders received on average 30–40 percent more than banks that were unconnected to BdF shareholders. By contrast, we found no difference in the evolution of lending between the two groups prior to the crisis; connected and unconnected banks also did not differ in terms of risk or solvency. Excluding systemically important financial institutions and banks that failed during the crisis increases the difference in crisis-period lending between connected and unconnected banks to more than 60 percent. This suggests that becoming a shareholder of the BdF was not a strategic choice by the largest banks before the crisis. Indeed, since France had never experienced a systemic commercial banking crisis, the reaction of the central bank during a panic was unknown.

When the surge in demand for liquidity came in November 1930, the BdF chose not to lend broadly to all eligible banks that requested it. Unconnected banks had nowhere else to turn because the BdF was the main source of short-term liquidity in the French economy; France lacked an active and accessible interbank lending market, and depositors had no knowledge of the recipients of the BdF's lending. Because the BdF rationed credit to unconnected banks, it did not provide enough high-quality liquid assets to the market to stop bank runs, and a panic ensued. Consequently, the financial panic morphed into a widespread banking crisis that ultimately required government interventions to save the central bank and halt the panic from spreading to the largest French banks. Bank runs continued in 1931 as market participants correctly surmised that the BdF would not lend broadly. The second period of peak distress in the autumn of 1931 only ended after the government intervened and bailed out a large failing commercial bank. The decision to lend selectively represented a failure by policymakers to recognize that a panic that was not arrested could spill over even to connected banks.

Throughout the banking crisis, the BdF was overtly concerned with the welfare of its shareholders—the connected banks—even as its nonperforming loans (i.e., loans with missed payments) ballooned and as it faced pressure to pay dividends to shareholders. In principle, selective lending was consistent with maximizing shareholder value. In practice, however, lending to banks with personal connections was financially disastrous for the BdF; it ultimately destroyed shareholder value since its lending policies during the autumn of 1930 allowed the banking crisis to grow into the largest in French history and spread to connected banks.

Our research provides new evidence that the BdF's poor financial position largely resulted from massive loans it had made in the first few weeks of the panic to *connected* banks, decisions that less than two months later led to a bailout from the French government during the last week of December 1930. This secret agreement, undisclosed to the public at the time, removed nonperforming loans from the central bank's balance sheet, with the French Treasury assuming these liabilities. The timing was particularly opportunistic as it provided window dressing for the BdF's year-end annual report, allowing its managers to state publicly that the bank had positive earnings and allowing it to pay its shareholders dividends. Indeed, despite the crisis, the bank paid a larger dividend at the end of 1930 than in any year prior to the panic.

The BdF's selective lending policy had long-term repercussions for its governance and led to a redesign of the central bank's lending policy because politicians held the BdF responsible for failing to stop the banking crisis. A political coalition led by Prime Minister Léon Blum completely overhauled the bank's governance, removing the significant influence of the 200 largest shareholders on policy by changing the voting structure to a one-share, one-vote model and reforming the selection of the board of directors and policy committees so they operated in the public's interest.

At first blush, one might think that a central bank of the past run by private shareholders is sufficiently different from central banks today and that our research is of only historical interest. On the contrary, just because a central bank is state-owned and has ethical rules does not mean it is beyond the reach of conflicts of interest. Research has shown that in many countries, especially those with weak rule of law and where corruption is prevalent, political connections for government lending play an important role. It is not obvious that central banks should be more immune to these problems than the governments that charter them.

One question that is difficult to answer is whether central bankers in countries with fewer conflicts of interest still rely on personal information about banks to conduct LOLR operations or if their professional experience might create a bias toward some institutions. Research has shown that personal connections to government agencies might matter even in countries with strong rule of law and that the past professional experience of central bankers affects their attitudes toward banking regulation. These considerations might be more important if the central bank faces potential losses.

NOTE

This research brief is based on Kris James Mitchener and Eric Monnet, "Connected Lending of Last Resort," National Bureau of Economic Research Working Paper no. 30869, January 2023.