

Bagehot on the Continent? How the Banque de France Managed the Crisis of 1889



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The Comptoir
d'Escompte
(now BNP Paribas)

What should a Central Bank do during a banking panic ?

Bagehot's answer : lend freely at a high rate of interest on good collateral.

- National Monetary Commission (1910), Interview with Governor of the Bank of France.
- Q. “Does the amount and the character of credit granted to other banks depend on the amount and the character of their accounts at the Bank of France?”
- A. “In periods of crisis in 1830, 1848, in 1870 in 1889, the general council of the Bank did not hesitate to come to the assistance of establishments which were in difficulties, but which held **assets of unquestioned character and value**, by extending to them the largest possible credits.”
- BUT 1889: 140 M F loan to an insolvent bank - the Comptoir d'Escompte de Paris (CEP)

Background of the 1880s: banking

- Stock Market Crash 1882→Recession. GDP recovers in 1888.
- Bank profits and dividends decline.
- Banking industry:
 - (1) the large limited liability banks, ‘deposit banks,’ engage in commercial and investment banking. Leaders: CL, SG, CEP.
 - (2) the private banks, the Haute Banque: merchant and investment banking, financed by capital. Biggest: Rothschild fr.
- No deposit insurance/implicit government. 1882, Union Générale fails
- The Banque de France: dual role central bank & private bank:
 - Haute Banque major shareholders & dominate Conseil Général, government appoints Governor.
 - Monopoly of note issue
 - Huge gold reserves—does not feel obliged to change discount rate
 - Discounts only three name or well-collateralized paper
 - Periodic renewal of charter→government influence.

