1 Conflict of Interest

Recall that financial intermediaries produce information and achieve economies of scope by providing multiple financial services (banking, underwriting, and insurance) to their customers.

However, economies of scope in information production may lead to potential problem: conflicts of interest.

Conflict of interest is a type of moral hazard problem that arises when an institution has multiple objectives and, as a result, has conflicts between those objectives (provide multiple financial services): conceal information or disseminate misleading information.

This is important because this lowers the quality of information in financial markets and increases asymmetric information problems. This makes financial markets less efficient in channeling funds into productive investment opportunities. This has become one of the most important issues in corporate governance.

Why do conflict of interest arise?

1.1 Underwriting and Research in Investment Banking

Information produced by researching on companies is used to underwrite the securities and sell to the investors. Conflict of interest arises between *brokerage* and *underwriting* services because the bank is attempting to simultaneously serve two client groups (security-issuing firms and security-buying investors). For example, in order not to lose its customer (Corporation A) to other competitors, the investment bank conceals negative information of Corporation A and underwrites securities on its behalf.

Spinning occurs when an investment bank allocates hot, but underpriced, IPOs to executives of other companies in return for their companies' future business with the investment banks.

1.2 Commercial Banking vs. Investment Banking

A commercial bank makes loans to Corporation A and later receives negative private information about Corporation A. In order to keep Corporation A from defaulting on

its loans, the bank conceals the negative information of Corporation A and underwrite securities on its behalf. This shifts default risk from the bank (depositors and the bank) to those investors who purchase the securities (bondholders).

1.3 Cross Holdings between Commercial Banks and Firms

For example, keiretsu in Japan comprises of a group of firms and financial institutions. Close relationship between firms and financial institutions may create moral hazard problems: the banks in the keiretsu may continue to make loans to its firms inefficiently, sacrificing the interest of depositors and bank shareholders.

1.4 Auditing and Consulting in Accounting Firms

An accounting firm may provide its clients with auditing services and also nonauditing services (consulting) such as taxes, accounting, and management information system.

The conflict of interest here is that auditors may provide an overly favorable audit to solicit or retain audit business.

1.5 Solutions to Conflict of Interest

1.5.1 Sarbanes-Oxley Act of 2002 (Public Accounting Return and Investor Protection Act)

1. To increases supervisory oversight to monitor and prevent conflicts of interest, the Act establishes a Public Company Accounting Oversight Board to monitor accounting firms, and increases the SEC's budget.

2. Makes it illegal for a registered public accounting firm to provide any nonaudit service to a client contemporaneously with an impermissible audit.

3. Beefs up criminal charges for white-collar crime and obstruction of official investigations.

4. Requires the CEO and CFO to certify that financial statements and disclosures are accurate.

5. Requires members of the audit committee to be independent.

1.5.2 Global Legal Settlement of 2002

1. Requires investment banks to sever the link between research and securities underwriting.

2. Bans spinning.

3. Imposes fines on accused investment banks

4. Requires investment banks to make their analysts' recommendations public.

5. Over a 5-year period, investment banks are required to contract with at least 3 independent research firms that would provide research to their brokerage customers.