



Bond underwriting by banks and conflicts of interest: Evidence from Japan during the pre-war period

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Abstract

Article 65 of the Securities and Exchange Law of Japan, which was carried into effect in 1948, prohibited banks from underwriting corporate securities partially because of the concern that combining the banking and securities businesses might result in a potential conflict of interest. This paper studies the pricing and long-term default performance of industrial bonds underwritten by commercial banks, the Industrial Bank of Japan (IBJ), and trust firms as compared to those underwritten by investment houses during the pre-war period in Japan when banks were allowed to underwrite industrial bonds. The evidence rejects the concern about the conflicts of interest.

Introduction

Article 65 of the Securities and Exchange Law of Japan was carried into effect in 1948 as a directive from the Allied Powers' General Headquarters (GHQ) after the end of World War II. The law prohibited commercial banks from underwriting industrial bonds partially due to the concern that combining banking and securities businesses might result in a potential conflict of interest with investors; i.e. that banks might use their informational advantage over investors to underwrite poor quality industrial bonds and make the bond issuers repay their debt obligations to the banks. Since the enactment of the Financial System Reform Law in 1993, commercial banks have been permitted to operate securities businesses through bank-owned securities subsidiaries, and they have been expanding their market shares in the domestic straight bond underwriting business at a rapid pace. It seems, however, that prior to the passage of the Financial System Reform Law, there had not been thorough discussion among financial authorities and academics about potential conflicts of interest between banks and investors.

The purpose of this paper is to analyze if there were conflicts of interest when banks were allowed to underwrite industrial bonds during the pre-war period, and re-examine the passage of Article 65 of the

Securities and Exchange Law and the Financial System Reform Law. First, we examine ex ante pricing of bonds underwritten by commercial banks and investment houses. Bank underwriting can have two effects on the pricing of securities. Since commercial banks are better informed about bond issuers than investment houses, there may be a greater certification effect when securities are underwritten by commercial banks. Thus, commercial-bank-underwritten bonds could be priced higher than investment-house-underwritten bonds. However, if a conflict of interest arises when securities are underwritten by commercial banks, commercial-bank-underwritten bonds could be priced lower than investment-house-underwritten bonds. According to Puri (1996), one can conclude that the net certification effect (or net conflict-of-interest effect) exists if commercial-bank-underwritten bonds are priced higher (lower, respectively) than investment-house-underwritten bonds. Our empirical results suggest that neither the net certification effect nor the net conflict-of-interest effect arises when bonds are underwritten by commercial banks. Similar results are obtained when pricing of industrial bonds underwritten by trust firms and the Industrial Bank of Japan (IBJ) is examined as compared to those underwritten by investment houses. The results suggest rejection of the concern about conflicts of interest.

Further, we examine ex post long-term default performance of bonds underwritten by commercial banks as compared to those underwritten by investment houses. In particular, mortality rates defined in Altman (1989) (i.e. default rates adjusted for the ages of bonds) are used to compare the default performance of commercial-bank-underwritten bonds and investment-house-underwritten bonds. Probit estimations are also used to control for factors that could possibly influence the default performance of bonds. Contrary to the conventional argument, the results show that both the mortality rates and the default probabilities of commercial-bank-underwritten issues were significantly lower than those of investment-house-underwritten issues. Similar results are obtained when default performance and default probability of trust-firm-underwritten issues and IBJ-bank-underwritten issues are compared with investment-house-underwritten issues. The evidence rejects the concern about conflicts of interest.

