The Competitive Impact of Commercial Bank Underwriting on the Market for Municipal Revenue Bonds

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Abstract

This paper examines the impact of commercial bank entry in the market for municipal revenue bonds. We show that issues underwritten by commercial banks have lower underwriter spreads but not lower yields relative to issues underwritten by nonbank investment firms. In particular, this is more significant for non-investment-grade bonds underwritten by commercial banks. Our results are consistent with the interpretation that bank entry has resulted in increased competition in the municipal revenue bond market and that the lower yields observed for bank-underwritten commercial bonds may be due to banks having private information. Overall, our results suggest that policy changes leading to the relaxation of restrictive provisions concerning bank underwriting of municipal revenue bonds have had beneficial effects.

Key words: Underwriting, spreads, monitoring, bank competition, certification municipal bonds.

1. Introduction

The tax-exempt municipal bond market in the United States is huge, with outstanding issues totaling more than $1.5 trillion and over $210 billion in issuance volume in 1999 alone (Bond Market Association, 2000). Until 1987, under the Glass-Steagall Act, with limited exceptions, commercial banks were prohibited from underwriting most municipal securities. Limited exemption was granted in 1968 under the Housing and Urban Development Act (HUD), allowing commercial banks to underwrite municipal revenue bonds for housing, university, and dormitory purposes (hereinafter referred to as bank-eligible bonds). All municipal revenue bonds other than these bank-eligible bonds are referred to as ineligible or non-bank-eligible bonds in the rest of the paper. In 1987, the provisions of the Glass-Steagall Act were relaxed to allow commercial banks to underwrite ineligible bonds, provided revenue from such underwriting constituted less than 5% of gross revenue. In 1989, and again in 1997, the Federal Reserve further raised the ceiling on underwriting of ineligible bonds to 10 percent and 25 percent, respectively. The passage of the Gramm-Leach-Bliley Act in 1999 resulted in the complete removal of all restrictive provisions on commercial bank underwriting of financial securities. Commercial banks now can participate directly in the investment banking market by underwriting and dealing in all securities and engage in almost any type of financial activity.
While research has examined the impact of commercial bank entry into corporate bond markets (for example, Roten and Mullineaux, 2000; Gande et al. 1999; Puri, 1994, 1996), scant prior literature exists concerning the impact of their entry into the tax-exempt municipal bond market. To our knowledge, prior literature has not examined this issue, especially after banks were allowed to underwrite all types of municipal bonds after 1987. This paper analyzes the impact of commercial bank’s entry as underwriters into the market for municipal revenue bonds. We investigate the characteristics of issues that are underwritten by commercial banks. We examine whether bank entry resulted in monopoly concentration in favor of commercial banks or banks and investment houses can coexist and compete. Our analysis also explores the procompetitive effects of bank entry in the municipal revenue bond market. Specifically, we examine if yields (to investors) and underwriter spreads have been affected because of increased competition consequent to bank entry.

Prior literature for many years debated the issue of granting the commercial banking sector expanded powers to compete. Leonard (1982) outlined the pros and cons of commercial banks competing in the market for municipal revenue bonds. Benston (1994) argued that universal banks with their superior information about their clients would monopolize the securities market. Gande et al. (1999) suggested that bank entry has a procompetitive effect on the market for corporate debt underwriting. Puri (1994, 1996) provided evidence that commercial banks play a certification role in the corporate debt market. Roten and Mullineaux (2000) found that commercial banks underwrite commercial debt with significantly lower gross spreads than investment banks.

Our analysis extends and contributes to this literature. Using a large sample of 7543 revenue bond issues during the period 1986–1999, our results suggest that bank entry has had a procompetitive effect in the municipal revenue bond market. While bank entry has not resulted in lower yields overall, controlling for other factors, underwriter spreads are significantly lower. Taken together, these results show that municipal revenue bond issuers also benefited through lower borrowing cost consequent to bank entry, contrary to the view expressed by the nonbank investment firms. In addition, these results are more pronounced for non-investment-grade issues managed by commercial banks. In 1997, the Federal Reserve increased the ceiling on permissible revenues to banks from underwriting bonds such as municipal revenue bonds from 10% of gross revenues to 25%. Our results show that this move allowing banks to underwrite larger volume also had competitive effects and led to lower yields.

These results, in conjunction with other literature that examine bank entry effects on corporate bond markets, provide some insights, not just on the impact of bank entry into the municipal revenue bond market but also for understanding the effects of bank entry into corporate bond markets. Puri (1994) and Gande et al. (1997) found that bank entry lowers yields for corporate bonds. However, they did not clearly establish why yields are lowered. Their results imply that banks possess private information, which may be a reason for lower yields. They do not rule out other reasons, however, such as analytics or distribution that may reflect other strengths that banks have. Our results provide some insight concerning this issue and suggest that the lower yields observed consequent to bank entry into the corporate bond market may be due to private information banks may possess.