Bond underwriting syndicates organized by commercial banks: evidence from prewar Japan

Masaru Konishi

Graduate School of Commerce and Management, Hitotsubashi University, 2-1 Kunitachi, Naka, Tokyo 186-8601, Japan

Received 15 June 2000; revised 31 August 2003
Available online 19 June 2004

The purpose of this paper is to empirically examine the nature of bond underwriting syndicates organized by commercial banks. I use a unique data set from Japan during a prewar period when banks were permitted to underwrite corporate bonds. The paper shows that risk aversion led to a greater tendency for investment houses to form a syndicate than commercial banks. The evidence is consistent with the argument against universal banking that asserts that commercial banks will be exposed to underwriting risk, thereby potentially undermining the stability of banking system.

© 2004 Elsevier Inc. All rights reserved.

JEL classification: G21; G24; N25

Keywords: Universal banking; Underwriting syndicate

1. Introduction

Since the enactment of the Financial System Reform Law in 1993, commercial banks in Japan have been allowed to operate securities businesses in the form of bank-owned securities subsidiaries. Banks have been aggressive in the expansion of their market share...
in the domestic bond underwriting business; for example, corporate bonds underwritten by bank subsidiaries rose from 32.6% in fiscal 1996, to 55.7% in fiscal 1997. This begs the question: Do commercial bank securities subsidiaries operate their securities businesses competently?

The purpose of this paper is to address this question. This paper studies the role that commercial banks play as a bond underwriter using data from Japan during a prewar period when commercial banks were permitted to underwrite corporate bonds. In particular, I examine the incentives for banks to organize bond underwriting syndicates using data from corporate bonds issued during the 1912–1935 period as a sample. This paper shows that syndicate size was not positively associated with the magnitude of the majority of proxies for underwriting risk for issues underwritten by commercial banks, suggesting that commercial banks were unable to reduce underwriting risk. For the sake of comparison, I also examined whether risk aversion led to a greater tendency for investment houses and the Industrial Bank of Japan (IBJ hereafter), which was heavily influenced by the government, to form syndicates when underwriting bonds. In contrast with commercial bank syndicates, this paper shows that the syndicate size of investment house and IBJ issues was positively associated with the magnitude of most of the proxies for underwriting risk. Overall, the evidence is consistent with the argument against universal banking that asserts that commercial banks will be exposed to underwriting risk, thereby potentially undermining the stability of banking system.

There are previous works related to the current analysis. Ang and Richardson (1994), Kroszner and Rajan (1994), and Puri (1994) highlight pre-Glass–Steagall periods in the US when commercial banks were permitted to underwrite corporate bonds, and examine the long-term default performance of issues underwritten by commercial banks compared with that of issues underwritten by investment houses. Puri (1996) focuses on a pre-Glass–Steagall era, and examines the pricing differential between bank-underwritten issues and investment house-underwritten issues. Gande et al. (1997) also examine the pricing differential between bank-underwritten issues and investment house-underwritten issues using modern US data. Their results discredit the concern about potential conflicts of interest; namely, the concern that banks use their informational advantage over investors to underwrite poor quality bonds and make the bond issuers repay their debt obligations to the banks.

Empirical results concerning conflicts of interest are rather mixed when Japanese data are used. Konishi (2002) focuses on a Japanese prewar period when banks were allowed to operate securities businesses, and examines pricing and long-term performance of bank-underwritten issues and investment house-underwritten issues. The results in the paper suggest rejection of the concern about conflicts of interest. Hamao and Hoshi (2000), Ito and Konishi (2000), and Konishi (2000) examine pricing differential between bank-underwritten issues and investment house-underwritten issues using modern data. They find evidence that is consistent with the concern about conflicts of interest. The current analysis differs from the previous works in that it highlights the incentives for banks to organize underwriting syndicates. Furthermore, because little has been explored about the bond underwriting by commercial banks during the prewar period, this paper is as much an explanatory analysis as a test of specific hypotheses on the role that banks play as an underwriter.