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Underwriter reputation and the quality of certification: Evidence from high-yield bonds

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ABSTRACT

This paper provides primary evidence of whether certification via reputable underwriters is beneficial to investors in the corporate bond market. We focus on the high-yield bond market in which certification of issuer quality is most valuable to investors owing to low liquidity and issuing firms' high opacity and default risk. We find bonds underwritten by the most reputable underwriters to be associated with significantly higher downgrade and default risk. Investors seem to be aware of this relation, as we further find the private information conveyed via the issuer-reputable underwriter match to have a significantly positive effect on at-issue yield spreads. Our results are consistent with the market-power hypothesis, and contradict the traditional certification hypothesis and underlying reputation mechanism.

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1. Introduction

Significant cases of debt underwriting fraud over the past decade have called into question both traditional theory (e.g., Booth and Smith, 1986; Allen, 1990) and empirical results that support the certification hypothesis for the corporate bond market (Livingston and Miller, 2000; Fang, 2005).[1] To determine whether the most reputable underwriters are necessarily associated with the highest-quality underwriting standards, we study certification in the U.S. corporate bond market between 2000 and 2008. Specifically, we examine whether high-yield bonds underwritten by reputable (i.e., high-market-share) lead underwriters are associated with significantly higher or lower downgrade and default risk. We further explore whether investors behave rationally in pricing the risk associated with reputable underwriters when bonds are issued. We thus, in contrast to most studies that deal with underwriters, test the certification hypothesis from the investor's point of view by asking whether certification benefits investors in the bond market.

The corporate bond market, particularly the high-yield segment, is an optimal test ground for our study for the following reasons. First, our analysis uses data post enactment of the Gramm–Leach–Bliley Act (GLBA) that repealed the Glass–Steagall Act in late 1999. The GLBA led to intensified competition among underwriters and a sharp decrease in investment banking fees, especially in the high-yield bond market in which commercial bank entry was strongest (Gande et al., 1999; Geyfman and Yeager, 2009; Shivdasani and Song, 2011). Second, compared to investment-grade bonds, high-yield bonds are particularly information-sensitive, low-liquidity securities not sold exclusively on the basis of credit ratings (Datta et al., 1997; Fridson and Garman, 1998).[2] Certification of issuer quality via underwriters is hence particularly valuable to both

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[1] In a *New York Times* (August 25, 2002) article titled "Underwriting Fraud", Citigroup, J.P. Morgan Chase, and Merrill Lynch are blamed for misusing their reputations for their own and clients' benefit to the detriment of investors. The article mentions Citigroup's involvement in a 2002 lawsuit brought by pension funds that had invested 12 billion dollars in WorldCom bonds and later claimed the bank had not adequately reviewed the state of WorldCom's business due to conflicts of interest. *"[T]here is no denying,"* the article stated, *"that prestigious banks helped bankroll huge frauds that hurt millions of investors."* Relatedly, Gopalan et al. (2011) report that J.P. Morgan syndicated a loan to Enron as its lead arranger just before the firm's bankruptcy filing.

[2] However, credit ratings are available and reduce the heterogeneity in the data. This allows for cleaner inferences on underwriter reputation (Fang, 2005).

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issuing firms and investors in this segment (Puri, 1999). Third, the vast majority of high-yield bond investors, predominantly insurance companies and mutual and pension funds (Standard and Poor's, 2007), are heavily regulated, engage only rarely in activism, and have rather long investment horizons. Thus, the effects of underwriter reputation on bond downgrade and default risk is highly important to these investors. Finally, issuing firms in the high-yield segment, often private or smaller public firms, are generally less visible than investment-grade issuers. Thus, with less reputational exposure, reputable underwriters may have less incentive to conduct business properly (Rhee and Valdez, 2009).[3]

According to the *certification hypothesis*, underwriters can help to reduce information asymmetries between investors and the issuing firm by certifying issuer quality through their reputation (see, e.g., Booth and Smith, 1986). In contrast to the issuing firm, underwriters' business model is based on repeated interaction with investors, which is why it pays for them to build costly reputation. However, as described in Chemmanur and Fulghieri (1994), problems of moral hazard can arise for underwriters with a very high reputation. They might have incentives to "milk" their reputations to avoid the costs of strict evaluation (i.e., underwriting) standards.[4] In a study of equity IPOs, Chemmanur and Krishnan (2012) extent this reasoning and argue that the focus of large and reputable underwriters may shift from certifying quality to maximizing the issuer's valuation (*market-power hypothesis*). In this paper, we examine whether the certification hypothesis can still be upheld in the high-yield bond market post GBLA, a period of increased competition and lower fees in the underwriting market (see, e.g., Gande et al., 1999). Relaxing underwriting standards may be one potential response of underwriters to increased competition for clients and league table positions in the wake of the repeal of the Glass–Steagall Act.[5] Reducing screening incentives or, more generally, product quality in response to increased competition and lower fees is consistent with the models of Bouvard and Levy (2009), Strausz (2005), and Shapiro (1983) and empirical evidence provided by Shivdasani and Song (2011). The latter show intensified competition in the wake of deregulation of the Glass–Steagall Act in 1996 to have adversely affected screening incentives of underwriters in the corporate bond market between 1996 and 2000.

