Conflict of Interest in Universal Banking:

Evidence from the Post-Issue Performance of IPO Firms[*]

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December 11, 1997

Abstract

Using a unique newly constructed data set on Israeli IPO firms in the 1990s, we study costs and benefits of universal banking. The post-issue accounting profitability of firms underwritten by bank affiliated underwriters that were also borrowers from the same bank in the IPO year, is significantly better than average. This is interpreted as evidence that universal banks use their superior information regarding underwritten firms to float the cherries, not the lemons. We also find, however, that the stock price performance of these firms during the first year following the IPO is lower than average. Furthermore, among these firms, the stock price performance of firms whose equity was purchased by an investment fund that is affiliated with the underwriting and lending

bank is even lower. We also compute first day returns for the IPO stocks. The first year underperformance is interpreted as IPO overpricing, which is consistent with the first day returns. Thus, bank managed funds pay too much for bank underwritten IPOs at the expense of the investors in the funds. We conclude that there is conflict of interest in the combination of bank lending, underwriting, and fund management. Although universal banks use their superior information regarding underwritten firms to float the cherries, investors in bank managed funds end up paying too much for the equity of these firms.

1 Introduction

Costs and benefits of universal banking have been at the center of the debate on banking reform in the United States and elsewhere. Proponents of universal banking argue that universal banks enjoy superior information regarding client firms and are, therefore, better qualified to serve as underwriters. Opponents stress that there is potential conflict of interest in universal banking, for example, between bank lending and bank underwriting. In fact, the desire to prevent conflict of interest led to the enactment of the, now controversial, Glass-Steagall legislation which requires complete separation between commercial and investment banking.

Existing empirical evidence on this issue is from the pre-Glass-Steagall period, most notably Ang and Richardson (1994), Kroszner and Rajan (1994), and Puri (1996). There is a real need for modern evidence, for example from Continental European countries where banking is universal. However, stock markets in Continental Europe have not been very active recently in terms of Initial Public Offerings (IPOs), rendering such a study hard to perform. Israel provides an excellent opportunity to study costs and benefits of legislation limiting the scope of bank activities. Banks in Israel are truly universal, operating in all segments of the capital market, underwriting securities, managing investment funds, and owning the equity of firms, directly as well as via these funds. Furthermore, there has recently been a large wave of IPOs on the Tel Aviv Stock Exchange. The universal banks were deeply involved in the IPO wave, both as underwriters and by purchasing, mainly through bank managed investment funds, large amounts of the newly issued equity.

We also use data on several performance and corporate governance measures, including ownership concentration and bank lending concentration.

We focus on evaluating the relative post-issue performance of the firms in our sample according to their affiliation with banks and bank underwriters. As measures of post-issue performance we use accounting profitability and the stock price performance during the first year following the IPO. The average post-issue accounting profitability of firms underwritten by a bank affiliated underwriter that were also borrowers from the same bank in the IPO year, is significantly better than average.[1] This is interpreted as evidence that universal banks use their superior information regarding underwritten firms to float the cherries, not the lemons.

We also find, however, that the stock price performance of these firms during the first year following the IPO is lower than average. Furthermore, among these firms, the stock price performance of those whose equity was purchased by an investment fund that is affiliated with the underwriting and lending bank is even lower. We also compute first day returns for the IPO stocks. The first year underperformance is interpreted as IPO overpricing, which is consistent with the first day returns. Thus, bank managed funds pay too much for bank underwritten IPOs at the expense of the investors in the funds. We conclude that there is conflict of interest in the combination of bank lending, underwriting, and fund management. Although universal banks use their superior information regarding underwritten firms to float the cherries, investors in bank managed funds end up paying too much for the equity of these firms.

In our regressions, we control for holdings by large shareholders finding that accounting monitoring.[2]

We ¯nd an overall decline in post-issue accounting pro¯tability, which is consistent with work by Jain and Kini (1994) who detect a decline in post-issue accounting performance for a sample of US ¯rms. Similar ¯ndings are obtained by Mikkelson, Partch, and Shah (1995) for a di®erent sample of US ¯rms. Pagano, Panetta, and Zingales (1995) who focus on the factors determining the decision whether and when to go public, also ¯nd, for a sample of Italian ¯rms, a decline in pro¯tability following an IPO. DeGeorge and Zeckhauser (1993) ¯nd similar results for a sample of reverse leveraged buyouts in the United States. It seems, therefore, that the decline in accounting pro¯tability following an IPO is an empirical regularity that transcends the structure of the ¯nancial system and the legislative environment. DeGeorge and Zeckhauser interpret their ¯ndings as driven mainly by pre-IPO window dressing. We provide evidence suggesting that in our sample, window dressing cannot fully account for the superior post-IPO performance of ¯rms with a bank underwriter-lender.[3]

The next section is devoted to a description of relevant aspects of universal banking in Israel and the IPO wave of the 1990s, and to a presentation of the data. Section 3 is devoted to the empirical analysis, in Section 4 we discuss the relation of the paper to the literature on con°ict of interest in universal banking prior to the Glass-Steagall legislation, and Section 5 concludes.

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[2] For the view that bank monitoring is driven by bank shareholding (rather than bank debt), see Edwards and Fischer's (1994) criticism of Cable (1985) who studies a sample of German ¯rms, and ¯ndings in Yafeh and Yosha (1997) for a sample of Japanese ¯rms; see also Hauser and Shohat (1991).

