Structural Changes in Corporate Bond Underpricing

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Abstract

We show that in the aftermath of the financial crisis underwriters systematically place the most underpriced bonds to closely affiliated investors. In our model, the post-crisis decrease in inventory-carrying capacities incentivizes underwriters to allocate bonds to related investors who require increased underpricing. We employ a novel identification strategy based on institutional investors’ past holdings of bonds issued by underwriters to isolate the strength of underwriter-investor relations. The relation channel fully explains the increase in underpricing from the pre-crisis to the post-crisis period. We underpin our mechanism by examining the trading activity of newly issued bonds. The results are informative about implications of post-crisis regulation.