In contrast to existing literature that relies exclusively on pre-GLBA data, we find that the most reputable underwriters increase rather than reduce issuing firms' informational costs. This is in line with our main finding that high-yield bonds underwritten by these banks are associated with significantly higher downgrade and default risk. In particular, we report that bonds underwritten by one of the Top 3 lead underwriters in the U.S. corporate bond market are significantly more likely both to be downgraded in the short and medium term and to default. Calculating marginal effects, we estimate the probability of a bond being downgraded within 6 or 24 months of issue at 3% and 15%, respectively, larger if the lead underwriter is one of the Top 3. The probability that the first rating action within the first 3 years of issue will be a downgrade is about 18% higher for bonds underwritten by a Top 3 underwriter. The marginal effect for bond default is about 2%. In line with the higher default probabilities we document, bonds underwritten by Top 3 lead underwriters experience significantly more downgrades (but not upgrades) both within the first 3 years of issue and in general. These results account for endogeneity, and do not hinge on the definition of underwriter reputation or use of binary or continuous variables measuring reputation. Moreover, the results do not change when we include additional controls, use additional rating performance variables, or examine subsamples of bonds by time to maturity.

In line with the increased downgrade and default risk associated with Top 3 lead underwriters, we find investor evaluation of the underwriting standards of the Top 3 to have a significantly positive effect on at-issue yield spreads. This finding is consistent with market efficiency, and suggests that the issuer-reputable underwriter matching conveys price-relevant information to bond investors. In other words, investors seem to be aware of this relation and demand a risk premium through a higher yield spread. The most reputable underwriters thus increase rather than reduce issuers' informational costs and, hence, do not seem to fulfill a certification function. Following Puri (1996), Fang (2005), and McCahery and Schwienbacher (2010), we use the inverse Mills ratio for the choice of a Top 3 lead underwriter in the second-stage regressions (Heckman, 1979) to measure the pricing effect of underwriter evaluation standards (i.e., ability to certify issuer quality). Our results suggest that investors generally should not, and do not, believe that at-stake reputation capital incentivizes the most reputable underwriters to report client quality honestly.

Our findings, in providing primary evidence from the bond market in favor of the *market-power* over the *certification* hypothesis, support recent results by Chemmanur and Krishnan (2012) and McCahery and Schwienbacher (2010). The former find reputable underwriters to be associated with equity IPOs priced further from intrinsic values, the latter, reputable lead arrangers in the loan market to be associated with higher loan spreads. In general, our findings suggest that the reputation mechanism does not work for the most reputable underwriters in the high-yield segment of the bond market. Our results also corroborate Gopalan et al.'s (2011) conclusion for the syndicated loan market—the structure of which is comparable to that of the high-yield bond market, and in which the same banks are dominant—that the largest lead arrangers do not suffer a loss of reputation when borrowers experience large-scale bankruptcies. As bonds underwritten by dominant banks are associated with significantly higher downgrade and default risk, and these banks stay on top of the league table throughout our sample period, our results seem to document a similar pattern for the high-yield bond market. Certification may thus not be the most important role played by large, reputable underwriters in instances of issuers for which risks associated with placing bonds are higher and financing opportunities fewer, as is generally the case in the high-yield bond market.[6]

In contrast to the most reputable (i.e., Top 3) underwriters, we find that bonds underwritten by one of the Top 4–Top 10 underwriters do not exhibit significantly higher downgrade or default risk. Accordingly, bonds underwritten by one of the Top 4–Top 10 underwriters, being significantly less likely to be downgraded or to default, seem to be associated with lower informational costs (and hence lower spreads). Our evidence further suggests that reputable underwriters actively manage their evaluation standards (i.e., product quality) in response to client-specific reputational

[3] The observation by Ljungqvist et al. (2006) that incentives to preserve reputation can be less constraining for banks that specialize in underwriting debt as compared to equity implies a greater willingness to test investor credulity.

[4] Chemmanur and Fulghieri (1994) posit, theoretically, the existence of a U-shaped relation between underwriter reputation and the quality of evaluation standards (i.e., certification quality).

[5] Regarding league table competition, Golubov et al. (2012) observe that the investment banking industry seems to be fixated on these rankings as they pursue future business, as documented in Rau (2000) and Bao and Edmans (2011) for the M&A market. Anecdotal evidence associates competition for league table rankings with lower underwriting standards. *The Wall Street Journal* observes in an article that reports that the industry's most-respected banks are rabid about staying in these rankings: *"If you want to understand the Street at its absurd best, watch men in Rolexes grub for credit for deals they barely worked on for clients who probably won't pay them"* (see "Gaming the Game: How the Street Plays the League Tables," April 10, 2007).

[6] That issuing firms' transactional (as well as opportunity) costs may play an at least equally important role is suggested by our first-stage regressions on lead underwriter choice (see Table 5), which find bond issue volume and high-yield market sentiment to significantly drive the choice of a Top 3 lead underwriter.

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