Private Credit Under Political Influence: Evidence from France

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Bank Loans to French Local Public Entities

1. **Large**

2. **Profitable** for banks

3. **Discrenationarily** allocated by **politicians**

[International comparison]

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   - Not subject to Public Procurement law

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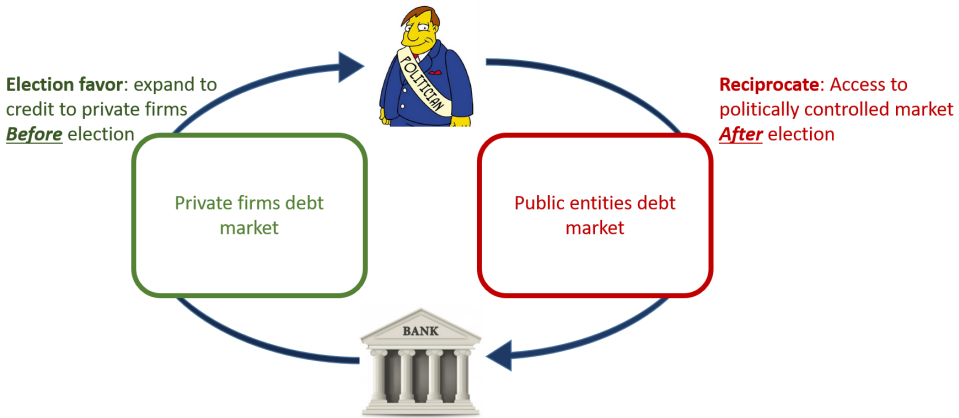
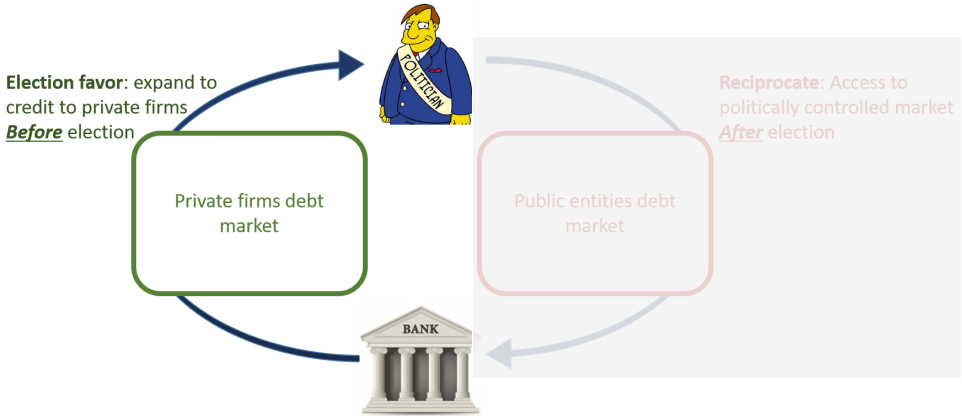
$\Rightarrow$ Room for **reciprocal favors** **politicians** $\longleftrightarrow$ **banks**

