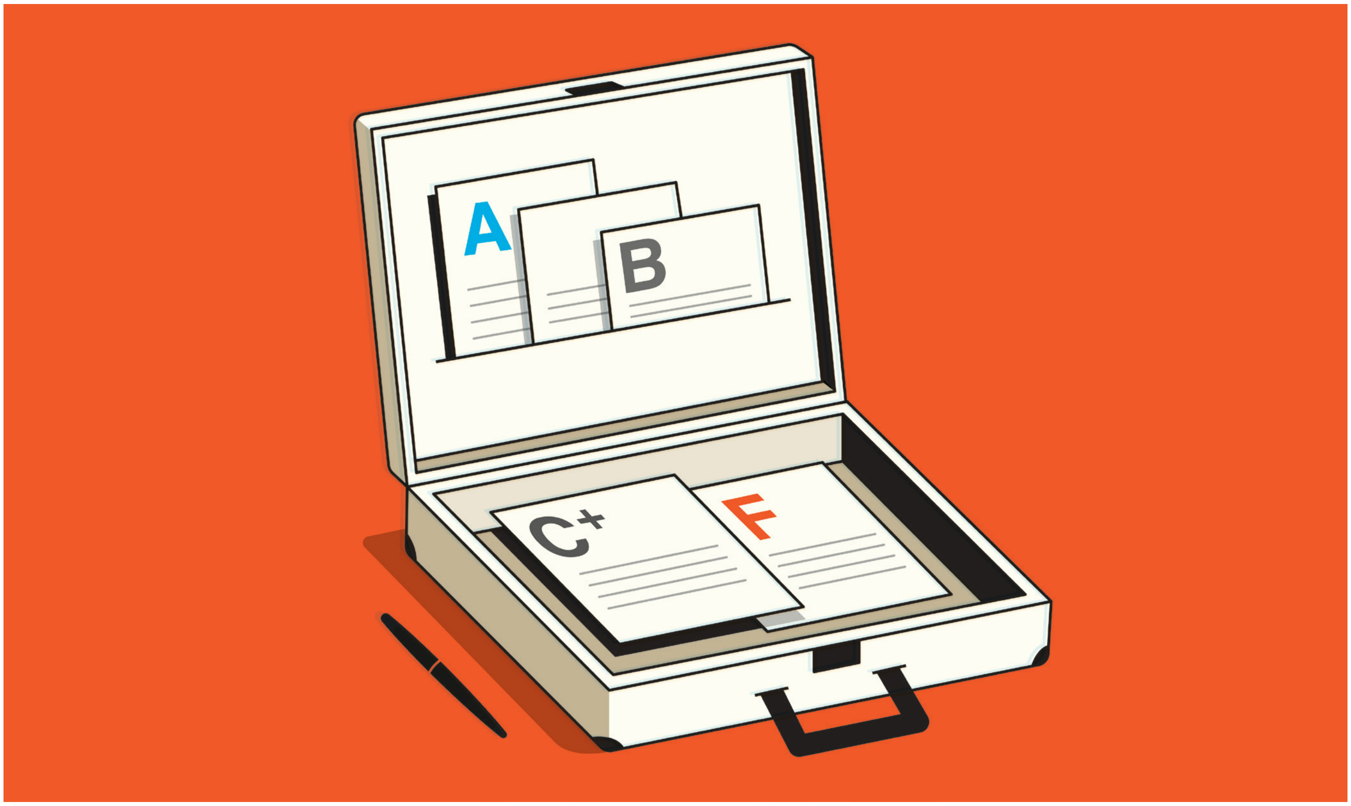


PERSPECTIVE

Be Tough, Not Rough, on Your Bankers

BY JUSTIN MARLOWE

Baseball legend Yogi Berra once said, “When you come to a fork in the road, take it.” Like with many “Yogi-isms,” it’s not quite clear what he meant. But upon further reflection, it seems Yogi is simpatico with today’s rock star management professor Adam Grant. According to Grant, good decision making is not about making the right decision, but rather about making the decision right. In other words, how you carry out a decision is more important than the decision itself.

Public finance investment banking is at its own proverbial fork in the road. States and local governments that will soon arrive there should follow Yogi and take it. And to comport with Grant’s advice, they should “be tough, not rough” on public finance bankers.

In October 2023, the Swiss banking giant UBS announced plans to scale back its municipal bond underwriting business (in other words, the process of taking bonds from a borrower to investors). To most in “Muniland,” this move was not entirely unexpected. UBS left the business after the financial crisis of 2008, only to reemerge in 2015. Since then, it had performed admirably. It was the go-to underwriter in certain niche corners of the market, and it built a strong secondary market sales and trading team (that is growing even today). But overall, it was a middle-tier player, ranking 15th in total underwriting in 2022.

