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Int. Fin. Markets, Inst. and Money 14 (2004) 329–349

Journal of
INTERNATIONAL
FINANCIAL
MARKETS,
INSTITUTIONS
& MONEY

www.elsevier.com/locate/econbase

League table: a study of the competition to underwrite floating rate debt

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Accepted 7 October 2003

Available online 9 April 2004

Abstract

We find evidence of price and non-price competitions in the competition for market shares among underwriters. The market pricing for underwriter's service is rationally determined. Gross spread is a function of cost of production and distribution, underwriter's organizational assets, and the extent of competition. Strategic discount pricing affects market share in the short run. There exists evidence of client loyalty to an underwriter, albeit much weaker than expected. The number of effective competitors for any particular issuer is quite small, ranging from three to five. Commercial banks are more aggressive in pricing to first-time issuers and have gained limited success in attracting clients of investment banks. They expand the market by bringing in new issuers, while causing gross spread to fall. © 2004 Published by Elsevier B.V.

JEL classification: G21; G24

Keywords: Bank competition; Client loyalty; Market share

1. Introduction

The investment banking industry, although dominated by internationally well-known large firms with deep pockets and history, is acknowledged to be highly competitive. Partly as a result of the industry's competitiveness, information on transactions is widely available. Witness the availability and periodic publication of the so-called 'League Tables' that rank relative positions in market share of investment banks in virtually all categories of investment

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banking business, from merger advising, to derivative structuring and trading, to private banking, and to underwriting of various securities. It is safe to say that investment banks do compete vigorously, via price and non-price means, to gain market leadership and prestige.

Recent studies on how underwriters compete include a study of the IPO underwriting market by Dunbar (2000), an investigation by Gande et al. (1999) of the effect of commercial banks' entry on the competition for underwriting in fixed rate debt market, and a study of investment banks' market share in the mergers and acquisitions market by Rau (2000). This paper conducts an in-depth study of the nature and extent of competitions in the underwriting market for floating rate debt (FRD) securities. We choose to study the floating rate debt market for two reasons. One, the market is very large in terms of both number of issues and dollar volume, and thus a large sample is available to compute meaningful market share statistics. Two, the market has an important advantage that 97% of the issues were handled by a sole underwriter as the book manager, which allows accurate identification of historical dealings between issuers and underwriters.

In this study, we investigate both price and non-price competitions. We examine both competition in the large, i.e., how underwriting fees are affected by market wide competitive factors such as the number of competitors and underwriters' organizational assets, and competition in the small, i.e., how an underwriter chooses to compete strategically for each issue by offering fee discounts. Specifically, we estimate the market wide pricing function for underwriting fees, from which we then calculate the premium (discount) fee charged by underwriters for each issue. We also examine market shares of major underwriters and their changes over time extensively.

Our study complements that of Gande et al. (1999), which investigates the increase in competition due to the entry of commercial banks in the fixed rate debt market, and that of Dunbar (2000), who finds issue performance, fees, and underwriters' organizational assets such as specialization and analyst reputation could affect underwriters' market share in underwriting IPOs. We extend their studies in several ways by investigating issues such as the value of an underwriter's organizational assets in terms of prior experience and innovative activity, the number of effective competitors at issuer level, the first mover advantage in introducing a client to this market, the presence of seasonality induced by the underwriters' desire to place well in the league table, and the ability of commercial banks to win investment banks' clients.

The remainder of the paper is arranged as follows. Section 2 gives a general description of the floating rate debt market and discusses the market price of underwriting services. Section 3 describes the data source and presents an overview of the FRD market. Section 4 reports the empirical results. Section 5 analyzes the impact of recent entry of commercial banks in the floating rate debt market. Summary and conclusions are given in Section 6.

2. The underwriting market of floating rate debt securities

2.1. Floating rate debt securities

We study floating rate debt securities whose maturity can be as short as less than a year and as long as 15 years or more. Their coupon rates are linked to a short-term interest rate

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