Underwriter size and bond markets: A case of market power or certification?

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Abstract

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Abstract

Since the late 1990s, the US market for new bond issues has experienced a dramatic rise of underwriting syndicates and a concurrent increase of their market shares. This condition allows us to revisit the long-standing question of whether the consolidation of “market power” created a moral hazard problem for the underwriter in terms of the costly effort and diligence they exercise to certify the “financial strength” or quality of the issue they bring to the market. We develop an aggregate market-share-based measure to differentiate the high from the low market power underwriters. Following classic financial distress literature, we also develop a unique “financial strength” model, which is used to assess the at-issue financial strength of a given firm, as well as track that firm’s financial strength in the years immediately following issuance. Our results show that, after accounting for its rating, when bonds are issued by high market power underwriters: (i) the issuing firms exhibit significantly lower at-issue financial strength, and; (ii) the issuing firms’ financial strength significantly deteriorates in the post-issuance period. Both findings support the hypothesis that market power creates a moral hazard situation for underwriters – specifically in the market for new bond issues in the US.