

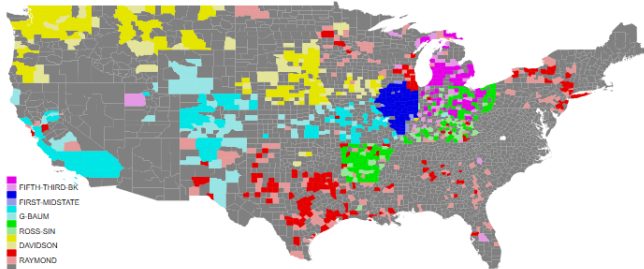
Specialization investments and market power in the underwriting market for municipal bonds.

Dario Cestau

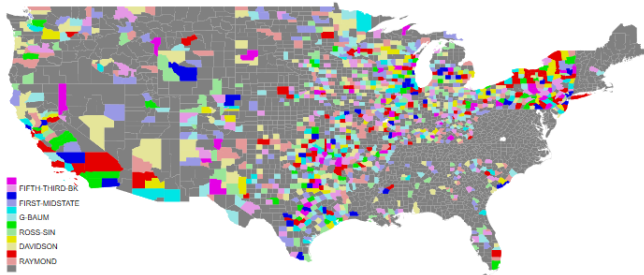
IE Business School

Heat map top 7-12 underwriters of school bonds

Actual



Theoretical



Why are underwriters segmented by state?

▶ Part 1:

- ▶ Question 1: Strong entry barriers. What are these barriers?
- ▶ Finding 1: Underwriters specialize either in competitive sales or negotiated sales in each state.
- ▶ Conclusion 1: They have different entry barriers.

▶ Part 2:

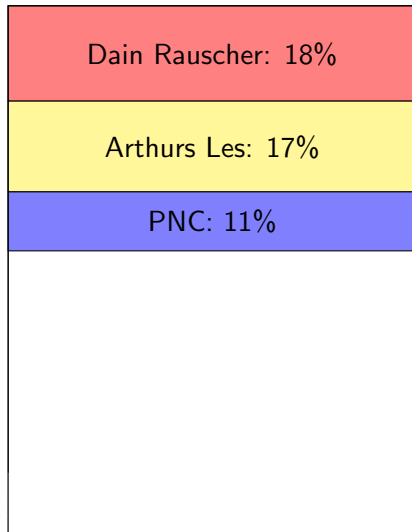
- ▶ Question 2: What are entry barriers for each sale type?
- ▶ Finding 2: Top negotiated underwriters tend to be local, and top competitive tend to be national banks based in NYC.
- ▶ Conclusion 2: Underwriting firms with pre-established broker-dealer relationships have an advantage in competitive sales. Local firms can provide more non-yield benefits, giving them an advantage in negotiated sales.

Sample

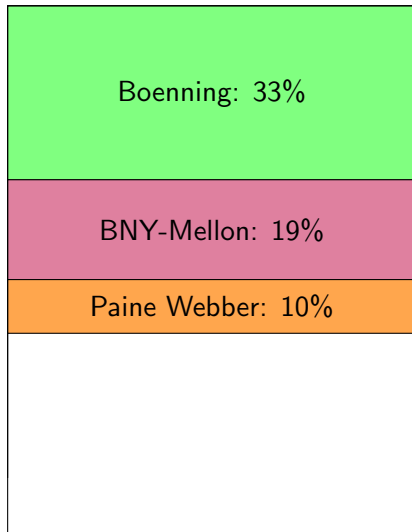
- ▶ Issuers: independent school districts.
 - ▶ Simple and homogenous across states.
 - ▶ School bonds constitute a large sample.
 - ▶ ISDs generally issue simple plain vanilla bonds.
 - ▶ They can't self-regulate.
- ▶ 63,389 deals in 36 states between 1990 and 2014.
- ▶ Periods: 5 periods of 5 years each: 150 state-periods.
- ▶ For each state-period, I measure the market shares of the top 3 competitive and the top 3 negotiated underwriters.

Pennsylvania 2000-04 - Market shares

Negotiated

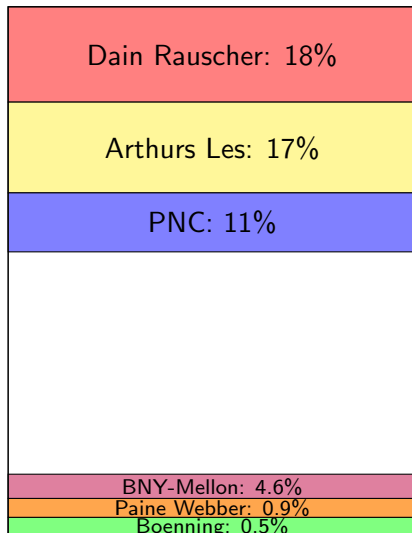


Competitive

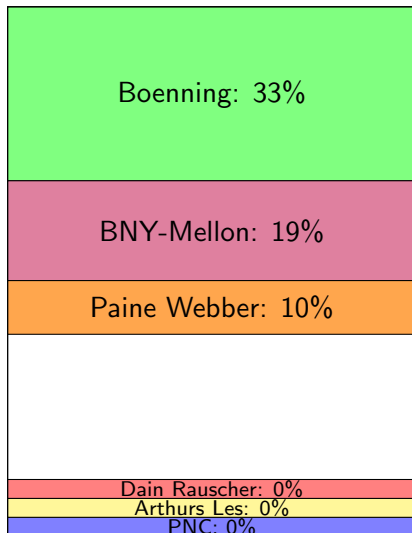


Pennsylvania 2000-04 - Drop market shares

Negotiated



Competitive



Median drops in market shares

- ▶ All bonds:
 - ▶ Top negotiated: 72% in deals, 85% in notional amount.
 - ▶ Top competitive: 69% in deals, 94% in notional amount.
- ▶ New-money unlimited vanilla example:
 - ▶ Negotiated: 84% in deals, 95% in amount.
 - ▶ Competitive: 88% in deals, 100% in amount.
- ▶ Ranking regression: $rknCOMP_{i,s} = a + b * rknNEG_{i,s} + \varepsilon$
 - ▶ High negotiated rankings lead to lower competitive rankings.
 - ▶ Substantial ranking reversion.
- ▶ **Not a spurious result:** they genuinely specialize.

Types of underwriters

- ▶ I classify each top underwriter in each state-period according to the location of the HQ relative to the state:
 - ▶ *Local-N*: local and never a top underwriter in another state.
 - ▶ *Local-X*: local and also a top underwriter in other states.
 - ▶ *Regional-1*: HQ in a contiguous state.
 - ▶ *Regional-2*: HQ at two state borders.
 - ▶ *National*: None of the above.

	Nat	Reg-2	Reg-1	Loc-X	Loc-N
Top 3 Neg	22%	12%	20%	19%	27%
Top 3 Comp	55%	5%	17%	15%	8%

Conclusion

Postulation:

- ▶ Underwriting firms with pre-established broker-dealer relationships have an advantage in competitive sales.
- ▶ Local firms can provide more non-yield benefits, giving them an advantage in negotiated sales.
 - ▶ Not know-how.
 - ▶ Not reputation (in the case of competitive sales).

Sales laws:

- ▶ Cestau et al.(2018): bans on private sales save 13bp per deal.
- ▶ 15 states have relaxed the bans of on negotiated sales. **Why?**
 - ▶ To favor local firms.
 - ▶ Local firms make a stronger lobby group.