# 97-13 The Bond Underwriting Process, Department of Administration

## Summary

Between January 1, 1994 and April 30, 1997, the State of Wisconsin sold underwriting firms over $1.8 billion par value of general obligation bonds and revenue bonds in 20 different bond offerings.

The underwriting firms, in turn, sold the bonds to investors. Concerns have been raised about the State's process to select bond underwriting firms, which earn a commission by selling bonds to final investors at a price higher than the price paid to the State. As requested by the Joint Legislative Audit Committee, we performed an audit of the State's bonding process and compiled basic information on the underwriting firms used between January 1, 1994 and April 30, 1997.

The State generally sells bonds to underwriters through one of two processes: competitive bidding or negotiated sales. Section 18.06(4), Wis. Stats., requires the State to have a competitive process for the sale of routine general obligation bonds to fund capital projects. Such bonds may be issued through a negotiated process only if the State rejects a competitive bid. We are not aware of any instance in which a competitive bid was rejected in favor of negotiating a bond sale. However, there are no restrictions on the method of sale for revenue bonds and general obligation bonds issued to fund veterans home loans or to refund debt previously issued at a higher interest rate.

Of the 20 bond offerings during our review period, 15 were issued through a competitive bidding process and five were sold through negotiation. For each bond offering, there is one lead underwriter dealing directly with the State and other underwriters helping to market the bonds. The State dealt with eight different lead underwriters in the 20 bond issues. Merrill Lynch & Co. and Goldman, Sachs & Co. each were lead underwriters four times, while Prudential Securities Incorporated and Bear, Stearns & Co. Inc. were each lead underwriter three times, as shown in the following table.

**Firms Acting as Lead Underwriters**
January 1, 1994 through April 30, 1997

| Underwriting Firm | Times Lead on a Competitive Sale | Times Lead on a Negotiated Sale | Total Times Acted as Lead Underwriter |
|---|---|---|---|
| Merrill Lynch & Co. | 3 | 1 | 4 |
| Goldman, Sachs & Co. | 4 | - | 4 |
| Prudential Securities Incorporated | 2 | 1 | 3 |
| Bear, Stearns & Co. Inc. | 1 | 2 | 3 |
| CS First Boston Corp. | 2 | - | 2 |
| J.P. Morgan Securities Inc. | 2 | - | 2 |
| Morgan Stanley & Co., Inc. | 1 | - | 1 |

| | | | |
|---|---|---|---|
| Robert W. Baird & Co. Incorporated. | - | 1 | 1 |
| Total | 15 | 5 | 20 |

Between January 1, 1994 and April 30, 1997, the State sold to underwriting firms bonds with a par value of $1,845,065,000. Competitive bidding accounted for 76 percent of these sales: bonds with a par value of $1,404,765,000 were sold competitively in 15 different bond offerings.

Five negotiated sales accounted for 24 percent, or $440,300,000 par value of bond sales. In comparison, all other states for which we could obtain information negotiated 33 percent of the par value of bonds they sold during the same period.

In sales that are bid competitively, the State performs the various tasks associated with issuing bonds, such as seeking bond counsel, obtaining a bond rating, preparing legal documents, and printing the bond prospectus. To solicit sealed bids from bond underwriters who wish to purchase the bonds, the State places a notice of sale in a national trade publication. Underwriters propose interest rates for the bonds, as well as the amount they are willing to pay the State for the bonds at the specified interest rates. The State sells the bonds to the underwriting firm whose bid provides for the lowest overall interest cost to the State. From the State's point of view, the level of profit gained by the winning underwriter when the bonds are later sold to investors is irrelevant, because the State's interest costs are already determined.

In contrast, in a negotiated sale, the State selects a lead underwriting firm at the start of the bonding process and works primarily with that firm to develop the bonds and bring them to the financial markets. The State negotiates with the lead underwriter to determine the structure of the bonds, including the interest rates to be paid on the bonds and both the amount the underwriter is to pay the State for the bonds and the amounts at which the bonds are to be sold to the ultimate investors.

There are no written procedures governing the process the Department of Administration's Capital Finance Office is to use in selecting underwriters in a negotiated sale. State procurement rules do not apply because the State generally does not pay underwriting firms directly for services received. Nevertheless, in an effort to ensure all underwriting firms are considered for selection, the Capital Finance Office uses a Request for Proposal (RFP) process to help to determine the underwriters with which the State may negotiate bond sales.