[3] A related paper is Michaely and Womack (1996) who study potential con°ict of interest within underwriting ¯rms that engage both in security issuance and provision of timely information about publicly traded ¯rms. They ¯nd, for a sample of US IPOs, evidence of con°ict of interest between the corporate ¯nance

2 Institutional Background and Data

2.1 Universal banking in Israel and the IPO wave of the 1990s

As in many Continental European countries, banks in Israel are truly universal, managing mutual and provident funds and controlling subsidiaries that specialize in underwriting or in mortgage origination. Banks own the stocks of manufacturing and insurance firms, typically up to 25 percent of a single firm's equity, and in some cases more. In 1995, for example, mortgage banks constituted, on average for the five largest banks, 11.3 percent of total book equity, long term credit banks constituted 1.3 percent, other financial institutions (including leasing companies, brokers, and underwriters) constituted 7.2 percent, and non-financial companies (including insurance companies) constituted 12.9 percent of total book equity value. The return on equity for these investments were 13.3, 2.1, 5.4, and 13.8 percent respectively.[4]

The banking system is also very concentrated. For example, the combined assets of the two largest banks constitute almost three quarters of total bank assets. The Herfindahl index in the local currency non-indexed bank deposit and bank credit segments of the market is about 0.25, with the five largest banks controlling over 95 percent of these activities. Concentration in banking is also prevalent in many European countries. For example, in 1990 the Herfindahl index of total bank assets was 0.24 in the Netherlands and 0.23 in Norway. In the same year, the five largest banks in France granted about 44 percent of bank credit and held over 58 percent of deposits.

An important feature of the Israeli banking system, not directly related to our study, management of the banks, and is currently engaged in a slow process of privatization.[5]

Provident funds play an important role in the Israeli capital market. These funds are long term saving instruments enjoying tax benefits, that can be redeemed after a period of no less than 15 years. Approximately 22 percent of the assets in the public's financial portfolio are managed by these funds. The funds are mostly bank managed (about 80 percent) with the three largest banks controlling about 47 percent of this segment of the market. Commission income from provident funds constituted in 1995 about 4 percent of total bank revenue.[6] Mutual funds constitute a short term liquid form of investment. More than 75 percent of mutual fund assets are managed by the three largest banks, and 12 additional percent are managed by four other banks. The concentration in investment funds is, therefore, also very high.[7] Commentators argue that concentration is not as high in underwriting, and that commercial banks are less dominant in this segment of the market. Our sample does not corroborate this view — in about 75 percent of the IPOs in our sample a bank affiliated investment house was a leading member of the underwriting consortium.

Until about 1990 the stock market was very thin and did not play a meaningful role as a source of capital. Furthermore, government involvement in capital markets was high. The financial markets reform, initiated in 1985, brought about a drastic reduction in the government's involvement in financial markets,[8] an extensive liberalization of international capital flows,[9] and minor changes in the organization of the intermediation sector.[10] Banks were required to reduce their holdings in corporate equity, and "Chinese Walls" were created between underwriting, fund management, and commercial banking activities. Despite these restrictions it is often argued that the steps taken were not satisfactory, leaving too much

¯led a complaint with the police against the two largest Israeli banks that had allegedly bought in 1994, via their provident funds, a large fraction of the IPO of an Israeli company despite evidence that the company was in bad shape. The reason for purchasing the stock was that the company owed large sums to the banks who bought the ¯rm's stock, on behalf of the depositors in the provident funds, to prevent the company from going under. In the two quarters following the IPO the company lost approximately $7 million, the entire amount raised in the IPO.[11] Without systematic research it is hard to establish whether banks with inside information about debtor ¯rms and market power in several segments of the capital market issued the securities of the lemons, as this anecdote suggests, or of the cherries.

The reform and the economic boom that Israel experienced in the past decade contributed to considerable development of the Tel Aviv Stock Exchange. Provident funds are now allowed to invest in corporate stocks and bonds, disclosure requirements (e.g. regarding top management compensation) are now more stringent, and trade in derivative securities has begun. Most important, perhaps, about 150 manufacturing ¯rms went public during the period 1991{5, almost tripling the number of manufacturing companies traded on the exchange. The banks were heavily involved in the IPO wave. As mentioned earlier, in about 75 percent of the IPOs in our sample a bank a±liated underwriter was a leading member of the underwriting consortium, and for approximately 37 percent of the ¯rms in the sample a bank managed fund purchased at least 5 percent of the equity of the newly issued ¯rm.

1994). We use data regarding these firms through 1995. We rely on the following data sources: (1) Financial statements of the firms, available for the two years prior to the IPO and for all subsequent years; (2) data on the number of banks each firm borrows from and the amounts borrowed. These data are obtained from the Supervisor of Banks at the Bank of Israel. Banks are required to report to the Supervisor only transactions with large borrowers (defined, for large banks, as borrowers with bank debt higher than 1.7 million New Israeli Shekel (NIS) — about $0.5 million, and with somewhat less debt for smaller banks). Approximately two thirds of the publicly traded manufacturing firms are defined as large borrowers by at least one bank. Since it is possible that firms that borrow from several banks will qualify as large borrowers only for some of the lending banks, rendering our bank debt data imprecise, we compare the total bank debt as reported by the banks to the Supervisor with the total bank debt as reported in the firm's financial statements. The discrepancies are minimal, suggesting that there is no danger of bias due to reporting practices; (3) data on the ownership structure of the publicly traded firms are collected from reports on large shareholders and company executives published annually by the Tel Aviv Stock Exchange. These data include the combined ownership of company executives and large shareholders owning at least 5 percent of the company's equity, as well as shareholding by banks and their subsidiaries;[12] (4) data on the ownership structure prior to going public and on the identity of the underwriters is from the prospectus submitted by each firm prior to the IPO; (5) the age of the firms is from the Registrar of Companies; (6) stock price data is official Tel Aviv Stock Exchange data, available at the Bank of Israel.

Table I displays descriptive statistics of the sample.[13] Firms with a bank underwriter

The pre-IPO fraction of the equity held by large shareholders is 96.2 percent, while the post-IPO holdings average at 80.8 percent. Israeli manufacturing firms are, therefore, relatively closely held even after going public. To measure leverage we use the ratio of total debt to liabilities.[14] Leverage before the IPO is 0.61 on average, declining to 0.36 after the IPO. This may be due to a desire on the part of firms to reduce bankruptcy risk, or it may simply reflect a general process of reduction in bank financing, independently of risk considerations. Since the corporate bond market in Israel has remained underdeveloped, providing only negligible funds to manufacturing firms, equity financing via IPOs may be interpreted as a way of reducing debt financing per se or, alternatively, as a way of reducing bank financing.

