Know Your Customer Informed Trading by Banks

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This study analyzes information production and trading behavior of banks with lending relationships. We combine trade-by-trade supervisory data and credit-registry data to examine banks' proprietary trading in borrower stocks around a large number of corporate events. We find that relationship banks build up positive (negative) trading positions in the two weeks before events with positive (negative) news, even when these events are unscheduled, and unwind positions shortly after the event. This trading pattern is more pronounced in situations when banks are likely to possess private information about their borrowers, and cannot be explained by specialized expertise in certain industries or certain firms. The results suggest that banks' lending relationships inform their trading and underscore the potential for conflicts of interest in universal banking, which have been a prominent concern in the regulatory debate for a long time. Our analysis illustrates how combining large data sets can uncover unusual trading patterns and enhance the supervision of financial institutions.