Reciprocal Favors

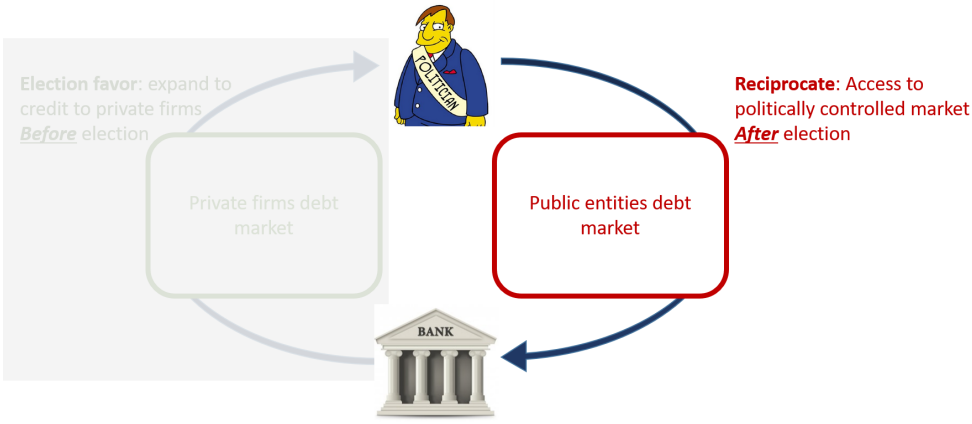


This Paper: First Part



- Do private banks expand credit to firms before elections to benefit political incumbents?

This Paper: Second Part



- Do political incumbents reciprocate the favor when re-elected by granting banks access to the market for local public entity debt?

Contributions to the literature

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1. Political credit cycles:
   - By **politically-connected** banks (Sapienza, 2004; Dinc, 2005 ; Claessens et al. 2008; Khwaja and Mian, 2005; Cole, 2009; Englmaier and Stowasser, 2017, Haselmann et al. 2018)
   - → **Contribution:** political credit cycle for **formally independent banks** in low corruption environment

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   - → **Contribution:** political credit cycle for **formally independent banks** in low corruption environment

2. Benefits of political connections:
   - Access to government contracts (Goldman et al., 2010; Tahoun, 2013; Amore and Bennedsen, 2012)
   - → **Contribution:**
     - Uncover large unregulated market
     - Alternative mechanism: reciprocal favors instead of political connections

Empirical Set-Up

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- Focus on members of parliament (MPs):
  - Most prominent local political figures
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- France over 2006-2017
- Focus on members of parliament (MPs):
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  - Elected for 5-year term in 550 constituencies
  - Election results + hand-collected political variables
- Administrative credit registry from Banque de France
  - Universe of credit to private corporations + public entities
  - Quarterly frequency
  - Matched to constituencies using geographical identifier of borrower

[summary stats]

Institutional Details: Loans to Public Entities

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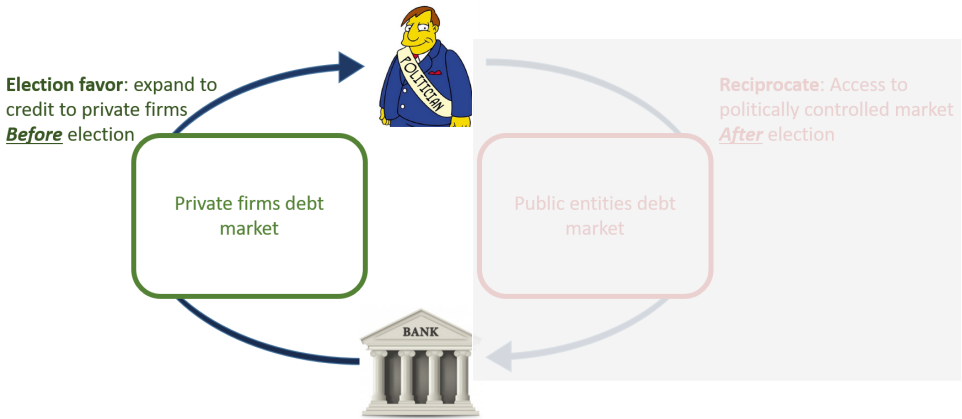
  - Spread = **150-200 bps**

Do Banks Grant Election Favors to Politicians?