There is a positive relation between the age of firms and their size. Large shareholders concentration is similar for small and large firms.[15] Bank debt concentration is higher for small firms, reflecting better opportunities for large firms to diversify credit sources. Alternatively, lower bank debt concentration for bigger firms may reflect constraints imposed on banks by the Supervisor regarding the amount of credit (as a fraction of bank equity) that can be extended to a single firm.[16] There are no substantial differences across industries in bank debt concentration and ownership concentration. Profitability and size do, however, vary across industries.

3 Empirical Analysis

3.1 The basic regression: Post-IPO accounting profitability

(PROF), operating profits normalized by sales (OPERAT), the return on assets (ROA), and the return on equity (ROE). The dummy variable ISSUE takes the value zero for firm-years prior to the IPO and the value one for firm-years following an IPO, including the IPO year. ISSUE is, therefore, a status variable that splits the sample into publicly traded and privately owned firms. The estimated coefficient of ISSUE represents the marginal effect of the change in status on the dependent variable.

An IPO entails changes in capital structure and in ownership concentration, which may affect the incentives and behavior of managers. If large shareholders indeed monitor managers (Shleifer and Vishny 1986), the reduction in ownership concentration as a result of an IPO should induce managers to devote less resources to screening projects, to pay less attention to selecting cost minimizing production processes, and to increase managerial perquisites. To control for changes in ownership concentration, we include the variable LGOWN, the total share of the firm's equity held by large shareholders, as a regressor. Since the pre-IPO holdings are available only for the year prior to the IPO, we assume that the ownership structure does not change in the two years prior to the IPO. If large shareholders discipline managers, or if managers are themselves large shareholders (LGOWN includes equity owned by senior officers of the company) then we would expect this variable to have a positive effect on profitability.[17]

An IPO, in and of itself, is accompanied by lower leverage. According to the free cash flow hypothesis this should facilitate managerial empire building (Jensen 1986, Perotti and Spier 1993) and should, therefore, lead to lower profits. Firms that issue new equity may, however, restore the pre-IPO leverage by raising new (bank or non-bank) debt, for example due to optimal bankruptcy risk considerations. We, therefore, include LEVERAGE, the ratio of total debt to liabilities as a regressor.

An IPO may also entail a reduction in bank monitoring, due to the lower dependence of the firm on bank lending. In and of itself, this should work in the same direction as the reduction in ownership concentration — lower profits. If, however, the stock market plays an important role in imposing discipline on management, e.g., by facilitating incentive contracts tying managerial compensation to the performance of the company's stock (Hölmstrom and Tirole 1993), then we should expect precisely the opposite — an increase in profits following an IPO. If banks indeed monitor, then it is reasonable to expect that monitoring will be more effective for firms with higher debt concentration. A bank that lends large amounts to a firm may have a greater incentive to reduce managerial waste, as well as greater influence on the behavior of managers, especially if the firm obtains a large fraction of its debt from this bank. We, therefore, include the variable HRFCRED, a Herfindahl index of concentration of the firm's bank debt, as a regressor. Other right hand side variables are SIZE, the size of the firm's balance sheet, and AGE, the number of years since incorporation. We include year dummies to control for aggregate year-specific effects and industry dummies to control for industry specific effects.

In most regressions we include the variables in levels, where observations are firm-years. The interpretation of regressions in levels for firm-years ("pooled" data) is that every year, given the explanatory variables, the dependent variable is chosen by each firm independently of the choice in previous or in subsequent years. To neutralize potential firm variable (not the deviation from the mean). The results for the ¯xed e®ects speci¯cation are overall similar.[19]

Our regressions include only the ¯rm-years for which there are data allowing us to calculate bank debt concentration. If in a particular year a ¯rm is de¯ned as large borrower by the Supervisor of Banks (see section 2.2 for the criteria) there is information regarding its bank debt in that year. Since investment, pro¯t retention, and ¯nancing policies of ¯rms determine whether they choose to become large borrowers, there is potential selection bias in our sample, which is corrected as follows. Using the entire population of manufacturing ¯rms publicly traded on the Tel Aviv Stock Exchange, of which approximately one third are not de¯ned as large borrowers, we run a probit regression where the dependent variable is a dummy variable that takes the value one when the ¯rm is a large borrower. As explanatory variables we include the ¯rms' age, size, and industry dummies. The coe±cients of age and of several of the industry dummies are highly signi¯cant, whereas size is not. We include the resulting Inverse Mill's Ratio in all our regressions.[20]

The use of bank debt data reduces the sample signi¯cantly from about 600 to 320 ¯rm-years. When we use all the 600 observations, omitting the variable HRFCRED, none of the results reported below change (in fact, the signi¯cance level of several coe±cients increases). We nevertheless include bank debt concentration in the regressions because we believe that it is a potentially important corporate governance variable that should be controlled for.

The results displayed in Table II indicate that there is a clearly visible and statistically

¯xed e®ects wash out, of course, while the time ¯xed e®ects are captured by the four year dummies and a constant.

signi¯cant decline in pro¯tability after an IPO, as can be seen from the negative and highly statistically signi¯cant negative coe±cient of the status variable ISSUE. This is obtained for all the pro¯tability measures as well as in the ¯xed e®ects regression using PROF. The magnitude of the coe±cient of ISSUE in the regression using PROF with \pooled" data is interpreted as follows: Controlling for the dilution of ownership, for potential change in bank debt concentration, and other variables, the change in status from a fully privately held company to a publicly traded company induces a decrease in pro¯tability of 4.6 percentage points. Compared to the 6.8 average pro¯tability in our sample (Table I), the decrease in pro¯tability is substantial.

By including ISSUE as a regressor we are in fact regarding the timing of the IPO as being chosen independently of pro¯tability. (The decision whether to go public is not relevant here since all the ¯rms in our sample go public eventually). Notice that if ¯rms are more likely to go public when pro¯tability is high, the coe±cient of ISSUE is biased upward, i.e. it should be even more negative. Therefore, for our purposes the potential endogeneity of ISSUE is not a major concern.

