CONFLICTS OF INTERESTS IN INVESTMENT BANKS

Ph.D. ***Andrei SIMONOV***
Michigan State University, Stockholm School of Economics and CEPR

CONFLICTE DE INTERESE ÎN BĂNCILE DE INVESTIŢII

Sunt studiate ultimele apariţii din literatura de specialitate cu referire la conflictele de interese în cadrul băncilor universale de investiţii, ce apar ca urmare a rolului proeminent al comerţului proprietar şi gestiunii activelor în banca universală. După cum se arată în literatura analizată, comerţul proprietar beneficiază de informaţia oferită de către departamentul de investiţii al băncii. Dat fiind faptul că angajaţii băncilor de investiţii sunt membri ai organelor corporative de vârf, băncile de investiţii şi lucrătorii bancari adesea oferă recomandări care contravin intereselor firmelor cliente.

Investment banks are in the heart of modern financial markets. From their humble origins in XIX century, investment banks were helping to provide "soft" information to financial markets that cannot be codified in usual arm's length contracts enforceable by the courts. In those distant times the investment banking was rarely involved in anything but advisory business. The most important asset that investment bank possess was reputation of its partners and employees. Capital that the investment bank possesses was almost unimportant. As In 1964 Morgan Stanley chairman Perry E. Hall declared that he didn't see the need for more than $10 million in capital. Six years later, in 1970, Morgan Stanley had 200 employees worldwide and $7.5 million in capital[1]. The reputation for honest business dealing was supported by semi-public service by leading investment bankers in form of corporate directorship. Sidney Weinberg who headed Goldman Sachs from 1930-es till 1969 was sitting at 31 different boards simultaneously and was highly respected for his service[2].

In the last twenty years we observe well defined movement towards more complex organization involved in other areas such as asset management and proprietary trading. Those changes were driven by the development in information technologies and financial theory. The most visible consequence of those theories is related to the development of derivative markets and related risk management techniques as well as creation of trading algorithms. As a result, traditional investment bank model especially among "top tier" banks is becoming almost extinct. To put this statement in perspective, note that the abovementioned Morgan Stanley in 2004 had 53,284 employees and $110.8 billion of capital[3], an increase of 250 times in number of employees. At this point, significant fraction of revenues of large investment banks is coming from the sources other than advisory services. In Morgan Stanley the average over 2002-2004 was 13% of revenue, while Trading and Principal Investment brought 42% of revenues. For some (most notably, Goldman Sachs) advisory fees are almost pocket change in comparison with other sources.

What are the consequences of that? As it was noted by Roger Altman (banker, also worked in Clinton Administration) noted that 'at the big banks, investment banking is being downgraded – the proprietary trading desks are driving these firms now'[4].

Regulators are perfectly aware about possible conflicts of interest and they erect "Chinese Walls" between different sides of their business. We know, however, that those attempts often fail. The role of Deutsche Bank Investment Banking division in changing the vote of DB Asset Management in Compaq-HP merger is well known. In the SEC's June 2006 SEC issued administrative order against Morgan Stanley, for allegedly failing to maintain and enforce written policies and procedures to prevent the misuse of material nonpublic information. According to the Order, which was entered without admitting or denying liability, Morgan Stanley "violated Section 15(f) of the Exchange Act and Section 204A of the Advisers Act" by failing to (among other things) surveil activity in certain securities traded in Morgan Stanley's proprietary accounts; and provide adequate written guidance in the firm's policies and procedures about such trading".

Recent paper I wrote with Massimo Massa and Andriy Bodnaruk[5] is dealing with trading done by different asset management and proprietary trading divisions of investment banks in the deals that banks advise. We looked at the US Mergers and Acquisitions market for the period January 1984 - February 2003. We analyze the relation between the fact that the advisor to the bidder holds a stake in the

[1] Beard, Patricia, 2007, "Blue Blood and Mutiny, HarperCollins

[2] Sidney J. Weinberg, "The Functions of a Corporate Director," address before the Harvard Business School Club of Cleveland, May 31, 1949. Available at www.gs.com.

[3] Morgan Stanley Annual Report, 2004. Available at www.sec.gov.

[4] 'When a boutique bank is big business', James Politi, Financial Times, February 5. 2006.

[5] Bodnaruk, Andriy, Massa, Massimo and Simonov, Andrei, "The Dark Role of Investment Banks in the Market for Corporate Control" (December 2007). EFA 2007 Ljubljana Meetings Paper Available at SSRN: http://ssrn.com/abstract=966202.

target and the probability of a firm becoming a target, the likelihood of contractual features increasing the probability of deal completion, the probability of success, the target's premium, and the long-run performance of bidder firms.