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 and examine ex post default performance of issues underwritten by commercial banks as compared to those underwritten by investment houses. Their results discredit the concern about conflicts of interest. Puri (1996) also focuses on a pre-Glass-Steagall period, but analyzes effects of bank underwriting on the ex ante pricing of securities. She did not find any evidence that affirms the need for concern about conflicts of interest. Gande et al. (1997) study the effects of underwriting by Section 20 subsidiaries on the pricing of securities using a modern data set, and found no evidence of conflicts of interest. Hamao and Hoshi (1998) and Ito and Konishi (2000) focus on underwriting by banks' securities subsidiaries after the enactment of the Financial System Reform Law in 1993, and they examine the effects of bank underwriting on the ex ante pricing of industrial bonds. Using different time frames and data sets, Hamao and Hoshi (1998) found no evidence of conflicts of interest, but Ito and Konishi (2000) found some evidence that is consistent with the concern about conflicts of interest. Contrary to the previous research, this paper highlights a unique pre-war period in Japan when commercial banks as well as the IBJ and trust firms were allowed to underwrite industrial bonds.

The paper is organized as follows. Section 2 provides some historical background on bond underwriting by commercial banks. Section 3 describes data and sample selection. Testable hypotheses are developed in Section 4. Section 5 examines the ex ante pricing of bonds underwritten by commercial banks, the IBJ and trust firms as compared to the pricing of investment-house-underwritten issues. Section 6 examines the long-term performance of bonds underwritten by commercial banks, the IBJ and trust firms as compared to that of investment-house-underwritten issues. Section 6 also studies the long-term performance of

commercial-bank-underwritten issues as compared to the IBJ- and trust-firm-underwritten issues to ascertain whether commercial banks were better informed about bond issuers than the IBJ and trust firms were. Section 7 reviews the implications of this paper.

Section snippets

Historical background

Japan is one of the few industrial countries where the banking and securities businesses have been legally separated until very recently....

Sample selection and data

The sample of bond issues is collected from a pre-war period when commercial banks as well as the IBJ and trust firms were allowed to underwrite industrial bonds and were heavily involved in the bond underwriting business. The IBJ is treated separately from commercial banks since it is a special bank founded under the IBJ Act of 1900 to promote long-term financing to heavy industries, which was the goal of the government at the time.

Bonds issued in the period January 1919–December 1927 are used ...

Hypotheses

Bank underwriting can have two possible effects on the pricing and long-term performance of industrial bonds. Since banks are better informed about bond issuers than investment houses due to repeated transactions with the issuers via lending activities, there may be a greater certification effect when securities are underwritten by banks than by investment houses....

Methodology

We run the following Ordinary Least Squares (OLS) regression to measure the differences in yield spread between commercial-bank-underwritten issues and investment-house-underwritten issues, controlling for other factors which may affect the yield spread:

$$\text{SPREAD}_i = \beta_0 + \beta_1 \text{BANK}_i + \beta_2 \text{CAPITAL/ASSET}_i + \beta_3 \text{LN(AMOUNT)}_i + \beta_4 \text{LN(AGE)}_i + \beta_5 \text{LN(SYNDICATESIZE)}_i + \beta_6 \text{SECURED}_i + \beta_7 \text{FIRSTISSUE}_i + \beta_8 \text{LONGTERM}_i + \beta_9 \text{INDUSTRY}_i.$$

the ex ante yield spread of an industrial bond over the ex ante yield of the...

Methodology

Firstly, we test for differences in mortality rates of bonds underwritten by banks and investment houses. This paper defines two kinds of mortality rates; marginal mortality rate and cumulative mortality rate. These measures are introduced in Altman (1989) to calculate the default rates of bonds that have been outstanding for equal periods of time, controlling the size of the denominator by accounting for maturities and past defaults.

The marginal mortality rate for the year t (MMR_t) is the...

Concluding remarks

This paper examined the pricing and long-term default performance of industrial bonds underwritten by commercial banks, the IBJ and trust firms as compared to those underwritten by investment houses. The data were collected from the pre-war period in Japan (January 1919–December 1927) when commercial banks as well as the IBJ and trust firms were allowed to underwrite securities.

The test results suggest that industrial bonds underwritten by commercial banks, the IBJ and trust firms were not...

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...Thus, my results are robust to endogeneity concerns. Existing works extensively explore the role of commercial banks in underwriting securities, especially via bank subsidiary security firms.²⁵ These papers propose two opposing views: the certification view and conflict-of-interest view...

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