Specification

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Predictions from simple “quid pro quo” conceptual framework:

1. Banks grant election favors only to obtain economic favors in return
   - When incumbent can influence allocation of public entity loans → $Powerful\ MP_{c,t}$
2. Politicians ask election favors only when most valuable
   - As the next election approaches → $Election\ Year_t$
   - When the next election is contested → $Contested_{c,t}$

Specification

$$\begin{aligned}\log(Credit_{c,t}) = \beta\ & Election\ Year_t \times Contested_{c,t} \times Powerful\ MP_{c,t} \\ & + Election\ Year_t \otimes Contested_{c,t} \otimes Powerful\ MP_{c,t} \\ & + \theta_c + \delta_{r,t} + \varepsilon_{c,t}\end{aligned}$$

"Banks expand corporate credit volumes when election approaches, all the more so in contested constituencies held by influential politicians"

$\otimes$: cross product

Variables Definitions

1. ***Election year***$_t$: parliamentary election takes place this year (and municipal elections if MP also runs for mayor- 25%)

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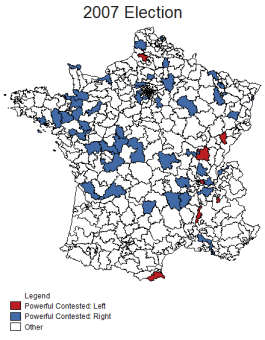
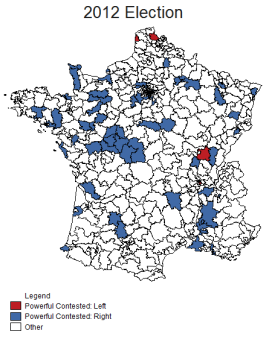
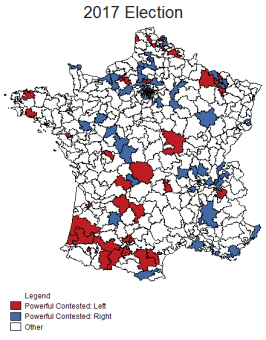
1. ***Election year***$_t$: parliamentary election takes place this year (and municipal elections if MP also runs for mayor- 25%)
2. ***Contested***$_{c,t}$: close-race elections or constituency not a stronghold for the incumbents' party
3. ***Powerful MP***$_{c,t}$:
   - Political clout (political longevity, has held prominent position in gvt)
   - Direct connections with other local politicians (same party as national or regional majority, or more than half mayors in the constituency)

Powerful and Contested MPs across elections







Election Favors

- *No* effect of contested election ≈ same macro path

	Log(Credit)		
	(1)	(2)	(3)
Contested × *Election Year*× *Powerful MP*			
Contested × *Election Year*	.018		
	(.014)		
Interacted terms	✓		
Constituencies	✓		
Time	✓		
Region × Time	–		
Observations	24,671		

Election Favors

- Private banks ↗ corporate credit only if incumbent contested **and powerful**

	Log(Credit)		
	(1)	(2)	(3)
Contested × *Election Year*× *Powerful MP*		.086***	.093***
		(.043)	(.044)
Contested × *Election Year*	.018		
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Interacted terms	✓	✓	✓
Constituencies	✓	✓	✓
Time	✓	✓	–
Region × Time	–	–	✓
Observations	24,671	24,671	24,671

Election Favors

- **Problem:** Potentially driven by constituency-level credit demand shocks

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  - Related to banks' characteristics [Banks' characteristics]
- Proxy for banks' valuation of the economic favor
  - Banks' actual participation in market for public entity loans
  - $Involved\ Bank_b$ = has public entity loans in balance sheet

Election Favors: The Role of Involved Banks

$$\begin{aligned}\log(Credit_{c,b,t}) = \beta\ & El.\,Year_t \times Contested_{c,t} \times Powerful\ MP_{c,t} \times Involved\ Bank_b \\ & + Involved\ Bank_b \otimes X_{c,t} \\ & + \theta_c \times \delta_t + \gamma_b \times \delta_t + \gamma_b \times \theta_c + \varepsilon_{c,b,t}\end{aligned}$$

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- High dimensionality fixed effects, control for:
  - Constituency × time : Local specific shocks (demand)
  - Bank-type × time : Bank-type specific shocks
  - Bank-type × constituency : Bank-type×constituency matching