The magnitude of the coe±cient of ISSUE in the regressions using ROA and ROE is larger than in the regression using PROF, which is most likely due to the fact that when new capital is raised, total assets and total equity increase right away whereas the return to new investment takes time to materialize. The pro¯t to sales and the operating pro¯t to sales ratios are not automatically a®ected by new equity or new assets on the balance sheet.[21] The results of regressions with di®erent pro¯tability measures are presented to emphasize the robustness of the ¯ndings, but the focus will be on the regression with PROF as the market, it should be associated with higher profitability. If leverage imposes discipline on managers, higher leverage should also entail higher profitability. The negative coefficient of leverage is not consistent with either of these interpretations. It may be driven by the natural reduction in leverage following an IPO. As a consequence, leverage is negatively correlated with ISSUE, so the coefficient of leverage picks up part of the effect of ISSUE. Another possibility is that leverage proxies for investment since firms that make large investments in plants and equipment are likely to borrow against these assets. These investments may mature slowly resulting in low profitability for a few years. The coefficient of ISSUE could then be interpreted as the change in profitability controlling for the amount of investment in collateralizable assets.

The coefficient of LGOWN is positive in all the regressions and is statistically significant in the PROF regression with "pooled" data and in the ROA and ROE regressions, confirming that large shareholders play an important role in corporate governance. The magnitude of the coefficient is similar in the three regressions where it is significant. It suggests that if the fraction held by large shareholders increases by one percentage point, profitability increases by about 0.13 percentage points (that correspond to approximately 2 percent of average profitability which is 6.8 percent). For most firms in the sample, LGOWN is almost constant through time (except in the year of the IPO). Therefore, in the fixed effects regression, the variable LGOWN for a given firm does not vary much around its time average (see footnote 18), and will have little explanatory power. It is interesting that despite the high ownership concentration after an IPO (LGOWN falls from 96.2 percent before the IPO to 80.8 percent after the IPO), the fraction held by large shareholders still

The Inverse Mill's Ratio from the large borrower regression is not statistically signi¯cant, suggesting that the pro¯tability of large borrowers is not di®erent on average from that of other ¯rms. Finally, bank concentration, HERFCRED, is not statistically signi¯cant in all the regressions which suggests that if banks have a monitoring role it does not decrease when ¯rms borrow from several banks.[23]

In subsection 3.3 we evaluate potential explanations for the decline in pro¯tability following an IPO. It is important to note that the precise interpretation of this phenomenon is not central for our analysis of potential con°ict of interest in universal banking. Our main focus will be on di®erences in the decline in pro¯tability between ¯rms that were underwritten by a lending bank and those that were not. These di®erences in post-IPO performance are most likely driven by considerations related to universal banking.

3.2 Post-IPO accounting pro¯tability and universal banking: Con°ict of interest or superior information?

To measure the e®ect of bank underwriting and lending on post-IPO pro¯tability, we construct a dummy variable that takes the value one if a bank served as a leading underwriter of the ¯rm's IPO and the ¯rm was a large borrower from the same bank in the IPO year, where leading underwriters are identi¯ed in the IPO prospectus and "large borrower" is de¯ned by the Supervisor of Banks. The variable takes the value one for roughly one third of the ¯rms in the sample. For brevity, we will refer to this variable as the bank underwriting and lending dummy. We also construct the variable REPAY, the fraction of the IPO proceeds designated in the IPO prospectus for the repayment of bank debt, that we interact the same value in all years, before and after the IPO. These variables are \characteristics" of the ¯rm. When interacted with ISSUE, their coe±cients measure their e®ect on the change in pro¯tability following an IPO.

The ¯rst column in Panel A of Table III displays the results of a pro¯tability regression with the bank underwriting and lending dummy as an additional regressor. The inclusion of this variable does not a®ect the coe±cients of the other regressors, and its coe±cient is positive but not signi¯cantly di®erent from zero. We run the same regression (not reported) using only pre-IPO ¯rm-years, i.e. with ¯rm-years for which ISSUE=0, also getting an insigni¯cant coe±cient for the bank underwriting and lending dummy. Our ¯rst conclusion is that ¯rms that are a±liated with a bank, in the sense captured by the bank underwriting and lending dummy, do not di®er ex-ante from other ¯rms in terms of pro¯tability.

The second column in Panel A of Table III displays the results of a pro¯tability regression with the bank underwriting and lending dummy interacted with the status variable ISSUE. The coe±cient of this variable measures the change in pro¯tability after the IPO of ¯rms with a bank underwriter-lender above and beyond the change in pro¯tability of the other ¯rms. The coe±cient is positive and statistically signi¯cant. (The coe±cients of the other regressors are not a®ected.) The coe±cient is also economically signi¯cant: The post-issue accounting pro¯tability of ¯rms with a bank underwriter-lender declines by 2.6 percentage points less than average, which is more than 50 percent less than the average decline in pro¯tability for the entire sample (see the coe±cient of ISSUE).[24]

We conclude from these ¯ndings that on the basis of observed pre-IPO pro¯tability alone, it is not possible to identify the ¯rms for which post-IPO performance will decline culture, and investment opportunities of these firms, generated through the lender-borrower relationship or as a result of expertise in underwriting. These results provide no evidence in support of the view that banks exploit the potential for conflict of interest by issuing the securities of below average firms. On the contrary, our findings regarding post-IPO accounting profitability strongly suggest that the combination of bank lending and underwriting results in better informed underwriting.

We further argue that window dressing cannot explain the observed differences in post-IPO performance between firms with and without a bank underwriter-lender. If window dressing were driving these differences, the positive coefficient of the bank underwriting and lending dummy interacted with the status variable ISSUE would be interpreted as indication that firms with bank underwriter-lenders window dress less. But then, since window dressing prior to an IPO means transferring profits through "creative accounting" from the future to the present, we should expect, for firms with a bank underwriter-lender, post-IPO profitability to be higher than average and pre-IPO profitability to be lower than average. Our results indicate, however, that post-IPO profitability is higher than average but pre-IPO profitability is not lower than average.

