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Career concerns of banking analysts

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We study how career concerns influence banking analysts' forecasts. Banking analysts' first (last) earnings forecast of the year is relatively more optimistic (pessimistic) for a bank that could be their future employer. This pattern is not observed when the same analysts forecast earnings of banks unlikely to be their future employer. We use the Global Settlement as an exogenous shock on career concerns and show that this forecast pattern is more pronounced after the Settlement. Moreover, we find evidence that analysts benefit from this behavior as analysts that are more biased in their forecasts of potential future employers are more likely to move to a higher reputation bank.

1. Introduction

Sell-side analysts are important information intermediaries in capital markets and as a result their research has been under scrutiny. While a large number of studies document that analyst coverage and forecasts have economic consequences (Bailey et al., 2003; Jackson, 2005), an equally large number of studies document that analyst forecasts are influenced by conflicts of interest (Beyer and Guttman, 2011; Cowen et al., 2006; Hong and Kubik, 2003; Jackson, 2005; Lim, 2001; Richardson et al., 2004; Schipper, 1991). In this paper we concentrate on the banking industry and investigate whether analyst forecasts are biased because of career concerns.

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Past studies have documented that analyst forecasts can be biased because of underwriting activities in the investment banking business, pressure to generate trading commissions, and career concerns (Hunton and McEwen, 1997; Lin and McNichols, 1998; Michaely and Womack, 1999; Dugar and Nathan, 1995; Dechow et al., 2000; O'Brien et al., 2005; Hong and Kubik, 2003). In terms of career concerns, past studies have documented that more optimistic analysts tend to experience favorable job separations (Hong and Kubik, 2003) and younger analysts tend to herd more (Hong et al., 2000). In these studies, the underlying source of career concerns is pressure from investment banking and/or brokerage business to please companies or buy-side portfolio managers respectively.

In this paper, we concentrate on a different source of conflicts of interest. Banking analysts issue forecasts for companies that constitute a large part of their outside opportunities in terms of employment. These analysts view the banks that they issue forecasts for as potential sources of employment, thereby increasing their incentives to satisfy those clients. This is independent of incentives to generate investment banking business or trading commissions, which exist for all companies they cover.

In order to examine whether this pressure to satisfy future potential employers is influencing analyst forecasts, we examine the pattern in the bias of their forecasts. In our research design we hold the analyst constant by requiring that the same analyst is forecasting earnings for companies with sell-side equity departments ('employers') and for companies with no sell-side equity departments ('non-employers'). We then show that banking analysts issue forecasts that are relatively more optimistic for employers in the beginning of the year. At the end of the year the opposite is true; banking analysts issue forecasts that are relatively more pessimistic for employers. Therefore, our research design is similar to a differences-in-difference specification where we observe, for the same set of analysts, the forecasting pattern early and late in the year and we compare this pattern for employers and non-employers. We limit our sample to those analysts who are not employed by the top investment banks and therefore could have relatively greater career concerns. Analysts that are already working for bulge investment banks have greater career opportunities and less incentive to move as they already work at the most reputable banks. Therefore, we treat analysts working at the top banks as a control group that allow us to scale our dependent variable of forecast bias. We report results using both this relative bias variable and an absolute bias variable relative to the stock price of the firm. We find similar results across both measures.

To further identify the effect of career concerns from forecasting earnings of a potential future employer we exploit an exogenous shock to future career opportunities. The Global Settlement of 2003 decreased significantly the budgets for sell-side research and as a result directly impacted the outside opportunities for sell-side analysts (Cowen et al., 2006). This could lead to exacerbation of career concerns and as a result a more pronounced walk-down to beatable earnings for employers. On the other hand, after the Global Settlement, the analysts could be more reluctant to bias their forecasts because that might anger other constituents that consume their forecasts, raising the probability of dismissal. The probability of a promotion at another firm might not look as attractive if analysts are more worried about just keeping their jobs after the settlement. We find that after the Global Settlement the transition from optimistic to pessimistic forecasts closer to the year-end is stronger. These findings are consistent with banking analysts understanding that their forecasts could impact future career opportunities and as a result provide a walk-down to beatable earnings.

We analyze future job separations to understand whether analysts benefit from such forecasting activity. We find that banking analysts who are pessimistic at their latest forecast are more likely to experience favorable job separations and move to a higher status brokerage house. This result is present only for analysts that exhibit this behavior towards employers, again consistent with analysts strategically biasing their forecasts because of career concerns.

Our identification strategy aims to mitigate the likelihood that other sources of bias, unrelated to a revolving door story, might cause our results. We do so by differentiating both across types of firms being forecasted (i.e. a bank with or without a research department) as well as across analysts (i.e. employed by a top-bank versus a non-top bank). We show that a walk-down to beatable earnings and upward job mobility is more pronounced when an analyst works for a non-top bank and forecasts earnings of a bank with a research department. It is hard to reconcile these findings with biases due to incentives to generate investment banking business or trading commissions, which should be present in both types of forecasted firms or analysts. For example, bias arising from incentives to generate investment banking business should be strong for banks with or without research departments and it should be less pronounced after the Global Settlement. Similarly, incentives to generate trading commissions should be as strong for analysts working at top banks and when forecasting earnings for banks without research departments. Of course, if for example, investment banking business or trading commissions are significantly higher for banks with research departments and analysts in non-top banks have stronger incentives to bias their forecasts to generate investment banking business or trading commissions that could explain our results. However, in our matched sample, banks with and without research departments exhibit very similar market capitalization, valuation ratios, analyst following, share turnover, and risk; all variables that could be related to investment banking or trading commission sources of bias. Moreover, reduced competition, due to brokerage house closures, following the Global Settlement could explain our results (Hong and Kacperczyk, 2010). We address this concern by examining whether the pattern we document holds for firms where analyst coverage did not decrease after the Global Settlement and therefore the competition effect is not at play. We find similar results for this subsample.

Our results contribute to a body of literature that investigates the sources of bias in analyst forecasts (Cowen et al., 2006). We complement this line of research by documenting a different source of conflict of interest. Effectively the conflict we document here relates to the 'revolving-door' phenomenon, which has been investigated in relation to audit partners (Menon and Williams, 2004; Geiger et al., 2005), SEC lawyers (deHaan et al., 2015), and credit rating analysts (Cornaggia