Conflict of interest in commercial bank security underwritings: Canadian evidence

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Abstract

The recent repeal of the Glass–Steagall Act in the US has cleared the way for commercial banks to enter the securities underwriting business. Many of the concerns that resulted in the original passage of the Glass–Steagall Act, however, still exist. One of these is the possible conflict of interest a universal bank faces. This paper provides evidence on this issue from the experience of Canada following its removal of restrictions on chartered bank ownership of investment dealers. Both ex ante bond yield comparisons between commercial and investment bank underwritten issues and equity price reactions to bond issue announcements provide no evidence of a conflict of interest.

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1. Introduction

The recent blurring of the distinctions between commercial and investment banks has raised a number of concerns. These include concerns over macro effects on the stability of the financial system, including the risk of bank failure and contagion,
and micro effects on the pricing of individual securities issues. One of the principal concerns over securities pricing effects has focused on the inherent potential for a conflict of interest in an organization that combines the roles of lender and underwriter.

Combining lending and underwriting may affect securities pricing in a variety of ways. While there are many potential securities pricing effects, including effects on competition and through differences in the relative monitoring abilities of commercial and investment banks, most of the literature has grouped these effects under two hypotheses: the conflict of interest hypothesis and the information advantage hypothesis.

The conflict of interest hypothesis argues that a joint bank/underwriter might underwrite a securities issue for a corporation in which it has a loan outstanding and whose default risk has increased. If the corporation has not yet missed any payments or violated any of the debt covenants, the bank has limited options to attempt to be compensated for this additional risk. One option is to underwrite a bond issue for the corporation and require the firm to use the proceeds to repay the loan, thereby shifting the increased default risk from itself to the securities market. While perhaps this is most significant for bank loans to lower quality firms, all firms (both high and low quality) that have increasing default risk would create a potential conflict of interest for the bank/underwriter. To the extent that this conflict of interest hypothesis is valid, mingling commercial and investment banking should increase securities yields as potential buyers react to this perceived risk.

Scope economies and informational advantages associated with a commercial bank establishing one relationship as both lender and underwriter may exist, however, which would lead in a competitive market to lower securities yields. Because of additional information the bank/underwriter has regarding the issuing firm from previous dealings (information that an investment bank underwriter does not have) the market may perceive commercial bank underwritten securities as less risky. This is the information advantage hypothesis.

The effect of mixing commercial and investment banking on securities yields depends on the relative strengths of the conflict of interest and information advantage hypotheses. This is fundamentally an empirical issue. Prior research from the US experience suggests that the information advantage dominates. Most of that research (Kroszner and Rajan, 1994; Ang and Richardson, 1994; Puri, 1994; Puri, 1996) use pre-1933 data prior to passage of the Glass–Steagall Act. However, more recent data from the 1990s (Gande et al., 1997; Hebb, 2000) provide evidence consistent with these results.

We provide insight into the potential effects of the coalescing of commercial and investment banking from recent Canadian experience. Canada revoked the law separating commercial and investment banking in the late 1980s. Following this legislative change, Canadian chartered banks moved very quickly to dominate the securities business. Our evidence from both the debt and equity markets suggest that the informational advantage effects dominated in affecting securities pricing and thus provides no support for the conflict of interest hypothesis. We thus confirm the results from studies of the US markets.
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