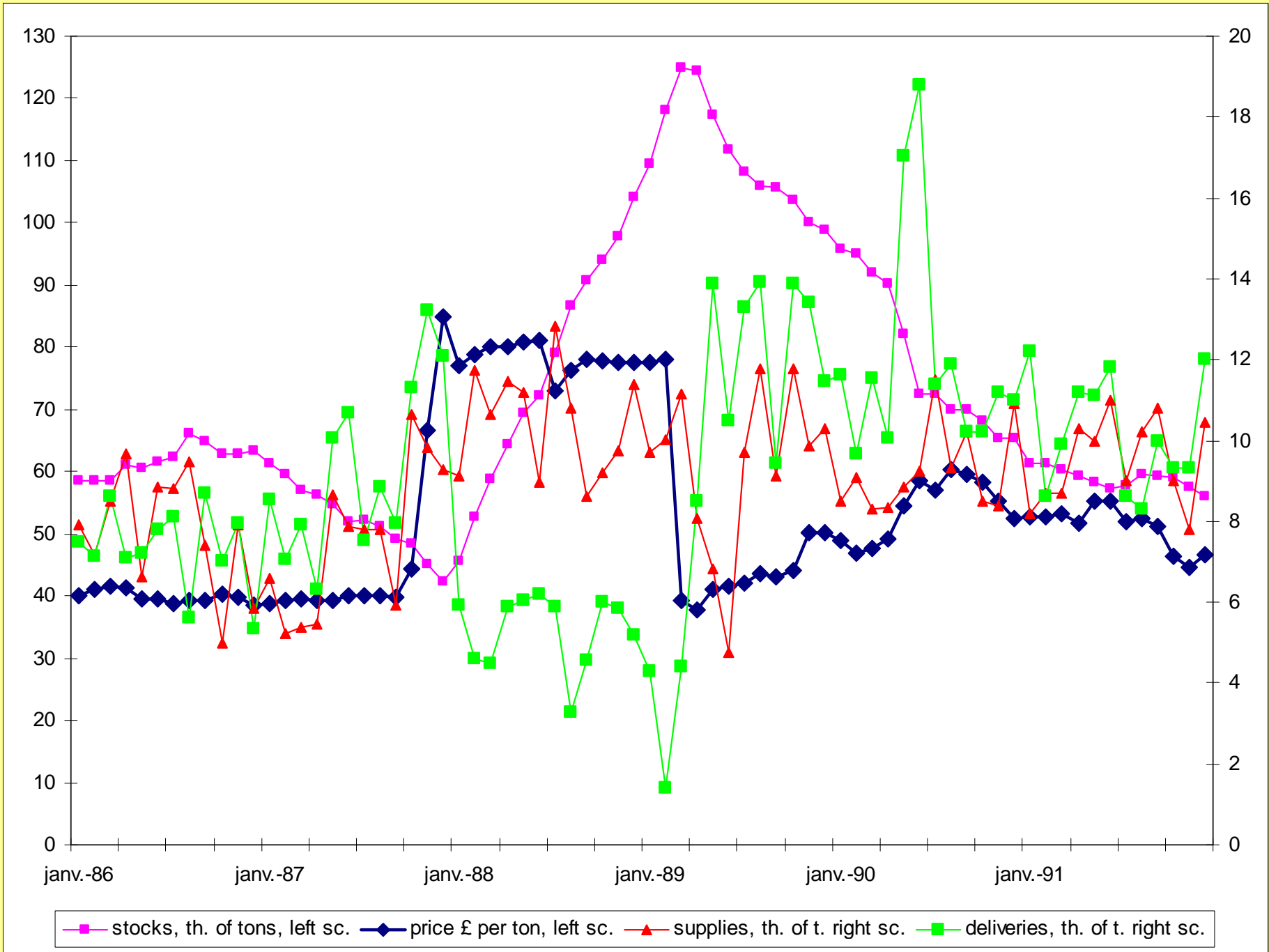
Background of the 1880s: politics

- Political Uncertainty:
 - Third Republic: truly republican leaders had governed only since 1876.
 - Threats by Monarchists and Bonapartists.
 - Scandals and Crises threaten Republic: 1882 crash, Bourse scandal, Panama Canal scandal.
 - Political rise of General Boulanger. Fears of a coup by him peaked in January 1889
- Universal Exposition opening in May 1889 – the centenary of the French revolution – Republicans see as a means to project the accomplishments of France under the Third Republic.
 - Bond financed.
 - A scandal or a financial crisis--last thing that the Republican government wanted in early 1889.

