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Politically Connected Banks:

Evidence from British Banking Experience in Pre-World War I Era

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Introduction

Various researches have shown that political connections can either be beneficial or detrimental to firms. Benefits and costs of political connections for banking sectors are:

Benefit	Cost
(1) Easier access to debt financing and lower taxation (Faccio, 2006)	(1) Governments' influences over banks to take economically unsound decisions (Dinç, 2005)
(2) Preferential treatment by governments to acquire more capital (Khwaja et al., 2005)	(2) The possibility that banks' performance would depend on political circumstance (Faccio et al., 2006)
(3) Increased likelihood of receiving governments' bail-out plans (Duchin et al., 2009)	(3) Tendency to provide loans to economically unviable, politically-connected firms (Faccio, 2006)

Majority of the studies on political connections focus on recent developing countries. Using the data set of British banks from 1877 to 1913, we try to find out how political connections influenced banks' performance in history. We try to prove the assumption that politically-connected banks generally perform poorly due to its aggressive tendency to provide loans to incompetent, politically-connected firms. Moreover, we analyze the impact of elections on banks.

Methodology

· Data

Biannual data on banks' board members were collected by previous researcher Arion Blas, who used British stock market yearbooks, *the Intelligence* and *the Yearbook*. Data on British banks from 1877 to 1913 were gathered from the online historical archive of *the Economist* magazine.

· Methodology

We employ a panel data set of all British banks that were in business from 1877 to 1913. Using biannual data on banks' board members, we run regressions of share price growth rate and total assets growth rate on various MP variables. In order to control for the average differences between banks and years, we use fixed effects methods. We run regressions only with English banks to see any difference between English banks and non-English banks. Moreover, to determine the impact of elections on banks' performance, we run regressions on election dummy variable. We also include interaction terms between election and MP variables to see how elections affect the influence of political connections over banks.

· Dependent Variables

The growth rate of share price	Banks' performance
The growth rate of total assets	Banks' aggressiveness or willingness to lend more

· Independent Variables

MP Dummy	= 1 if a member of the British Parliament (MP) was on a bank's board during a year
# of MPs	The number of MPs on a bank's board during a year
MP Ratio	The number of MPs divided by the number of all directors on board
Size	Size of a bank = ln (Bank's Total Asset)
Election	= 1 if election has taken place in the past two years
Election* MP Dummy	Interaction term of Election and MP Dummy
Election* MP Ratio	Interaction term of Election and MP Ratio

Results

(1) Regressions of the growth rate of share price

	(1)	(2)	(3)	(4)	(5)	(6)
MP Dummy	-0.018			-0.022		
	(0.017)			(0.019)		
# of MPs		-0.011			-0.023	
		(0.012)			(0.016)	
MP Ratio			-0.113			-0.253
			(0.161)			(0.191)
Size	-0.030	-0.030	-0.030	0.021	0.023	0.020
	(0.021)	(0.021)	(0.021)	(0.023)	(0.022)	(0.022)
Constant	0.320	0.323	0.315	-0.218	-0.250	-0.212
	(0.339)	(0.339)	(0.341)	(0.335)	(0.330)	(0.327)
Observations	2067	2067	2067	1172	1172	1172

(2) Regressions of the growth rate of total assets

	(7)	(8)	(9)	(10)	(11)	(12)
MP Dum.	-0.035**			-0.042***		
	(0.014)			(0.014)		
# of MPs		-0.021**			-0.023***	
		(0.008)			(0.008)	
MP Ratio			-0.246***			-0.245***
			(0.109)			(0.079)
Size	0.191***	0.191***	0.190***	0.135***	0.134***	0.132***
	(0.026)	(0.026)	(0.026)	(0.032)	(0.032)	(0.032)
Cons.	-2.923***	-2.931***	-2.914***	-2.006***	-2.000***	-1.960***
	(0.409)	(0.409)	(0.410)	(0.500)	(0.503)	(0.501)
Obs.	2290	2290	2290	1221	1221	1221

(3) Regressions including election dummies

	(13)	(14)	(15)	(16)
	Growth of Share Price		Growth of Asset	
MP Dummy	-0.011		-0.048***	
	(0.022)		(0.015)	
MP Ratio		-0.098		-0.362***
		(0.213)		(0.107)
Election	-0.105***	-0.108***	0.007	0.006
	(0.033)	(0.033)	(0.031)	(0.031)
Election*MP Dummy	-0.017		0.027*	
	(0.023)		(0.015)	
Election*MP Ratio		-0.038		0.253*
		(0.195)		(0.140)
Size	-0.030	0.030	0.191***	0.190***
	(0.021)	(0.021)	(0.026)	(0.026)
Constant	0.543*	0.547*	-2.921***	-2.904***
	(0.309)	(0.309)	(0.409)	(0.411)
Observations	2067	2067	2290	2290

Standard errors in parentheses, *** p<0.01 ** p<0.05 * p<0.10

· The regression results from (1) to (6) indicate that there is no significant relationship between the banks' share price growth rate and MP variables.

· The regressions results from (7) to (12) demonstrate that the growth rate of banks' total assets and MP variables are negatively correlated. Regressions (5), (6), (11) and (12) show that excluding non-English banks do not result in different outcomes.

· The regression results from (13) to (16) suggest that elections lower share prices, but do not affect the growth rate of banks' total assets.

Conclusions & Discussions

· The absence of any significant relationship between the share price growth rate and the MP variables indicate that there is no relationship between political connection and a bank's underperformance.

· Negative correlation between the growth rate of a bank's total asset and the MP variables also contradicts our assumption. We find that politically-connected banks pursue less aggressive loan policy.

· English banks and non-English banks do not differ with regards to the effect of political connections on banks' performance.

· Our findings that elections do not affect the growth rate of banks' total assets contradict the previous study that showed the banks' tendency to increase lending in election years (Dinç, 2005).

· Our findings display substantially different results from other previous researches. Since the data we employed were produced a century ago, they might be imperfect. Another reason would be different historical circumstance. There needs further research on this.

References

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