Election Favors: The Role of Involved Banks

- Effect entirely driven by involved banks

	log(Credit)			
	Not Involved	Involved	All	
Contested × *Election Year* × *Powerful MP*	-.001	.139***		
	(.065)	(.048)		
Contested × *Election Year* × *Powerful MP* × *Involved Bank*				
Cross terms	✓	✓	✓	✓
Constituencies×Bank Type	✓	✓	✓	✓
Region × Time	✓	✓	✓	✓
Bank × Time	–	–	✓	✓
Constituencies × Time	–	–	–	✓
Observations	24,671	24,671	49,336	49,336

Election Favors: The Role of Involved Banks

- Robust to control for bank and constituency shocks

	log(Credit)			
	Not Involved	Involved	All	
Contested × *Election Year* × *Powerful MP*	-.001	.139***	-.001	–
	(.065)	(.048)	(.063)	
Contested × *Election Year* × *Powerful MP* × *Involved Bank*			.142***	.142***
			(.067)	(.066)
Cross terms	✓	✓	✓	✓
Constituencies×Bank Type	✓	✓	✓	✓
Region × Time	✓	✓	✓	✓
Bank × Time	–	–	✓	✓
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Tracing Out Politically-Driven Credit

- Industry characteristics at sic−2 (62 distinct)

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Industry characteristics:	ST liquidity needs			
Proxy	Working cap/ Sales		Interest payment/ VA	
Sample	Low	High	Low	High
$Contested \times Election\_year$	.035	.329***	–.076	.221***
$\times Powerful\_MP \times Involved\_bank$	(.069)	(.118)	(.080)	(.082)
High *minus* Low		.293**		.297***

Tracing Out Politically-Driven Credit

- Industry characteristics at sic–2 (62 distinct)
- Industries in economic decline

Industry characteristics:	ST liquidity needs				Declining industries			
Proxy	Working cap/ Sales		Interest payment/ VA		VA/ Assets		Prob. bankruptcy	
Sample	Low	High	Low	High	Low	High	Low	High
$Contested \times Election\_year$	.035	.329***	–.076	.221***	.194***	–.109	–.121	.182***
$\times Powerful\_MP \times Involved\_bank$	(.069)	(.118)	(.080)	(.082)	(.082)	(.090)	(.160)	(.068)
High *minus* Low		.293**		.297***		–.304***		.304*

Ruling Out Alternative Stories

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- Banks holding public entity debt in their balance sheet are more likely to be officially connected with politicians
  - Extract **composition of the board** of all main banks holding public entity debt from their annual prospectus from AMF
  - Compare with list of mayors and MPs $\Rightarrow$ 1 MP and 6 mayors

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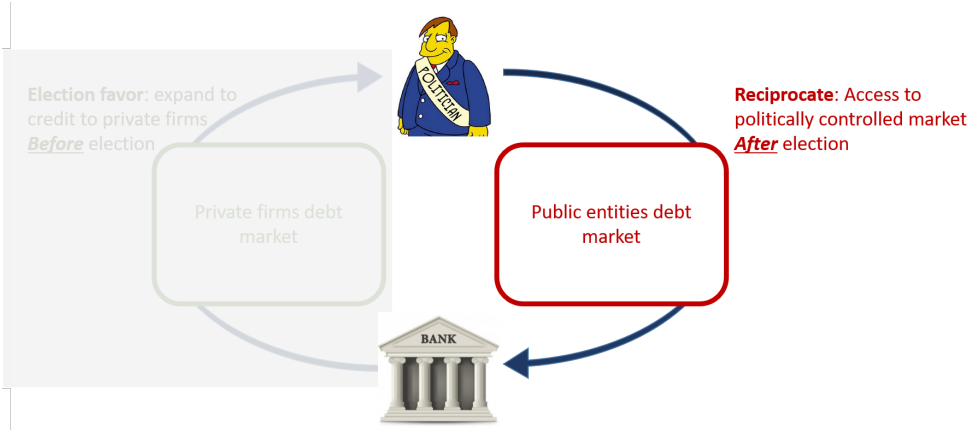
  - Extract **composition of the board** of all main banks holding public entity debt from their annual prospectus from AMF
  - Compare with list of mayors and MPs $\Rightarrow$ 1 MP and 6 mayors
- Banks holding public entity debt more likely to lend to firms executing government contracts. **But:**
  - French public procurement procedure extremely strict and often winning firms are not in the same constituency as the contract
  - Exclude sectors benefiting from public procurement contracts (from *Observatoire economique de la commande publique*)

