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THE BOND UNDERWRITING PROCESS

The State of Wisconsin issues bonds for a variety of purposes, including general obligation bonds to finance capital construction projects and revenue bonds to finance highway construction. From January 1, 1994 through April 30, 1997, the State sold over \$1.8 billion in par value of bonds to underwriting firms that, in turn, sold them to investors. Of the 20 general obligation and revenue bond issues sold to underwriters, 15 involved a competitive bidding process and 5 were negotiated sales.

For each bond offering, a lead underwriter deals directly with the State as head of a syndicate that includes senior managers, co-managers, and members of the selling group. The State dealt with eight different lead underwriters in the 20 bond issues. The difference between what underwriters paid the State and what they received from investors provides for both underwriter costs and profits and was estimated to be nearly \$5.7 million for bond sales that were competitively bid, and \$2.9 million for negotiated sales.

Competitive Bid Bond Sales Are Based on Overall Interest Costs

The 15 bond offerings that were sold to underwriters by competitive bid had a par value of \$1.4 billion. Wisconsin statutes require competitive bidding for routine general obligation bonds to finance capital projects, and six of the sales by competitive bid fell into this category. The others were revenue bonds to finance highway construction and general obligation bonds to finance veterans housing loans or to refund earlier general obligation bonds. There are no statutory restrictions on the method by which these bonds may be sold.

To win a competitive bid, the lead underwriter must offer the lowest overall interest cost to the State. Goldman, Sachs & Co. was lead underwriter for 4 of the 15 sales by competitive bid, and Merrill Lynch & Co., was lead underwriter for 3. Five other firms were lead underwriters for the remaining eight competitive bid sales. In total, 98 different underwriting firms participated in various syndicates for bonds sold by competitive bid during our review period.

The State Selects the Underwriters for Negotiated Sales

The five bond offerings that were negotiated sales had a par value of \$440.3 million. They were issued to refund earlier general obligation bonds and to provide Clean Water Fund loans to municipalities for construction or improvement of wastewater treatment facilities. In a negotiated sale, the State selects a lead underwriter at the start of the bonding process and works primarily with that firm to develop the characteristics of the bond offering and bring it to the financial markets. Negotiations determine the structure of the bonds, including their interest rates, the amount the underwriter will pay for the bonds, and the amounts at which they will be sold to investors. The State also assigns roles to other firms that will join the lead underwriter in purchasing the bonds and selling them to investors. Bear, Stearns & Co., Inc., was lead underwriter for two negotiated sales, while Merrill Lynch & Co., Prudential Securities Incorporated, and Robert W. Baird & Co., Incorporated, each were the lead underwriter once. However, two firms sold more than half of the total negotiated bonds issued: Merrill Lynch sold almost \$151 million, or more than 34 percent, and Bear, Stearns sold more than \$93 million, or 21 percent.

The selection of underwriters is largely based on the evaluation of proposals submitted by underwriters in a Request for Proposal process. However, the Department of Administration does not have formal written procedures to describe and govern the underwriter selection process. Moreover, documentation of the scoring done by those evaluating proposals was incomplete: three of the eight scoring sheets we expected to find either were not prepared or were misfiled.

Nevertheless, we noted nothing in our audit to indicate that the underwriter selection process was not fair and equitable.

Interest Rates and Costs to Issue Bonds Appear Reasonable

The Department of Administration has a methodology to assess whether the interest rates at which the State issues bonds are reasonable compared to the rates of other governmental entities' bonds. This methodology indicates that Wisconsin's bonds were issued at interest rates comparable to the rates of other municipal issuers with the same Aa bond rating as the State's.

A lesser, though still important, consideration is the cost to issue bonds. Wisconsin's average costs of \$4.04 per \$1,000 of competitively bid bonds and \$6.64 per \$1,000 of negotiated bonds compare favorably to those of other states for which data were available, which were \$5.72 for competitively bid and \$7.28 for negotiated bond sales.

Minority Participation Goals Have Not Been Fully Met

Statutes require that at least 6 percent of the State's competitively bid and negotiated bonds be underwritten by minority-owned firms, although this statutory 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 the 6 percent requirement was not achieved.

Although the Department of Administration's Capital Finance Office attempts to give preference to minority underwriters in the underwriter selection process, it did not meet the 6 percent requirement in bond sales by competitive bid: only 1.31 percent of these sales were underwritten by minority firms in fiscal year (FY) 1994-95, and only 1.86 percent in FY 1995-96. The 6 percent requirement was exceeded in negotiated sales for both years: 15.38 percent of negotiated sales were underwritten by minority firms in FY 1994-95, and 17.08 percent in FY 1995-96.

For negotiated sales, the State is able to ensure a higher degree of participation by minority-owned firms because it directly selects the firms that will underwrite the bonds. However, in a competitive sale the State accepts the lowest bid; therefore, a preference for a minority-owned firm can be exercised only in the unlikely event of a tie bid. Regional and women-owned firms may be given priority in underwriter selection, although there is no statutory requirement to do so.

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