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Sell Side

How Shrinking Spreads Are Making the Muni Underwriting Business Unsustainable

By Aaron Weitzman and Kyle Glazier
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Shrinking underwriting spreads may be threatening the municipal underwriting business, and underwriters, attorneys, financial advisors, and other market participants are thinking seriously about the causes and long-term implications of this reality.

Since 1996, underwriting spreads have decreased $3.13 per $1,000 face value of bond issues. In 1996, underwriters were making $7.77 per $1,000 face value of bond issues and in 2015, that number was down to $4.64 – the lowest since 2008 when the amount was $4.89.

"We're all chasing a small number of deals," said a banker who asked not to be named. The banker said he wondered if the resulting diminished compensation and lower spreads will cause firms to reduce the number of deals they take on, and how that could impact muni issuers who need creative solutions and low-cost access to capital.

A second banker said that, with new-issue volume relatively flat, there is immense competitive pressure for every deal that comes to market.

"Many firms are qualified so underwriting fees end up being a very easily quantifiable single point of differentiation. When a selection process ultimately comes down to one single factor in fees, that downward pressure only intensifies," he said.

Rick Kolman, who stepped down as head of public finance at US Bank in February, said that underwriters are undervaluing their services and allowed themselves to fall into a business model that doesn't make sense long-term.

"They'd like to blame issuers or financial advisors," Kolman said. "The Street has done it to themselves."

Kolman stressed that while it would not be accurate to point the finger at any one group of market participants, he said he is "baffled" by how underwriters underprice their services "to the point of absurdity." He said that some issuers are willing to pay higher spreads for value-added services, but issuer officials often feel pressured by the optics of leaving a cheaper transaction on the table if local press or watchdogs take notice of it. The result is a lower profitability that won't make sense for underwriters in years to come, he said.

"It's not going to be long-term sustainable," said Kolman. "I don't see how it's possible."

The first banker noted that the introduction of the Build America Bonds subsidy program in 2009 led to two years of elevated underwriting spreads while the program was in effect, climbing to $6.21 in 2009 from $4.89 the previous year.

"When BABs came to market in 2009 and 2010, they were a new product that commanded higher takedowns and the benefits for the issuer were significant," the second banker said. " BABs were a big catalyst for issuance and market volume was increasing," he said.

Underwriting spreads have declined steadily since the program's dissolution at the end of 2010. The second banker said that many in the industry are calling for a new, similar product to be created to change the current dynamic.

"However, a market-based approach rather than a product-based approach would likely be more beneficial in the long run for all market participants, including issuers," the banker said. "The current trajectory is not sustainable and underwriters simply don't have the ability to expand resources and take any underwriting risk when there is little compensation to support it."

In an environment of continued shrinking, consolidating and even shuttering of municipal underwriting firms, the first banker said that resource allocation is becoming increasingly important.

"For low-margin opportunities, it becomes very challenging to commit the same level of resources, both in terms of personnel and balance sheet capital. It's simply not possible to take on risk and operate at what essentially amounts to a loss indefinitely," said the second banker.

Frank Shafroth, director of the Center for State and Local Leadership at George Mason University, pointed to economic factors driving the low spread environment and predicted that political realities are unlikely to foster change anytime soon.

"With the House beginning to focus on federal tax reform, no one can count on what the outcome might be," Shafroth said. "Uncertainty hardly produces an environment in which state and local leaders would be more motivated or likely to make long-term capital investments. So reduced state and local issuance will reinforce greater competition amongst underwriters, and, lo and behold, tighter spreads."

Despite the recovery from the great recession, Shafroth continued, many states have yet to rebuild their financial cushions to pre-recession levels and in 22 states employment rates remain below 2007 levels. Many states and localities are also wrestling with rising pension and OPEB liabilities and other considerations that could further inhabit new issuance, Shafroth noted.

"So I would not anticipate those spreads will improve: we will have to await the next State of the Union address to get a sense of the country's direction for the future," he said.

A securities lawyer who asked not to be identified said that it is fair to say that underwriter compensation is "under attack," but that it is also important to remember that those firms can profit in other ways, some of them less transparent and some even fraudulent as they seek more "underhanded" ways of profiting. The lawyer pointed to the August 2015 enforcement action brought by the Securities and Exchange Commission against Edward Jones. The commission found that instead of selling new bonds to customers at the initial offering price as required, the firm took bonds into its own inventory and then improperly sold them to customers at higher

prices.

Investment banks are already feeling the struggle of hiring and retaining promising talent in the public finance business, Kolman added, because young people are seeing the trend and deciding that it doesn't make sense for them to devote a career to munis.

Financial advisors serving as municipal advisors to issuers often have a seat at the deal table, and their input can impact the spread.

"Transaction management and execution is one of a range of services provided for the municipal entity clients of the firm," said Larry Kidwell, president of Tennessee-based financial advisory firm Kidwell & Company. "Market participants who are familiar with our firm would agree that we bring a high degree of concentration to levels of spread to benchmark indexes in transaction execution, and we believe this is a part of the fiduciary duty a municipal advisor owes to issuer clients. Spreads should vary depending upon transaction issuer, type, security, structure, term, credit rating, and market timing, among other factors."

Kidwell added that many issuers may not be aware of the spreads they pay in transactions where 5%, or other premium couponing structures are utilized, where the yield to worst for investors is the yield to best for issuers. Kidwell said his firm would support a rule requiring the reporting of yield to maturity for every municipal securities transaction.

Negotiated transactions are feeling the pinch more than competitive deals. In 1996 at their peak, spreads for competitive sales were at $7.53, 30 cents below negotiated deals. They saw a low of $4.12 in 2007. Spreads for competitive deals were at $4.96 in 2015, coming back up from $4.58 in 2014.

"There are higher spreads in the competitive space because there is so much balance sheet exposure and they have to charge for it," said the first banker.

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