Banks' Reward: Market for Public Entity Debt



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- **Solution**:

  1. Take **residual of corporate credit** after filtering out bank×constituency FE ⇒ gives the deviation relative to mean bank behavior
  2. **Rank** banks the year of the election ⇒ gives the involvement of a bank relative to other banks in the constituency

  $$Favor_{b,c,t} = (ResCredit_{b,c,t} - \overline{ResCredit_{c,t}})/\overline{ResCredit_{c,t}}$$

Empirical Framework

$$\begin{aligned}\Delta^{\tau} Credit^{public}_{c,b,t} &= \beta_1 \; Favor_{b,c,t} \times Contested_{c,t} \times Powerful\ MP_{c,t} \times Reelected_{c,t} \\ &+ \beta_2 \; Favor_{b,c,t} \times Contested_{c,t} \times Powerful\ MP_{c,t} \\ &+ Constituency\ Characteristics_{c,t} \otimes Favor_{b,c,t} \\ &+ \theta_{c,t} + \delta_{b,t} + \varepsilon_{b,c,t}\end{aligned}$$

- Bank involvement rewarded when favor valuable and politician influential

$\Delta^{\tau} Credit^{public}_{c,b,t}$ = Haltiwanger growth rate of lending to public entities between the election year and τ years later with $\tau \in \{2, 4\}$

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- Constituency $\times$ election fixed effects

$\Delta^{\tau} Credit^{public}_{c,b,t}$ = Haltiwanger growth rate of lending to public entities between the election year and τ years later with $\tau \in \{2, 4\}$

Evidence of Reciprocal Favors

- Banks who granted election favors to the incumbent are rewarded

	$\Delta^2 Credit^{public}_{c,b,t}$		$\Delta^4 Credit^{public}_{c,b,t}$	
	(1)	(2)	(3)	(4)
Contested × *Powerful MP*×*Bank Favor* × Reelected	0.749***	0.623**	0.870***	0.806***
	(0.295)	(0.274)	(0.354)	(0.333)
Contested × *Powerful MP* × *Bank Favor*	-0.661***	-0.535**	-0.699***	-0.617**
	(0.248)	(0.230)	(0.289)	(0.273)
Interacted terms	✓	✓	✓	✓
Constituencies × Election FE	✓	✓	✓	✓
Bank × Election FE	–	✓	–	✓
Observations	94,220	94,220	87,811	87,811

Evidence of Reciprocal Favors

– But only if incumbent is reelected

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Evidence of Reciprocal Favors

- Local entities controlled by local vs. central politicians

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Dependent variable	$\Delta^2 Credit^{public}_{c,b,t}$		$\Delta^4 Credit^{public}_{c,b,t}$	
Politicians controlling public debt	Local [1]	Central [2]	Local [3]	Central [4]
Contested × *Powerful MP*×*Bank Favor* × *Reelected*	.624** (.279)	.109 (.097)	.685** (.326)	.022 (.102)
Contested × *Powerful MP*×*Bank Favor*	−.469*** (.198)	−.110 (.073)	−.333** (.125)	−.045 (.0701)
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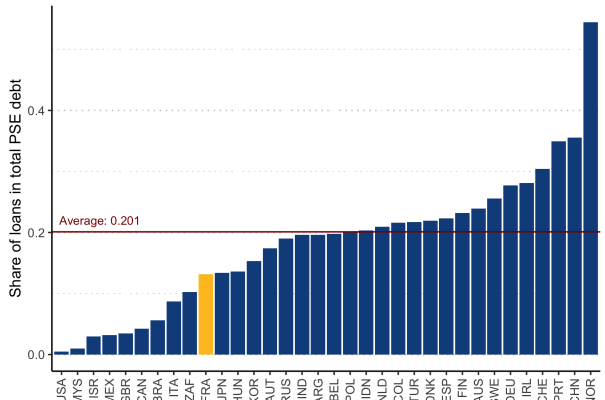
⇒ Increase transparency on allocation of public entity loans

⇒ Look beyond banks' formal independence

Thank you!

