Commercial banks getting underwriting business:
Tying or business building?

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Article history:
Received 26 November 2011
Received in revised form 29 November 2012
Accepted 5 December 2012

JEL classification:
G21
G24

Keywords:
Universal banking
Tying
Business building
Underwriting

I investigate how commercial banks can use lending to attract underwriting business from loan clients. My empirical evidence indicates that rather than using less credit and higher spreads to punish firms that do not give them underwriting business (i.e., coercive tying), banks use more credit and lower spreads as incentives for firms to give them future underwriting business. Further, banks that continue business relations by lending again to firms are rewarded with a higher probability of receiving those firms' future underwriting business. My results do not support recent concerns of tying behavior by banks. Rather, the evidence suggests that banks use discounted lending to attract underwriting business. My results indicate that the ability to lend may have an impact on how investments banks compete for underwriting business.

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1. Introduction

Commercial banks have been successful at entering the securities underwriting market over the last two decades, particularly for debt issues. As banks move farther away from their central lending business, the question of how they channel their loan clients to newer products becomes relevant. Practitioners and policymakers have debated banks' ability to channel underwriting business of their loan clients through coercion, particularly by their ability to withhold credit or charge higher interest rates if a firm does not give them underwriting business (which I refer to as tying). On the other hand, banks can also use lending as a business building tool to attract underwriting business from firms. My analysis contributes to the literature by analyzing how the ability to lend can have an impact.
on how banks compete for underwriting business. In particular, the presence of an underwriting business can change the way banks conduct their lending business. Thus, I analyze how the mix of products a bank offers affects its incentives in terms of lending and loan pricing. In the aftermath of the recent financial crisis, many commercial and investment banks have merged (e.g., Bank of America and Merrill Lynch; JP Morgan and Bear Stearns) and some large investment banks have converted themselves to bank holding companies (e.g., Goldman Sachs and Morgan Stanley). Such events have hastened the convergence of investment and commercial banking businesses in the U.S. since the financial crisis, making questions related to how these financial firms link lending and underwriting even more important and timely.

A fundamental problem in the analysis of the tying argument described above is one of benchmarking. One way of analyzing this issue is to compare loan frequencies and yield spreads of loans to firms that use their banks as underwriters to those of firms that do not use their banks as underwriters. Observing lower loan frequencies and higher yield spreads for firms that do not award underwriting business to their banks may indicate tying. However, this evidence can also imply that banks reward firms that do use them as underwriters with more loans and lower interest rates (which I refer to as “bundling”). Thus, I benchmark firms that do not use their lender as underwriter (i.e., where potential retaliation by banks may be expected if tying practices exist) to firms whose lenders do not have underwriting ability. Since lenders without underwriting ability are not motivated to use their lending business to build an underwriting business, they are a more appropriate benchmark. A result suggesting that a bank with underwriting ability is less likely to lend to and more likely to charge higher interest rates to firms that do not use it to underwrite relative to a bank without underwriting ability may be evidence of coercive tying by the former type of bank. Thus, using banks without underwriting ability as a benchmark can lead to more direct evidence regarding coercive tying by eliminating potential bundling effects. Another benefit of this empirical approach is that it allows an analysis of how the presence of underwriting business affects a bank’s lending and pricing decisions. In particular, it provides evidence about whether banks use more frequent lending and favorable lending terms as a “carrot” to attract underwriting business.

I analyze the tying hypothesis mentioned above, wherein banks threaten to restrict credit and give worse terms to firms that do not give them underwriting business, and tests it against an alternative business building hypothesis wherein banks, while not able to force firms to give them underwriting business, attempt to strengthen their relationships and use more lending and favorable terms as leverage to obtain their underwriting business. My empirical evidence supports the latter hypothesis and not the former, indicating that banks may not be able to engage in systematic tying between lending and underwriting. Rather, banks that have underwriting ability lend more and charge lower yield spreads on loans to their clients, potentially to strengthen relationships with their clients. In addition, banks that engage in such business building are rewarded by firms with more future underwriting business. The business building activities of banks are more significant with investment-grade firms, consistent with banks attempting to win clients that are more likely to issue securities in the future. These results are consistent with the existence of a competitive loan market and effective anti-tying regulations.

While there has been no systematic study examining banks’ tying of lending and underwriting, allegations of such practices exist. According to a 2003 survey by the Association of Finance Professionals (AFP), corporate executives feel that banks make the availability and terms of credit contingent

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1 While the terms bundling and tying are sometimes used interchangeably, I assign them strict definitions: tying refers to the coercive practice of banks punishing firms that do not give them underwriting business by not lending to such firms or charging them higher interest rates; bundling refers to banks rewarding firms that give them underwriting business with more lending and lower interest rates.

2 Prior studies in this area have argued that banks have a natural cost advantage in underwriting because of their information about loan clients from prior lending relationships. These studies find that banks may share some of the cost savings they obtain when they underwrite debt issues of their loan clients. I analyze an alternative channel of business building by commercial bank underwriters that does not depend on their information advantage. See also Bolton et al. (2007) for a different motivation of one-stop banking – namely, banks’ ability to credibly provide information to their customers – and Freixas et al. (2007) for an analysis of risk taking by universal banks.
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