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Does underwriter reputation matter in the municipal bond market?

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Abstract

We examine the role of underwriter reputation in the tax-exempt municipal bond market. Using a large sample of 10,239 tax-exempt municipal bonds, we show that generally, reputation matters. Municipal bond issues lead managed by larger and more prestigious underwriters have significantly lower borrowing costs, lower yields, and lower underwriting gross spreads. Our results are consistent with the view that reputation facilitates underwriter activities that leads to reducing information asymmetries between borrowers and issuers in the municipal bond market. Our results are also consistent with larger and more reputable underwriters providing a certificatory role for issues underwritten by them.

JEL classification: G24; H72; H74

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1. Introduction

This study examines the impact of underwriter reputation on issuer borrowing costs, bond re-offering yields (yields), and underwriter gross spread (spreads), in the tax-exempt municipal bond market. We study this issue in the municipal sector because the municipal bond market is large (for example, a record US$ 419 billion issuance volume in 2004 alone),[2] has several

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unique features that distinguish it from the corporate securities market (for example, the tax-exempt status and segmentation by types of issue, issuer, and region), and because the issue of underwriter reputation in this market has not been adequately examined. Besides, given the contradictory findings concerning underwriter reputation effects in the corporate sector, additional evidence from the municipal sector can permit a better understanding of underwriter reputation effects overall.[3]

We use a large sample of 10,239 tax-exempt municipal issues covering the period 1990–1999 to analyze underwriter reputation effects for issuers and investors. We examine if issuers benefit by incurring lower borrowing costs (true interest cost)[4] if they utilize the services of more prestigious underwriters. We study if investors accept higher prices and lower yields for bonds underwritten by more prestigious underwriters. We analyze underwriter benefits and behavior by examining the relationship between underwriter reputation and underwriter gross spreads. We examine if results are uniform across sample partitions based on factors such as bid type (negotiated or competitively bid), and credit quality (investment grade bonds or non-investment grade/non-rated bonds). Given that the municipal market is segmented on regional lines (Feroz & Wilson, 1992), we consider both national and regional reputation effects for underwriters in our analyses. In addition, our measure of underwriter reputation is contemporaneous and takes into account changes over the time period of our study.

Our results show that using a more prestigious underwriter results in significantly lower borrowing costs for issuers. This result is seen not just for our full sample, but also for sub-samples using competitively bid and negotiated bonds, and non-investment grade bonds.[5] Similar results are seen for yields also.[6] Examining underwriter gross spreads, our results show that spreads are lower for our full sample, and for the competitively bid and negotiated sub-samples. Our results for spread are similar to the results obtained in the corporate sector (Chen & Mohan, 2002). Also, as noted by Livingston and Miller (2000), these results may also be consistent with more prestigious underwriters striving to maintain or increase market share. Overall, these results suggest that in general, reputation effects for more prestigious underwriters observed in the corporate IPO market

[3] Studies that show a positive certification effect associated with prestigious underwriters for equity offerings include Beatty and Ritter (1986), Johnson and Miller (1988), Carter and Manaster (1990), Megginson and Weiss (1991), Michaely and Shaw (1994), Carter, Dark, and Singh (1998), and Helou and Park (2001). Livingston, Pratt, and Mann (1995) and Livingston and Miller (2000) provide some evidence for corporate bonds that lower offering yields are associated with more prestigious underwriters. Welch (1989), Allen and Faulhaber (1989), Chemmanur (1993), Beatty and Welch (1996), Asquith, Jones, and Kieschnick (1998), Fishe (2002), Krigman, Shaw, and Womack (1999), and Fohlin (2000) are studies that do not show beneficial effects for issuers using more prestigious underwriters. While Peng and Brucato (2004) show that prestigious underwriters benefit issuers of negotiated bonds in the municipal bond market, Roden and Bassler (1996) do not find any beneficial effects for issuers of municipal bonds using more prestigious underwriters.

[4] True interest cost (TIC) is a commonly used measure of borrowing costs to the issuer. It is the basis on which most bids are awarded to underwriters by issuers in the municipal bond market. TIC takes into account the time value of money, and is the rate that discounts all future cash payments that the issuer will have to make, such that the sum of their present value equals the bond proceeds. TIC has been widely used in prior research (for example, IanGershberg, Grossman, & Goldman, 2001), and in practice.

[5] In accordance with prevalent practice, bonds rated AAA, AA, A, and BBB by Standard and Poor's or rated Aaa, Aa, A, and Baa by Moody's are classified as investment grade. All other bonds including non-rated bonds are classified as non-investment grade.

[6] Yield is different from TIC. Yield (used in this study and obtained from the Securities Data Company database) is dependent on and calculated based on the price paid by investors to underwriters when the bonds are first offered for sale by underwriters. TIC which represents borrowing costs to issuers is calculated using the price at which the bonds are purchased by underwriters from the issuers. The difference between YIELD and TIC is the underwriter gross spread.