The third column in Panel A of Table III displays the results of a profitability regression with the bank underwriting and lending dummy interacted with REPAY as an additional regressor. The coefficient of this variable indicates whether, for firms with a bank underwriter-lender, profitability is affected by the fraction of the IPO proceeds designated for repayment of bank debt. The fourth column displays the results of a similar regression with the bank underwriting and lending dummy interacted with both REPAY in the combination of bank lending and underwriting. If banks had exploited the potential for con°ict of interest they would have issued the equity of low quality ¯rms that owe them large sums of money to help these ¯rms repay their bank debt. We ¯nd no evidence in support of this claim.

Next, we ask whether there is con°ict of interest in the combination of bank underwriting, lending, and fund management. We construct the dummy variable FUNDLEND that takes the value one if a bank managed investment fund purchased at least 5 percent of the shares of the newly issued ¯rm during the ¯rst year following the IPO and the ¯rm was a large borrower from the same bank in the IPO year.[25] We then construct the dummy variable BIGCONF that takes the value one if FUNDLEND is one and, in addition, the same bank was a leading underwriter of the ¯rm's IPO. That is, BIGCONF is the intersection of the bank underwriter-lender dummy and FUNDLEND. From the coe±cient of FUNDLEND in Panel B of Table III we learn that the post-IPO accounting pro¯tability of ¯rms purchased by bank managed funds is not higher or lower than average. The coef¯cients of BIGCONF, and of BIGCONF interacted with ISSUE are also not signi¯cantly di®erent from zero, although the latter is close to being signi¯cant at the 10 percent level. Clearly, there is no evidence that bank managed funds were involved in purchasing the stock of the lemons.

3.3 The decline in accounting pro¯tability following an IPO: Discussion

It seems that the decline in accounting pro¯tability following an IPO is an empirical regularity. Jain and Kini (1994) and Mikkelson, Partch, and Shah (1995) obtain similar results

¯nd similar results for a sample of reverse leveraged buyouts in the United States.

There are several interpretations, not necessarily mutually exclusive, for the decline in pro¯tability following an IPO. DeGeorge and Zeckhauser (1993) interpret their ¯ndings as driven mainly by pre-IPO window dressing (see also Jain and Kini 1994). Firms that are about to go public window dress their accounting numbers in order to look more attractive at the time of the IPO. This will tend to overstate pre-IPO pro¯ts and understate post-IPO pro¯ts. In our sample, the post-IPO pro¯tability of ¯rms with a bank underwriter-lender is higher than average but their pre-IPO pro¯tability is not lower than average. Thus, window dressing cannot account for the di®erence in post-IPO pro¯tability of ¯rms with and without a bank underwriter-lender.

Another explanation is that an IPO entails a reduction in bank monitoring due to the lower dependence of the ¯rm on bank lending, and at the same time it may improve monitoring by allowing managerial compensation to be conditioned on stock price performance. Our ¯ndings are consistent with the view that bank monitoring regarding project choice is reduced following an IPO, and is not fully compensated for by stock market monitoring, at least not in the ¯rst few years following the IPO. It should be noted, however, that we do not detect a signi¯cant e®ect of bank debt concentration on pro¯tability. What seems to matter for pro¯tability is the status of the ¯rm | whether it is a publicly traded company or whether it is (still) under the exclusive supervision of large shareholders and banks.

Our results are not driven by a \hot issue market" e®ect since they continue to hold even when we control for the \hot issue market" of 1993 (see footnote 23). Furthermore, the pro¯tability of the companies that went public during this year was not low as compared go public at the peak of their performance. If this were the case, we would see that the post-IPO profitability of firms with a bank underwriter-lender declines more than average, not less than average.

Finally, it is possible that our results are driven, at least in part, by the fact that in 1994 the average profitability of the firms in the sample was particularly low, a feature which is picked up by the coefficient of ISSUE. It should be noted, though, that the low profitability of the firms in our sample in 1994 does not reflect macroeconomic conditions (1994 was not a bad year for the Israeli economy), nor does it reflect the performance of the entire manufacturing sector whose profitability in 1994 was similar to that in 1991–3. The low profitability in 1994 must somehow be related to the fact that most firms in our sample went public one or two years prior to 1994, and furthermore, the decline in profitability is attenuated for firms with a bank underwriter-lender.

As we emphasized earlier, the exact reason for the decline in profitability following an IPO is not central for our analysis. Whether window dressing, optimal timing, or ineffective stock market monitoring is responsible for this phenomenon, the central phenomenon from our perspective is that the decline in profitability is lower for firms with a bank underwriter-lender.

4 Post-IPO Stock Price Performance

We study the stock price performance of the IPOs in our sample in order to evaluate whether they were priced correctly, and if not, whether the stock price performance of firms with a risk adjusted excess returns should be zero for all stocks. Suppose that IPOs are priced correctly only on average, namely, investors are unaware of the di®erences in post-IPO pro¯tability among ¯rms. Then, a representative investor who buys a portfolio of all the IPOs should earn a zero risk adjusted excess return. The risk adjusted excess return on the stocks of ¯rms with a bank underwriter-lender should be positive while the excess return on the other stocks in the portfolio should be negative. The results we obtain are not consistent with either of these scenarios, and suggest that the stocks of IPO ¯rms are not priced correctly in a systematic way that points to con°ict of interest in the combination of bank underwriting, lending, and fund management.

We turn to the analysis. The sample consists of 82 IPOs (out of the 138 IPOs used to study post-IPO accounting performance). The reason for excluding 56 ¯rms is that they issued bundles of straight equity and convertible securities that were not priced separately in the IPO day, rendering the computation of excess returns hard. To ensure that we do not create a selection problem, we run a probit regression where the dependent variable is a dummy for issuing such bundles. The coe±cients of all the explanatory variables but one are very small and not signi¯cantly di®erent from zero, including accounting pro¯tability and the bank underwriting and lending dummy. Only ¯rm size is positive with a t-statistic of about 1.5. We conclude that no apparent selection bias is created by focusing on ¯rms that did not issue bundles of straight equity and convertible securities.

