Available online at www.sciencedirect.com
SCIENCE DIRECT
Journal of International Money and Finance
23 (2004) 367–384
Journal of International Money and Finance
www.elsevier.com/locate/econbase

Commercial bank underwriting of credit-enhanced bonds: are there certification benefits to the issuer?

Anthony Saunders [a], Roger D. Stover [b,*]

[a] *John M. Schiff Professor of Finance, Stern School of Business, New York University, New York, NY 10012-1126, USA*
[b] *Professor of Finance, 103 E.O. Building, College of Business, Iowa State University Ames, IA 50011, USA*

Abstract

Recent studies have expanded the commercial bank certification hypothesis to include banks acting in an underwriting capacity. This paper further develops that research by focusing on the industrial revenue bond market in which banks have the unique opportunity to simultaneously act as both credit guarantor and underwriter. When explicitly allowing for bank-issued standby letters of credit (guarantees), we find significantly greater yield spreads for those bonds underwritten by commercial banks compared to bonds underwritten by investment banks. Overall, no net benefit appears to accrue to the bond issuer when attempting to achieve joint (or double) certification benefits by employing commercial banks as both credit guarantor and underwriters except in the special case where the *same* bank acts as both guarantor and underwriter. This limited certification effect is further validated when the credit quality of participating banks is accounted for. This result is consistent with an "economy of scope" in monitoring and reusing information.

Keywords: Bank certification; Bond pricing

1. Introduction

Regulatory constraints on investment banking activities have severely limited the opportunity for studying the role of commercial banks as security underwriters in the United States. Nevertheless, general findings to date suggest that smaller-sized

* Corresponding author.
E-mail address: rstover@iastate.edu (R.D. Stover).

0261-5606/$ - see front matter
doi:10.1016/j.jimonfin.2004.01.003

firms that issue lower quality debt benefit most by having an underwriting relationship with a commercial bank. Specifically, Puri (1996) finds that commercial bank underwritings of corporate bonds, in the pre-Glass-Steagall Act period, resulted in better pricing for smaller and lower credit rated issuers than similar issues underwritten by investment banking firms. Gande, Puri, Saunders and Walter (1997) draw similar conclusions for bond offerings in the 1985–1996 period when banks were allowed to use their Section 20 securities subsidiaries to engage in corporate bond underwritings. However, Roten and Mullineaux (2002) find little difference in the yield spread between commercial bank and investment bank underwritten bonds in the later 1995–1998 period. Such conflicting findings may suggest that both underwriters may have unique areas of expertise in bond issuance. Our study expands on the above research by examining the potential certification benefits, in terms of issuance costs, that (may) occur when commercial banks simultaneously act as both credit guarantor and underwriter in municipal bond financing transactions.

Commercial banks are unique participants in the industrial revenue bond primary market as they frequently issue standby letters of credit, as a means of credit enhancement (or guarantee), and underwrite the actual bond offering itself. Consequently, the issuance of a standby letter of credit backing by a commercial bank might be viewed as a positive signal regarding the quality of the borrower since the bank's issuance of the guarantee can be considered as certification of the borrower's credit quality. Similar certification effects have been found with loans and loan renewals (i.e. see James, 1987, for example). Indeed, the municipal revenue bond market is well recognized for its high degree of information asymmetry among issuers and investors.[1] As a result, such certification services may be viewed as highly valuable. In addition, commercial banks concerned about reputation may also bring certification benefits to the issuer through the underwriting process (see Puri, 1996, for example).

To examine the benefits of "double" certification, that is to examine the benefits to the issuer from using commercial banks as both standby letter of credit guarantors and underwriters, a sample of industrial revenue bond issues offered during the 1987–1998 period were segmented into a sub-samples containing those bonds with (without) standby letter of credit backing and underwritten by investment banks, and bonds with (without) standby letter of credit backing and underwritten by commercial banks. Using these sample partitions, as well as identifying separate sub-samples where the same bank offered both services (as opposed to different banks offering the two services separately), the empirical tests focus on the market's response to the type of underwriting undertaken. The market's response is measured by the size of the tax adjusted reoffering yields achieved by the issuer relative to matched maturity U.S. Treasury securities.

Since a standby letter of credit-backed bond is essentially a transaction-based loan in which a bank's guarantee provision cannot be inferred as indicative of a long-term banking relationship, and thus a long term monitoring role, any certifi-

[1] See Robbins, Apostolou and Strawser (1985) and Ingram, Raman and Wilson (1989).