For every lead advisor in each deal we identify the stake that it holds in the target firm. This is based on the position that the advisor holds either directly or through the other financial entities – insurance firms, commercial banks, mutual funds, pension and hedge funds – that are affiliated with the financial conglomerate to which the advisor belongs.

We first show that the presence of advisors helps to predict if a firm will be a takeover target. Conditioning on firms with similar industry and size characteristics, firms in which the advisors to the bidder hold a stake are 45 percentage points more likely to become targets, with the probability of becoming a target increasing from the unconditional sample mean of 4.2% to 6.1%. Later, we build the trading strategy long in the actual positions of the advising investment banks and short in the positions of the non-advisory banks. This strategy delivers 1.40% per month (adjusted for risk). This provides a lower bound estimate of the informational advantage that the advisory bank has with respect to other sophisticated market players.

Unfortunately, it seems that the harm goes beyond the trading. It seems that the targets that investment banks selected in those deals are more expensive to begin with (by about 10%). In addition, the price that is paid in those deals is higher. If the advisor to the bidder holds a stake in the target firm, the target's premium increases by 590 basis points from 30.6% to 36.5% with respect to the case in which the advisor to the bidder does not hold such a stake. An increase of one standard deviation in the (dollar value of the) average fraction of the target firm held by the advisor to the bidder implies a premium 310 (290) basis points higher than average.

Overall, these findings suggest that advisors do take advantage of their privileged position, not only by acquiring positions in the deals on which they advise, but also by directly affecting the outcome of the deal in order to realize higher capital gains from their positions. These results provide important insights into the conflicts of interest affecting financial intermediaries that can both advise on corporate events and invest in the equity market.

What about Sidney Weinberg shoes? Bodnaruk, Massa and Simonov did not find any positive role that investment bankers who occupy board seats play in the process. However, there is now some literature that is related to role of financial board members. Dittmann, Maug, and Schneider[6] from University of Mannheim analyze the role of bankers on the boards of German non-financial companies and find that banks that are represented on a firm's board promote their investment banking services and increase their lending to firms in the same industry. They also find evidence that the presence of bankers on the board causes a decline in the valuations of non-financial firms. They also do not find convincing evidence for standard explanations that bankers use board seats to monitor their equity interests or their interests as lenders, or that bankers are capital market experts and help firms to overcome financial constraints.

In the United States, Guner, Malmendier, and Tate[7] find that financial experts significantly affect corporate decisions, though not necessarily in the interest of shareholders. First, when commercial bankers join boards, external funding increases. But, the increased financing affects mostly firms with good credit and poor investment opportunities. As a result, those funds tend to be wasted on inefficient projects. Second, investment bankers on the board are associated with larger bond issues, but also worse acquisitions. Third, they find little evidence that financial expertise matters for compensation policy or for experts without affiliation to a financial institution. The results of those two papers suggests that bankers use board representation in non-financial firms is in the interest of their banks, but not in the interest of the shareholders in these firms.

What are possible policy implications? Large universal banks are able to utilize the economy of scale and scope. However, they are prone to conflict of interest, especially in the area of advising, where the reliance on human capital and reputation is the largest. One might think that this would create a niche for boutique investment banks[8]. Unfortunately, we do not have the evidences that the advise given by independent investment banks is no better then the advise given by universal banks (Song and Wei, 2008)[9]

Full service investment banks are likely to stay and are unlikely to yield market share to boutique investment banks. It is also difficult to implement better supervision procedures (stock appearance of the watch list is an important information leak by itself). Probably, full disclosure and awareness on the part of investment banks and client firms will eventually help to minimize the damage.

[6] Dittmann, Ingolf, Maug, Ernst G. and Schneider, Christoph, "Bankers on the Boards of German Firms: What They Do, What They are Worth, and Why They are (Still) There" (February 1, 2008). ECGI - Finance Working Paper No. 196/2008 Available at SSRN: http://ssrn.com/abstract=1093899.

[7] Guner, A. Burak, Malmendier, Ulrike and Tate, Geoffrey Alan, "Financial Expertise of Directors" (January 2006). NBER Working Paper No. W11914 Available at SSRN: http://ssrn.com/abstract=875673.

[8] Boutiques are actively using the perception of the market place. For example, the following quote is taken from Lazard' registration Statement:"We are an independent firm, free of many of the conflicts that can arise at larger financial institutions as a result of their varied sales, trading, underwriting, research and lending activities. We believe that recent instances of perceived or actual conflicts of interest, and a desire to avoid any potential future conflicts, have increased the demand by managements and boards of directors for trusted, unbiased advice from professionals whose main product is advice".

[9] Song, Weihong and Wei, Jie(Diana), "The Value of "Boutique" Financial Advisors in Mergers and Acquisitions" (February 22, 2008). Available at SSRN: http://ssrn.com/abstract=1108736.