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Banking relationships and access to equity capital markets: Evidence from Japan's main bank system

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Abstract

We study the role of banking relationships in IPO underwriting. When a firm in Japan goes public, it can engage an investment bank that is related through a common main bank, or can select an alternative investment bank. The main bank relationship can be an efficient way for the investment bank to acquire information generated by the main bank, but may give rise to conflicts of interest. We find that main bank relationships give small issuers increased access to equity capital markets, but that issuers of large IPOs often switch to non-related investment banks that are capable of managing large offerings. While investment banks seek to exploit bargaining power with related issuers, issuers respond to expected high issue cost by switching to non-related investment banks. The net result is that total issue costs through related and non-related investment banks are similar. With respect to aftermarket performance and use of proceeds, we find no evidence of conflict of interest or self-dealing for either the main bank or the investment bank.

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1. Introduction

Policy makers in many countries have grappled with whether integration of commercial banking and investment banking services is likely to benefit or harm corporate clients and their investors. If commercial banks are integrated into investment banking, the banks might engage in "self-dealing" by underwriting public offerings of credit clients to effect wealth transfers to themselves. Further, integrated banks may gain bargaining power over credit clients who seek investment banking services. On the other hand, the commercial bank's experience with its clients could reduce information costs, resulting in greater access to capital markets.

In the US, early controversy concerning allegations of abuse by commercial banks in securities underwriting resulted in the Glass–Steagall Act (The Banking Act of 1933), provisions of which prohibited affiliations between investment banks and commercial banks. Repeal of these provisions in 1999 signaled the view, expressed in congressional hearings, that potential benefits of improved access outweigh potential conflicts of interest when banks provide both lending and underwriting services.[3] One argument in favor of repeal was that integration could increase capital market access for small, young, and/or relatively unknown firms.

Investment banks can be related to commercial banks in various ways, ranging from integration through a common holding company (as in the US) to overlapping ownership and management (as in Japan, where, banks are related through *keiretsu* structures). In Japan, business firms have credit relationships with commercial "main banks". Main banks, in turn, may hold equity interests in their credit clients, including investment banks. In this paper we study the impact of the relationships among firms, main banks, and investment banks in Japan's initial public offering (IPO) underwriting market. Issuing firms can choose whether to engage an investment bank that is related, by virtue of sharing the same main bank, or to engage a non-related investment bank.

Previous studies of banking relationships and underwriting markets generally have not found evidence of conflicts of interest. These studies have focused on debt, preferred equity, or seasoned equity offerings (SEOs). A stronger test of conflict of interest is to examine those securities for which informational asymmetries are likely to be material, such as IPOs. Furthermore, there is little modern evidence of how relationships between commercial and investment banks facilitate market access. Accordingly, in this paper we examine the pricing and performance of IPOs. The Japanese IPO market in the late 1990s is particularly well-suited to testing for conflicts of interest because informational asymmetries are likely to be material, and because the period is one of extreme financial system stress for Japan. Both information asymmetry and financial system stress increase incentives for bankers to behave opportunistically. By focusing on IPOs in Japan, we "stack the deck" in favor of finding evidence of conflicts, thereby addressing an important aspect of banking relationships. The time period has the additional advantage of spanning two different underwriting

[3] The Gramm–Leach–Bliley Act (The Financial Services Modernization Act of 1999) repealed provisions contained in Sections 20 (formal affiliations of commercial and investment banks) and 32 (overlapping boards) of the Glass–Steagall Act.