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Deregulation of bank underwriting activities: impacts in the Euro–yen and Japanese corporate bond markets

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Abstract

The purpose of this paper is to examine the impact of a 1993 relaxation of the restrictions governing the underwriting operations of Japanese banks on bond issues in the Euro–yen and Japanese corporate bond markets. Evidence is presented to suggest that the relaxation of the restrictions governing the underwriting operations of Japanese banks was associated with a significant fall in spreads in both the Euro–yen and Japanese corporate bond markets.

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Keywords: Deregulation; Euromarket; Japanese Bond market; Spreads; Underwriting

1. Introduction

The purpose of this paper is to examine the impact of a 1993 relaxation of the restrictions governing the underwriting operations of Japanese banks operating in the Euromarket on spreads on bonds issued in the Euro–yen and Japanese corporate bond markets. To date, analyses of these markets have been undertaken separately.

Following the literature on spread determination for corporate bonds issued in the United States (see, for example [13,14]), the recent literature examining spread determination on corporate bonds issued in Japan has focused on either the existence of conflicts of interest occurring when banks are allowed to act as underwriters in the bond market, or reductions in spreads/commissions when banks enter the

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underwriting market [4,7,17,18]. Recently, there has been an upsurge of interest in the analysis of the Euromarket. Melnik and Nissim [10] examine the determinants of underwriter fees, underwriter spreads and underpricing in the Euro-dollar bond market in 1996–1997. Melnik and Nissim [11] investigate the impact of the introduction of the Euro on issuance costs for Euro-dollar, Euro-Franc, Euro-Guilder and Euro-Mark bonds. For Euro-yen bonds, recent analyses include investigations of the term structure of high grade Euro-yen bonds (see [5]); the existence of conflicts of interest in underwriting [17]; and the impact of three Japanese deregulations on bond spreads in the Euro-market [12].

This paper investigates the factors influencing spreads on corporate Euro-yen bond issues by firms resident in Japan and spreads on corporate bonds issued in Japan over the period April 1991 to February 1994. This paper differs from the existing literature in the following points. First, this paper investigates the impact of the deregulation of the three bureaus agreement on the domestic Japanese bond market. At the time of this deregulation, there is a significant fall in spreads in both the domestic and Euro-yen bond markets. Second, it appears to be the first paper that simultaneously examines spread determination in both the Euro-yen bond and domestic Japanese markets over the same period of time. This examination enables a comparison of the determinants of the spreads of the two types of bonds, and also the pricing of those determinants. Earlier findings that reject the existence of conflicts associated with bank underwriting in the Euro-yen market are confirmed.

The plan of this paper is as follows. Section 2 briefly describes changes in the Japanese underwriting market in the 1990s, and the likely impact of these changes on spreads in the Japanese corporate bond and Euro-yen bond markets. Details of the models to be estimated are contained in Section 3. The data used are explained in Section 4, and Section 5 presents the empirical results. Section 6 concludes the paper.

2. Underwriting in the Japanese securities market

Underwriting is one of the four principal ‘securities’ businesses; the other three being: ‘dealer’ business; ‘broker’ business; and ‘selling’ business: Securities and Exchange Law (*Shoken torihiki ho*) Article 28(2). Articles 2 and 65 of the Securities and Exchange Law require firms wishing to engage in securities business to obtain the permission of the Financial Services Agency (formerly the Ministry of Finance), and prior to 1993 this permission was denied to banks wanting to engage in underwriting business within Japan.

The Eurobond market is often viewed as a market for raising funds through bond issues that is relatively free from regulation and taxes (see [8]). Despite this, in the past, the Japanese government has limited the extent to which Japanese financial institutions can act as intermediaries in this market, and the extent to which Japanese firms can make use of the market for raising funds. One of the reasons for this was to prevent an undermining of regulations in the Japanese domestic financial markets. Until 1998, Japanese banks underwriting bonds abroad were subject to the “three bureaus agreement” (*Sankyoku goui*). The three bureaus agreement is an agreement made in August 1975 between three bureaus of the former Ministry of Finance, the Securities Bureau, the Banking Bureau and the International Finance Bureau, regarding the underwriting of foreign bonds (*gaisai*) issued by Japanese firms. The agreement was implemented through administrative guidance called the “three bureaus administrative guidance” (*Sankyoku shido*). Although the agreement acknowledges that foreign subsidiaries of both Japanese securities companies and banks are able to act as underwriters in the issues of foreign bonds by Japanese

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