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Conflict of interest in universal banking: Bank lending, stock underwriting, and fund management☆

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Abstract

Using a newly constructed data set on Israeli Initial Public Offering (IPO) firms in the 1990s, we study costs and benefits of universal banking. We find that a firm whose equity was underwritten by a bank affiliated underwriter, when the same bank was also a large creditor of the firm in the IPO year, exhibits significantly better than average post-issue accounting performance, but that its stock performance during the first year following the IPO is considerably lower than average. When an investment fund managed by the same bank is heavily involved in the IPO as buyer of the newly issued equity, the stock performance during the first year following the IPO is even lower. This, together with

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negative first day returns, is indication of IPO overpricing. We interpret these findings as evidence that universal banks use their superior information regarding client firms to float the stock of the 'cherries', not the 'lemons' (as measured by post-issue accounting performance), but that bank managed funds pay too much for bank underwritten IPOs, at the expense of the investors in the funds. These results suggest that there is conflict of interest in the combination of bank lending, underwriting, *and* fund management.

JEL classification: G21; G24; G23; G28; G32; G35

Keywords: Universal banking; Conflict of interest; Bank underwriting and fund management; Initial public offerings

1. Introduction

Costs and benefits of universal banking are at the center of the debate on banking reform in many countries, and public interest in this topic is likely to rise in light of the 1999 Gramm–Leach–Bliley Act that repeals the Glass–Steagall Act in the United States.[1] Much attention has been devoted to potential conflict of interest between bank lending and bank underwriting. Proponents of universal banking emphasize economies of scope in information gathering arguing that bank (or bank affiliated) underwriters have better knowledge of client firms and are, thus, more qualified to serve as underwriters. Opponents argue that bank underwriters may take advantage precisely of such information, trying to off-load the securities of low quality firms onto unsuspecting investors.

Existing empirical evidence on this issue is mainly from the pre-Glass–Steagall period, and there is a real need for more modern evidence.[2] Israel

[1] See, e.g., *The New York Times*, 5 November 1999: 'Congress Passes Wide-Ranging Bill Easing Bank Laws'. The new legislation also substantially amends the 1956 Bank Holding Company Act, allowing bank holding companies to engage in a wide range of activities that are 'financial in nature', such as insuring, guaranteeing, providing financial investment advisory services, issuing or selling instruments representing interests in pools of assets, underwriting and dealing in securities, and more.

[2] The pre-Glass–Steagall period studies we are aware of are Ang and Richardson (1994), Kroszner and Rajan (1994, 1997), and Puri (1994, 1996). Gande et al. (1997) provide modern evidence exploiting the recent relaxation in the United States of some Glass–Steagall restrictions regarding underwriting by commercial banks, and Hamao and Hoshi (1998) study bank underwriting of corporate bonds in Japan after 1994, in light of similar reforms there. Closely related are studies of the relative performance of venture capital backed IPOs in the United States and Japan, by Gompers and Lerner (1999) and Hamao et al. (1998), respectively. Gompers and Lerner (1999) draw lessons for the debate on universal banking.