



# Effects of IPO mispricing on the risk and reputational capital of commercial banks

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## Abstract

We provide direct evidence regarding the risk and reputational capital implications of commercial bank securities underwriting activities. Using a large sample of commercial bank underwritten initial public offerings (IPOs) and comparisons with investment bank underwritten issues, we find that (1) commercial banks are no more likely to misprice IPOs than are traditional investment banks, and (2) the market reaction to mispriced IPOs is no greater for commercial banks than for traditional investment banks. Our evidence, thus, is consistent with the policy implications of other research justifying repeal of the Glass–Steagall Act. Specifically, we find no evidence that bank shareholders or the public are exposed to greater risk when banks are allowed to underwrite securities. © 2003 Elsevier Inc. All rights reserved.

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## 1. Introduction

Commercial banking organizations have entered significantly into securities underwriting since the 1987 Federal Reserve Board decision to allow limited underwriting powers for banks' Section 20 subsidiaries. Section 20 underwriting powers initially were limited to municipal revenue bonds and mortgage-related securities. However, by the late 1990s, major commercial banks were among the leading underwriters of high-yield corporate bonds, initial public offerings (IPOs) of equity, and other types of security. The *American Banker* (July 6, 1999, p. 4) reported that Section 20 subsidiaries led almost 20% of all IPOs in the second quarter of 1999.

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The expansion of commercial banking organizations into securities underwriting, especially the underwriting of equity and equity type issues, raises a number of important questions. First, does the melding of commercial and investment banking within an organization create potential conflict of interest problems between commercial banks in their traditional role of lenders and in their new role as securities underwriters? Second, does security underwriting increase the perceived risk and/or reduce the reputational capital of the parent commercial bank? Passage of the 1933 Glass–Steagall Act, which “prohibits commercial banks from underwriting, holding, or dealing in corporate securities, either directly or through securities affiliates” (Kroszner and Rajan, 1994), was based to a considerable extent on the argument that the banking collapse of the early 1930s was largely attributable to commercial bank securities activities (Benston, 1996). Recently, the importance of these issues was elevated by the late 1999 passage of legislation that repealed the Glass–Steagall Act and is widely expected to result in more rapid consolidation of the commercial banking, securities, and insurance industries.

Many studies have focused on the existence of a conflict of interest resulting from mixing the traditional banking function with other types of financial services. This conflict of interest may exist because commercial banks have an incentive to misuse private information derived from their customer relationships (i.e., loan, deposit, trust, or other relationships). This misuse could take the form, for example, of bringing to market the debt securities of troubled borrowers, thus, shifting credit risk from the bank as lender to the capital market. However, an extensive literature has been unable to find evidence of such a conflict of interest.

Ang and Richardson (1994), Kroszner and Rajan (1994), and Puri (1994, 1996) examine the evidence in the pre-Glass–Steagall era while Gande, Puri, and Walter (1997), Gande, Puri, and Saunders (1999) and Fields, Fraser, and Bhargava (2003) examine the more recent period when Section 20 subsidiaries have engaged in securities underwriting. None finds any empirical evidence that would support the existence of a conflict of interest.

In contrast, there is relatively little evidence regarding the effects on commercial banks’ reputational capital and risk of introducing securities underwriting (or other types of securities activities) into the normal banking functions. Most of the studies that do exist address the issues using pre-Glass–Steagall data. For example, White (1986) demonstrates that only a few bank failures in the early 1930s were associated with bank/securities operations. He also provides evidence from a multivariate model that, *ceteris paribus*, banks that had a securities affiliate were less likely to fail in the pre-Glass–Steagall period than banks that did not. However, Boyd and Graham (1993) provide simulation evidence that bank holding company mergers with securities firms would most likely increase risk. More recently, Bhargava and Fraser (1998) show that Federal Reserve authorization for Section 20 subsidiaries to engage in corporate debt and equity underwriting and subsequent expansion of the potential revenues from these underwriting activities produced increases in market-based risk measures for the parent commercial banks.

We examine evidence from IPOs underwritten by commercial and investment banks and focus primarily on two questions.<sup>1</sup> First, are the IPOs underwritten by commercial banks more likely to be mispriced than investment bank underwritten IPOs? Second, does the mispricing (particularly extreme

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<sup>1</sup> Giddy (1985) compares the riskiness of all public equity issues (both IPOs and secondary offerings) from 1976 through 1983 with that of underwritten bond issues, and finds that, once differences in margins are taken into account, equity underwriting is not more risky than bond underwriting. However, he also shows that IPO issues are much more risky than secondary offerings.

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