

**Comments on “The Default Puzzle: Underwriters and Sovereign Bond Markets, 1815-2007”**

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I appreciate the opportunity to comment on the paper, “The default puzzle: underwriters and sovereign bond markets.” Marc Flandreau, Juan Flores, Norbert Galliard, and Sebastián Nieto-Parra have written a careful and comprehensive study, commendable in the manner in which they examine the mechanics of sovereign debt issuance over the past two centuries. Having documented the government sales of debt, they go on to offer a plausible mechanism to explain changes in patterns over time.

They direct our attention to market mechanisms, specifically the middlemen in transactions or the entities that make the invisible hand work. The events over the past two years have shown such focus to be important, as it is precisely problems at those middlemen that help to explain the contraction in financial trading, the increase in market spreads, and the drying up of new lending recently witnessed. Concern about such middlemen includes understanding their incentives, capital positions, and balance sheets. In that regard, this paper takes to heart limits of arbitrage arguments,

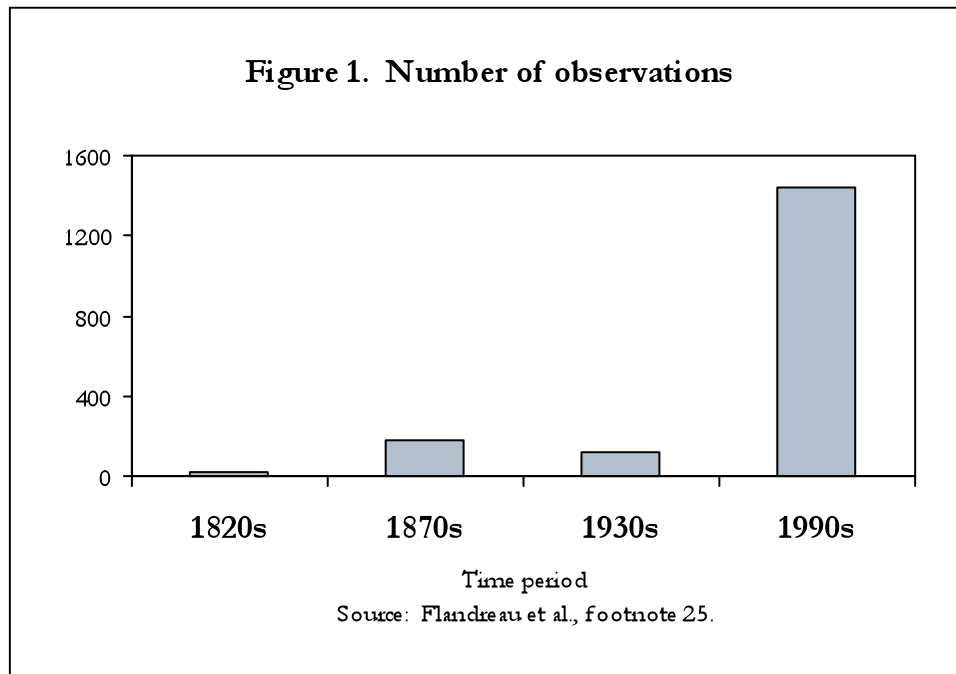
which could help explain why financial markets act sometimes at variance to behaviour expected from atomistic agents exploiting all opportunities for trade.<sup>1</sup>

To put it simply, the authors construct underwriting league tables for four periods. They essentially recreate what *Bloomberg* magazine would have looked like in the 1820s, 1870s, 1930s, and most recently. They show how those league tables evolved in significant ways. They then offer a plausible explanation that explains those changes by the rising role of rating agencies. Before the dominance of rating agencies, investment banks had the responsibility for signaling sovereign creditworthiness by supporting after-issuance market-making in that debt. When rating agencies became the dominant purveyor of this stamp of creditworthiness, investment banks laid-off that responsibility and no longer needed to support the markets for the debt they had underwritten.

The authors' examination of the rise of rating agencies is eminently plausible, but how much confidence can be placed given this sparseness of the data? Figure 1 reports the number of observations for the four main periods examined by the authors. As is evident, there is an order-of-magnitude difference between the most recent data compared to the prior three periods.

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<sup>1</sup> As discussed in Andrei Shleifer and Robert W. Vishny, "The Limits of Arbitrage" *The Journal of Finance*, Vol. 52, No. 1 (Mar., 1997), pp. 35-55.



More fundamentally, observing that investment banks no longer play a certifying role does not reveal if they gave up that role or were replaced. As much as I like this paper, I am concerned that the authors rest too much on a single potential mechanism explaining the change. I take that change as a fact, because the authors present their evidence in such a compelling fashion. But was it all rating agencies?

I believe that there are five plausible explanations for a shift in the role of investment banks as certifying agents. First, there is the rise in rating agencies as the authors suggest. Second, information costs have declined considerably over the past two centuries. Third, agency problems may have increased over time within the firms as financial institutions became more complicated. Fourth, the loss in support of sovereign debt sales may have followed from a decline in a cross subsidy in which the sovereign had received some compensation in return for other benefits it provided investment banks. Lastly, it may simply be a decline in concentration in the financial

industry. I will address each of these five possibilities in turn. Both the explanation of the change noted over time and the policy implications of that change depend on which of the five seem more plausible.

