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Average Underwriting Spreads Stagnant in 2023, but Negotiated, Refunding Spreads Rise.

Average underwriting spreads for all bonds were stagnant in 2023, continuing a 15-year downward trend, but negotiated and refunding deal spreads rose while competitive spreads fell.

Underwriter spread ticked up slightly, rising to $3.66 in 2023 from $3.64 in 2022. Spreads on negotiated bonds rose to $3.76 in 2023 from $3.62 in 2022, while spreads on competitive deals fell to $2.71 from 2022's $3.89, according to LSEG data.

Refunding spreads rose to $3.36 in 2023 from $2.86 a year prior, while new-money spreads dropped to $3.79 from $3.84 over the same period, per LSEG.

The decline of underwriting spreads has been happening for several years, and Michael Decker, senior vice president of policy and research at Bond Dealers of America, sees that trend continuing as firms become more efficient, reduce business costs and leverage technology, thus driving spreads lower, he said.

The gross underwriting spread is the payment or discount that an underwriter receives for marketing a deal. It is calculated as the dollar amount of the underwriting discount per $1,000 of an issue.

"Tight underwriting spreads in 2023 followed, for the most part, a well-entrenched trajectory that has backdropped the primary municipal market for years, and so the negligible bump in spreads does not come as a surprise," said Jeff Lipton, managing director of credit research at Oppenheimer.

Spreads first fell below $4 in 2022, the first time in almost 20 years, well below the $5.58 in 2004. Spreads fluctuated between nearly $5 and $5.50 from 2004 through 2008 before hitting a high of $6.21 in 2009. From there, spreads continued to trend downward.

The first half of 2023 saw underwriting spreads rise to $3.70 billion in 1H 2023 from $3.54 in 1H 2022.

Wider spreads during the first half of last year were tied to specific market conditions at that time, according to Lipton.

"Banks had stepped away to some extent given the dislocations of last March from [Silicon Valley Bank] and the easing desirability of tax-exempt munis given the cost-of-funds for banks and taxable equivalent yield analysis," he said.

Some other institutional buyers took "to the sidelines" amid heavy market volatility, he said.

Last year's supply "received ample support from active Q4 issuance, helping to normalize spreads," Lipton said. Issuance in 2023 ticked down 1.7% to $384.715 billion.

Additionally, part of the underwriting spread compression comes from increased competition in the muni market, market participants said.

“What you’re seeing is the race to the bottom, in terms of folks that are trying to win deals,” said Laci Knowles, a managing director and public finance banker at D.A. Davidson.

The muni market is a volume-based business, and to make money firms need to do a large number of deals, she said.

And if firms lower their fees, they can secure more deals, adding more money to their balance sheets, she said.

“There’s no secret sauce to do any types of transactions for a number of them, and so people can do them for lower fees,” Knowles said. “And maybe the deal isn’t perfect, but it gets it over the finish line.”

That competition partly contributed to the exit of Citi and UBS, participants say.

The business departures by Citi and UBS could have intermittent implications for underwriting spreads, but the commitments entered into by other dealers should help to contain any meaningful spread movement, Lipton said.

While there may not be a quantitative loss by the exit of two major underwriters, Decker said there are opportunities for the remaining firms to access talent they may have been unable to recruit otherwise.

“The idea that two fewer firms are chasing after the same issue will hopefully make things a little easier for the firms that remain,” he said.

Despite the decline in spreads, Decker noted spreads can only “go so low.”

“Underwriters have to be able to cover their expenses when they’re underwriting a deal, cover their risk, and, and make a reasonable profit on a transaction,” he said.

“You get to a point where spreads are so low that the margin on a deal for an underwriter becomes thin, but there’s a floor there,” Decker noted.

Given expectations for higher supply this year, underwriting spreads should remain tight, Lipton said.

“Unforeseen market and/or credit conditions could result in noted advances in spreads, yet such conditions could prove transitory, with spreads reverting to lower levels,” he said.

For example, Lipton noted “a large deal or several large deals could create wider spreads as more spread is usually needed to move paper and hedge risk.”

Should headline risk emerge surrounding a particular credit or sector, he said “spreads could temporarily expand until market participants have time to digest the development and hopefully conclude that there is no systemic impact across the municipal asset class.”

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