Conflicts of Interest in Municipal Bond Advising and Underwriting

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Conflict of Interest: “a situation in which a party to a transaction can potentially gain by taking actions that adversely affect its counterparty” (Mehran and Stulz, 2007)

**Conflicts of interest common when acquiring financial information**

- Credit Rating Agencies
  
  (Jiang, Stanford and Xie, 2012; Griffin and Tang, 2011)

- Equity Research
  
  (Agrawal and Chen, 2008; Fang and Yasuda, 2009)

- Retirement planning services
  
  (Boyson, 2019; Bhattacharya, Illanes and Padi, 2019)

Of potential conflicts in muni bond issuance, focusing on underwriters who also sell advice
“Right now, a financial professional advising a municipality can guide the municipality towards securities tailored to his firm’s advantage, then resign and act as underwriter. This is a classic example of conflict of interest.”
- Mary Schapiro, Chair of the SEC, May 7, 2010

Quasi-Experiment from Recent Regulation:

- Dodd-Frank (2010) charged SEC and MSRB with regulating advice


- Forbids advisors from underwriting same issue, in effect Nov. 27, 2011
Does prohibiting advisors from underwriting affect borrowing costs?

- Fixing a conflict of interest lowers costs (SEC, 2010; MSRB, 2011)
  - Advisor Underwriter ↓ ➞ Advice Quality ↑ ➞ Costs ↓

- Taking away a potential underwriter raises costs (Bond Dealers of America, 2019)
  - Advisor Underwriter ↓ ➞ Underwriter Competition ↓ ➞ Costs ↑

Effect of limiting dual advising on 20,038 competitive bond sales

- Diff-in-diff Results: Borrowing costs ↓ by 5.3% (11.4 basis points)

- Driven in part by ↑ underwriter competition: 0.9 more non-advisor underwriters competing
  - Larger impact on less competitive auctions, schools
Municipal Bond Issue Data

Four primary data sources:
- SDC Platinum for bond issues and characteristics
- The Bond Buyer for bids and bidder identities
- MSRB EMMA for secondary market prices and yields
- Financial advisor ownership from Bergstresser and Luby (2018)

Sample of interest:
- 20,038 tax-exempt, general obligation, competitive issues over $1 million, repeat issuers
- 4,093 unique issuers issuing 4.9 times on average
- Sample ends in 2015 before fiduciary rule (Rule G-42)
Research Design: Difference-in-Differences

- Potential “Dual advisor” \( \equiv \) advisors whose firm underwrites issues they advised pre-2011
- Dual Advisor market shares and trends

Difference-in-Differences Regression Model

\[ Y_{ijt} = \alpha_j + \beta (\text{Dual}_{ijt} \times \text{Post}_t) + \delta_2 \text{Dual}_{ijt} + \delta_1 \text{Post}_t + \xi X_{ijt} + \varepsilon_{ijt} \]

- \( i \) denotes issue, \( j \) denotes municipality, while \( t \) denotes date
- \( Y_{ijt} \) is the interest rate or number of auction participants
- \( \text{Post}_t \) is an indicator function for dates after November 26, 2011
Raw Difference-in-Differences (Winning Bid)

- Normalizing levels in 2011
Conditional Difference-in-Differences (Winning Bid)

- Borrowing costs decrease by 11.4 basis points on average
Auction participation by non-advisors up by 0.9
Total auction participation increases by 0.4
Change in Winning Bid by Issuer Type

A. Full Sample

B. School Districts
Research Design: Difference-in-Differences

Identifying assumption: parallel trends
▶ Without intervention, dual and independently advised issue outcomes change in parallel

Threats to Identification and Tests
▶ Selection into using dual advisor changing?
  ▶ Define issuer-level treatment \( Dual_j \in [0, 1] \) based on pre-regulation behavior

▶ Dual advisors specialize in small, long maturity issuers. Different outcomes?
  ▶ Complementary cross-sectional identification using selection model (ATE)

▶ Market factors influencing types of advisors differently?
  ▶ Placebo test using untreated advisors associated with investment banks
Mechanisms: Increasing Standardization, Liquidity

Several margins where bond structure can affect borrowing costs

- Advisors can “guide the municipality towards securities tailored to his firm’s advantage”

- Find 3 changes in bonds issued with dual advisors after regulation:
  - School bonds increase likelihood of credit ratings (Wes Clarke, 1997)
  
  - School bonds increase likelihood of credit enhancements

  - School bond term structure changes slightly (shorter maturities, one CUSIP per year, etc.)

- Manifests as increased liquidity and decreased price dispersion in secondary markets
Mechanisms: Asymmetric Information in Auctions

- In a common value auction with asymmetric information:
  - Informed underwriter (advisor) gets positive information rents
  - Other underwriters randomize bids for zero expected rents

- **Hypothesis:** advisor wins auction $\implies$ larger profits (gross spread)

- Calculate gross spread as bid minus average market yield (7 day)

- In preperiod, regress spread on advisor bid and advisor win indicators
  - Gross spreads 3.5 bp (6%) lower when advisor bids and loses
  - Auctions that the advisor wins have higher gross spread

- Evidence of asymmetric information and **winner’s curse** pre-MSRB Rule G-23
Concluding Remarks

Does prohibiting advisors from underwriting affect borrowing costs?

- Yes, borrowing costs decrease when advisors cannot underwrite
- Advisor bids more than fully replaced by other underwriters
- Low competition issuers, schools are the winners in the regulation
- Fiduciary rules, alone, would not fix negatives of allowing advisors to underwrite due to harming competitive interactions