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Banking Consolidation Raises the Costs for Local Governments to Issue New Debt.

Security underwriting is a pillar of the financial system, since a bond or equity issuer usually relies on an intermediary to take on the risk of its security before it goes to the open market. Newly issued corporate equity, corporate bonds, and municipal bonds (or "muni" bonds) comprised $102 billion, $883 billion, and $410 billion, respectively, in the United States in 2022. Despite the high volume, some argue that security issuance has not reached its full potential in terms of serving the real economy due to the deterrence of high levels of fees in the underwriting process. In particular, muni bond market watchdogs warned that issuers could "easily be taken advantage of — urged to issue needless or poorly structured bonds, pushed to accept high interest rates or duped into paying hundreds of thousands in unreasonable fees", which could have put strain on the US K-12 education system.

How should we view underwriting fees? Are underwriters rightfully compensated for performing their tasks, perhaps because security underwriting is inherently intricate and involves considerable risks? What happens when underwriters possess disproportionate market power and earn economic profits beyond the competitive level? In a recent paper, I direct my attention to the muni bond market. Studying consolidating activities as shifters of underwriter market power, I gain insight into its role in shaping the security issuance market.

Local governments usually issue muni bonds to fund infrastructure projects such as roads and water lines. The muni bond market rivals the corporate securities markets in the total volume of issuance nationally. Compared to the corporate securities underwriting market, though, the muni bond underwriting market is much more geographically fragmented. For example, none of the top three underwriters in California during 2010-2020 was a top ten in Massachusetts, nor vice versa. On the contrary, the top ten corporate bond underwriters were the same in these two states with only slight difference in the rankings, and there was also significant overlap in the corporate equity underwriters. Moreover, muni bond underwriting is a dynamic industry which has seen ample consolidation in recent decades. The average HHI based on local underwriter market shares rose from around 1,000 to 1,500 in the past three decades, accompanying 197 mergers and acquisitions (M&As) deals. These features allowed me to study the effects of M&As to understand both the costs and efficiencies that such consolidation produces and, most importantly, its impact on the local governments that rely on the industry.

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