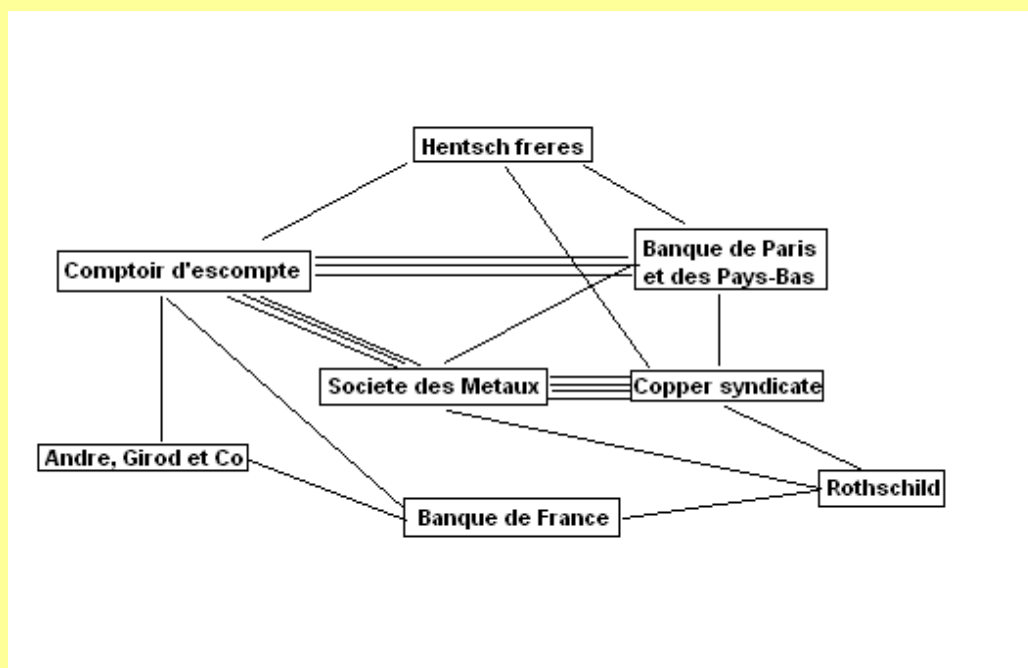


Cornering Copper

- Attempt at worldwide monopoly.
- Pierre-Eugène Secrétan, head of the Société industrielle et commerciale des métaux (SM)----a highly leveraged commodities company that used off-balance sheet derivatives to speculate in copper.
- In the end SM had capital of 50 million francs, and
- (1) Buys existing copper stocks—goes into debt of 300 million francs
- (2) purchases of contracts with mines for forward contracts for 96,600 tons of copper, if valued at £70 a ton =169 million francs.
- Well known in press, though details obscure.
- If Secrétan's scheme only involved metals companies, wealthy investors and private investment banks→ large losses, but no banking crisis.
- But, limited resources-→so Secrétan seeks support of leading limited liability---leveraged commercial banks. A banking crisis.



How to Ensnare the Banks? Work the Conflicts of Interest!