Three RFP processes were used to select underwriters for bonds issued during the period we reviewed. Two RFP processes were used to select underwriters for general obligation bonds to refund previously issued bonds, and another to select underwriters for Clean Water Fund bonds to make loans to Wisconsin municipalities to construct or repair waste water treatment facilities. As part of the RFP process, the Capital Finance Office typically contracts with a financial advisor to review underwriter proposals and prepare a summary of them. In addition, the Capital Finance Office establishes an evaluation committee of two or three individuals to review the proposals. Members on the review committees have included the Director of the Capital Finance Office, the Executive Assistants in the Department of Administration and the former Department of Development, General Counsel to the State of Wisconsin Investment Board, the Commissioner of Securities, the Executive Director of the Wisconsin Housing and Economic Development Authority, and a business person on the Authority's board, although not all of these individuals were on each of the review committees. Based on various criteria outlined in the RFP, the evaluation committee selects several underwriters deemed capable of successfully negotiating and marketing the State's bonds. Cost is not one of the criteria used in selecting underwriters through this process.

The RFP process is an appropriate way to ensure that the selection of underwriters is fair and equitable. However, we are concerned that the Capital Finance Office does not keep complete records documenting the basis for selecting specific underwriting firms. For example, three of eight score sheets ranking the RFPs were not available for our review. We include a recommendation that the Capital Finance Office more fully document the basis for selection of qualified underwriters in order to ensure the underwriter selection process is perceived as being fair and equitable.

The State does not complete a separate RFP process each time it desires to negotiate a bond sale. Rather, the Capital Finance Office will typically select a different firm from the list of qualified underwriters to serve as lead underwriter each time a bond sale is negotiated. The rotation of lead underwriters is intended to encourage other underwriters to put forth strong efforts on the State's behalf in order to receive consideration for the lead role in a future bond issue. However, the Capital Finance Office is not required to rotate underwriters, and no underwriter is guaranteed to negotiate a bond sale with the State by virtue of being selected through the RFP process.

In order to assess whether the State of Wisconsin's bonds are issued at reasonable interest rates, whether sold competitively or negotiated, the Capital Finance Office has developed a methodology to compare the rates at which they were issued to the rates of other states' and municipalities' bonds, as well as bonds previously issued by the State. In February 1994, one of the State's financial advisors reviewed Capital Finance's methodology and concluded that, overall, it was sound. Information provided by the Capital Finance Office indicates that, over the last three years, Wisconsin bonds were issued at rates comparable to those of other municipal issuers with the same Aa bond rating. In addition, after considering certain factors such as bond call provisions, there does not appear to be a significant difference in interest rates between Wisconsin's competitively bid bonds and bonds issued through negotiation.

The State requests and receives information from underwriting firms about the price at which the underwriting firms intend to offer bonds to investors. Since the underwriters' goal is to sell the bonds for more than the amount paid to the State, this information allows the Capital Finance Office to calculate the amounts the underwriters expect to receive for selling the State's bonds. Because underwriters perform relatively more work to sell negotiated bonds, their expected net proceeds are typically greater for these bonds. In total, the underwriters expected to receive $5,673,936 to market the 15 competitively bid bonds issues, and $2,925,283 to market the 5 negotiated bonds. This is equivalent to an issue cost to the State of $4.04 for every $1,000 of competitively bid bonds, and $6.64 for every $1,000 of negotiated bonds. These rates compare favorably to those of other states, whose average during our review period was $5.72 per $1,000 for competitively bid sales, and $7.28 per $1,000 for negotiated sales.

In addition to the lead underwriter, the State selects other underwriting firms to act as senior managers and co-managers of negotiated bond sales. These firms assist in the review of bond documents but generally do not deal directly with the State. Because the State selects all of the managing underwriters, the State is able to give preference to minority-owned firms, women-owned firms, and firms with a strong regional or Wisconsin presence. Sections 18.16 and 18.64, Wis. Stats., require the Building Commission to ensure that at least 6 percent of the public debt and revenue obligations contracted during the fiscal year be underwritten by minority-owned firms. This requirement is waived if the Secretary of the Department of Administration submits a report to the Legislature's Joint Committee on Finance specifying the reasons for not achieving the 6 percent requirement.

Although the Capital Finance Office attempts to give preference to minority underwriters in the underwriter selection process, only 1.31 percent of the competitively bid bonds were underwritten by minority firms in fiscal year (FY) 1994-95, and only 1.86 percent were underwritten by minority firms in FY 1995-96. It did, however, surpass the requirement for negotiated sales, with minority firms underwriting 15.38 percent in FY 1994-95, and 17.08 percent in FY 1995-96. Although there are no statutory provisions related to women-owned firms, these firms underwrote 2.07 percent of the bonds during FY 1995-96.

Appendix I summarizes the 15 competitively bid bond sales during our review period, and Appendix II summarizes the five negotiated sales, including the underwriting firms involved with the sales.

****