Amid the financial crisis that started in 2007, large US investment banks such as Bear Sterns and Lehman Brothers have completely disappeared from the banking scene. The universal banking model, which allows financial conglomerates to combine a wide range of financial activities, emerged during the 1990s, particularly after the Gramm-Leach-Blieley Act of 1999 that formally repealed the Glass-Steagall Act of 1933. This system is arguably a more desirable structure for financial institutions from the viewpoint of policy makers due to its resilience to adverse shocks. This drastic change in the landscape of the financial industry has many implications for corporations in the United States. In this paper, we focus on the informational impact.

Constructing walls within an organization to protect various interests is nothing new. Think of the supposed separation of church and state, editorial and advertising, and lending and equity trading divisions within large financial conglomerates. If these walls fail, the theory is that bank-affiliated analysts can acquire private information about the firms that borrow from them, helping improve the accuracy of the earnings forecasts pertaining to those firms. But does this really happen in practice? Based on our empirical analysis, the answer is yes. The enhanced forecast accuracies are even more pronounced for borrowers with greater informational asymmetry and more undisclosed bad news, and for deals with financial covenants. The analysis also shows that the informational advantage of bank-affiliated analysts exists only when the affiliated banks serve as lead arrangers, not merely as participating lenders. Overall, the evidence suggests that information does flow over the walls of commercial banking into equity research divisions within financial conglomerates.

The traditional role of banks Traditionally, have played the role of financial intermediary, collecting money from depositors and lending to other businesses. In doing so, banks that lend have a unique information advantage and an incentive to monitor those borrowers. For example, borrowers usually have a much closer relationship with their banks than with investors in their public securities such as stocks and bonds. In particular, borrowers often provide their lenders with materials and price-sensitive information, such as revenue projection updates or acquisition and divestiture plans, well in advance of its release to the public. In the absence of a perfect "Chinese Wall" separating the public from the private domain...
Does Information Flow Over the Walls within Large Banking Conglomerates? 

Analysis Finds that Bank-Affiliated Analysts Benefit from Lending Relationships

XIUMIN MARTIN, Washington University in St. Louis

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The results provide a consistent picture that there is information spillover from commercial lending to equity research divisions of financial conglomerates. Relative to benchmark forecasts, bank-affiliated analysts reduce the annual EPS forecast error by 17%.

Changes in the financial business landscape have many implications for corporations in the United States. Our study focuses on the informational impact. Within a financial conglomerate, the private borrower information possessed by loan officers can migrate to the public domain—the equity analysts and public trading and sales divisions. Consequently, security analysts can incorporate this information into their earnings forecasts and stock recommendations, which is eventually transmitted to the market before the borrower makes any public announcement. According to professor Xiumin Martin, “The lending side of the commercial banking business traditionally receives a lot of proprietary information from borrowers so lenders can monitor them. For example, borrowers are often required to provide lenders periodic financial statements that are not available to the public. Analysts on the public domain side are not supposed to get private or proprietary information, so all of their forecasts should be based solely on publicly available information. If these financial giants, what we call conglomerates, and their equity analysts show superior forecasting ability and that ability only improves after they have a loan with a specific borrower, that gives us a really strong belief or provides convincing evidence that the superior information generated from the lending business somehow leaked out or was shared with the equity analysts.”

Earnings forecasts of bank-affiliated analysts improve in accuracy after loan origination

Based on syndicated loans obtained from Dealscan database, analyst forecasts from First Call, and companies’ financial information from Compustat, our empirical analysis uncovers four key findings. First, the accuracy of earnings forecasts from a bank-affiliated analyst for a borrower increases after the loan origination compared to the forecasts made by the same analyst for nonborrowing firms and compared to the forecasts made by non-bank-affiliated analysts for the same borrower. Relative to the benchmark forecasts, bank-affiliated analysts reduce the annual EPS forecast error by about 17% of the average EPS forecast error in the sample. Second, the increase in forecast accuracy of bank-affiliated analysts is more pronounced for borrowers with greater information asymmetry as measured by size and the standard deviation of analyst forecasts. For example, these borrowers are usually smaller in size and the forecasts of their security analysts are more diverse. Third, the increase in forecast accuracy of bank-affiliated analysts concentrates in instances where borrowers experience bad news, when borrowers have high credit risk, such as lower credit ratings or no credit ratings and a higher leverage ratio, and when loans contain financial covenants. Fourth, an informational advantage exists for conglomorate analysts only when conglomerates serve as lead arrangers but not as participating lenders. Taken together, the results provide a consistent picture that there is information spillover from the commercial lending division to the equity research division of a financial conglomrate and that bank-affiliated analysts benefit from this information spillover via more accurate forecasts.

Are these information spillovers beneficial?

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. In recent years, regulators and market participants have expressed concerns that the spillover of private information into the public domain might breach confidentiality agreements between lenders and issuers and, more importantly, could lead to illegal trading. Banks have tried to address this concern by establishing limits to the flow of information among different parts of a financial conglomrate: i.e., erecting Chinese Walls. Analysts, along with public trading and the sales desks they’re associated with, belong to the public side of the wall and are therefore not supposed to receive private information. Our findings suggest that despite the presumed existence of Chinese Walls, financial analysts still have access to superior information from lending relationships and take advantage of this access in improving their forecast accuracy. As a consequence, information spillover among different divisions within a financial conglomrate is likely to be of greater concern.
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