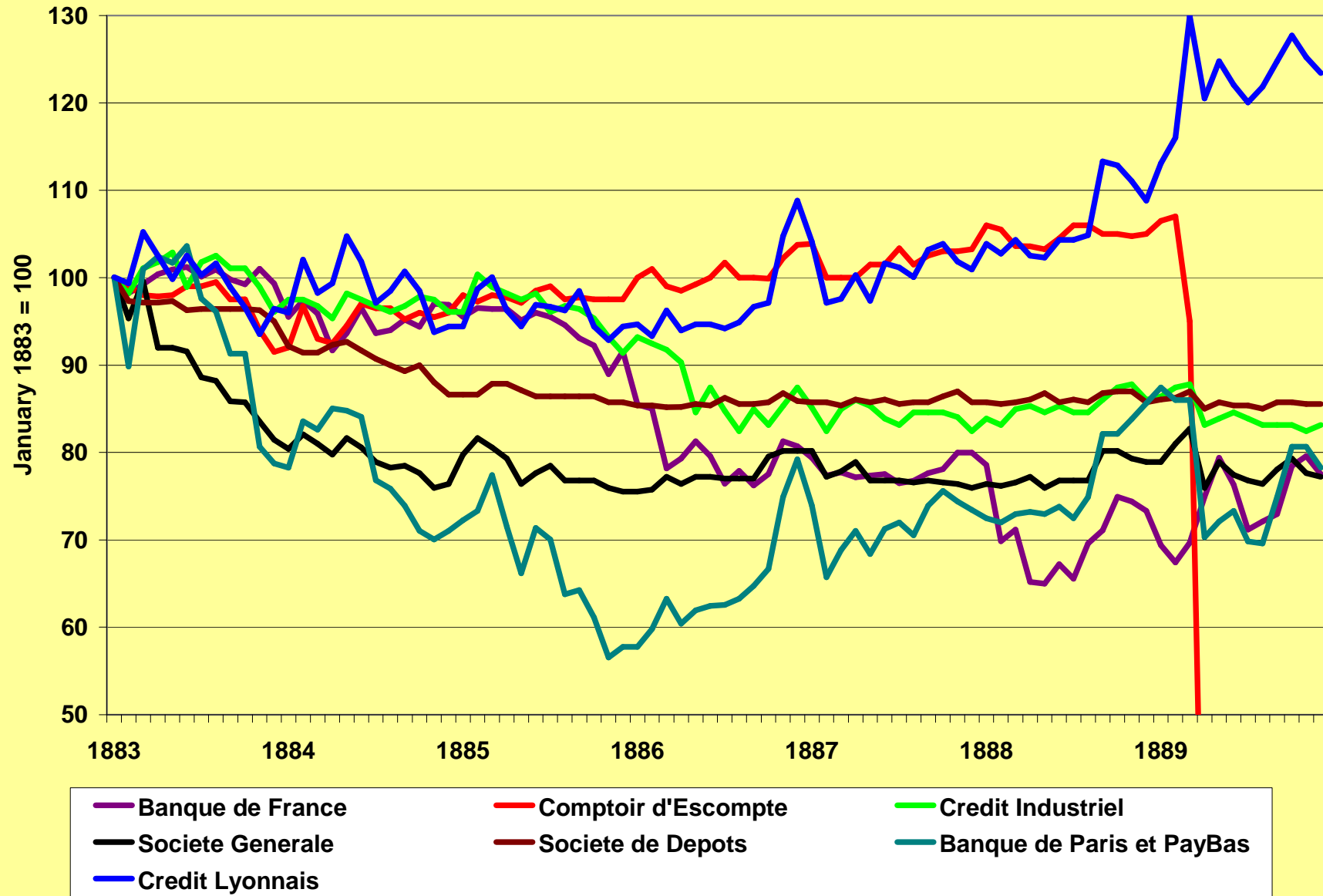


- Central Role of the Haute Banque in the management of the deposit banks and BdF
 - Hentsch— chairman of CEP, own banque, BPP board and copper scheme
 - Rothschild—own banque, on the BdF & major shareholder in SM
- Two of the three *censeurs* of the BdF were on CEP board.

Seduction of the CEP

- Miraculously, the CEP and CL are the only two banks to maintain dividends in depressed 1880s.
- Henri Germain of CL—impressive network growth with prudent credit policy.
- CEP: Earnings and dividends grow—but only as “other earnings” category grows—its off-balance sheet!!
- CEP Shareholders meeting January 1889, toast Denfert-Rochereau’s (head of CEP) success.