The authors build the case for a changed role of the rating agencies and my fellow discussant delves into that in detail, so let us take that case as already established.

The second possibility I raised was that financial information has gotten cheaper. For much of history, size and sophistication conveyed an advantage. We all know the story of Rothschild's network of carrier pigeons that brought him the news of Wellington's victory at Waterloo before anyone else.<sup>2</sup> If some large firms had advantages in collecting and interpreting information about a sovereign, might they not show that in which offerings they underwrote and which markets they supported? And would they not be the same issues? Over time, as more firms learn about market prospects and current prices because of the declining cost of information, the advantage of large firms is eroded as is their support of secondary markets. Only a little bit of introspection produces a long list of innovations that have lowered the cost of information over time, including the telegraph, the transatlantic cable, the telephone, satellite transmission, and the Internet. International initiative also played

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<sup>2</sup> Niall Ferguson reviews the importance of gathering and interpreting information in creating the investment banking institution in *The House of Rothschild: Volume 1: Money's Prophets: 1798-1848* (New York: Penguin Press), 1999.

a role, important among them the International Monetary Fund's standards on the transparency of information about government accounts.<sup>3</sup>

The third possibility that I offered was that perhaps big investment banks have become more difficult to govern over time. The modern financial firm is a large complicated institution, taking advantage of tax and regulatory arbitrage in many different jurisdictions. Its balance sheet has been fractured in the effort to avoid holding capital. Risks have been sliced by the use of derivative instruments. In the United States, the same entity may have to report to several different supervisory agencies. And accounting roles are extraordinarily complicated, as is the tax code. As a result, managers probably have a harder time monitoring employees. These monitoring problems were reflected in recent abuses of suitability in lending and securitization. As the bond between principal and agent weakens, employees no longer act in the longer-term interest of their firm. In such an environment, intertemporal trades that benefit a firm's value by increasing its credibility are viewed, instead, on a transaction-by-transaction basis. Thus, after-markets support of sovereign issuance no longer stands the scrutiny of the selfish. The changes the authors note, then, are another manifestation that reputation does not matter the way it once did.<sup>4</sup> In that regard, the extended quote from Daron Acemoglu in the paper fits nicely in that line of reasoning.

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<sup>3</sup> The IMF's Special Data Dissemination Standard (SDDS) is described at <http://dsbb.imf.org/Applications/web/sddshome/>

<sup>4</sup> This is an argument I made in a chapter in a recent Federal Reserve volume, "The Benefits of Playing Well," available at <http://www.aei.org/speech/100064>.

Fourth, investment banks support of sovereign markets might be part of a more complicated bargain with governments. In particular, for a considerable period governments issued debt in ways in which auction theorists predicted was unlikely to generate the most revenue from the sales. Sovereign sales are examples of common-value auctions, where participants in the auction have readings on the values of the items sold by a variety of means. Selling such debts by an underwriting syndicate similarly ranks low in expected revenue. In both, the selling format does not release information when it matters to demanders and lowers to expected revenue from sales.<sup>5</sup> Perhaps, in return for granting this subsidy in the primary market, governments might have required those firms to participate in the secondary market trading. In the United States, for instance, primary dealers in U.S. treasury securities had advantages in treasury auctions and responsibilities to the Treasury in secondary markets. In recent years, Treasury issuers have taken to the lessons of auction theorists and moved to single-price auctions, which are more efficient in generating revenue. But if there is less money left on the table in the primary market, investment banks will put less effort in secondary markets.

Fifth, changes in market behavior over time might merely reflect a maturation of markets associated with sustained economic growth and increases in wealth. As more capital moves into investment banking, the more generalized search for higher returns might lower returns for all. Simply put, as capital flows further and further

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Essentially, the incentives put on the table associated with complicated financial, accounting, and tax regulations made inroads on market discipline.

<sup>5</sup>This is described in Vincent Reinhart, "An Analysis of Potential Treasury Auction Techniques," Federal Reserve *Bulletin*, June 1992.

out into the fields, returns fall and we observe more competition and more turnover. That competition probably lowers fees and underwriting but also involves less after-issuance protection. A good example comes to mind from the changes in the institutional trading of equities on the New York Stock Exchange in the mid 1970s. Mid-decade, fixed-rate commissions were outlawed. Not long after, commissions per share for large trades fell precipitately, volume increased, but investment banks devoted less of their equity into the business.

In sum, the authors' explanation is plausible but not necessarily unique. One hopes that differentiation among the explanations might be possible by looking at other data. Is market power about the size of the firm in that market or the absolute size of the firm? And what happened to profits and share prices of financial firms? What is the trend to the average transaction cost over time? This is a fascinating paper and the authors deserve our appreciation in building a new data set. The paper increases the profession's understanding and will no doubt be the first of many more to come on the topic.