For each ¯rm we calculate the ¯rst day return using the opening and closing price on the day of the IPO. To calculate the excess return during the ¯rst year after the IPO we use the following procedure. For each stock we compute weekly returns, adjusted for dividends, for stock the intercept and slope in a CAPM regression.[27] Using these estimates of intercept and slope, the market returns, and the riskless rate proxy for the corresponding weeks, we construct the expected return for each stock, according to the market model.[28] Using the returns of the stock in weeks 1–52 after the IPO we then compute excess returns.[29]

The first day stock return and the first year excess return for the entire sample are displayed in the first row of Table IV. Although neither is significantly different from zero, the point estimates indicate that there is no underpricing in the first day and a negative excess return in the first year. The dummy variable FUNDLEND takes the value one if a bank managed investment fund purchased at least 5 percent of the shares of the newly issued firm during the first year since the IPO and the firm was a large borrower from the same bank in the IPO year. For these firms there is a 20 percent negative excess return in the first year following the IPO, statistically different from zero at the 10 percent level.[30] The first year negative excess return is interpreted as IPO overpricing, which is consistent with the negative, though not significant, first day return. A plausible interpretation is that bank managed funds paid too much for these IPOs, and continued to purchase stocks of these companies for a while (or at least refrained from selling them), helping to maintain a high price for these stocks. By the end of the first year the price dropped substantially generating a substantial negative excess return.[31]

The dummy variable BIGCONF takes the value one if the same bank was an underwriter-lender and one of its funds purchased at least 5 percent of the firm's stock in the IPO year. The stocks of these firms exhibit an even more negative and significant (at the 5 percent level) excess return during the first year (30.8 percent), which is consistent with overpricing (significant at the 10 percent level) in the first day of trade.

These findings point to conflict of interest in the combination of bank lending, underwriting, and investment fund management. A bank managed investment fund that purchases the equity of a newly issued firm which is a large borrower from the same bank and was underwritten by the same bank (BIGCONF=1), inflicts on investors an average loss of over 30 percent relative to the market within one year. The unequivocal conclusion is that although bank underwriters issue the cherries, bank managed funds pay too much for the stocks of these firms. Bank managed funds also pay too much for the stocks of newly issued firms that are large borrowers from the same bank (FUNDLEND=1) irrespective of the identity of the underwriter, inflicting on investors an average loss of about 20 percent relative to the market within one year. Thus, there is conflict of interest between bank lending and bank fund management regardless of bank underwriting.

A similar phenomenon is observed when the sample is split according to the bank underwriting and lending dummy that was used in the previous section. The stocks of firms with a bank underwriter-lender exhibit a highly negative and significant (at the 5 percent level) excess return (18.4 percent) during the first year, which is consistent with (not statistically significant) overpricing in the first day of trade. As can be seen in the second to last row of Table IV, this is not driven entirely by purchases of the IPO stocks by funds managed by the underwriting and lending bank. This is most likely explained by the concentration in the investment fund management and the underwriting industries. These industries are sufficiently collusive to induce non-bank investment funds, or funds explanations for this wave of withdrawals is the poor performance of the funds to which the performance of IPO stocks no doubt contributed.[32]

The lesson from this evidence is that the combination of bank lending, underwriting, and investment fund management results in conflict of interest. In the absence of market power the scale of the phenomenon would probably be smaller, resulting in lower negative excess returns on IPO stocks, but the incentives to engage in such behavior would still be present.

5 Relation to the Empirical Literature on Conflict of Interest in Universal Banking

Ang and Richardson (1994), Kroszner and Rajan (1994), and Puri (1994, 1996) have recently studied the effect of universal bank underwriting on the quality of issues using pre-Glass-Steagall US data. Ang and Richardson argue that corporate bonds underwritten by banks exhibited lower default rates. They further report that these bonds were priced correctly generating lower ex-ante yields. This is evidence that bank underwriters were successful in picking the cherries. They also find that the ex-post prices of these bonds are predicted equally well for bonds issued by bank underwriters and for bonds issued by non-bank underwriters, concluding that the quality of bonds underwritten by banks was not misrepresented.[33]

Kroszner and Rajan (1994) also find that, within investment grade categories, firms whose bonds were underwritten by banks exhibited lower default rates, which suggests that would have been appropriately discounted by the market.

Puri (1996) shows that within several risk categories, ex-ante yields were lower on bonds underwritten by banks, and interprets this as evidence of the "certification role" of universal banks, due to their superior information. She also argues that the effect is more pronounced where there is limited information (e.g. in new issues).

All three studies examine mostly corporate bond issues, and define firm affiliation with a universal bank on the basis of the identity of the underwriters. None include data on the bank debt of the firms, nor on their debt structure more generally. Whether a universal bank is a creditor of the underwritten firm is very important for the bank's ability to acquire information regarding the firm, and for its incentive to misrepresent the firm's quality. In this respect, our study is unique since we have data on whether the underwritten firm was a borrower of the underwriting bank.

Our study is novel in other respects as well. First, we use modern data from a country where the universality of the banking system is more pronounced. Second, we focus on stock IPOs rather than on corporate bond issues, and examine both accounting profitability and stock returns. Finally, the wide scope of activities of Israeli banks enables us to examine another dimension of universal banking, namely the effect of combined investment fund management with bank lending and bank underwriting.

Overall, our results, as well as those of the studies discussed here, indicate that universal banks tend to underwrite high quality firms, as measured by default rates in the earlier studies, and by post-issue accounting profitability in our study. Like Puri (1996), we also find that the price of issues by bank underwriters is higher ex-ante. However, while Puri correctly had they occurred. We present direct evidence for the existence of con°icts of interest, and show that these are not adequately re°ected in the market price. One possible explanation is that, unlike pre-Glass-Steagall US, the Israeli banking sector is far more universal and far more concentrated, features which enable Israeli banks to take advantage of their universality. Although Israel may be an extreme case, universal banks in many Continental European countries resemble their Israeli counterparts more than they resemble US banks in the 1920s.