French Bank Stocks



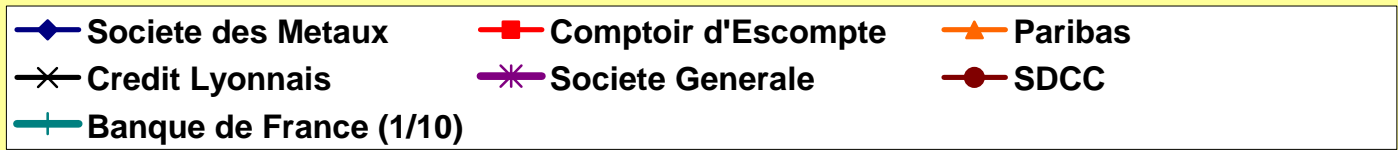
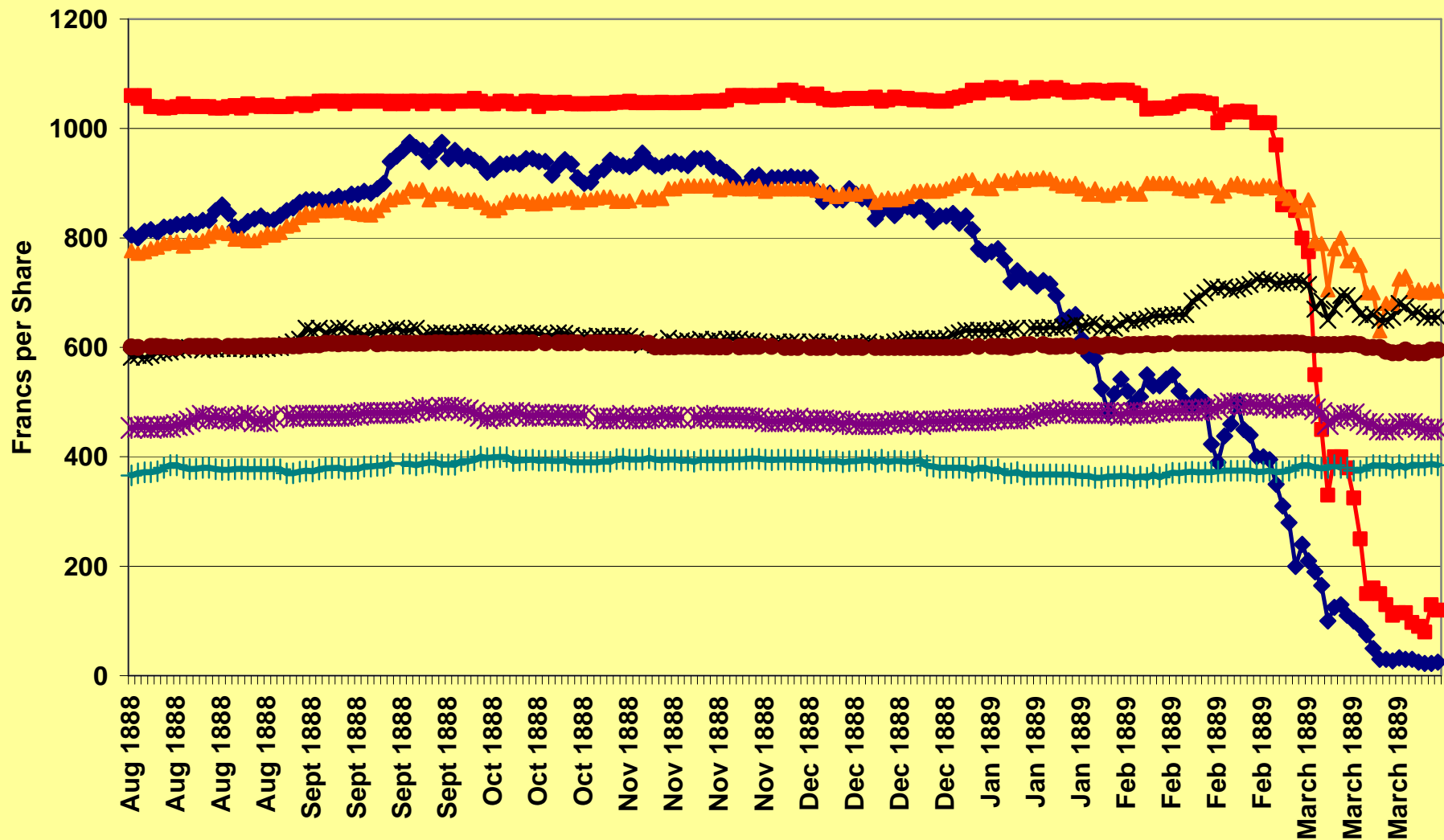
Role of the Comptoir d'Escompte

- 1887—CEP serves as banker to the copper syndicate
- December 1887 CEP signs first guarantee for SM future contract---enhances mining companies confidence in SM
- Denfert-Rochereau does not inform his board until March 1888. Some protest but board chairman is Hentsch.
- Support for SM grows.
 - substantial on-balance sheet credits for warehoused copper;
 - vast off-balance sheet guarantees for the SM's forward contracts: 269 M F for 1888, 242M F for 1889, 244 M F, for 1890---roughly equal to world output.
- Paribas is also compromised by insider conflict of interest, but lower exposure

What did the BdF know and When did it know?