The real shock came a few months later when Citi announced its plan to leave municipal bonds. Citi was a major player. It accounted for ten to 15 percent of new municipal bond underwriting each year since the Great Recession. It was a stalwart across the many sub-industries within municipal bonds, and it famously leaned into municipal bonds when others pulled back. There’s no question it will take years for other banks to fill the hole left by Citi’s exit. Moreover, there are rumors that other large banks will leave in the near future.

What sent two big banks running for the exit, with others potentially to follow? Broadly speaking, there’s three factors.

One is a shift from local to hyper-local. The old adage is that there’s no municipal bond market, but there are 50 markets for municipal bonds. In other words, investors tend to maximize the tax and other advantages of municipal bonds by focusing their portfolios on issuers within their own state. Growing hyper-partisanship and the evolving state-level "anti-ESG" movement has further narrowed the universe of potential purchases for many investors. For bankers, that makes the job of finding buyers more difficult. It also means that deep, long-standing connections to the local investment community matter more than ever. International banking giants like Citi and UBS could no longer be everything to everyone all at once.

Technology also matters. Today, more than a dozen companies advertise artificial intelligence solutions for the municipal bond market. They offer products and services designed to evaluate and predict the prices of municipal bonds in real time; to automate regulatory compliance and financial reporting requirements; to build and maintain customized portfolios for high net-worth individuals; and to address many of the market's other unique challenges. These same technologies allow smaller and upstart firms to enter the market, compete immediately, and scale quickly.

The net effect is stronger competition and, in turn, thinner profit margins. To illustrate, consider that data from the California Debt and Investment Advisory Commission—one of the few reliable sources for data on underwriting costs—shows that in the past decade the average fee an underwriter earned on a California general obligation bond shrunk by more than half, from just over $9 per thousand dollars of borrowed money to just under $4.50. For essential revenue bonds like public utilities, it's fallen from about $5.75 to $2.75.

States and local governments have also become savvier consumers. In a thoughtful analysis of Citi's exit, Goldman Sachs analyst Christian Lin points out that today's state and local governments want "closer, long-term relationships with 'their brokers' in executing specialized and localized financing.[1] Not to mention, some local governments themselves were developing savvy, corporate-style debt management teams and asked more thoughtful, challenging questions." The fact that issuers want better execution on behalf of taxpayers is a good thing. But it makes a tough business even tougher.

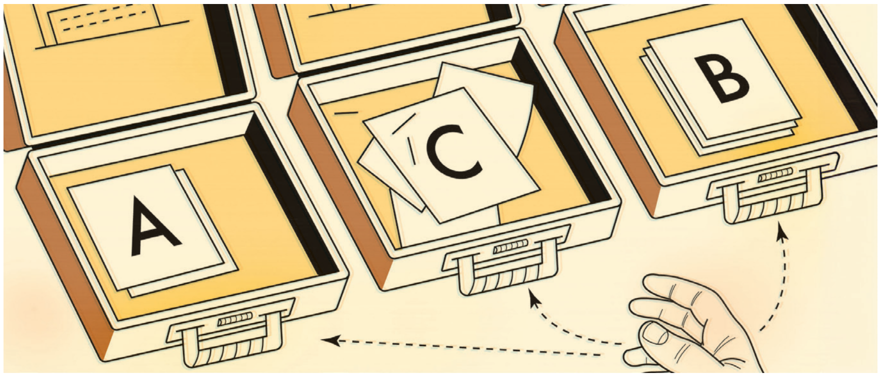
For state and local borrowers, this is a tremendous opportunity, if well played. As the industry becomes more localized and specialized, bankers are eager for the business and willing to work harder than ever. The challenge is to not push them past the breaking point. In other words, be tough on your bankers, but don't be rough.

What does this mean in practice? It's fine—encouraged, in fact—for borrowers to ask their bankers tough questions. How did they arrive at the prices investors were willing to pay? How did the sales force present the deal to investors? What sorts of comparable bonds did they use to benchmark their expectations? How did they respond to unexpected market developments? Asking these types of questions is being tough on behalf of taxpayers. Fighting with bankers over one more basis point just as the deal is about to close is being rough.

Encouraging underwriters to participate in both competitive and negotiated underwritings on new bonds is the right kind of tough. It signals to taxpayers that a banker is keeping a close eye on how a borrower's bonds perform in the market. Demanding or requiring they participate in both is rough.

Asking bankers to make a clear and compelling case for why they belong in an underwriting pool is tough. Kicking an underwriter out just to show that you're willing to kick one out is rough. Encouraging an underwriter to allocate credit for the sale to underwriters in a certain way (for example, a designation policy) is tough. Dictating that policy is rough.

The municipal finance business is at a fork in the road. If states and localities "take it" the right way, they can do well by taxpayers, and make sure bankers are there when they need them in the future. ■



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[1] Christian Lin, "Case Study: Citigroup Spotlight pt. 4," Christian Inc. Substack newsletter, March 30, 2024 (christianinc.substack.com/p/case-study-citigroup-spotlight-pt-586).