Bond Underwriting by Commercial Banks and Coflicts of Interest: Evidence from Japan in a Pre-War Period

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Article 65 of the Securities and Exchange Law of Japan was enacted in 1948 and prohibited commercial banks from underwriting corporate securities concerning that combining banking and securities businesses might result in potential conflicts of interest to investors; i.e. the banks may use their informational advantage over investors to underwrite poor quality corporate bonds and make the bond issuers to repay their debt obligations to the banks.

The purpose of this paper is to analyze empirically if there exist the conflicts of interest when commercial banks are allowed to underwrite securities in two ways. First, I examine ex ante pricing of corporate bonds underwritten by commercial banks and investment banks in a pre-War period when commercial banks were allowed to underwrite corporate securities. Bank underwriting can have two effects on the pricing of securities. Since commercial banks are better informed about bond issues than investment banks, there may be a greater certification effect when securities are underwritten by commercial banks than by investment banks.　Therefore, commercial bank underwritten bonds can be priced higher than investment bank-underwritten bonds. However, if conflicts of interest arise when securities are underwritten by commercial banks, commercial bank-underwritten securities are priced lower than investment bank-underwritten securities. I conclude that net conflicts-of-interest effects exist if bonds are priced higher when commercial bank underwritten bonds are priced lower than investment bank-underwritten bonds. I found no net conflicts-of-interest effects, which in turn indicates that concerns about conflicts of interest can be doubted at least for late 1920's in Japan.

Second, I examine ex post default performance of commercial bank underwritten bonds as compared to investment bank underwritten bonds for the same period. The results suggest that commercial bank underwritten bonds defaulted less than investment bank underwritten bonds, which also indicates that the conflicts of interest did not exist in the pre-War period.