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Conflict of interest and certification in the U.S. IPO market [☆]

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ABSTRACT

We examine the long-term return performance of U.S. IPOs underwritten by relationship banks. We show that, over one- to three-year horizons, IPOs managed by relationship banks experience buy-and-hold benchmark-adjusted returns that are similar to those observed for a matching sample of stocks managed by non-relationship underwriters. This result holds even when the returns' skewness and cross-sectional correlation is accounted for. Further, we examine the calendar-time returns on a portfolio that is long the stocks underwritten by relationship banks and short ex-ante similar stocks taken public by non-relationship institutions. Again, we conclude that the two groups of IPOs yield similar long-run returns. These findings support the certification role of relationship banks and suggest that, in this respect, the effect of the 1999 repeal of Sections 20 and 32 of the Glass–Steagall Act has not been negative.

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1. Introduction

There has been an extensive debate in the United States regarding the costs and benefits of participation by commercial banks in the securities underwriting business. When banks lend to firms they acquire proprietary firm-specific information about their clients (e.g., Diamond, 1991; Rajan, 1992; and Stein, 2002). A more informed bank can effectively certify a firm's value and facilitate the underwriting of its client's securities, especially its initial public offering (IPO). However, a lending bank's

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informational advantage presents a conflict of interest, since a bank that has a stake in a firm has incentives to promote the overpriced issuance of a junior claim. We add to this debate with a study of the long-run performance of IPOs underwritten by commercial banks. First, we examine the cross section of buy-and-hold benchmark-adjusted returns on IPOs taken public by relationship and non-relationship banks. Second, we study the calendar-time returns on a portfolio that is long the stocks underwritten by relationship banks and short ex-ante similar stocks taken public by non-relationship institutions. In both cases, we find that over one- to three-year horizons IPOs underwritten by relationship banks yield returns similar to those on IPOs managed by non-relationship underwriters. These findings support the certification role of relationship banks underwriting their clients' IPOs.

The 1933 Glass–Steagall Act sought to address the potential conflict of interest and banned commercial banks from the market for corporate securities underwriting (Sections 20 and 32 of the Act). Over the past two decades this restriction has been relaxed. The deregulation process began in 1987 when regulators reinterpreted Section 20 of the Glass–Steagall Act and allowed some banks, such as JP Morgan and Bankers Trust, to set up Section 20 subsidiaries which can underwrite corporate securities (e.g., Puri, 1999). This process culminated in the 1999 Gramm–Leach–Bliley Financial Modernization Act, which brought down the 'firewalls' that limited information, resource, and financial linkages between Section 20 subsidiaries and their parent holding companies as well as with their commercial banking affiliates.

Motivated by these policy developments, previous studies have investigated the conflict-of-interest and certification debate by examining the underwriting of bonds. For instance, Kroszner and Rajan (1994) and Puri (1994, 1996) provide evidence based on bond issues underwritten prior to the enactment of the Glass–Steagall Act. Gande et al. (1997) use data on bond issues from January 1993 to March 1995. Consistent with the certification view, Puri (1996) and Gande et al. (1997) find that debt issues managed by commercial banks exhibit relatively higher prices, and further, Puri (1994) shows that bank underwritten issues defaulted less than non-bank underwritten issues. Also consistent with the certification role of banks, Kroszner and Rajan (1994) find that bond issues underwritten by commercial banks had default rates lower than similar issues managed by investment banks.

Here we consider a new sample, IPOs underwritten by the firm's pre-IPO bank during the period from 1998 to 2000, and present additional evidence that helps us understand the consequences of bringing down the commercial-investment bank firewalls. By combining different data sources, we identify the firm's pre-IPO bank, the IPO underwriters, and the firm's characteristics. As such, we can precisely identify the IPOs that were underwritten by a bank subject to a potential conflict of interest. In the rest of the article we refer to the bank that served the firm prior to its IPO as the relationship bank, while we refer to a bank that did not serve the firm prior to its IPO as an independent or outside bank.

We examine whether IPOs underwritten by relationship banks exhibit abnormal long-run returns compared to equity issues underwritten by independent banks. This analysis adds to Schenone (2004) who focuses on the underpricing of IPOs that had a relationship with a prospective underwriter. As a first step we focus on the cross-section of buy-and-hold abnormal returns (BHARs). We start out by computing mean BHARs, with holding periods from one to three years, for stocks managed by a relationship bank. For each of these IPOs we identify a matching stock with similar risk characteristics that was managed by an independent underwriter. We do not find significant differences in performance between the returns on the two samples of stocks. This result is robust across the different benchmarks that we use to compute abnormal returns and across holding periods.

Fama (1998) warns that the results of a long-run performance study based on buy-and-hold abnormal returns should be interpreted with caution. Concerns arise from systematic errors due to imperfect expected return proxies (the 'bad-model' problem), the skewness of individual-firm long-horizon BHARs, and the cross-sectional correlation of BHARs that overlap in calendar time. We attempt to address these issues. To limit the bad model problem, we consider benchmark portfolios that are similar to the IPO stocks on characteristics known to be related to average returns. We focus on portfolios of stocks ranked by size and book-to-market, but we also examine industry-ranked portfolios and different market indices (S&P 500, Nasdaq, as well as a portfolio comprising NYSE, AMEX, and NASDAQ stocks). Further, we consider a logarithmic transformation to reduce the skewness of individual-firm long-horizon BHARs. More importantly, to deal with calendar-time dependence we estimate the cross-

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