6 Summary

We provided evidence that the post-issue accounting pro¯tability of ¯rms underwritten by bank a±liated underwriters that were also borrowers from the same bank in the IPO year is signi¯cantly better than average, but that the stock price performance of these ¯rms during the ¯rst year following the IPO is lower than average. Furthermore, the stock price performance of ¯rms whose equity was purchased by an investment fund that is a±liated with the underwriting and lending bank is even lower. We interpret this as evidence that universal banks use their superior information regarding underwritten ¯rms to °oat the cherries, not the lemons, but that the combination of bank lending, underwriting, and investment fund management results in con°ict of interest. Bank managed funds pay too much for bank underwritten IPOs at the expense of the investors in the funds.

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Table I: Sample Statistics, 1991-1995

Panel A displays statistics for the entire sample. Panel B displays statistics for the subsample of firms where a bank served as a leading underwriter and the firm was a large borrower from the same bank in the IPO year, where leading underwriters are indentified in the IPO prospectus, and “large borrower” is defined by the Supervisor of Banks. Panel C displays statistics for firms whose underwriter was not a lending bank. PROF is the ratio of net profits to sales (in percent), SIZE is the size of the firm’s balance sheet (in million 1994 NIS), AGE is the number of years since incorporation, LEVERAGE is total debt divided by liabilities, HRFCRED is a Herfindahl index of concentration of the firm’s bank debt, LGOWN is the total share of the firm’s equity held by large shareholders (in percent), where a large shareholder is defined as holding at least 5 percent of the firm’s equity or a managerial position in the firm, and N is the number of observations (firm-years).

Panel A. The Full Sample

	MEAN	S.D.	MEDIAN	N
PROF	6.8	14.4	6.8	618
SIZE	66.3	99.8	36.8	616
AGE	20.5	15.1	17.0	615
LEVERAGE	0.44	0.22	0.40	616
HRFCRED	0.76	0.27	0.98	328
LGOWN	85.5	12.2	85.7	603

Panel B. Firms with a Bank Underwriter that is also a Major Lender

	MEAN	S.D.	MEDIAN	N
PROF	6.8	8.5	6.9	202
SIZE	91.2	112.6	52.1	202
AGE	25.3	15.5	27.0	202
LEVERAGE	0.48	0.19	0.47	202
HRFCRED	0.71	0.28	0.69	172
LGOWN	86.5	10.9	87.0	196

Panel C. The Other Firms in the Sample

	MEAN	S.D.	MEDIAN	N
PROF	6.8	16.6	6.8	416
SIZE	54.1	90.5	32.2	414
AGE	18.2	14.3	14.0	413
LEVERAGE	0.42	0.24	0.38	414
HRFCRED	0.81	0.26	1	156
LGOWN	84.9	12.8	84.5	407

Table II: Post-IPO Accounting Profitability

The dependent variables are, respectively, PROF, the ratio of net profits to sales, OPERAT, operating profits to sales, ROA, return on assets, and ROE, return on equity (all in percent). The regressions are OLS using pooled data, except when denoted by "fixed effects", where firm-specific effects are allowed. Heteroskedasticity-consistent standard errors are reported in parentheses. The Inverse Mill's Ratio is derived from a probit procedure which identifies the attributes of "large borrowers" included in the sample, SIZE is the size of the firm's balance sheet in million 1994 NIS, AGE is the number of years since incorporation, LEVERAGE is total debt divided by liabilities, HRFCRED is a Herfindahl index of concentration of the firm's bank debt, LGOWN is the total share of the firm's equity held by large shareholders (in percent), where a large shareholder is defined as holding at least 5 percent of the firm's equity or a managerial position in the firm, and ISSUE is a dummy variable which takes the value zero in all firm-years prior to the IPO and the value one thereafter. * denotes a coefficient significant at the 5 percent level and ** denotes a coefficient significant at the 10 percent level.

	PROF	**PROF (fixed effects)**	**OPERAT**	**ROA**	**ROE**
C	YES	YES	YES	YES	YES
Industry Dummies	YES	YES	YES	YES	YES
Year Dummies	YES	YES	YES	YES	YES
Inverse Mill's Ratio	-34.0 (44.5)	-3.5 (39.2)	-44.3 (54.4)	-5.7 (59.4)	-69.9 (122.1)
SIZE	0.00456 (0.00402)	0.025** (0.013)	0.00405 (0.00474)	0.00367 (0.00448)	0.00705 (0.00861)
AGE	0.08 (0.22)	0.01 (0.20)	0.13 (0.28)	-0.7 (0.30)	0..06 (0.60)
LEVERAGE	-22.3* (2.5)	-17.4* (4.3)	-18.9* (4.5)	-19.7* (3.4)	-17.1** (9.3)
HRFCRED	-0.2 (1.7)	-2.02 (2.07)	-0.1 (2.0)	2.6 (1.9)	0.1 (2.6)
LGOWN	0.13* (0.04)	-0.01 (0.04)	0.11* (0.05)	0.06 (0.04)	0.19* (0.08)
ISSUE	-4.6* (1.5)	-4.9* (1.5)	-5.1* (1.6)	-9.2* (2.5)	-15.9* (4.0)
Adjusted R-squared	0.40	0.37	0.27	0.38	0.36
N	320	319	315	321	309

