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Predicting the past: Understanding the causes of bank distress in the Netherlands in the 1920s

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Abstract

Why do some banks fail in financial crises while others survive? This article answers this question by analysing the effect of the Dutch financial crisis of the 1920s on 142 banks, of which 33 failed. We find that choices of balance sheet composition and product market strategy made in the lead-up to the crisis had a significant impact on banks' subsequent chances of experiencing distress. We document that high-risk banks – those operating highly-leveraged portfolios and attracting large quantities of deposits – were more likely to fail. Branching and international activities also increased banks' default probabilities. We measure the effects of board interlocks, which have been characterized in the extant literature as contributing to the Dutch crisis. We find that boards mattered: failing banks had smaller boards, shared directors with smaller and very profitable banks and had a lower concentration of interlocking directorates in non-financial firms.
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1. Introduction

The Dutch economy suffered a sharp recession in the early 1920s after it had experienced a period of exceptional performance in the 1910s. Following Fisher's (1933) debt-deflation theory of great depressions, Jonker and Van Zanden (1995) argue that this recession's principal cause was over-indebtedness combined with price deflation. Dutch businesses had benefited greatly from the First World War, a conflict in which the Netherlands remained neutral (De Jong, 2005); a short post-war boom prolonged their prosperity (Van Zanden, 1997a). The large and sustained declines in aggregate demand and prices that followed were the consequence of falling export demand and monetary policy due to the gold standard. Debt-deflation put pressure both on Dutch businesses and on the banking sector that they had come to rely on. Instability for

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banks has since been widely classified as constituting a financial crisis (e.g. Bernanke and James, 1991; Reinhart and Rogoff, 2009). Jonker and Van Zanden (1995) estimate that 35 banks suffered financial distress in this crisis; De Vries (1989) puts the number closer to 70. Of the 142 banks considered in this article, which together constitute 83% of the nominal equity value of the Dutch financial services sector, we document 33 that suffered distress at some stage in the crisis.

This article quantitatively investigates the determinants of this unequalled bank distress in the Netherlands by using discrete choice models to "predict the past". Bank-level financial accounting, product market competition and board composition data included in popular contemporary investor manuals are used to assess how policy decisions influenced banks' fate. In particular, we ask how banks' choices made before the debt-deflationary downturn affected their subsequent performance in the banking crisis. This article complements De Vries (1989) and Jonker and Van Zanden (1995) by systematically distinguishing between the characteristics of distressed and non-distressed banks. As such, this article adds a new and more nuanced understanding of this period in Dutch economic history. Though we agree that the crisis of the 1920s was caused by extensive deflationary pressures, our methodology shows that its consequences for the country's financial service providers stem from bank-specific risk factors, including the characteristics of their relationships with other banks and non-financial firms.

While our main goal is to shed new light on an unresolved historical question, finding an answer to the role of pre-crisis conditions for crisis-period performance is interesting for three further reasons: (1) it facilitates the economic identification of the roots of bank distress because its causes were largely exogenous, but its effects on the banking sector were partly determined endogenously; (2) because of the absence of prudential supervision in the Netherlands at the time of the crisis, this historical episode illustrates how banks may behave when there is little expectation of state intervention; and (3) it provides a better understanding of product market competitive choice and the workings of relationship banking in times of crisis.

The methodology that we employ follows work which uses discrete choice models to determine why banks fail (Kolari et al., 2002; Ravi Kumar and Ravi, 2007). Following Meyer and Pifer (1970), Martin (1977), and Pettway and Sinkey (1980), we use bank-level accounting data to measure capital adequacy, asset quality, earnings and liquidity. Our data on the determinants of failure are taken from 1917, while the failures start in 1920. This implies that all decisions were taken in 1917 or earlier, but the crisis was caused by the troubles the banks' clients and business connections faced in 1920 and later. All banks in our sample – failing or not – were confronted with the same economic conditions, but not all banks failed. Our empirical strategy explores the possibility that failing banks made bad lending and financing decisions up to 1917 and suffered their consequences in the 1920s. In other words, we document bad policy decisions, conditional on changing economic circumstances. Although the precise developments after 1917 were not foreseeable for the bankers, those making good decisions anticipated a worsening of conditions.

In this article we take a broad view of bank distress. We include many of the standard balance sheet-based and control variables found in the literature on banking crises. The Dutch financial sector was highly fragmented at the time of the crisis and the banks in our sample exhibit wide variation in their product market choices and positioning. We incorporate variables which describe market structure and the presence of international activities in order to measure these effects. Descriptions of the Dutch financial services sector in this period suggest that bank directors were positioned strategically on the boards of related financial and non-financial corporations with the explicit task of safeguarding their employers' interests (e.g. De Graaf, 2012). We use information from the banks' boards, and in particular their networks of interlocking directorates, to explore the impact of a form of relationship banking that emerged in the Netherlands in the 1910s.

Our results are as follows. We find that the balance sheet composition of banks before the crisis period had a significant impact on their probability of suffering distress in the 1920s. In particular, banks with higher leverage and more deposits were at greater risk of suffering distress. Much in line with the established view of this crisis, we attribute this to the combined exposure to debt-deflation – which rendered long-term loans riskier – and the post-war boom that came immediately before it – which caused a short-lived banking bubble. We find that younger and exchange-listed banks were more vulnerable in times of crisis.

The effects of banks' product market strategies and competition are mixed. On the one hand, we find that banks with branches and international activities were more likely to suffer distress. We take this to be evidence of the risk of doing business further away from banks' headquarters, a strategy which is associated with higher monitoring costs. On the other hand, we find no discernible effect of competition, measured as the relative market representation over the regions where a bank is active in the domestic market.

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