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## Commercial banks in investment banking Conflict of interest or certification role?

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### Abstract

When commercial banks make loans to firms and also underwrite securities, does this hamper or enhance their role as certifiers of firm value? This paper examines empirically the pricing of bank-underwritten securities as compared to investment-house-underwritten securities over a unique period in the U.S. (pre-Glass-Steagall) when both banks and investment houses were allowed to underwrite securities. The evidence shows that investors were willing to pay higher prices for securities underwritten by banks rather than investment houses. The results support a certification role for banks, which is more valuable for junior and information sensitive securities.

*Key words:* Glass-Steagall; Banks; Certification; Conflict of interest; Security pricing

*JEL classification:* G21; G24; N22

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## 1. Introduction

There has been considerable controversy in the U.S. concerning the participation of commercial banks in corporate securities underwritings. Arising from concerns that combining underwriting with lending presented a potential 'conflict of interest' that was detrimental to investors, the Glass-Steagall Act of 1933 effectively prohibited commercial banks from underwriting corporate securities. Recently, the debate on allowing commercial banks to underwrite corporate securities has resurfaced, both in Congress and among regulators.<sup>1</sup> The interesting question is: Does the empirical evidence regarding conflicts of interest support the concerns of those opposed to Glass-Steagall deregulation? This paper investigates this question by analyzing *ex ante* pricing of securities underwritten by commercial banks and investment banks in a pre-Glass-Steagall period.

To understand how conflicts of interest are reflected in a security's price, it is important to examine the underwriters' incentives in certifying a security's value. The key difference between commercial banks' and investment banks' (hereafter, 'house') incentives arise from the loan-making activities of commercial banks. In making and monitoring loans, commercial banks obtain information about a firm not generally known to external investors<sup>2</sup> (for example, through scrutiny of internal budget statements and factory/inventory inspections). Unlike banks, investment houses do not, in general, acquire private information from lending activities. As a result, high information collection costs can induce investment houses to produce less information than banks, despite potential reputation losses from 'uninformed' certification (see Puri, 1994b, for a theoretical derivation

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<sup>1</sup>The Glass-Steagall Act of 1933 prohibited national banks from engaging in securities activities, either directly or through affiliates. The Act was passed amidst allegations of abuses by commercial banks, recorded in the Pecora Committee hearings which conducted an investigation of misdoings of banks (see U.S. Senate hearings on Stock Exchange Practices, 1934). In 1987, the provisions of Glass-Steagall were relaxed with some banks (for example, J.P. Morgan and Bankers Trust Co.) being allowed to set up Section 20 subsidiaries that could underwrite securities. These are subject to 'firewalls', that is, no communication with the parent bank is allowed. Recently the Office of the Comptroller of Currency (OCC) proposed that direct bank subsidiaries be allowed to underwrite securities (*New York Times*, November 29, 1994). Further, the Clinton administration, as outlined in a speech by Treasury Secretary Robert Rubin, proposed the elimination of Glass-Steagall (*Wall Street Journal*, February 27, 1995).

<sup>2</sup>As informed lenders, banks can convey information about the firm to outside creditors in the absence of an underwriting function, through say, renewal of loans, see for example, Fama (1985). Empirical evidence of a certification role of banks is provided in James (1987), in Lummer and McConnell (1989) where renewal of loans acts as a positive indicator of firm value, and in James and Weir (1990) where the existence of a banking relationship results in less IPO underpricing. Booth and Smith (1986) also refer to a certification role for intermediaries.

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