- Council of Regents---some members (perhaps Rothschild) were aware and were involved to some degree.
- Supervision process: periodic reviews of borrowers by rotating regents---Feb 1888 Rothschild gives very favorable reviews to SM--
“Affaire très sérieuse conduite avec intelligence.”
- May 1888. Grants advances to SM on copper warrants up to 52 million francs. Asked by Girod (Bd. of SM, partner in bank with André who is a Regent). 40,000 tons, price £80 a ton, advance for only 65%, so safe as long as price above £52 a ton, and guaranteeing signatures of several banks, including CEP.
- Price of copper stable, stock prices of SM and CEP stable.
- Copper stocks continue to rise.
- Price of SM falls from 975 francs at peak 9/1888 to 900 12/1888, continues fall in early 1889

Stock Prices, August 1888-March 1889



Desperation of the SM

- Secrétan needs capital to continue buying increasing copper output;
- Organizes Compagnie auxiliaire des métaux (CAM), January 1889, funded with 40 million francs of capital --- SM to take 59% of the shares = pyramid scheme;
- Hope: CAM gain access to the discount window of the Banque de France;
- Refused---bank understands the trick;
- End of January 1889, the CAM stops buying copper for future delivery and by March 1 all purchases cease;
- For cash Secrétan sell his shares in SM and Rio Tinto—they fall.
- Copper price £80 until late February---£76 on March 2

“Affaire des Warrants”

- Other banks refuse to renew signatures on SM copper warrants—CEP substitutes for them.
- February 27, Governor interviews Girod (CE) and Joubert (Paribas) about the “Affaire des Warrants.” Banque considers renewing advance but collateralized at a price of £44 a ton.
- At Rothschild’s suggestion, Banque sends telegrams to U.S. mines to determine willingness to renegotiate future contracts.
- March 1 interview of Denfert-Rochereau by Governor—provides detailed information on CE balance sheet and exposure--the true insolvent condition of the CE was revealed.
- Denfert-Rochereau commits suicide—heavy run on CE begins
- Three estimates of CEP position give (fro a capital of 80 million F), losses from loans and guarantees for copper contracts range from 145 million to 197 million F.
- The Minister of Finance and Regents fear contagion would produce a banking panic and endanger a weak economic recovery.

The Lifeboat

- March 7: Minister of Finance summons heads of banks and BF to night meeting---CEP must receive 100 M F before opening or it would stop payments;
- March 8: Governor convenes regents at 9 a.m.---banks open at 10 a.m.
- 100 million F loan to CEP against “all its assets” with bank syndicate + board of CEP providing guarantee for losses to BF up to 20 million F
- Furious debate of Regents---stop panic v. against statutes of BdF;
- Vote 11-4, one vote more than required supermajority
- Pillet-Will resigns in protest.
- Soon after, another 40 M F loan required with another 20 M F guarantee.

Was there a true danger of a general panic? Share price declines show no reason for BdF to intervene

	<i>March 1 to 8</i>	<i>Month of March</i>
CEP	-43.3%	-87.6%
Paribas	-10.8%	-21.2%
CL	-6.5%	-9.3%
SG	-0.5%	-2.1%
SDCC	-0.6%	-8.2%
BF	2.2%	3.5%

Also: daily data on deposits at SG : no evidence of run on CEP spreading

End ?

- SM—liquidated—Secretan 3 months in prison
 - Contracts with mines annulled in French courts (not English)
 - Board pays 2.5 M F;
 - Liquidation pays all creditors holding collateralized debt and 43% of unsecured debt by 1894;
 - Continue manufacturing—sell off this part as Compagnie française des métaux for 18 M F.
- CEP
 - New Comptoir national d'escompte de Paris (CNEP) established. 40 M F capital, half paid-in
 - Founders shares to previous shareholders and underwriting banks.
 - Public confidence restored, capital flows in.
- BdF
 - All loans 100M + 40M F paid back---though bank must wait and hold copper; partial recovery of copper prices helps.
 - Minister sends bill to Parliament for early renewal of its charter

Danger of Moral Hazard?

Did Rescue → Future Risk-Taking?

Penalties and Purges

- Suicide Denfert-Rochereau/Secretan 3 months prison
- CEP Conseil d'Administration assessed 50 M FF by liquidators who vigorously pursue all—including Hentsch.
- Two conflicted Censeurs (internal auditors) of BdF are dismissed
- Paribas dismissed conflicted board members and censeur.
- Success? only one minor bank failure and no runs until World War I.