

# **Is Universal Banking Justified? Evidence from Bank Underwriting of Corporate Bonds in Japan**

Jun-Koo Kang and Wei-Lin Liu\*  
Michigan State University

## **Abstract**

As the Glass-Steagall restrictions on bank underwriting were relaxed in the U.S. during the 1990s, the Financial System Reform Act (FSRA) of 1993 in Japan allowed commercial banks to underwrite securities. Using a large sample of unsecured corporate bond issues in Japan after the passage of the FSRA, we examine the debate on the role of commercial banks when they underwrite securities of firms with which they have prior lending relationships. We find that the issues underwritten by banks derive significantly lower prices (i.e., higher yields) than do those underwritten by houses. However, after the offerings, bank-underwritten issues do not experience as high a probability of credit rating downgrades as do house-underwritten issues. Taken together, these results strongly reject the certification view and suggest that the differences in ex ante yields are attributable to conflicts of interest. Our results contrast sharply with much of the evidence in the U.S., which documents a certification role for banks. Further analysis shows that the yield spreads of bonds are positively related to the market share of bank underwriters. Since banks that are more rapidly expanding their underwriting business face a greater need to provide investors with high-reward investment opportunities, our result suggests that banks excessively discount the prices of bonds in order to attract potential investors. Furthermore, we find that the lending relationships between bank underwriters and issuers weaken significantly more for issues with a better post-issuance rating performance. This result contradicts the information-misrepresentation view that banks underwrite poor-quality securities in order to use the proceeds from the issues to pay off loans. Rather, it is consistent with the price-discount view since bank underwriters who want to increase their market share in bond underwritings need to provide investors with profitable investment opportunities and thus have an incentive to extend credit to poor-quality issuers so that these issuers can maintain sufficient liquidity for future financial needs. We also find that competition from investment houses limits but does not eliminate these conflicts. Finally, we find that the magnitude of conflicts of interests the banks create is different for main-bank underwriters and other-bank underwriters. Although the main-bank- and other-bank-underwritten issues are on average priced similarly, the former exhibit a significantly lower probability of ex post rating downgrades than do the latter. Overall, our findings from the Japanese data suggest that it is premature to generalize the U.S. experience with universal banking to economies that have different traditions in their bank relationships.

---

\* Kang is from the Department of Finance, The Eli Broad College of Business, Michigan State University, East Lansing, MI 48824-1121, Tel.: 517-353-3065, Fax: 517-432-1080, E-mail: [kangju@pilot.msu.edu](mailto:kangju@pilot.msu.edu); and Liu is from the Department of Finance, The Eli Broad College of Business, Michigan State University, East Lansing, MI 48824-1121, Tel.: 517-353-1795, Fax: 517-432-1080, E-mail: [liu@bus.msu.edu](mailto:liu@bus.msu.edu).