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The Costs and Benefits to Municipal Bond Issuers of Close Ties to Banks.

Banks are key players in the municipal bond market, holding approximately 20% of outstanding municipal bonds. In a paper presented at the Municipal Finance Conference in July 2024, Gustavo S. Cortes of the University of Florida, Igor Cunha of the University of Kentucky, and Sharjil Haque of the Federal Reserve Board find that banks are more likely to hold bonds with issuers with which they have an established relationship. This study uses novel (and confidential) data on larger banks' portfolios from the Federal Reserve, which collected the data for its stress testing exercise. This provides far more detail and specificity about holdings than data available to authors of previous studies.

Banks prefer larger, longer-maturity, and insured bonds as well as bonds with higher-credit ratings, but are less sensitive to these factors when picking bonds from an issuer with which the bank has other relationships.

These relationships benefit both banks and issuers, the authors conclude. Banks extract information from lending relationships to enhance investment decisions. They can more accurately price bonds at initial issue and find undervalued opportunities, resulting in better-performing bonds.

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The Brookings Institution

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July 30, 2024