Table III: Post-IPO Accounting Profitability and Universal Banking

Panel A examines the effect of combined bank underwriting and lending activities on client firm performance. Panel B examines the effect of combined bank lending and fund management activities on firm performance. The dependent variable is PROF, the ratio of net profits to sales (in percent). All the regressions are OLS using pooled data (qualitatively similar results using other measures of profitability, or allowing for firm-specific effects are not shown). Heteroskedasticity-consistent standard errors are reported in parentheses. The variables that measure the effect of universal banking on firm performance are defined as follows: The bank underwriter and lender dummy takes the value one if a bank served as a leading underwriter and the firm was large borrower from the same bank in the IPO year, where leading underwriters are indentified in the IPO prospectus, and "large borrower" is defined by the Supervisor of Banks. REPAY is the fraction of the IPO proceeds desginated in the prospectus for the repayment of bank debt, FUNDLEND is a dummy variable which takes the value one if a bank-managed investment fund purchased at least 5 percent of the firm's equity in the IPO year and the firm was a large borrwer from the same bank in the same year. BIGCONF is a dummy variable which takes the value one if FUNDLEND is one, and in addition, the same bank was a leading underwriter of the firm's IPO (i.e. if both the underwriter-lender dummy and FUNLEND equal one). Other variables are as follows: The Inverse Mill's Ratio is derived from a probit procedure which identifies the attributes of "large borrowers" included in the sample, SIZE is the size of the firm's balance sheet in million 1994 NIS, AGE is the number of years since incorporation, LEVERAGE is total debt divided by liabilities, HRFCRED is a Herfindahl index of concentration of the firm's bank debt, LGOWN is the total share of the firm's equity held by large shareholders (in percent), where a large shareholder is defined as holding at least 5 percent of the firm's equity or a managerial position in the firm, and ISSUE is a dummy variable which takes the value zero in all firm-years prior to the IPO and the value one thereafter. * denotes a coefficient significant at the 5 percent level and ** denotes a coefficient significant at the 10 percent level.

(Continued on the next page)

Table III - Continued

Panel A. Combined Bank Lending and Underwriting

	PROF	PROF	PROF	PROF
C	YES	YES	YES	YES
Industry Dummies	YES	YES	YES	YES
Year Dummies	YES	YES	YES	YES
Inverse Mill's Ratio	-28.1 (44.6)	-20.1 (44.2)	-31.0 (45.7)	-24.3 (44.8)
Bank Underwriter and Lender Dummy	0.83 (0.84)			
Bank Underwriter and Lender Dummy*ISSUE		2.3* (0.9)		
Bank Underwriter and Lender Dummy*REPAY			0.5 (1.6)	
Bank Underwriter and Lender Dummy*REPAY*ISSUE				2.1 (1.6)
SIZE	0.00408 (0.00410)	0.00403 (0.00407)	0.00425 (0.00430)	0.00357 (0.00424)
AGE	0.05 (0.22)	-0.02 (0.22)	0.06 (0.23)	0.03 (0.22)
LEVERAGE	-22.3* (2.5)	-22.3* (2.5)	-22.3* (2.5)	-22.2* (2.5)
HRFCRED	-0.03 (1.7)	0.15 (1.7)	-0.16 (1.7)	0.11 (1.7)
LGOWN	0.13* (0.04)	0.12* (0.04)	0.13* (0.04)	0.12* (0.04)
ISSUE	-4.7* (1.5)	-5.9* (1.6)	-4.6* (1.5)	-4.9* (1.6)
Adjusted R^2	320	320	320	320
N	0.40	0.41	0.40	0.40

Table III - Continued

Panel B. Combined Bank Lending and Fund Management

	PROF	PROF	PROF	PROF
C	YES	YES	YES	YES
Industry Dummies	YES	YES	YES	YES
Year Dummies	YES	YES	YES	YES
Inverse Mill's Ratio	-34.6 (44.5)	-33.9 (44.3)	-32.4 (44.1)	-28.0 (44.1)
FUNDLEND	0.3 (1.0)			
FUNDLEND*ISSUE		0.7 (1.0)		
BIGCONF			0.8 (1.1)	
BIGCONF*ISSUE				1.9 (1.3)
SIZE	0.00474* (0.00413)	0.00493 (0.00410)	0.00465 (0.00400)	0.00490 (0.00401)
AGE	0.08 (0.23)	0.08 (0.22)	0.07 (0.22)	0.05 (0.22)
LEVERAGE	-22.4* (2.5)	-22.4* (2.5)	-22.4* (2.5)	-22.7* (2.5)
HRFCRED	-0.1 (1.7)	-0.1 (1.7)	-0.1 (1.7)	-0.1 (1.7)
LGOWN	0.13* (0.04)	0.12* (0.04)	0.13* (0.04)	0.13* (0.04)
ISSUE	-4.6* (1.6)	-4.8* (1.6)	-4.7* (1.6)	-5.0* (1.6)
Adjusted R^2	0.40	0.40	0.40	0.40
N	320	320	320	320

Table IV: Post-IPO Stock Returns

The table displays returns on IPO shares (dividends and capital gains) on the IPO day and one year after the IPO. One year excess returns are relative to “expected returns” that are calculated using “betas” estimated from weekly returns in the second year after the IPO (qualitatively similar results are obtained when excess returns are calculated relative to average market returns without adjustment for risk). Fifty six issues which combined both stocks and convertible securities are omitted. The upper part of the table focuses on combined bank lending and fund management activities and the lower part on combined bank underwriting and lending activities. The bank underwriter and lender dummy takes the value one if a bank served as a leading underwriter and the firm was large borrower from the same bank in the IPO year, where leading underwriters are indentified in the IPO prospectus, and “large borrower” is defined by the Supervisor of Banks. FUNDLEND is a dummy variable which takes the value one if a bank-managed investment fund purchased at least 5 percent of the firm’s equity in the IPO year, and the firms was a large borrower from the same bank in the same year. Finally, BIGCONF is a dummy variable which takes the value one if FUNDLEND is one, and in addition, the same bank was a leading underwriter of the firm’s IPO (i.e. if both the underwriter-lender dummy and FUNLEND equal one). * denotes that the return is different from zero at the 5 percent level, and ** denotes that the return is different from zero at the 10 percent level.

	FIRST DAY RETURNS	ONE YEAR EXCESS RETURNS
ALL IPO’s (N=82)	0.006	-4.9
FUNDLEND=1 (N=14)	-3.7	-20.0**
FUNDLEND=0 (N=68)	0.8	-1.8
BIGCONF=1 (N=10)	-7.7**	-30.8*
BIGCONF=0 (N=72)	1.1	-1.3
Bank Underwriter and Lender Dummy=1 (N=26)	-3.3	-18.4*
Of which FUNDLEND=0 (N=16)	-0.5	-10.7
Bank Underwriter and Lender Dummy=0 (N=56)	1.5	1.3