Do Bank-Affiliated Analysts Benefit From Lending Relationships?

Xiumin Martin
Within a banking conglomerate, a “Chinese wall,” or “informational firewall,” exists to inhibit the flow of inside information from the private side to the public side of the institution. It’s no secret that occasionally the legally mandated, invisible barrier leaks and undisclosed information finds its way to the public marketplace to the benefit of a select few. In some of the latest scholarship on the hot-button topic, Xiumin Martin, an assistant accounting professor at Olin Business School, and a co-author show how equity analysts benefit from relationships on the private side of their banks.

The research indicates that stock pickers employed at banks, which also loan huge sums of money to publicly traded companies, are able to publish more accurate earnings forecasts. (An equity analyst’s worth is associated with how accurately he or she can predict the future earnings of a publicly traded company.)

“Our findings suggest that despite the purported existence of Chinese Walls, financial analysts still have access to superior information from lending relationships and exploit this access to improve their forecast accuracy,” the authors said in the paper, which was published in the *Journal of Accounting Research*. Titled “Do Bank-Affiliated Analysts Benefit From Lending Relationships?,” the paper was co-written by Ting Chen, a professor at Baruch College, The City University of New York. The two professors analyzed a sample of bank loans and analyst forecasts from 1994 to 2007.

They found that the informational advantage is present only for banks that serve as the lead arrangers of the loans. Lenders merely participating in syndicate loans do not have the same advantage.

Furthermore, when the lending information suggests that companies are in financial trouble, analysts are even better than their competitors at predicting earnings per share, or EPS. The paper does not offer any suggestions on how the knowledge is exchanged.

The concept of the informational firewall dates all the way back to the stock market crash of 1929. Federal regulation requires that banks divide the public side of the bank, which typically handles equity research and trading, from the private side of a financial conglomerate, which deals with undisclosed information. In the present day, this means that stock analysts are barred from attending meetings with executives of the companies they cover if an investment banker or deal maker is also present. In addition, analysts cannot solicit business on behalf of their banks’ mergers and acquisitions teams.

In 2003, some of largest U.S. investment firms agreed to a pay a more than billion-dollar settlement over the conflicts of interest between their securities research and investment banking business. Some of the money has been funneled to firms that publish independent stock research.

However, analysts from large banks still have a great deal of influence over the market, and the issue over the Chinese wall is much-discussed in the finance world. “Although information sharing is beneficial to financial conglomerates, it is not without controversy, particularly when much of the superior information comes from ongoing correspondence between borrowers and banks,” the study found.