International comparison

Figure: Share of bank loans in total public sector debt



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Bank Debt of Public Entities

	Short-term credit		Medium/long-term credit	
Type	Vol. (€ mn)	Share	Vol. (€ mn)	Share
Central government	187	2.7%	1,794	1.1%
Local service of central government	292	4.2%	9	0.0%
Local government	4,248	61.4%	131,000	81.0%
Management of state-owned land	13	0.2%	117	0.1%
Education-related entities	2	0.0%	31	0.0%
Hospital & other healthcare	971	14.0%	23,000	14.2%
Public housing	13	0.2%	3,562	1.4%
Other public entities	1,196	17.3%	3,561	2.2%
Total	6,922		162,000	

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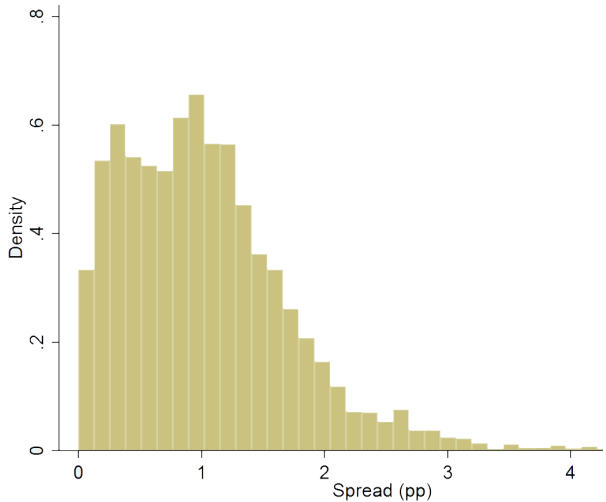
Spread: Cross-Sectional Distribution



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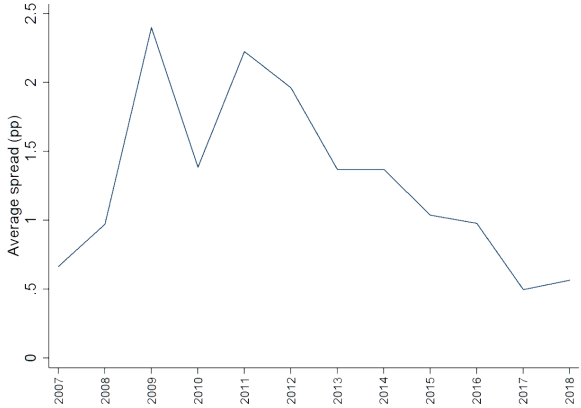
Spread: Time Series Variation



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Summary Statistics of Economic Variables by Constituency

Variable	Mean	Std. Dev	p25	p50	p75
Short-term credit (€ thousands)	238,661	414,427	85,679	134,455	240,466
Total credit (€ thousands)	474,681	592,651	151,798	242,073	528,096
Number of banks	145	44	116	136	164
Number of involved banks	82	23	67	79	93
Employment	56,503	30,442	39,664	49,539	61,439

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Characteristics of Banks Lending to Public Entities

Bank type	#banks	Mean sh. lending to local public entities	#cities	Share of entities owned by foreign groups	Share of cooperative banks
No lending	459	0.0%	338	17%	3%
1st tercile	73	0.3%	2,121	5%	11%
2nd tercile	72	9.3%	1,897	1%	58%
3rd tercile	72	45.8%	1,698	3%	76%

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