Conflicts of Interest in Municipal Debt Advising and Underwriting

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Abstract

This paper studies how financial advisors affect borrowing costs for state and local governments. Before Dodd-Frank, municipal financial advisors were not regulated by the Municipal Securities Rulemaking Board (MSRB). MSRB Rule G-23 was amended in November 2011 to prohibit financial advisors from serving as the underwriter for any issue that they advise in order to eliminate potential conflicts of interest. Using a difference-in-differences approach, I compare the outcomes of tax-exempt, general obligation bond issues with dual advisors, advisors who also offer underwriting services, to the outcomes of similar issues with independent advisors issued between 2008 and 2015. I find that bonds with dual advisors see interest costs fall by 8.08 basis points (3.33% on average) after the advisor is no longer allowed to serve as underwriter. The drop in interest costs in the primary market is driven in large part by an increase of 0.8 bids from non-advisors on average. To identify mechanisms responsible for the observed increase in market competition and decrease in municipal borrowing costs, I employ a common value auction model to separate the effects of asymmetric information between bidders from under-provision of advisory services.

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