Conflicts of Interest in Municipal Bond Advising and Underwriting

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October 15, 2019

Current version available

Abstract

This paper studies how conflicts of interest between financial advisors and municipalities affect borrowing costs of state and local governments. While municipal financial advisors were historically allowed to serve a dual role as advisor and underwriter, this practice was abolished in 2011. Using a difference-in-differences approach, I compare bond issues with dual advisor-underwriters to other bond issues with independent advisors using within municipality variation. I find that bonds with dual advisors see interest costs fall by 8.15 basis points (3.7% on average) after the advisor is no longer allowed to serve as underwriter. This drop in interest costs is driven by a 16% increase in competition from non-advisor underwriters. I show evidence of information asymmetries deterring non-advisor competition pre-reform, bond structure standardization post-reform, and no change in underwriter quality.

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